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

BTMC-132
Fundamentals of Management

Block

1

BASIC CONCEPTS, FORMS AND FINANCING OF BUSINESS

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*BTMC – 132 was adopted / adapted from Three Courses, namely – **BCOE 108, ECO – 01** and **ECO – 03** of School of Management Studies. (SOMS)

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January, 2019

ISBN :

Printed and published on behalf of the Indira Gandhi National Open University, New Delhi by Prof Jitendra Kumar Srivastava, Director, School of Tourism,
Laser Typeset by : Tessa Media & Computers, C-206, A.F.E.-II, Okhla, New Delhi
Printed at :

BLOCK I BASIC CONCEPTS, FORMS AND FINANCING OF BUSINESS

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

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

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

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

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

UNIT 1 NATURE AND SCOPE OF BUSINESS

Structure

1.0 OBJECTIVES

After studying this Unit, you should be able to:

- identify broad categories of human activities
- describe what is business
- list the features and objectives of business
- classify business activities and their inter-relationship
- explain the nature of business organisation
- explain who is an entrepreneur

1.1 INTRODUCTION

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

1.2 HUMAN ACTIVITIES

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

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

1) **Non-economic Activities**: These are the activities which are conducted by the human beings due to love and affection, social obligation, religious obligation, physical requirement, patriotism, etc., but not for earning money. The housewife cooking for the family, children going to school and playing games, people going to a temple or a mosque for prayer, a social worker working for the uplift of the poor, etc., are some such examples. Persons who participate in such activities do not get any direct economic benefit.

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

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

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

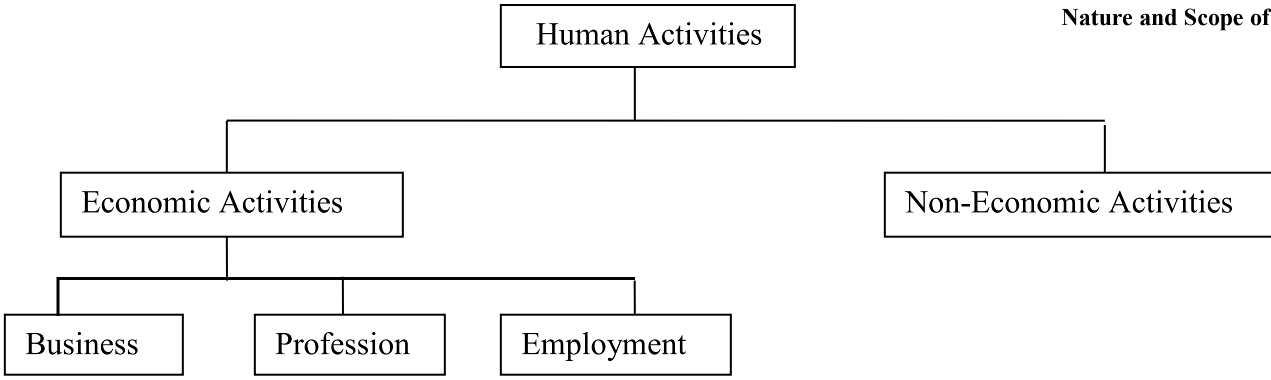

Figure 1.1: Classification of Human Activities

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

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

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

1.3 BUSINESS

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

1.3.1 Essential Features of Business

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

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

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

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

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

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

1.3.2 Objectives of Business

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

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

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

1) Earning of satisfactory profits.
2) Exploring new markets and creation of more customers.
3) Growth and expansion of business operations of the firm
4) Making innovations and improvements in goods and services so that custo -mers get improved and more economic goods and services.

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

1) Providing more and more employment opportunities to the people in the country
2) Supply of quality goods to the community
3) Providing goods at reasonable price
4) Ensure fair returns to investors
5) Avoidance of profiteering and unfair practices.
6) Production of goods in accordance with national interests and priorities.

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

1) Fair deal to employees in terms of wages and incentives.
2) Providing better working conditions and environment to the employees.
3) Provide job satisfaction.
4) Provide the employees more and more promotional/growth opportunities.

1.3.3 Classification of Business

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

Check Your Progress A

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

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2) What is business?

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3) What is profession?

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4) What is employment?

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

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

6) State whether the following statements are True or False

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

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

iii) Employment is an economic activity ....

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

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

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

vii) Industry and commerce together constitute Business activity ....

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

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

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

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

1.4 INDUSTRY

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

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

1.4.1 Classification of Industry

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

1) On the basis of the nature of activity
   a) Extractive industries
   b) Genetic industries
   c) Manufacturing industries
   d) Construction industries
2) On the basis of the nature of goods produced
   a) Consumer goods industries
   b) Producer goods industries
3) On the basis of the level of investment
   a) Heavy industries
   b) Light industries
4) On the basis of size of the activity
   a) Small scale industries
   b) Large scale industries
5) On the basis of area of operations
   a) Regional industries
   b) National industries
   c) Multinational industries

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

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

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

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

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

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

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

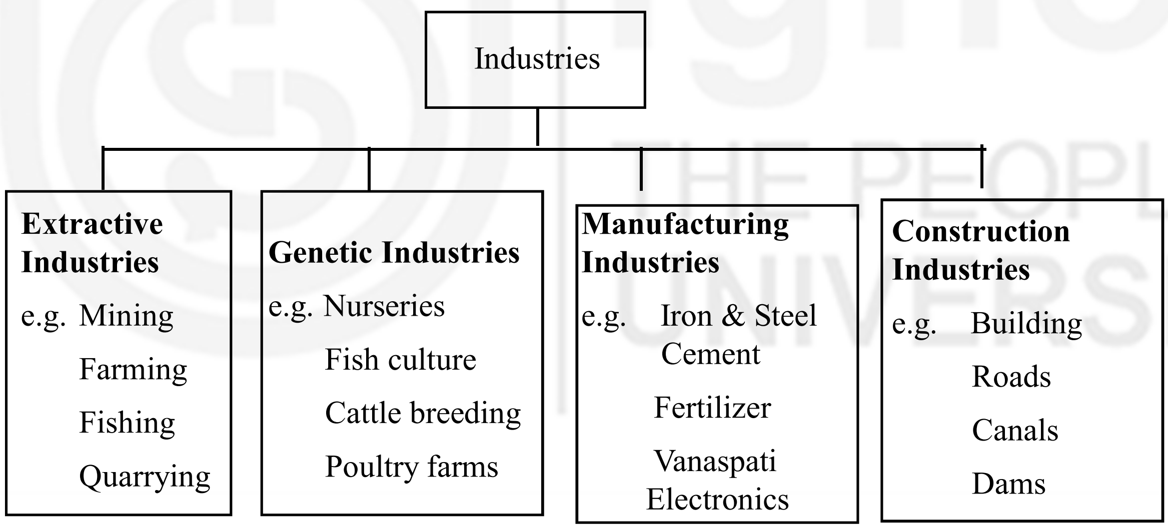

Figure 1.2: Classification of Industries Based on the Nature of the Activity

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

Check Your Progress B

1) Distinguish between business and industry**.**

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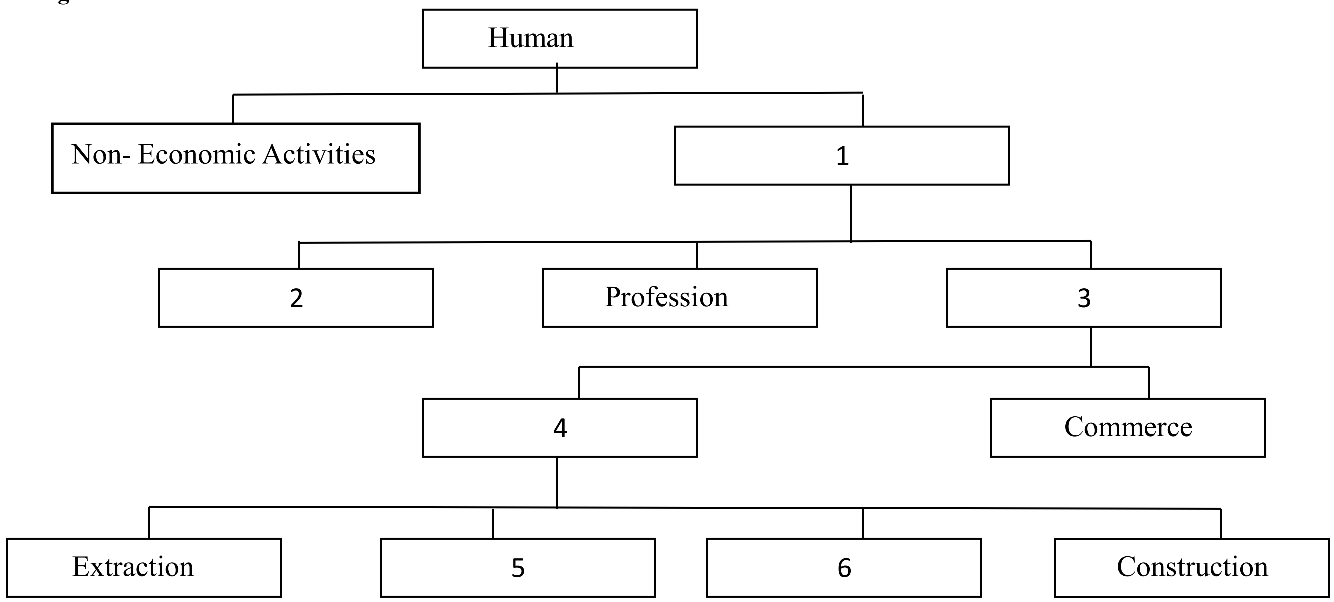
2) Fill in the blank columns.



3) To which category of industry the following activities belong:

Activities	Category of Industry
i) Fishing in the sea	....
ii) Raising coal from a mine	....
iii) Weaving of cloth	....
iv) Construction of a dam	....
v) Preparing of wooden furniture	....
vi) Cattle breeding	....
vii) Development of railway track	....
viii) Producing rail engine	....

1.5 COMMERCE

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

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

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

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

1.5.1 Trade

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

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

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

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

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

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

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

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

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

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

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

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

1.5.2 Aids to Trade

Activities which facilitate the trade are called 'aids to trade'. Thus, all human activities which eliminate the hindrances and facilitate the flow of goods from producers to consumers come under aids to trade. They are also called 'auxiliaries to trade'. The whole range of activities coming under aids to trade may be classified into five categories: 1) transportation, 2) warehousing, 3) insurance, 4) advertising, and 5) banking.

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

Transportation can be of three types:

a) Land transportation — road, rail ,

b) Air transportation— aeroplane

c) Water transportation—boat, ship

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

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

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

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

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

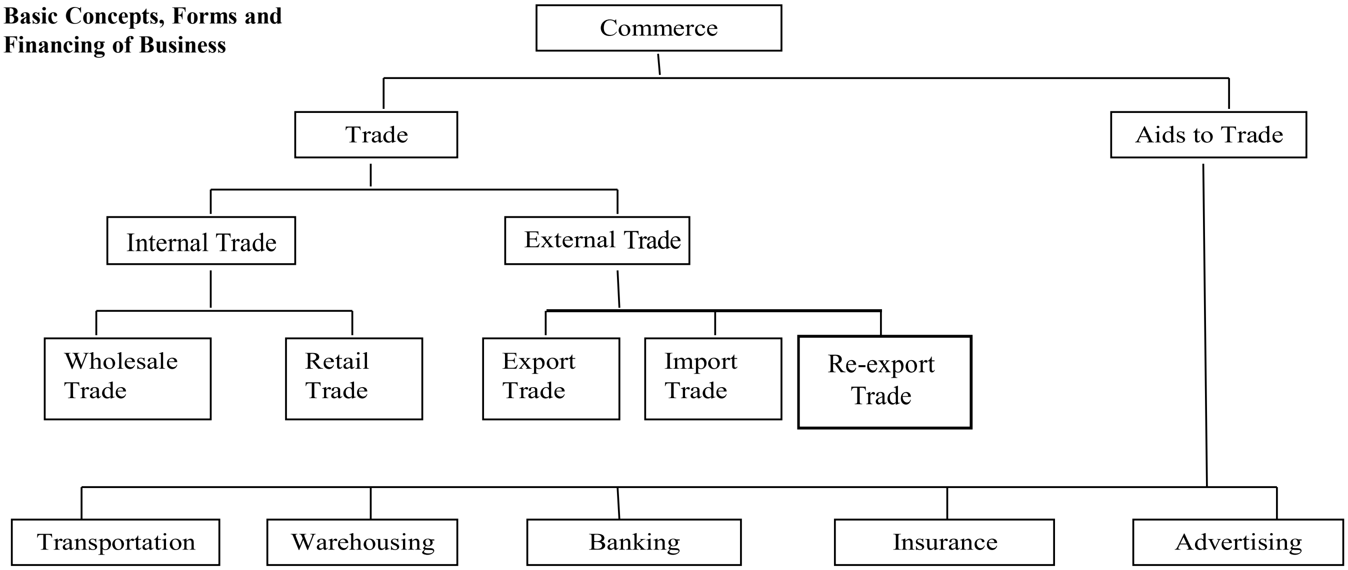


Figure 1.3: Classification of Commerce

Check Your Progress C

1) What is the difference between commerce and industry?

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

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3) How is trade different from commerce?

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

	Hindrance	Name of the Business Activity
i)	Hindrance of distance	....
ii)	Hindrance of time	....
iii)	Hindrance of risk	....

iv) Hindrance of finance ....

v) Hindrance of knowledge ....

vi) Hindrance of person ....

5) State whether the following statements are True or False.

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

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

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

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

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

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

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

viii) External trade is also called home trade True ☐ False ☐

1.6 RELATIONSHIP BETWEEN TRADE, INDUSTRY AND COMMERCE

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

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

1.7 ORGANISATION

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

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

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

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

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

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

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

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

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

1) Sole proprietorship

2) Partnership firm

3) Company

4) Cooperative society

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

1.8 ENTREPRENEUR

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

1.8.1 Characteristics of an Entrepreneur

If you read business history, you will come across the names of many persons who may be called entrepreneurs. Rockfeller and Henry Ford of the United States, Karl Benz and Gottfried Daimler of Germany, Soichiro Honda of Japan, are well known names of entrepreneurs, who started industrial organisations and made fortunes. In our country, J. N. Tata, G. D. Birla, Kirloskar and others have set up successful manufacturing industries. Small business firms have often succeeded because of the part played by entrepreneurs. It may be useful to know whether they had anything common as regards their personal characteristics. It has been found that there are certain elements in the character of entrepreneurs which are usually prominent in them.

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

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

3) **Desire to Achieve Goals:** They have a strong desire to overcome problems and setting up successful business ventures which eventually give adequate

profits. They considered profit as a measure of their achievement and performance rather than making money alone.

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

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

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

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

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

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

1.9 LET US SUM UP

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

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

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

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

Organisation makes the business proposition into a reality. It brings together required components, puts them on work systematically, and coordinates and controls their activities effectively to achieve the objective of earning profit. There are four basic forms of business organisation: 1) sole proprietorship, 2) partnership, 3) company, and 4) cooperative society. All business starts with an idea. A person who conceives the idea of doing a particular type of business, mobilize the resources and bring the organisation into existence is called an entrepreneur. Certain common elements in the character of entrepreneurs include independence, hard work, desire to achieve goals, open-mindedness, optimistic outlook etc.

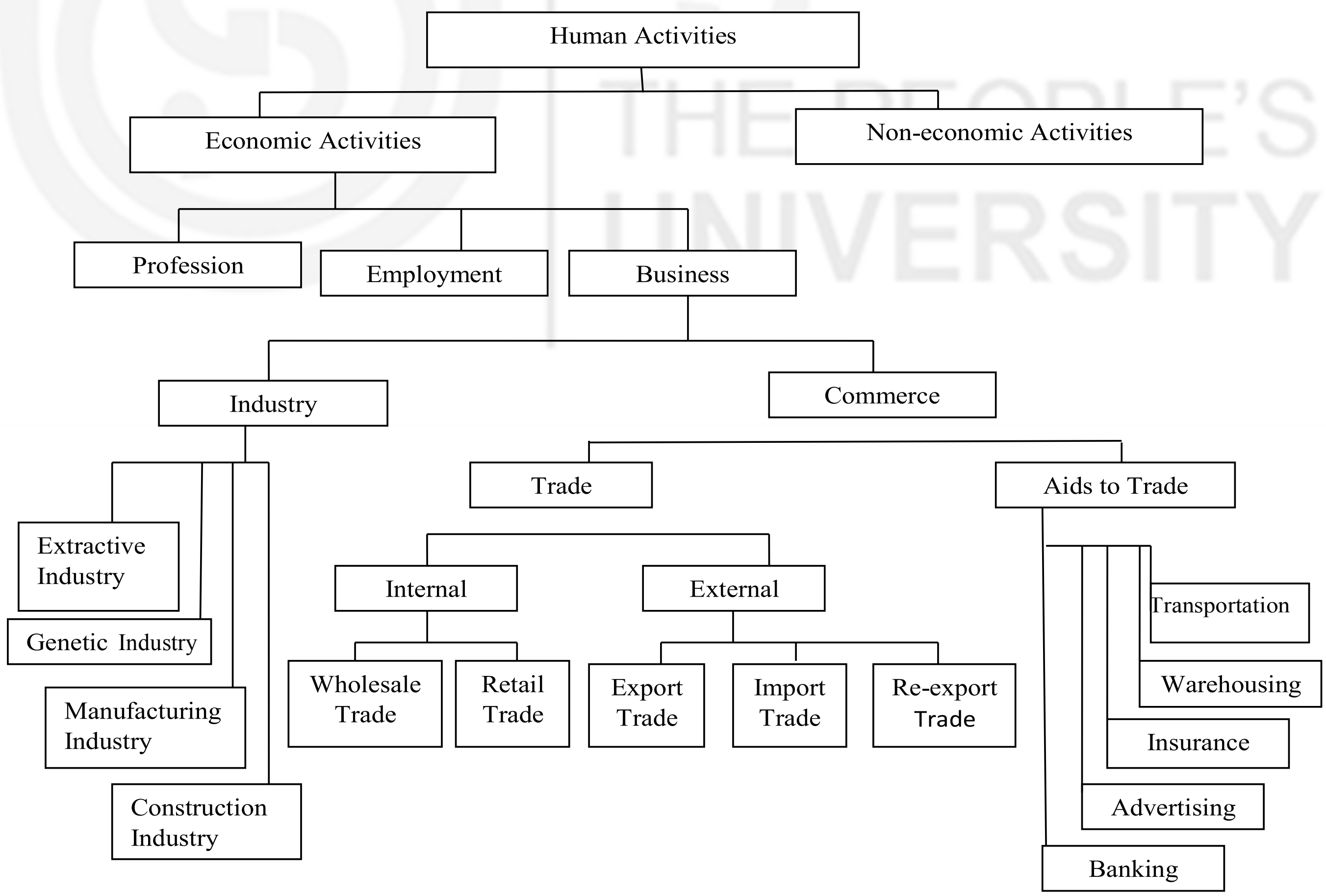

Figure 1.4: Classification of Human Activities

1.10 KEY WORDS

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

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

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

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

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

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

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

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

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

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

Export Trade: Selling goods in another country.

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

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

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

Import Trade: Buying goods from another country.

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

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

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

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

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

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

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

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

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

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

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

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

1.11 SOME USEFUL BOOKS

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

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

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

1.12 ANSWERS TO CHECK YOUR PROGRESS

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

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

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

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

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

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

1.13 QUESTIONS FOR PRACTICE

1) What is business? Explain its features and objectives.
2) Is business different from profession and employment? Discuss.
3) What is industry? Explain its classification with illustrations.
4) What do you understand by commerce? Briefly explain the classification of commerce with suitable examples.
5) What do you understand by organisation? What are the basic forms of business organisation?

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

UNIT 2 FORMS OF BUSINESS ORGANISATION-I

Structure

2.0 OBJECTIVE

After studying this Unit, you should be able to:

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

2.1 INTRODUCTION

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

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

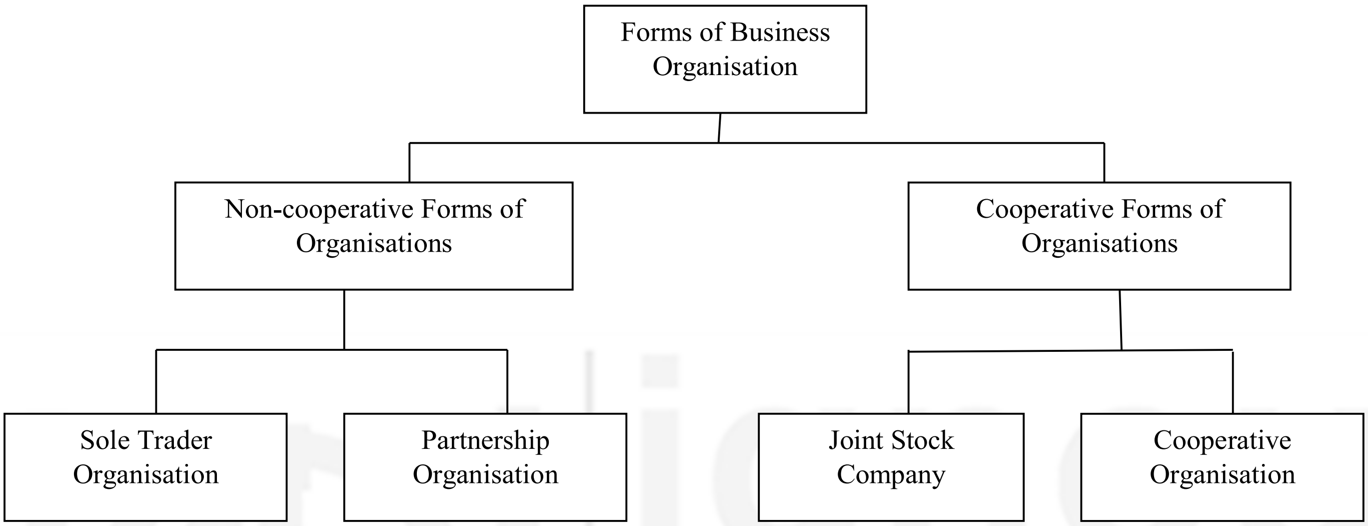

Figure 2.1: Various Forms of Business Organisations

2.2 SOLE TRADER ORGANISATION

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

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

2.2.1 Main Features

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

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

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

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

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

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

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

7) **Less legal formalities**: To set up sole proprietorship, no legal formalities are required. Of course, there are some legal restrictions for the setting up of a particular type of business. For example, an individual cannot start a bank or an insurance company. But one can start a fruit stall or a cycle shop without much legal formalities. However, in some cases a licence may be required. For example, to start a restaurant, you need licence from municipal corporation

2.2.2 Merits and Limitations

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

Merits

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

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

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

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

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

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

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

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

Limitations

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

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

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

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

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

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

7) **Less scope for economic of scale:** Sole trader usually operates on small scale only. So, he can not enjoy the benefits of large scale production or buying or selling. This may raise the cost of business operations.

Check Your Progress A

1) Fill in the blanks.

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

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

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

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

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

2) State whether the following statements are True or False.

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

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

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

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

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

2.3 PARTNERSHIP FORM OF ORGANISATION

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

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

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

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

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

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

2.3.1 Main Features

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

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

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

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

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

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

6) **Unlimited liability:** In respect of business debts, each partner has unlimited liability. This means that if the assets of the firms are not sufficient to meet the obligations of the firm, the partners have to pay from their private assets.

The creditors can even realise the whole of their dues from one of the partners. Thus, all the partners are jointly and severally liable for all business debts and obligations.

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

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

2.3.2 Classification of Partners

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

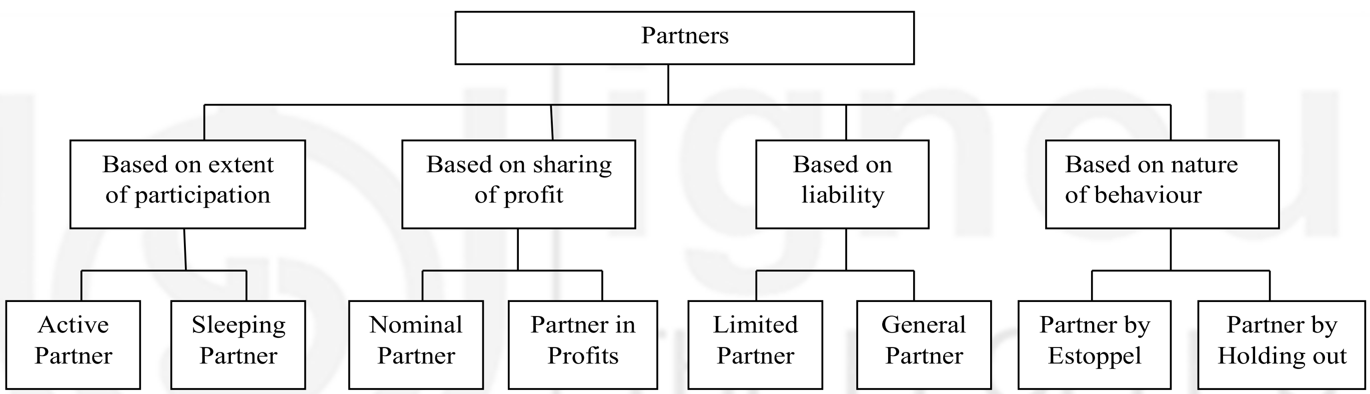

Fig. 2.2: Classification of Partners

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2.3.3 Partnership Deed

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

1) Name of the firm.
2) Nature of the business to be carried out.
3) Names of the partners.
4) The town and the place where business will be carried on.
5) The amount of capital to be contributed by each partner.
6) The profit and loss sharing ratio of each partner.
7) Loans and advances by partners and the interest payable on them.
8) The amount of drawings by each partner and the rate of interest allowed thereon.
9) The rate of interest on capital.
10) Duties, powers, and obligations of partners.
11) Remuneration, if any, payable to the active partner.
12) Maintenance of accounts and arrangements for audit.
13) Settlement in the case of dissolution of partnership.
14) The methods of evaluation of goodwill on admission or death or retirement of a partner.
15) The method of revaluation of assets and liabilities on admission or death or retirement of a partner.
16) The method of retirement of a partner and the arrangement for the payment of the dues of a retired or decreased partner.
17) Arbitration in case of disputes among partners.
18) Arrangements in case a partner becomes insolvent.

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

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

2.3.4 Merits and Limitations

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

Merits

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

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

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

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

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

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

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

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

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

Limitations

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

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

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

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

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

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

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

Check Your Progress B

1) Fill in the blanks.

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

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

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

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

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

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

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

2) State whether the following statements are True or False.

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

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

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

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

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

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

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

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

2.4 JOINT HINDU FAMILY FIRM

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

In Hindu Law there are two schools:

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

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

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

Important features of the Joint Hindu Family Firm are:

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

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

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

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

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

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

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

2.5 COMPANY FORM OF ORGANISATION

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

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

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

In a joint stock company, the shareholders are the real owners of the company. Their liability is limited. They can also transfer their shares to others. Since the shareholders are very large in number, the company cannot be managed by all. They elect a board of directors to manage the company. The destiny of the company is guided and directed by the directors. These directors employ some people to carry on the day-to-day business of the company. The company can raise additional funds by issuing debentures (also called bonds). You will learn about the company form of organisation, its main features, classification and formation in detail in Block II (Unit 5-9). Here we list the merits and limitations of the company form of organisation.

2.5.1 Merits and Limitations

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

Merits

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

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

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

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

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

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

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

8) **Professional management:** You know that the management of a company is in the hands of the directors who are elected by shareholders. Normally, experienced persons are elected as directors. You also know that day-to-day activities are managed by salaried managers. These managers are the experts in their respective fields. As companies have large scale operations and profits, attracting good professional managers are easy by paying

attractive salaries. Thus, company form of organisation gets the services of professionals on the Board of Directors and in various management positions.

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

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

Limitations

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

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

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

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

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

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

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

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

Check Your Progress C

1) State whether the following statements are True or False

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

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

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

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

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

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

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

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

2.6 COOPERATIVE FORM OF ORGANISATION

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

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

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

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

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

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

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

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

2.6.1 Main Features

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

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

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

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

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

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

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

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

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

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

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

2.6.2 Classification of Cooperatives

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

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

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

3) **Marketing cooperatives**: When the producers form into a cooperative society for the purpose of arranging the sale of their output, it is called marketing cooperative. These societies are started in order to protect

producers from exploitation by the middlemen when they market their products.

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

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

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

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

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

2.6.3 Merits and Limitations

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

Merits

1) **Easy formation:** Formation of a cooperative society is easy as compared to the formation of a company. Cooperative society is a voluntary association and so it does not require long and complicated legal formalities at the time

of formation. Any 10 adult persons can voluntarily form themselves into an association and get it registered with the Registrar of Cooperatives.

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

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

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

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

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

Limitations

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

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

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

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

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

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

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

Check Your Progress D

1) State whether the following statements are True or False.

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

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

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

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

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

2) Fill in the blanks.

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

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

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

   iv) Primary motive of cooperative is ....

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

2.7 LET US SUM UP

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

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

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

Limitations of sole proprietorships and partnerships gave rise to company form of organisation. A company is an artificial person created by law, with a distinctive name, a common seal and perpetual succession. Major advantages of company form of organisation include shareholders' limited liability, transferability of shares, stability of existence, ease of obtaining additional capital, more managerial expertise, etc. Major limitations are cost and difficulty of formation, more government regulations, lack of secrecy, less scope of prompt decision making, etc.

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

2.8 KEY WORDS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2.9 SOME USEFUL BOOKS

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

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

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

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

2.10 ANSWERS TO CHECK YOUR PROGRESS

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

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

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

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

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

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

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

2.11 QUESTIONS FOR PRACTICE

1) What do you understand by sole trader organisation? State merits and limitations of sole trader organisation?
2) Partnership organisations emerged essentially because of the limitations and failures of the sole proprietorships. Discuss.
3) What is partnership? How does it differ from a joint stock company?
4) What is a joint stock company? Explain how it overcomes the limitations of non--corporate form of organisation.
5) Discuss the special features of a cooperative form of organisation. How it is different from a company?
6) What is the main objective of a cooperative form of organisation? Explain its merits and limitations.

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

UNIT 3 FORMS OF BUSINESS ORGANISATION II

Structure

3.0 OBJECTIVES

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

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

3.1 INTRODUCTION

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

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

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

3.2 REQUISITES OF AN IDEAL FORM OF BUSINESS ORGANISATION

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

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

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

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

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

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

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

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

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

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

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

3.3 COMPARISON OF VARIOUS FORMS OF ORGANISATIONS

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

Table 3.1: Comparative Study of Different Forms of Organisation

S.	Basis of Comparison	Sole Proprietorship	Partnership	Private Limited Company	Public Limited Company	Cooperative Organisation
1	Formation	Easiest. No legal formalities required	Quite easy. No rigid legal formalities	Difficult due to legal formalities	Quite difficult due to many legal formalities	Few legal formalities are involved
2	Legal status	No separate legal status	No separate legal status	Separate legal status	Separate legal status	Separate legal status
3	Membership	Single owner	Minimum is 2 Maximum is 10 in banking business and 20 in others	Minimum 2 and maximum 50	Minimum 7 and no maximum limit	Minimum 10 and no maximum limit
4	Capital	Very limited capital	Limited capital	Larger capital resources	Any amount of capital can be raised	No substantial
5	Management and ownership	Owner management	Owner management	Control, risk and ownership generally go together	Complete separation of management from ownership	Not managed by all members
6	Managerial expertise	Very limited expertise	Limited expertise	Scope for expertise	Very wide scope for expertise	Scope for expertise
7	Owner's liability	Unlimited	Unlimited	Limited	Limited	Limited subject to By-laws
8	Basis of profit sharing	Fully enjoyed by owner	Shared by partners as per agreement	Shared by owners in the proportion of shares held	Shared by owners in the proportion of shares held	Volume of business by each member
9	Ownership transfer	At will and relatively easy	Restricted and relatively difficult	Restricted and relatively difficult	At will and very easy	Restricted
10	Business stability	Depends upon the life of owner	Depends upon the life, insolvency, retirement of partners	Perpetual existence Death , insolvency of the members does not effect the life	Perpetual existence. Death , insolvency of the members does not effect the life	Death , insolvency of its members does not effect the life
11	Business secrets	Full secrecy	Secret shared by the partners	Secrets shared by the members	Exposed to public	Exposed to members
12	State regulations	Almost nil	Very little	Considerable regulations	Excessive regulations	Considerable regulations
13	Tax liability	No special income tax	No special income tax	Heavily taxed and income is double taxed	Heavily taxed and income is double taxed	Exemption from income tax
14	Flexibility	It is an elastic organisation. There is no need of written documents	It can be changed only by the consent of all partners. It requires partnership deed which can be changed by the consent of all the partners	It is an elastic organisation	It is an unelastic organisation. Its Memorandum of Association is difficult to change. It can be changed through the permission of the Govt.	It is an unelastic organisation. Its Memorandum of Association is difficult to change,. It can be changed through the permission of Govt.
15	Auditing of accounts	Not required	Not required	Compulsory	Compulsory	Compulsory
16	Winding up	At will	At will	Under the Act	Under the Act	Under the Act

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

Check Your Progress A

1) List the features of an ideal form of business organisation.

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....

2) State whether the following statements are True or False

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

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

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

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

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

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

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

3) Fill in the blanks.

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

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

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

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

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

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

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

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

3.4 CRITERIA FOR THE CHOICE OF ORGANISATION

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

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

a) At the time of starting a business

b) At the time of expansion.

3.4.1 Criteria at the Time of Starting a Business

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

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

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

3) **Area of operation:** The area of operation of the business also influences the choice of form of organisation. If the area is limited and confined to a

particular locality, the suitable form of organisation may be sole proprietorship. In case the area is widespread, the suitable form may be a joint stock company.

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

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

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

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

3.4.2 Criteria at the Time of Expansion

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

i) Need for larger financial resources.

ii) Need for internal reorganisation and control.

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

iv) Increase in governmental controls and regulations.

v) Increase in tax liability.

vi) Increase in the problem of control and coordination

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

3.5 CHOICE OF FORM OF ORGANISATION

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

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

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

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

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

Check Your Progress B

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

   ....

   ....

   ....

   ....

2) State whether the following statements are True or False

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

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

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

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

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

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

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

3) Put a (√) mark against correct answer.

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

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

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

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

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

3.6 LET US SUM UP

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

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

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

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

3.7 SOME USEFULE BOOKS

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

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

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

3.8 ANSWERS TO CHECK YOUR PROGRESS

A) 1. See Section 3.2

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

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

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

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

3.9 QUESTIONS FOR PRACTICE

1) Explain the features of an ideal form of business organisation. Which form can be considered to be an ideal in all respects?
2) None of the four forms of business organisations has all the features of an ideal form of organisation. Discuss.
3) Explain the factors determining the choice of the form of business organisation.
4) You plan to start a business. How would you choose the suitable form of organisation for your business?
5) Company form of organisation is the most ideal form for all types of businesses Discuss.
6) A. partnership firm has decided to expand its business which requires more capital and expertise. Should it take more partners or convert it into a private limited company-Give your advice with suitable arguments.

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

UNIT 4 METHODS OF RAISING FINANCE

Structure

4.0 OBJECTIVES

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

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

4.1 INTRODUCTION

In the previous Units you have learnt about the nature of business activities, the types of business in which individuals may be engaged, and the different forms in which business activities may be organised. You know that adequate capital is necessary for financing various activities of the business, and, therefore, raising of finance is a pre-requisite for setting up any business unit. No one can start a business unless adequate capital is available. In this Unit you will learn why finance is needed, what the sources of finance are and the methods of raising finance to meet capital requirements of the business.

4.2 NEED FOR AND IMPORTANCE OF FINANCE

We all know that every business activity requires money to run it. Take the case of manufacturers. They must have a place to produce goods. They must buy machinery and raw materials, engage workers and managers, pay for electricity and water supply, and incur expenses for delivery of goods to their customers. Similarly, take the case of traders. They must buy goods and have godown to keep them. They have to arrange for the delivery of the goods to their customers. They must employ people for loading and unloading of goods, for keeping accounts as well as for bill collection. Take another example of goods transportation business. The transporters must buy trucks, must engage drivers and helpers, incur expenses on diesel, repairs and servicing of the vehicle, and so on. All these can be undertaken only with the help of finance. Thus, money is required for all types of business activities, be it manufacturing or trading or transportation or any other kind. It is true that income is earned by business when goods are sold and services have been rendered. But this takes place afterwards. Goods must be produced or purchased before they can be earned. It costs money to build a factory, to buy machinery and raw materials, to hire a place for the business office, to pay rent, wages and salaries, and to meet day to day expenses. So no one can run a business without first raising adequate finance, of course, this is done in anticipation of future income, on the assumption that customers will buy the goods and services offered to them.

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

4.3 TYPES OF FINANCIAL NEEDS

Broadly speaking, there are two ways of classifying the financial needs of the business. I) On the basis of the extent of permanence, we can classify the financial needs into: a) fixed capital, and b) working capital. Ii) On the basis of the period of use, we can classify the financial needs into: a) long-term capital, and b) short-term capital. Look at Figure 4.1 for the classification of financial needs.

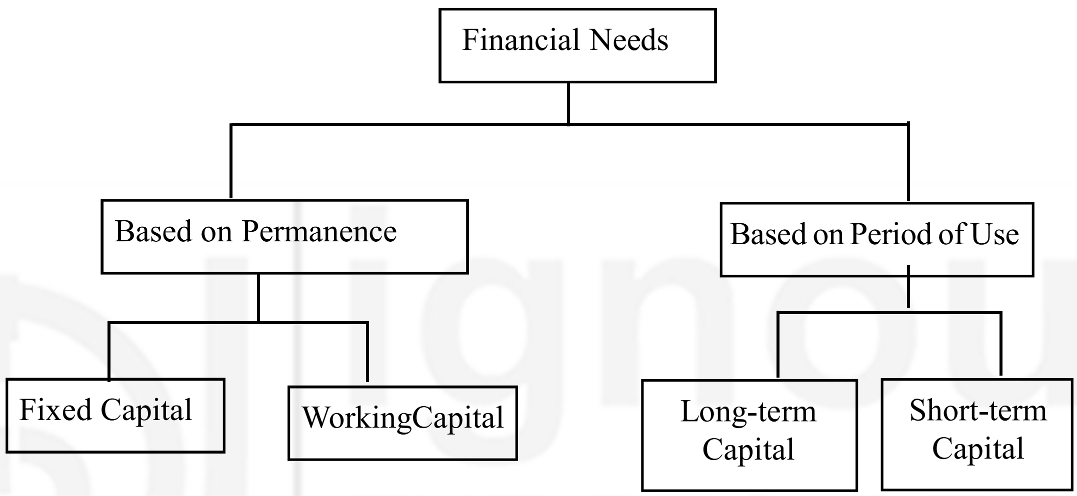

Figure 4.1:Classification of Financial Needs

4.3.1 Fixed Capital and Working Capital

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

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

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

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

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

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

4.3.2 Long-term Capital and Short-term Capital

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

4.4 CAPITAL STRUCTURE

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

4.4.1 Ownership Capital

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

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

4.4.2 Borrowed Capital

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

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

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

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

4.4.3 What is Capital Structure?

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

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

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

Check Your Progress A

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

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

   ii) No one can run a business without finance.

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

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

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

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

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

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

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

2) Fill in the blanks with appropriate works.

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

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

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

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

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

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

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

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

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

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

4.5 METHODS OF RAISING CAPITAL

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

1) Investment of own savings
2) Raising loans from friends and relatives
3) Arranging advances from commercial banks
4) Borrowing from finance companies

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

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

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

1) Issue of shares

2) Issue of debentures

3) Loans from financial institutions

4. Loans from commercial banks

5) Public deposits

6) Retention of profits

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

1) Trades credit

2) Factoring

3) Discounting bills of exchange

4) Bank overdraft and cash credit

5) Public deposits

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

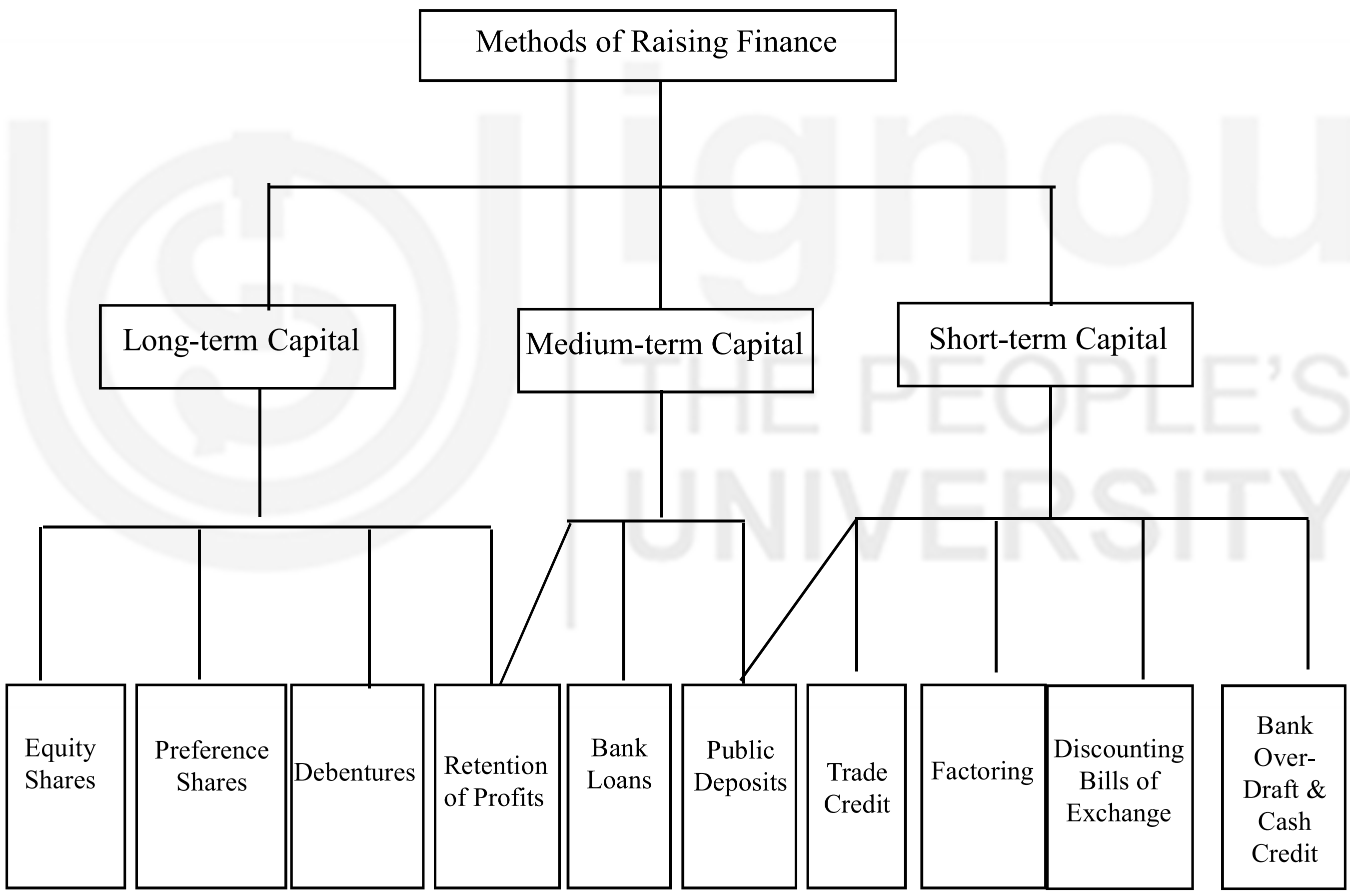

Figure 4.2 Methods of Raising Finance by Companies

Note: 1. Public deposit could be used for both medium-term as well as short-term purposes.

2. Retention of profits could be used for both Long-term as well as short-term capital purposes.

4.5.1 Issue of Shares

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

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

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

Preference shares: Issue of preference shares is another method of raising long-term capital. It has certain merits. Dividend is payable on preference shares at a fixed rate and is payable only if there are profits. Hence, there is no compulsory burden on the company's finances. Secondly, preference shareholders do not have voting right. So they cannot take part in the management of the company and thus are not a threat to the promoters. Another advantage of preference shares is that the company can declare higher rates of dividend for equity shareholders in good years because the rate of preference dividend is fixed. Besides, permanent use of preference share capital is also not essential. A company may issue redeemable preference shares and have the flexibility of paying off the amount if necessary and replace it by some other type of capital.

Some investors subscribe to preference shares because of preferential rights as to the payment of dividend and the return of capital. But others do not prefer it due to the fixed return as well as some risk of non-payment of dividend. Also they do not derive any benefit by way of rise in market price of the shares as is the case with equity shares.

4.5.2 Issue of Debentures

Companies generally have powers to borrow and raise loans by issuing debentures as securities of specified face value. The rate of interest payable on debentures is fixed at the time of issue, and they are recovered by a charge on the property or assets of the company, which provide the necessary security for payment. Debentures are mostly issued to finance the long-term requirements of business. There are certain advantages of issuing debentures.

i) Because of the fixed interest on debentures, companies with stable income can secure higher returns on equity capital by trading on equity.

ii) The rate of interest is usually lower than the expected rate of return on share capital. This is because debenture holders do not bear any risk.

iii) Debentures do not carry any voting right. Hence management by promoters or existing directors remains unaffected.

However, if the earnings of the company are uncertain or unpredictable, issue of debentures may pose serious problems for the company due to the fixed obligation to pay interest and repay the principle. The company is liable to pay interest even if there is no profit. If there is default in payment of interest or repayment of the principle, assets can be attached by order of the court. Trading companies which generally do not have large fixed assets cannot provide adequate security for issue of debentures. Even for manufacturing companies the capacity to raise loans is limited by value of their properties and assets.

5.5.3 Loans from Financial Institutions

Long-term and medium-term loans can be secured by companies from financial institution like the Industrial Finance Corporation of India, Industrial Credit and Investment Corporation, State-level Industrial Development Corporation, etc. These financial institutions grant loans for a maximum period of 25 years against approved schemes or projects. Loans agreed to be sanctioned must be covered by securities by way of mortgage of the company's property or hypothecation or assignment of stocks, shares, gold, etc.

Usually the financial institutions nominate one or two directors to have some degree of control over the functioning of the company. These nominee directors may not allow decisions to be made by the Board of Director affecting the interest of the lending institution. The loan agreement may also provide for conversion of loans into equity capital after a stated period if the lending institution so desires.

The most important advantage of this method of raising finance is that the rate of interest payable is lower than market rate. But there is a close security of the investment project before loans is sanctioned. The potential profitability of the project and the potential ability of the company to discharge its interest and repayment obligations are strictly evaluated. Also the companies are required to comply with a number of legal and technical formalities. Hence a long time is taken in the process of negotiating a loan from the financial institutions.

5.5.4 Loans from Commercial Banks

Medium-term loans can be raised by companies from commercial banks against the security of properties and assets. Thus, funds required for modernisation and renovation of assets can be borrowed from banks. Generally 50% to 75% of the value of industrial assets is granted as loan after the bank is satisfied about the earning capacity of the company and its ability to generate sufficient cash flows. The bank does not require any legal formality except that of creating a mortgage on the assets. Besides, the loan can be repaid in parts and interest saved to that extent. Short-term loans can also be obtained from banks on the personnel security of the directors of the company. These are known as clean advances.

5.5.5 Public Deposits

Companies often find it convenient and necessary to raise funds by inviting their shareholders, employees and the general public to deposit their saving with the company. The Companies Act permits such deposits to be received for a period up to 3 years at a time. Thus, public deposits can be a raised by companies to meet their short-term and medium –term financial needs. It is a simple method of raising finance for which the company has only to advertise in the newspapers giving particulars about its financial position as prescribed by the Companies Act. The deposits are not required to be covered by mortgaging assets or by other securities. Moreover deposits can be invited by offering a higher rate of interest than the interest on bank deposits. But companies are not permitted to raise unlimited amounts of fund through public deposits.

5.5.6 Retention of profits

Profitable companies do not generally distribute the whole amount of profits as dividend. A certain proportion is transferred to reserves and utilised as additional capital. Thus the financial needs of a company can be met by retaining a part of the annual profits. This may be regarded as reinvestment of profits or '**ploughing back of profits'**. Since retained profits actually belong to the shareholders of the company, these are treated as a part of ownership capital, and may be used to meet long medium and short-term financial needs. The main advantage is that there is no legal formality involved, nor does the company have to depend on external investors to raise capital. Retention of profit is a sort of self financing of business. However, only the on-going profitable companies can make use of this source of finance. For profitable companies transfer up to 10% of current profits is legally permitted. A company may transfer more than 10% of profits to reserves provided it fulfils certain conditions laid down in the rules framed under the companies Act. In short, more than 10% of current profits can be retained only after declaring a minimum rate of dividend consistent with the dividend distributed in the past.

5.5.7 Trade Credit

Just as companies sell goods on credit, they also buy raw materials, components, stores and spare parts on credit from different suppliers. Hence, outstanding amounts payable to trade creditors as well as bills payable relating to credit purchases are regarded as sources of finance. Generally suppliers grant credit for a period of 3 to 6 months, and thus provide short-term finance to the company. Availability of this type of finance is closely connected with the volume of business. When the production and sale of goods increase, there is automatic increase in the volume of purchases, and more of trade credit is available. On the other hand, if sales decline there is a corresponding decline in purchases of materials, and consequent decline in trade credit as a source of finance. Thus creditors, balances (account payable) and bills payable help companies to finance current assets, i.e., stock of materials and finished goods as well as book debts. However, trade credit also involves loss of cash discount which could be earned if payments were made within 7 to 10 days from the date of purchase. This loss is regarded as the cost of trade credit.

5.5.8 Factoring

The amounts due to a company from customers on account of credit sale generally remain outstanding during the period of credit allowed i.e. till the dues are collected from the debtors. If necessary, book debts may be assigned to bank and cash realised in advance from the bank. By this arrangement the responsibility of collecting the debtors' balances is taken over by the bank on payment of specified charges by the company. This is a method of raising short-term capital and known as 'factoring'. It helps companies to secure finance against debtors' balances before the debts are due for realisation, and incidentally also helps in saving the effort of collecting the book debts. The bank charges payable for the purpose is treated as the cost of raising funds. Keeping in view the risk of bad debts, the amount to be made available by banks is calculated so as to provide for a margin for non-realisation of debts. The disadvantage of factoring is that customers who are in genuine difficulty do not get the facility of delaying payment which they might have otherwise got from the company.

5.5.9 Discounting Bills of Exchange

This method is widely used by companies for raising short-term finance. When goods are sold on credit, bills of exchange are generally drawn for acceptance by the buyers of goods. The bills so drawn are payable after 3 or 6 months depending on the prevailing practice among traders. Instead of holding the bills till the date of maturity, companies generally prefer to discount them with commercial banks on payment of a charge known as bank discount. Bills are endorsed in favor of the bank so as to enable it to realise the amount of the bill on maturity from concerned parties. The amount of discount is deducted from the value of bills at the time of discounting. The rate of discount to be charged by banks is prescribed by the Reserve Bank of India from time to time. It really amounts to the interest for the period from the date of discounting to the date of maturity of the bill. If any bill is dishonored on maturity, the bank returns it to the company which then becomes liable to pay the amount to the bank. The cost of raising finance by this method is the discount charged by the bank.

4.5.10 Bank Overdraft and Credit

Arranging cash credit and overdraft with commercial banks is a common method adopted by companies for meeting short-term financial requirements. Cash credit refers to an arrangement on a continuing basis whereby the commercial bank allows money to be drawn as advance from time to time within a specified limit known as cash credit limit. This facility is granted against the security of goods in stock, or promissory notes bearing a second signature, or other marketable instruments like government bonds. The company is allowed to draw whatever amount is required at different times within the limit agreed upon. The cash credit limit may be revised according to the value of securities. The money drawn can be repaid as and when possible. Interest is charged on the actual amount withdrawn.

Overdraft is a temporary arrangement with the bank which permits the company to overdraw from its current deposit account with the bank upto a certain limit. The overdraft facility is also granted against securities as in the case of cash credit. Interest is charged on the actual amount overdrawn.

The rate of interest charged on cash credit and overdraft is relatively much higher than the rate of interest on bank deposits. But this method of financing has the flexibility of allowing funds to be drawn for short-term purposes according to changing needs which depend on business conditions.

Check Your Progress B

1) Six methods of raising finance are mentioned below. Indicate by tick marks the methods which can be used for raising fixed capital.

   i) Issue of equity shares

   ii) Clean advance from banks

   iii) Public deposits

   iv) Loans from financial institutions

   v) Discounting of bills

   vi) Issue of preference shares

2 Which of the following methods can be used by a company for raising short-term finance? Put a tick mark against those methods only.

   i) Issue of debentures

   ii) Cash credit

   iii) Public deposit

   iv) Bank overdraft

   v) Term loans from banks

3) Read the following statements and indicate which of them are True or False.

   i) 'Trading on equity' is possible if a company issues preference shares and debentures for raising necessary capital.

   ii) Fixed capital can be raised by issuing preference shares.

   iii) Factoring means appointing a bank as collecting agent.

   iv) Equity shares capital can be used for investment in fixed assets as well as current assets.

   v) Bills of exchange can be discounted with a bank on payment of interest in advance.

   vi) Any amount of public deposits can be raised by a company.

   vii) Issue of debentures must be covered by adequate security of assets.

   viii) Cash credit is just like clean advance from banks.

   ix) Term loans can be raised from commercial banks for long term purposes.

   x) Trade credit helps in financing short-term investments.

4 Fill in the blanks with appropriate words selected from the words given in the brackets.

i) Equity shares are issued for ……… (investment in fixed assets, financing operating expenses, modernisation of plants)

ii) Short term working capital is generally raised from ……….. (fixed assets, goods in stock bank balance)

iii) Cash credit is granted against the security of ………….. (fixed assets, goods in stock, bank balance)

iv) The cost of trade credit is………. (loss of profit, loss of cash discount, loss of interest)

v) Amount due from customers on account of credit sale requires …………….. financing. (long-term medium term, short term)

4.6 LET US SUM UP

Every business firm requires money or finance to run its activities. The importance of finance has increased in modern times for two reasons: (i) business activities are now undertaken on a much larger scale than in the past, and (ii) manufacturing processes have become more complex than before.

Broadly speaking, the financial requirements of a business are of two types: i) fixed capital and ii) working capital. Finance required to purchase fixed assets is known as fixed capital or long–term capital. Finance needed for investment in current assets is known as working capital or circulating capital. The nature of business and size of the business unit generally determine that amount of fixed capital needed. On the other hand, the amount of working capital depends upon the nature of business, the time required for completing the manufacturing process, and the terms on which materials are purchased or goods are sold.

Funds raised to meet the financial requirements of a business can be classified as ownership capital and borrowed capital. The amount of capital invested in a business by its owners (proprietor, partners or shareholders) is known as ownership capital. Borrowed capital may be raised by way of direct loans, or by issue of debentures or bonds in the case of a company. Ownership capital is raised by companies by issuing shares. Borrowed capital is often used to drive the benefit of higher rates of return on owners' investment. This is known as 'trading on equity'.

'Capital structure' refers to the relative proportion in which different sources of long-term finance is used to meet the total requirements. The proportion of fixed interest bearing capital in the total capital is known as 'capital gearing'.

The main difference between long-term finance and short-term finance is that the former is required for use over a longer period, five years or more, while the later is required for a short period of less than a year. Finance required for a period of 2 to 5 years is known as medium-term finance.

Sole proprietorship concerns and partnership firms have limited opportunities of financing their business. They can use one or more of the following methods of raising funds: investment of own savings, raising loans from friends and relatives, advance from commercial banks and borrowings from finance companies, all against personal security or against the security of their own assets and properties.

A company may decide to use one or more of the following methods to meet the needs of long-term and medium-term finance: issue of shares, issue of debentures, loans from financial institutions, loans from commercial banks, public deposits and retention of profits.

To raise short-term finance, a company may use trade credits, factoring, discounting bills of exchange, arranging bank overdraft and cash credits, and raising public deposits. Each of these methods has certain advantages as well as disadvantages.

4.7 KEY WORKS

Borrowed Capital: Fund raised by way of loans or issue of debentures, which entitle the investors (i.e. lenders) to claim regular payment of interest and repayment of the loan when due.

Capital Gearing: The proportion of fixed interest-bearing capital in the total capital of a business.

Capital Structure: Proportion in which different sources of long-term finance are used to meet the total funds requirement, like shares, debentures, loans, retained profits, etc.

Factoring: Assignment of book debts to a bank and receiving cash in advance with the responsibility of collecting the debts taken over by the bank on payment of specified charges.

Fixed Capital: Funds required for purchase of fixed assets like land, building, plant and machinery, furniture, etc.

Long-term Finance: Finance required for use over a long period, five years or more, meant for purchase of fixed assets and continuous investment in a part of the current assets.

Medium-term Finance: Fund required for use over a period of 2 to 5 years, generally for renovation of building, modernisation of plant and machinery, etc.

Ownership Capital: Funds invested by owners of business for permanent use, which entitle then to decide how the business activities will be managed and what will be their share in the profits.

Public Deposits: Deposits raised from the public for medium or short-term financial needs.

Short-term Finance: Funds required for short periods, less than a year, meant for financing current assets which fluctuate due to changing volume of business.

Trade Credit: Outstanding amounts payable to suppliers of raw materials and consumable items and bills payable relating to credit purchases.

Trading on Equity: Use of borrowed capital to have a higher rate of return on equity capital.

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

4.8 SOME USEFUL BOOKS

Bhushan, Y.K. 1987. *Fundamentals of Business Organisation and Management*, Sultan Chand & Sons: New Delhi. (Part 8, Chapters 1 & 2)

Kuchhal, S.C. *Corporation Finance*, Chaitanya Publishing House: Allahabad.

Paish, F.W. 1975. *Business Finance*, Pitman: London (Chapters 1-3) Singh, B.P. and T.N. Chhabra. 1988. *Business Organisation & Management*, Kitab Mahal: Allahabad. (Chapters 16 & 17).

4.9 ANSWERS TO CHECK YOUR PROGRESS

A 1) i) False ii) True iii) False iv) True

v) True vi) True vii) True viii) False ix) True

2) i) Fixed ii) working iii) Long-term iv) One

v) 25 vi) Fixed vii) Short-term viii) Short-term

3) 1) iv) 2) v 3) vi 4) vii 5) ii 6) iii 7) i

B 1) i, iv, vi

2) ii, iii, iv

3) i) False ii) Trueiii) False iv) True v) True

vi) False vii) True viii) False ix) False x) True

4) i) investment in fixed assets

ii) commercial banks

iii) goods in stock

iv) iv) loss of cash discount

v) short-term finance

4.10 QUESTIONS FOR PRACTICE

1) Discuss briefly the importance of finance in business. Distinguish between fixed capital and working capital.
2) State the purposes for which working capital is required. Discuss the factors determining working capital needs.
3) What are the advantages of raising capital through borrowings?
4) What is meant by ownership capital? What are its merits and limitations?
5) State the methods of raising fixed capital.
6) What are the methods of raising short-term capital? Discuss.
7) Briefly explain the merits and demerits of issuing debentures. Compare it with equity shares as a method of raising fixed capital.
8) Compare the relative advantages and disadvantages of issuing equity shares and preference shares.
9) What are the advantages of raising finance through public deposits? What are the legal requirements to be fulfilled for raising public deposits?

10) Discuss briefly 'factoring' and 'discounting of bills of exchange' as methods of raising short-term finance

11) What do you understand by overdraft and cash credit facilities? Mention the types of securities required for cash credit and overdraft.

12) What is meant by capital structure? What factors should management take into account while deciding on a capital structure?

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

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2

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Units 1-4

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*BTMC – 132 was adopted / adapted from Three Courses, namely – **BCOE 108, ECO – 101** and **ECO – 103** of School of Management Studies. (SOMS)

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January, 2019

ISBN :

Further information on Indira Gandhi National Open University courses may be obtained from the University's office at Maidan Garhi. New Delhi-110 068 or visit University's web site http://www.ignou.ac.in

Printed and published on behalf of the Indira Gandhi National Open University, New Delhi by Prof Jitendra Kumar Srivastava, Director, School of Tourism,

Laser Typeset by : Tessa Media & Computers, C-206, A.F.E.-II, Okhla, New Delhi

Printed at :

BLOCK 2 COMPANY FORMATION

The company form of business organisation is the most appropriate and popular form in a complex modern day environment. In this form of organisation, money is invested by a large number of persons called shareholders who maybe scattered over different parts of the country or even the world.

For the formation of a company and the commencement of its business, a company has to prepare a number of documents, of these, the main documents are: (i) Memorandum of Association (ii) Articles of Association and (iii) Prospectus.

In this block comprising of five units, we have discussed the nature and types of companies, the role of promoters, the procedure of formation of a company as well as the importance, contents and legal implications of Memorandum of Association, Articles of Association and Prospectus . The five units are.

Unit: 5 explains the nature of a company, the distinction between company and partnership and the various types of companies that can be formed.

Unit: 6 describes the procedure for the formation and winding up of a company. It is divided into four stages: (i) Promotion; (ii) Filing of necessary documents; (iii) Incorporation/Registration; (iv) Commencement of business and winding up.

Unit: 7 deals with Memorandum of Association and discusses the meaning, purpose, contents and the procedure for alteration of different clauses of Memorandum.

Unit: 8 explains the meaning, purpose and contents of Articles of Association and describes the procedure for its alteration. It also discusses the effect of Memorandum and Articles and Doctrine of Constructive Notice as well as Doctrine of Indoor Management.

Unit: 9 deals with Prospectus and explains its meaning, purpose and contents. It also discusses remedies available to an aggrieved party in case of misrepresentation in the prospectus.

UNIT 5 NATURE AND TYPES OF COMPANIES

Structure

5.0 OBJECTIVES

After studying this Unit, you should be able to:

- define a company;
- distinguish between company and body corporate;
- describe the characteristic features of a company;
- explain the concept of corporate veil,
- describe the various types of companies;
- understand associations not for profit; and
- describe an illegal association.

5.1 INTRODUCTION

The Companies Act, 2013 received the assent of the President on 29th August and was notified on 30th August, 2013. It has 470 sections and VII schedules, whereas the Companies Act 1956 had 658 sections and XV schedules. This Act provides detailed rules regarding formation, management and administration and winding up of companies by Tribunals. It has made changes in provisions relating to memorandum, definition of prospectus, appointment of auditors, and accounting standards and financial statements and investigations etc. In this Unit you will study the meaning and definition of a company, the main features of a company form of business organisation, and the various types of companies that can be formed in India.

5.2 MEANING AND DEFINITION OF A COMPANY

The term 'company' may be described to imply an association of persons formed for some common object or objects. The purposes for which people may wish to associate themselves are multifarious and include economic as well as non-economic objectives. However, the term 'company' is normally reserved for those associated for economic purpose, i.e., to carry on a business for gain. **This should, however, not give you an impression that a company under the companies Act cannot be created for non-economic or charitable purposes. In fact, Section 8 of the Companies Act, 2013 allows formation of non-profit associations as companies.**

Partnerships often describe themselves as 'A, B. C and Company'. But, this does not make the firm a company in the legal sense of the word; it only suggests that there are other persons also in the association.

In legal terminology a company means a company incorporated or registered under of the Companies Act, 2013 or under any of the earlier Companies Acts. Section 2(20) of the Companies Act, 2013 defines **a company to mean a company incorporated under this Act or under any previous company law.** This definition, however, is not exhaustive because it does not reveal the meaning and characteristics of a Company. Thus we have to see definition of a Company as given by famous Jurists.

Lord Justice Lindley defines a Company as follows:

"A company is an association of many persons who contribute money or money worth to a common stock and employ it in some trade or business, and who share the profit and loss (as the case may be) arising therefrom. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it, or to whom it belongs, are called members. The proportion of capital to which each member is entitled is his share. Shares are always transferable although the right to transfer them is often more or less restricted."

Another definition as given by ***Chief Justice Marshall*** reads as follows:-

"A company is a person, artificial, invisible, intangible and existing only in the eyes of law. Being a mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence."

According to ***Lard Haney***, "A company is an incorporated association which is an artificial person created by law, having a separate entity, with a perpetual succession and a common seal."

From the above definitions, it is clear that a company has a corporate and legal personality. It is an artificial person and exists only in the eyes of law. It has an independent legal entity, a common seal and perpetual succession.

5.3 COMPANY VS. BODY CORPORATE

Body corporate means an association of persons which has been incorporated under some statute having perpetual succession, a common seal and having a legal entity different from the members constituting it. Section 2 (11) of the Companies Act, 2013 defines the expression 'body corporate' as follows:

"'Body corporate' or 'Corporation' includes a company incorporated outside India, but **does not include** –

i) a co-operative society registered under any law relating to co-operative societies; and

ii) any other body corporate (not being a company as defined in this Act), which the Central Government may, by notification, specify in this behalf".

A body corporate may be-

a) corporation sole, or

b) corporation aggregate.

A **'corporation sole'** is a body corporate constituted in a single person who, in right of some office or function, has corporate status. Examples of 'corporation sole' are to be found in perpetual offices such as the President, Governors, Crown, Ministers, and a public trustee. A corporation sole is not a "body corporate" for the purposes of the Companies Act, 2013. It is still a legal person and as such person it can be a member of a company- **Star Tile Works Ltd. v.N. Govindan (1956).**

A '**corporation aggregate'** consists of a group of persons contemporaneously associated so that they form a single person, e.g., a limited company, a trade union.

It may be of interest to note at this stage that because of inclusion of a company incorporated outside India within the definition of body corporate, a number of previsions of the Companies Act, 2013 apply to such companies; for example, Section 380 requires foreign companies carrying on business in India to deliver certain documents to the Registrar of Companies.

The expression 'corporation' or 'body corporate' is, thus, wider that the word 'company'. A company, as noted above, is a corporation aggregate.

5.4 IS COMPANY A CITIZEN

Although a company is regarded as a legal person (though artificial), it is not a citizen either under the Constitution of India or the Citizenship Act, 1955 **- Heavy Engineering Mazdoor Union V. State of Bihar (1969).** The Supreme Court of

India in **State Trading Corporation Ltd. v. CTO (1963)** held that a corporation including a company cannot have the status of a citizen under theConstitution of India. Thus, under the Constitution, a company has no fundamental rights which are expressly available to citizens only. It can, however, claim the protection of those fundamental rights which are available to all persons, whether citizens or not, for example, the right to own property.

In **Narasaraopeta Electric Corporation Ltd. v. State of Madras (1951),** the High Court observed that a company incorporated under the Indian Companies Act does not satisfy the requirements of the definition of 'citizen' in Article 5 of the Constitution and therefore is not a citizen.

A company is also not allowed to lay claim to fundamental rights on the basis of its being an aggregate of citizens. Once a company or a corporation is formed, the business of the company or the corporation is not the business of the citizens but that of the company or corporation formed as an incorporated body and the rights of the incorporated body must be judged on that footing and cannot be judged on the assumption that they are the rights attributable to the business of individual citizens- Supreme Court in **Telco Ltd. v. State of Bihar (1964).**

Although a company cannot be a citizen, yet it has a nationality, domicile and residence. A company is said to be resident and national of the place and country where it is incorporated.

5.5 MAIN FEATURES OF A COMPANY

On analysing the various legal and juristic definitions of the term 'company' you will observe that a company formed and registered under the Companies Act has certain special features which distinguish it from the other forms of organisations. The main characteristics features of a company are as follows.

1) **Creation of Law:** A company is an association of persons (except in case of 'One Person Company') registered under the Companies Act. It comes into existence only when it is so registered. Minimum number required for the purpose is 2, in case of a private company and 7, in case of a public company. Only one person can form a 'one person company' *(Section 3).*

2) **Artificial Person:** a company is created with the sanction of law and is not itself a human being. It is, therefore, called artificial; and since it is clothed with certain rights and obligations, it is called a person. A company is accordingly an artificial person.

3) **Separate Legal Entity:** Unlike partnership, company is distinct from the persons who constitute it. Section 9 says that on registration, the association of persons becomes a body corporate by the name contained in the memorandum.

   The legal status of a company has been aptly described by the Supreme Court of India in **Tata Engineering & Locomotive Co, Ltd. v. State of Bihar** as follows:

   "The corporation in law is equal to a natural person and has a legal entity of its own. The entity of the corporation is entirely separate from that of its shareholders; it bears its own name and has a seal of its own; its assets are separate and distinct from those of its members; it can sue and be sued exclusively for its own purpose".

Even though the company lacks physical existence, for purposes of law it is regarded as an independent legal person who has a personality of its own and is different from the members constituting the company. Therefore, a company can enter into a contract with any of its members. A person can own its shares and also be its creditor. A shareholder of a company cannot be held liable for its acts and debts even though he virtually holds the entire share capital. No member can either individually or jointly claim any ownership rights in the assets of the company during its existence or on its winding up. Similarly, creditors of the company are creditors of the company alone and they cannot take action against the members of the company.

Even where a single shareholder virtually holds the entire share capital, a company is to be differentiated from such a shareholders. In the well known case of **Salomon v. Salomon & Co. Ltd. (1895-99),** Salomon was running a shoe business in England. He formed a company known as 'Salomon & Co. Ltd.' It consisted of Salomon himself, his wife, his four sons and a daughter. The shoe business of Mr. Salomon was sold to the company for £30,000. Mr. Salomon received from the company purchase price in the form of £20,000 fully paid shares of £1 each and £10,000 in debentures which carried a floating charge over the assets of the company and the balance in cash. One share of £1each was subscribed for in cash by each member of Salomon's family. Saloman was appointed the managing director of the company. During the course of business, the company became liable for some unsecured loan. The company in less than one year ran into financial difficulties and the liquidation proceedings started. On winding up, the assets realized £6,000. The company owed £10,000 to Mr. Salomon and £7,000 to unsecured creditors. Thus, after paying off the debenture holder (Mr. Salomon), nothing was left for unsecured creditors. Salomon and Salomon & Co. Ltd. was one and the same person. The company was only a façade to defraud the innocent creditors. Mr. Salomon should not be treated as a secured creditor, outside creditors should be paid first. The House of Lords held that the company had been validly constituted, and it is independent of its members. So Salomon is entitled to get his money first as he is a secured creditor. The business belonged to company and not to Salomon. Salomon was its agent; the company was not the agent of Salomon.

In **T.R. Pratt (Bombay) Ltd. Vs. E.D. Sasoon and Co. Ltd.,** it was observed that under the law, an incorporated company is a distinct entity, and although all the shares may be practically controlled by one person, in law a company is a distinct entity. Similarly in **Abdul Haq vs. Das Mal,** an employee sued a director of the company for the recovery of the amount of salary due to him. It was held that he could not succeed because the remedy lied against the company and not against the directors or members of the company.

As a consequence of separate legal entity, the company may enter into contracts with its members and vice-versa. Thus, a shareholder can be the creditor of the company.

4) **Limited Liability:** A major advantage enjoyed by a company is that the liability of its members is limited. The company being a separate person, its

members are not as such liable for its debts. You will later study that on the bases of liability, companies may be classified as (i) Companies limited by shares, (ii) Companies limited by guarantee, (iii) Companies limited by guarantee but having share capital, and (iv) Unlimited liability companies.

In case of a *company limited by shares,* the liability of members is limited to the nominal value of shares held by them. Thus, if the shares are fully paid up, their liability will be nil. In case of a *company limited by guarantee*, the liability of the members is limited up to the amount guaranteed by a member. But, in case of a *guarantee company having share capital,* the liability shall be limited to the aggregate of the amount remaining unpaid on the shares held by a member and the amount guaranteed by him.

You may note that, the Companies Act, 2013 allows companies to be formed with liability of members as unlimited. In case of an unlimited liability company, the liability of members shall not be limited to the nominal or face value of the shares held by them; they shall continue to be liable till each paisa of company's debts and liabilities has been paid off. However, the company being a separate legal entity, no suit can be filed by the creditors directly against the members.

5) **Separate Property:** Shareholders are not, in the eyes of the law, part owners of the undertaking. In India, this principle of separate property was best laid down by the Supreme Court in **Bacha F. Guzdar v. Commissioner of Income Tax, Bombay (supra).** The Supreme Court held that a shareholder is not the part owner of the company or its property, he is given only certain rights by law, e.g., to vote or attend meetings, to receive dividends.

   In **Macaura v. Northern Assurance Co. Ltd. (1925),** it was held that a member does not even have an insurable interest in the properly of the company. In this case, Macaura held all except one share of a timber company. He insured the company's timber in his own name. On timber being destroyed by fire, his claim was rejected because he had no insurable interest in that timber. The Court observed: "No shareholder has any right to any item of property of the company for he has no legal or equitable interest therein".

6) **Perpetual Succession:** The term perpetual succession means the continued existence. The existence of the company is not affected by reasons such as the insolvency, death, unsoundness of mind of its members. The company has a perpetual succession. Members may come and members may go but the company goes on. It continues even if all its human members are dead. Even where during the war, all the members of a private company, while in general meeting were killed by a bomb, the company survived. Not even a hydrogen bomb could have destroyed it. In the aforesaid eventuality, the legal successors of the deceased shareholders will become the members. But this does not mean that a company can never come to an end. A company is creation of law it can be brought to an end by the process of law.

7) **Transferability of Shares:** One particular reason for the popularity of companies has been that their shares are capable of being easily transferred. The shares of a public company are freely transferable. A shareholder can transfer his shares to any person without the consent of other members. Articles of association, even of a public company can put certain restrictions

on the transfer of shares but it cannot altogether stop it. A shareholder of a public company possessing fully paid up shares is at liberty to transfer his shares to anyone he likes in accordance with the manner provided for in the articles of association of the company. **The Companies Act, 2013, vide Section 58(2) provides that without prejudice to sub-section (1), the securities or other interest of any member in a public company shall be freely transferable Provided that any contract or arrangement between two or more persons in respect of transfer of securities shall be enforceable as a contract. Thus, the present Act upholds shareholders' agreements providing for 'Right of first offer' and 'Right of first refusal' as valid even in case of a public company.**

However, a private company is required to put certain restrictions on transferability of its shares but the right to transfer is not taken away absolutely even in case of a private company.

8) **Common Seal:** A company being an artificial person is not bestowed with body of natural being. Therefore, it has to work through its directors, officers and other employees. But, it can be held bound by only those documents which bear its signatures. Common seal is the official signature of a company. A metallic seal should be used. Every company must have a common seal with its name engraved on the same.

   As per Section 22(2), a company may, under its common seal, through general or special power of attorney empower any person to execute deeds on its behalf in any place either in or outside India. It further provides that a deed signed by such an attorney on behalf of the company and under his seal where sealing is required, shall bind the company and have the effect as if it were under its common seal. As per Companies (Amendment) Act, 2015, common seal is optional.

9) **Company may sue and be sued in its own name:** As juristic person, company can sue and be sued in its own name. This is so because a company has a separate legal existence. A company may enter into contracts and can enforce the contractual rights against others and it can be sued by others if it commits a beach of contract.

Check Your Progress A

1) Define a company.

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2) Enumerate the main features of a company.

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3) State, whether the following statements are true or false:

   i) A computer is the creation of law.

   ii) A company is an artificial person

   iii) Since company is an artificial person, it can commit no wrong nor can it be sued in its own name.

   iv) Like a partnership, a company comes to an end when any shareholder of the company dies

   v) A company although is a corporate person yet it is not a citizen.

   vi) The liability of a member is limited to the face value of the shares held by him.

5.6 LIFTING THE CORPORATE VEIL

Under Para 5.5, you learnt that a company has separate legal entity independent and different from its members. This principal of separate legal entity was well established in the famous case of **Salomon v. Salomon and Company Ltd**. On incorporation a line of demarcation or a veil is drawn between the company and its members. In fact, a company is an association of persons and such persons are the real beneficial owners of all the corporate property. Real persons behind the company are disregarded once they have formed a company and given the status of a legal entity.

As a consequence of this separate legal entity, the company enjoys several advantages which you have studied in foregoing para. But, the advantages of incorporation are allowed to be enjoyed only by those who want to make an honest use of the 'company'. In case of a dishonest and fraudulent use of the facility of incorporation, the law lifts the corporate veil and identifies the persons who are behind the scene and are responsible for the fraud. The corporate veil is said to be lifted when the court ignores the company and concerns itself directly with the officers or members of the company. Prof. Gower has observed, "When the law disregards the corporate entity and pays regard instead to the individual members behind the legal façade, it is known as lifting the veil of corporate personality".

You should, however, note that the power of the court to lift the corporate veil is purely discretionary. The court will lift the corporate veil when it is in the public interest to do so. In **Cotton Corporation of India Ltd. v. G.C. Odusumathd (1999),** the Karnataka High Court observed that lifting of the corporate veil of a company, as a rule is, not permissible in law unless otherwise provided by clear words of the statute or by very compelling reasons such as where fraud is intended to be prevented or trading with enemy company is sought to be defeated.

The circumstances under which the courts may lift the corporate veil may broadly be grouped under the following two heads:

A) Under statutory provisions

B) Under judicial interpretations

5.7 KINDS OF COMPANIES

Companies can be classified according to various bases. These are:

1) On the basis of incorporation
2) On the bases of liability
3) On the bases of control

See figure 5.1 to have an overall view of the different types of companies.

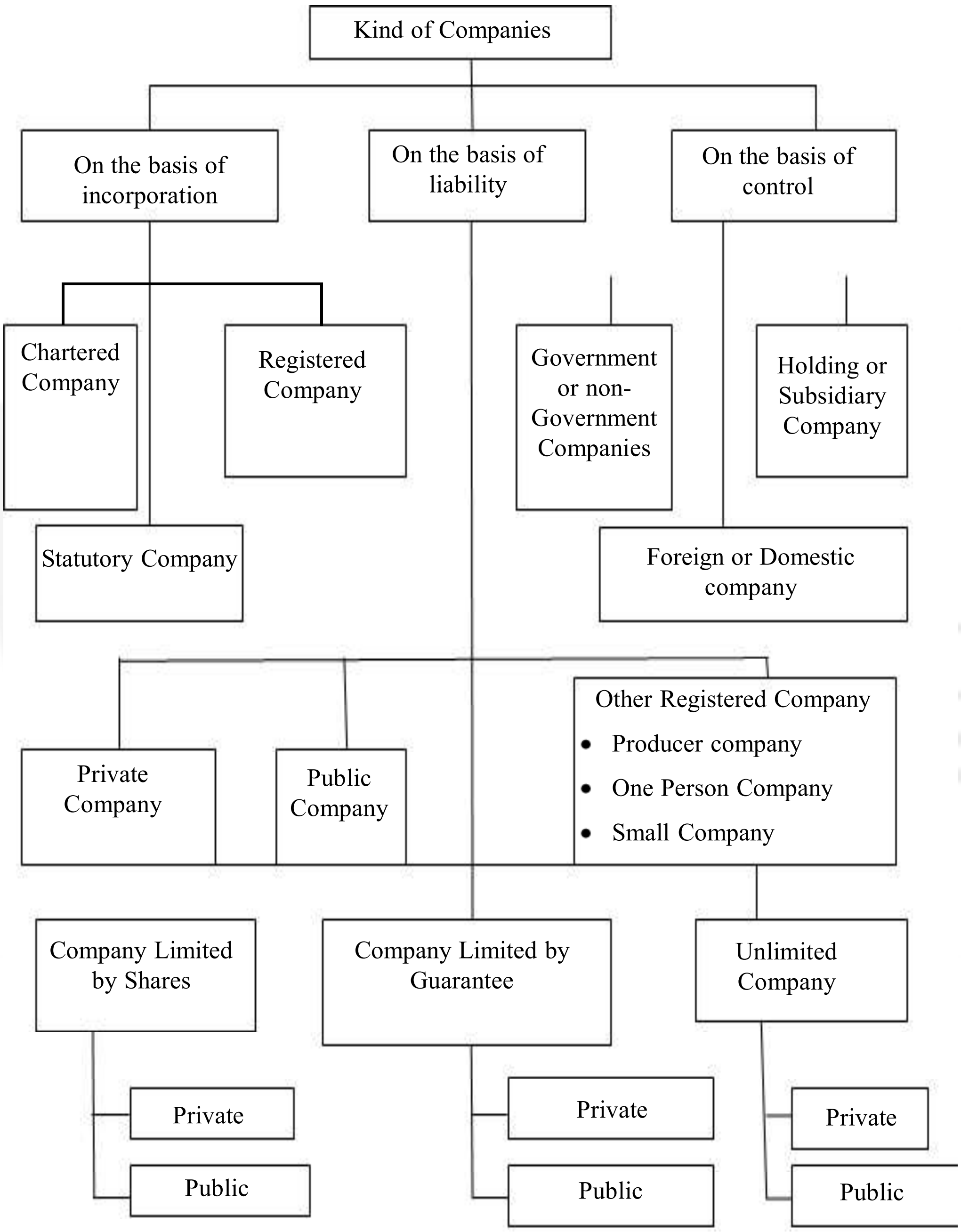

Fig. 5.1: Kinds of Companies

5.7.1 On the Basis of Incorporation

Depending upon the mode of incorporation, companies may be divided into the following three categories:

i) **Chartered Company:** A company incorporated under a special charter granted by the King or Queen of England is called 'chartered company'. A charted company is regulated by its charter and the Companies Act does not apply to it. The charter also prescribes the nature of business and the powers of the company. The familiar examples of chartered companies are the East India Company and the Bank of England. *This type of company cannot now be formed in India.*

ii) **Statutory Company:** A statutory company is one which is created by a special Act of Parliament or a State Legislature. Such companies are usually formed for achieving a purpose related with public utilities. The nature and powers of such companies are laid down in the Special Act under which they are created. However, the provisions of the Companies Act are also applicable to them in so far as they are consistent with the provisions of the Special Act. A statutory company also has a separate legal entity and it is not required to use the word 'limited' after its name. The audit of such companies is conducted by the Controller and Auditor General of India (C&AG) and the annual report of working is required to be placed before the Parliament or State Legislature, as the case may be. Familiar examples of such companies are Reserve Bank of India, The Life Insurance Corporation of India, The Food Corporation of India, State Bank of India, etc.

iii) **Registered or Incorporated Company:** A registered company is one which is registered in accordance with the provisions of the Companies Act 2013 and also includes companies formed and registered under any of the previous Acts. A registered company comes into existence only when it receives the certificate of incorporation. Registered Companies are governed by the provisions of the Companies Act, 2013.

A registered company may either be a private company or a public company. A *private company* is one which by its articles of association (a) restricts the right of transfer of shares; (b) except in case of a one person company limits the number of its members to two hundred (not including members who are the present or past employees); (c) prohibits any invitation to the public to subscribe for any securities of the company [Section 2(68)].

On the other hand, a ***public company*** is one which is not a private company is a private company but subsidiary of a public company even where such subsidiary company continues to be a private company in its articles [Section 2 (71)].

Following are the main points of distinction between a private company and a public company:

1) ***Minimum Number of Members*** **[Section 3]:** In the case of a private company minimum number of persons to form a company is two while it is seven in the case of a public company.

2) ***Maximum Number of Members*****:** In case of private company the maximum number must not exceed two hundred whereas there is no such restriction on the maximum number of members in the case of a public company.

3) ***Transferability of Shares [Sections 44]:*** As per Section 44, the shares of any member in a public company shall be movable property transferable in the manner provided by the articles of the company. In a private company, by its very definition, articles of a private company have to contain restrictions on transferability of shares.

4) ***Prospectus [Section 2 (68)]:*** A private company cannot issue a prospectus, while a public company may, through prospectus; invite the general public to subscribe for its securities.

5) ***Minimum number of Directors [Section 149]:*** A private company must have at least two directors, whereas a public company must have at least three directors.

6) ***Retirement of Directors [Section 152]:*** Directors of a private company are not required to retire by rotation, but in case of a public company at least 2/3rd of the directors must be such whose period of office is subject to retirement by rotation.

7) ***Quorum for General Meetings [Section 103]:*** Unless the articles of the company provide for a larger number, ***in case of a public company***, the quorum shall be-

   i) Five numbers personally present if the number of members as on the date of meeting is not more than one thousand;

   ii) Fifteen members personally present if the number of members as on the date of meeting is more than one thousand but up to five thousand;

   iii) Thirty members personally present if the number of members as on the date of the meeting exceeds five thousand;

   In the case of a private company, unless Articles provide for a higher number, two members personally present, shall be the quorum for a meeting of the company.

8) ***Managerial Remuneration*** **[Section 197]:** In a private company, there are no restrictions on managerial remuneration, but in the case of a public company total managerial remuneration cannot exceed 11 per cent of the net profits. The remuneration payable to each managing/ whole time director or manager cannot exceed 5 per cent of the net profits unless approval of the Central Government has been taken. Likewise, there are restrictions on the remuneration payable to ordinary directors also.

9) ***Public Deposits:*** A public company is free to accept deposits from the public (subject, however, to the provisions of sections 76). A private company cannot accept deposits from the public.

5.7.2 On the Basis of Liability

On the bases of liability, an incorporated company may either be (i) a company limited by shares, or (ii) a company limited by guarantee; or (iii) an unlimited company.

i) **Company Limited by Shares:** A company having the liability of its members limited by the memorandum, to the amount, if any, unpaid on the shares respectively held by them is termed “a company limited by shares” [Section 2(22)]. Such a company is commonly called Limited Liability Company although the liability of the company is never limited; it is the liability of its members which is limited. The liability of members can be enforced at any time during the existence and also during the winding-up of the company.

Such a company must have share capital as the extent of liability is determined by the face value of shares. However, there is no liability to pay any balance amount due on the shares, except in pursuance of calls duly made in accordance with law and the articles, while the company is a going concern or of calls made in the event of winding of the company.

ii) **Company Limited by Guarantee:** A company limited by guarantee may be defined as a company having liability of its members limited by the memorandum to such amount as the members may respectively undertake by the memorandum to contribute to the assets of the company in the event of its being wound-up **[Section 2 (21)].**

Such a company may or may not have share capital**.** If a company limited by a guarantee is formed without any share capital, then the members would be liable to pay only the guaranteed amount and that too when the company goes into liquidation. But if the company limited by guarantee is formed with share capital, then the members are also liable to pay the unpaid amount on their shares. But the guaranteed amount can be called up only at the time of winding-up of the company.

iii) **Unlimited Company:** A company having no limit on the liability of its members is an unlimited company [Section 2(92)]. Thus, in the case of an unlimited company, the liability of each member extends to the whole amount of the company's debts and liabilities. It may be seen that the liability of members of an unlimited company is similar to that of the partners but unlike the liability of partners, the members of the company cannot be directly proceeded against. Company being a separate legal entity, the claims can be enforced only against the company. Thus, creditors shall have to institute proceedings for winding-up of the company for their claims. But the official liquidator may call upon the members to discharge the debts and liabilities without limit.

An unlimited company may or may not have share capital.

Under Section 18, a company registered as an unlimited company may subsequently convert itself into a limited liability company. Any debt, liabilities, applications or contracts in regard to or entered into, by or on behalf of the unlimited company before such conversion shall not be affected by such conversion.

5.7.3 On the Basis of Control

Let us study the classification of companies on the basis of control, i.e., who effectively controls the affairs of the company. On this basis, the companies may be grouped as follows:

i) Holding and Subsidiary Companies

ii) Government Company

iii) Foreign Company

i) Holding and Subsidiary Companies

Generally speaking, if one company controls another company, the controlling company may be termed as the 'Holding company' and the company so controlled as a 'Subsidiary'.

According to Section 2 (87) "subsidiary company" or "subsidiary", in relation to any other company (that is to say the holding company), means a company in which the holding company-

i) controls the composition of the Board of Directors; or

ii) exercises or controls more than one-half of the total share capital* either at its own or together with one or more of its subsidiary companies:

A company (let's call it Company 'S') shall be deemed to be the subsidiary of another company (let's call it Company 'H') only in the following cases:

a) When the company (Company 'H') controls the composition of Board of Directors of other company (Company 'S').

b) When the Company 'H' holds more than half of the total share capital of Company 'S'. Again, where Company 'H' together with Company 'S' holds more than half of the total share capital of company 'Z', then company 'Z' will be subsidiary of Company 'H'.

c) When Company 'S' is a subsidiary of a Company 'T' which itself is a subsidiary of Company 'H'.

Only in any of the above cases, would the Company 'S' be deemed a subsidiary of Company 'H'.

As you have just learnt from the above discussion, a holding company is usually a very major shareholder of its subsidiary but both continue to enjoy separate legal entities in the eyes of the law. Unless there is a specific contract between the two companies, one cannot be said to be the agent of another. A subsidiary company also cannot be said to be a part of the holding company.

ii) Government Company

Section 2 (45) of the Companies Act, 2013 defines a Government company to mean any company (registered under the Companies Act) in which not less than 51% of the paid- up share capital is held by:-

i) the Central Government; or

ii) any State Government or Governments; or

iii) partly by the Government and partly by one or more State Governments

A subsidiary of a Government company shall also be treated as a Government company.

Engineers India Ltd. (EIL), BHEL, and Hindustan Aeronautics Ltd. (HAL), are examples of Government companies. A statutory corporation formed under special Act of Parliament or State Legislature, like Life Insurance Corporation of India, is not a 'company' under the Companies Act, 2013 and as such is not a Government companies. These are corporations as distinguished from Government Companies and are incorporated as well as governed by respective separate Acts.

* *As per Central Government Rules, "Total Share Capital", is defined to be aggregate of the paid-up equity share capital and paid-up preference share capital. (Rule No 1.2(1)(s)).*

A government company registered under this Act is not an agent of the government. It enjoys, like any other company registered under the Companies Act, an entity distinct from its members. Employees of such a company cannot be said to be the employees of the Government. Again, like any other company, it may be registered as a private company or a public company. Further, like any other company, it is governed by the provisions of the Companies Act 2013.

iii) Foreign Company

As per Section 2 (42) "foreign company" means any company or body corporate incorporated outside India which –

a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

b) conducts any business activity in India in any other manner.

However, *as per Section 386(C), having a share transfer office or share registration office will constitute a place of business*.

Section 380 requires the following documents to be filed with the Registrar of Companies within thirty days of the establishment of place of business in India by a foreign company:

a) a certified copy of the charter, statues or memorandum and articles, of the company or other instrument constituting or defining the constitution of the company and, if the instrument is not in the English language, a certified translation thereof in the English language;

b) the full address of the registered or principal office of the company;

c) a list of the directors and secretary of the company containing such particulars as may be prescribed;

d) the name and address or the names and addresses of one or more persons resident in India authorised to accept on behalf of the company any notices or other documents required to be served on the company;

e) the full address of the office of the company in India which is deemed to be its principal place of business in India;

f) particulars of opening and closing of a place of business in India on earlier occasion or occasions;

g) declaration that none of the directors of the company or the authorised representative in India has ever been convicted or debarred from formation of companies and management in India or abroad; and

h) any other information as may be prescribed.

Where any alteration is made or occurs in the documents delivered to the Registrar under this section, the foreign company shall, within thirty days of such alteration, deliver to the Registrar for registration, a return containing the particulars of the alteration in the prescribed form.

Again, as per Section 382, a foreign company is obliged to conspicuously exhibit on the outside of every office or place, where it carries on business in India as well as in every prospectus issued by it:

i) the name of the company,

ii) the country in which it is incorporated,

iii) the fact that liability of its members is limited.

The aforesaid should also be stated on all business letters, bill heads, letter paper, all notices and other official publications of the company in legible English and also in a language in general use in the locality in which the office or place is situated.

Section 381 requires that every foreign company (except a foreign company or such class of foreign companies which have been exempted by the Central Government) shall, in every calendar year,

a) make out a balance sheet and profit and loss account in such form, containing such particulars and including or having annexed or attached thereto such documents as may be prescribed; and

b) deliver a copy of those documents to the Registrar.

Provisions of Section 92 of the Act relating to the filing of the annual return with the Registrar of Companies are also applicable to a foreign company.

Check Your Progress B

1) What is meant by corporate veil?

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2) What is a statutory company?

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3) What is meant by a registered company?

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4) What is meant by a company limited by guarantee having share capital?

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5) What is a Government Company?

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6) Fill in the blanks:

a) An incorporated company can come into existence as a chartered company, as a statutory company and as …………………company.

b) In a company limited by guarantee, a member is required to pay the guaranteed sum only if the company is ……………………………………………………………………

c) A government company is one in which not less than …………………………………….. per cent of the paid up share capital is held by the Central Government.

d) A foreign company which establishes a place of business in India after the commencement of the Companies Act, 2013, shall deliver to the Registrar of Companies, necessary documents for registration within ……………….. days of establishing the place of business in India.

7) State, whether the following statements are true or false:

i) Once a company has been registered as an unlimited company, it cannot be converted into a limited company without dissolving the company.

ii) A Government company is not governed by the provisions of the Companies Act, 2013.

iii) In a Government company, company's paid up share capital can be held partly by the Central Government and partly by one or more State Governments.

iv) A foreign company may carry on business in India and carries on its business in a foreign company.

v) A foreign company is a company registered in India and carries on its business in a foreign company.

vi) In case of holding company and a subsidiary company both companies continue to enjoy separate legal status.

vii) A private company which is a subsidiary of a public company is a public company.

8) State which of the following alternative is correct:

a) A private company

i) must have at least 7 members, ii) cannot have more than 50 members iii) must prohibit any invitation to public to subscribe for its shares, iv) must file a statement in lieu of prospectus

5.8 OTHER KINDS OF REGISTERED COMPANIES

Other kinds of registered companies include:

i) Producer Company

ii) One Person Company

iii) Small Company

5.8.1 Producer Company*

Based on the recommendations of Dr. Alagh Committee, the following is the summary of important provisions relating to Producer Companies:

1) **Meaning of Producer Company:** A producer company means a body corporate engaged in any activity connected with or related to any primary produce. 'Primary *produce*' means *(i)* produce of farmers, arising from agriculture (including animal husbandary, bee farming, etc.); *OR (ii)* from any other primary activity which promotes the interest of farmers or consumers; *OR (iii)* produce of persons engaged in handloom, handicraft and other cottage industries; *OR* (iv) by-products or ancillary of the aforesaid activities.

2) **Minimum and Maximum Number of Members:** Any ten or more producers** who are individuals or any two or more producer institutions*** or a combination of ten or more individuals and producer institutions may form and incorporate a company as a Producer Company. However, no person, who has any business interest which is in conflict with business of the Producer Company, shall become a member of that Company.

There is no ceiling on maximum membership.

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* It may be noted that vide Section 465 of the Companies Act, 2013, producer companies shall continue to be governed by the existing provisions of the Companies Act, 1956 until a special Act is enacted.

** Producer means any person engaged in any activity connected with any primary produce.

*** Producer Institution means a producer company or any other institution having only producer(s)/ producer company(ies) as its members whether incorporated or not having any of the objectives referred to in section 581B and which agreed to make use of the series of the producer company(ies) as provided in its articles.

3) **Share Capital:** The share capital of a producer company shall consist of equity shares only.

4) **Transferability and Transmission of Shares:** Shares of a member of a producer company shall not be transferable except to an active member with the previous approval of the Board. Shares, if allowed to be transferred, shall be at par value only.

   However, in the event of death of a member, shares will be registered in the name of his nominee who must be a producer:

5) **Liability of Members:** Liability of members of a Producer Company shall be limited to the amount, if any, unpaid on the shares held by them.

6) **Promoters' Remuneration:** The Producer Company may, with the approval of its members at its first general meeting, reimburse to its promoters all direct costs associated with the promotion and registration of the company including registration, legal fees, printing of a memorandum and articles.

7) **Status of a Private Company:** On registration, the Producer Company shall become a body corporate as if it is a private limited company without, however, any limit to the number of members thereof and without use of the word private as part of its name. As per Section 581F, name of a producer company shall end with the words 'Producer Company Limited'.

8) **Voting Rights of Members**

   a) Where the membership consists (i) solely of individual members; or (ii) of individuals and producer institutions, the voting rights shall be based on a single vote for every Member, irrespective of his shareholding or patronage of the Producer Company.

   b) In a case the membership consists of Producer institutions only, the voting rights of such Producer institutions shall be determined on the basis of their participation in the business of the Producer Company in the previous year, as may be specified by Articles. However, during the first year of registration of a Producer Company, the voting rights shall be determined on the basis of the shareholding by such Producer institutions.

9) **Cessation of Membership:** Whereas, no person, who has any business interest which is in conflict with business of the Producer Company, shall become a member of that company, a member, who acquires any business interest which is in conflict with the business of the Producer Company, shall, cease to be a member of that company and be removed as a Member in accordance with articles. Again, a person will cease to be a member, where he ceases to be a primary producer. He will, however, be paid par value of his shares or any other value that may be determined by the Board.

10) **Benefits to Members**

    a) Members shall not receive full value of the produce pooled or supplied. 'Withheld price' shall be paid later in cash or equity shares, as per the decision of the Boards.

b) Every member shall receive a limited return on the capital contributed by the members.

c) Members may be allotted bonus shares.

d) Surplus, if any, after making (i) provision for limited return and reserves (as required under Section 581(ZI) (ii) providing for the development of the business of the Producer Company; (iii) providing for common facilities; may be distributed to members as bonus in proportion to their respective participation in business. This may be given in cash or by way of equity shares.

11) General Meetings:

i) **First AGM:** The first annual general meeting (AGM) of a producer company shall be held within 90 days of incorporation to discuss appointment of directors; and adoption of articles of association. *No extension of time is permissible.*

ii) **Subsequent AGMs:** Gap between two AGMs must not be more than 15 months. ROC may extend this period for a maximum period of 3 months.

iii) **Time and Place of AGM:** Provisions in this regards are same as applicable to other companies. Thus, AGMs should be held at the registered office, on a day which is not a public holiday and during business hours.

iv) **EGM (Extraordinary general Meeting):** An EGM shall be called by the directors on a requisition duly signed by 1/3rd or more of the members who are entitled to vote there at.

v) **Notice:** Notice of every general meeting shall be sent to (a) every member; and (b) the auditor.

vi) **Quorum:** Quorum for AGM shall be 1/4th of total number of members. Articles may however fix higher quorum. No requirement for quorum has been prescribed for EGM.

5.8.2 One Person Company (OPC)

Section 2 (62) of the Companies Act, 2013 defines 'One Person Company' to mean a company with only one person as its members. Section 3(1)(c) provides that a company may be formed for any lawful purpose by one person, where the company to be formed is to be One Person Company, that is to say, a private company by subscribing his name to a memorandum and complying with the requirements of the Act in respect of registration.

An OPC may be registered as 'limited by shares' or 'limited by guarantee'.

However, the memorandum of One Person Company shall indicate the name of the other person, with his prior written consent in the prescribed form (Form No. INC.3), who shall, in the event of the subscriber's death or his incapacity to contract become the member of the company and the written consent of such person shall also be filed with the Registrar at the time of incorporation of the One Person Company along with its memorandum and articles.

Such other person may withdraw his consent in such manner as may be prescribed. On the death of the promoter member of an OPC, the person nominated by such promoter member shall be the person recognised by the company as having title to all the shares of the member and shall be entitled to the same dividends and other rights and liabilities to which such sole promoter member of the company was entitled or liable.

The member of One Person Company may at any time change the name of such other person by giving notice and shall intimate the Registrar any such change within such time and in such manner as may be prescribed.

The works "One Person Company" shall be mentioned in brackets below the name of such company, wherever its name is printed, affixed or engraved.

Relaxations available to OPCs

Relaxations given to an OPC include:

i) There is no need to prepare a cash-flow statement [Section 2(40)].

ii) The annual return can be signed by the Director and not necessarily a Company Secretary (Section 92).

iii) There is no necessity for an Annual General Meeting (AGM) to be held (Section 96).

iv) Specific provisions related to general meetings and extraordinary general meetings would not apply (Sections 100 to 111).

v) Compliance can be said to have been done if the resolutions are entered in the minutes' book of the company (Section 122).

vi) It would suffice if one director signs the audited financial statements (Section 134).

vii) Financial statements can be filed within six months from the close of the financial year as against 30 days (Section 137).

viii) An OPC needs to hold only one meeting of the Board of Directors in each half of a calendar year and the gap between the two meetings should not be less than ninety days (Section 173).

Special Provisions applicable to OPCs

Where the OPC limited by shares or by guarantee enters into a contract with the sole member of the company who is also the director of the company, the company shall, unless the contract is in writing, ensure that the terms of the contract or offer are contained in a memorandum or are recorded in the minutes of the first meeting of the Board of Directors of the company held next after entering into contract (Section 193). This will not apply to contracts entered into by Company in the ordinary course of its business.

As per the Rules framed by the Central Government:

1) Only a natural person who is an Indian citizen and resident in India shall be eligible to incorporate a One Person Company or be appointed as a nominee for the sole member of a One Person Company. The term "resident in India" means a person who has stayed in India for a period of not less than 182 days during the immediately preceding 1 financial year **(Rule No. 3.1)**

2) No person shall be eligible to incorporate more than a One Person Company or become nominee in more than one such company *(Rule No. 3.2).*

3) No minor shall become member or nominee of the One Person Company or can hold share with beneficial interest (*Rule No. 3.4*).

4) Such Company cannot be incorporated or converted into a company under section 8 of the Act (*Rule No 3.5*) or carry out Non-Banking Financial Investment activities including investment in securities of any body corporate (*Rule No 3.6*).

5) Where the paid up share capital of a One Person Company exceeds 50 lakh rupees and its average annual turnover during the relevant period exceeds 2 crore rupees, it shall cease to be entitled to continue as a One Person Company. ***(Rule No 3.7). It may convert itself into a private or public company within a period of 6 months from the date its paid up capital exceeds Rs. 50 lakh and* turnover exceeds Rs. 2 crore (Rule No. 6).***

6) **Conversion of One Person Company into a private company or a public company:** One Person company can get itself converted into a Private or Public company after increasing the minimum number of members and directors to 2 or minimum of 7 members and 3 directors as the case may be, and by maintaining the minimum paid-up capital as per requirements of the Act for such class of company and by making due compliance of section 18 of the Act for conversion i.e. Conversion of companies already registered ***(Rule No 6).*** **However, such a company cannot convert voluntarily into any kind of company unless two years is expired form the date of its incorporation *(Rule No 3.7).***

5.8.3 Small Company

The concept of Small Company has also been introduced for the first time in the Companies Act, 2013. According to Section 2 (85) of the Companies Act, 2013, "small company" means a company, other than a public company:

i) paid-up share capital of which does not exceed fifty lakh rupees or such higher amount as may be prescribed which shall not be more than five crore rupees; and**

ii) turnover of which as per its last profit and loss account does not exceed two crore rupees or such higher amount as may be prescribed which shall not be more than twenty crore rupees:

However, the expression 'small company' small not include:

a) a holding company or a subsidiary company;

b) non-profit association (i.e., companies registered under Section 8 of the Companies Act, 2013);

c) a company or body corporate governed by any special Act.

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* The Word 'or' has been substituted by the word 'and' vide the Companies (incorporation) Amendment Rules 2015 date 1.5.2015

In such company there is no need to prepare cash flow statement, annual return can be signed by the Director or Secretary and to hold only one meeting in one half of calendar year and gap between two meetings should not be more than 90 days.

5.9 ASSOCIATION NOT FOR PROFIT

An "Association not for profit" is an association which is formed not for making profits but for the promotion of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of environment or any such other object (Section 8). Such an association may or may not be registered as a company under the Companies Act. When such an association is registered as a company with limited liability, it may be given a licence by the Central Government.

The Central Government may grant such a licence if it is proved to the satisfaction of the Central Government that a person** or an association of persons proposed to be registered under this Act as a limited company –

i) has in its objects the promotion of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of environment or any such other object;

ii) intends to apply its profits, if any, or other income in promoting its objects; and

iii) intends to prohibit payment of any dividend to its members.

When the above conditions are fulfilled, the Central Government may, by licence, direct that the person or association may be registered as a company with limited liability without the addition to its name of the word "Limited' or the words "Private Limited".

Examples of such companies are registered under Section 25 (now Section 8) include Mohan Bagan Club, Gymkhana Club, Delhi District Cricket Association (D.D.C.A) etc.

5.10 ILLEGALASSOCIATIONS

5.10.1 Meaning

Section 464 of the Companies Act, 2013 read along with Rule 10 of the Companies (Miscellaneous) Rules, 2014 provides that no association or partnership consisting of more than 50 persons shall be formed for the purpose of carrying on any business that has for its object the acquisition of gain by the association or partnership or by the individual members thereof, unless it is registered as a company under this Act or is formed under any other law for the time being in force. Thus, if such an association is formed and not registered under either the Companies Act or any other law, it will be regarded as an 'Illegal Association' although none of the objects for which it may have been formed is illegal.

** You may note that under Section 8, the use of the word 'person' appears to allow even a single person to form a company for the objects specifies. However, Rule 3 (5) of the Companies (Incorporation) Rules, 2014 categorically provides that One Person Company cannot be incorporated or converted or converted into a company under section 8 of the Act.

5.10.2 Exceptions

a) **A Hindu undivided family (HUF) carrying on any business,** that is, a joint Hindu family may carry on any business, even for earning profits and with any number of members without being registered or formed in pursuance of any India Laws as required by Section 464 of the act, and yet it will not be illegal association. But, where two joint Hindu families join hands to carry on business, the provisions of Section 464 become applicable. However, in such a case, in reckoning the numbers of such an association, the minor members shall be excluded. As regards adult members, both male and female members shall be taken into account.

b) **An association or partnership, if it is formed by professionals who are governed by special Acts.**

5.10.3 Consequences

Following are the effects of an association being illegal:

1) Every member of such an association or partnership carrying on business shall be punishable with fine which may extend to one lakh rupees.

2) Every member is personally liable for all liabilities incurred in the business.

3) Such an association cannot enter into any contract.

4) Such an association cannot sue any of its members or any outsider, not even if the association is subsequently registered as a company.

5) It cannot be sued by a member or an outsider for any debts due to him because it cannot contract any debt.

6) It cannot be wound-up even under the provisions relating to winding-up of unregistered companies.

7) Can a member sue for partition or dissolution or accounts of an illegal association? The question was brought before the High Court of Allahabad in **Mewa Ram v. Ram Gopal (1926).** It was held that where an association was illegal and the business had been carried for some years, none of its members could sue for partition because partition would involve realisation of the assets of the company and payment of its debts, the very things which would be done in a suit for dissolution of partnership or winding-up of a company. It should be noted that while an unregistered firm can be dissolved, an illegal association cannot be dissolved because law does not recognise its very existence.

8) The illegality of an illegal association cannot be cured by subsequent reduction in the number of its members **(Kumar Swami Chettiar v. M.S.M. Chinnathambi Chettiar).**

9) The profits made by an illegal association are, however, liable to assessment to income-tax **(Gopalji Co. v. CITA).**

Check Your Progress C

1) What is the difference between One Person Company and a Small Company?

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2) What is 'Illegal Association'?

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3) Fill in the blanks:

   a) An auditor for a government company is appointed by the ……………………..………..

   b) Under Section ……………………………… Of the Act, any association created not for profit may be exempted by the Central Government and be registered with limited liability without using the work 'limited' as its last word.

4) State, whether the following statements are true or false:

   i) A partnership firm can be a member of an association not for profit.

   ii) An illegal association has no independent personality.

5) State which of the following alternative is correct:

   b) An illegal association is

   (i) A partnership formed for illegal activities, ii) a partnership with more than 100 partners, iii) a partnership dissolved by a court of law, iv) an HUF with more than 100 members.

5.11 LET US SUM-UP

A 'Company' implies an association of persons for some common object or objects. A 'company' under the Act is defined to mean a "company formed and registered under the Companies Act, 2013 or under any of the previous Company laws".

A company is characterised by the following features: (1) It is an incorporated association registered under the Act. (2) On registration, it becomes a body corporate and thus acquires an entity distinct from the members constituting it. (3) Although, a company is recognised as a person enjoying the rights and obligations thereof, it is an artificial person and exists only in contemplation of law. (4) The liability of members of a limited liability company is limited to the extent of the amount unpaid on the shares held by him or the amount guaranteed by him. (5) A company being a distinct entity, the property of the company is also separate. Shareholders are not the part owners of the undertakings. A member does not even have an insurable interest in the property of the company (6) The shares of a company are movable property, transferable in the manner provided by the articles of the company. (7) A company being an artificial person cannot be incapacitate by illness or otherwise. Members may come and go but the company can go on forever. (8) A company has to work through the agency of human beings but it can be held bound by only those documents which bear its signatures – the common seal.

A company is an entity distinct from the members but is an artificial person. The persons who are engaged to manage its affairs may commit certain illegal acts or frauds in its name. It may, therefore, become necessary to identify and hold these individuals personally liable for their deeds. In other words, the veil of corporate personality may be pierced or lifted. The circumstances under which the corporate veil can be lifted are as follows:

a) Under Statutory Provisions

b) Under judiciary interpretation

A 'company' should, however, be distinguished from a 'body corporate'. The expression 'body corporate' is a wider expression than 'company'. 'Body corporate' includes, besides a 'company', a company incorporated outside India, public financial institutions, nationalised banks and any other association of persons declared as a body corporate by the Central Government.

A company is a person in the eyes of law. It also has a domicile and nationality. The courts have held that company is not a citizen and therefore cannot be said to have the fundamental rights expressly conferred upon citizens, only. However, those fundamental rights which are available to all persons, whether citizens or not, like the right to own property are available to the company.

Kinds of Companies: Companies may be classified into the following categories (i) Chartered companies; (ii) Statutory companies; and (iii) Registered Companies. A registered company may be either a company limited by shares or a company limited by guarantee or an unlimited company. Such company may, either be a private company or a public company. Foreign companies are those which are incorporated outside India, but have a place of business in India.

A company is deemed to be the holding company of another, if that other is its subsidiary. A company is deemed to be a subsidiary of another company only if:

i) the other company controls the composition of its board of directors;

ii) the other company holds more than half of the nominal value of its equity share capital; or

iii) it is subsidiary of any other company which, in turn, is the subsidiary of holding company

Producer companies are the companies in which any ten or more producers who are individuals or any two or more producer institutions may form and incorporate a company as a Producer Company.

One-person Company is a one shareholder corporate entity, where legal and financial liability is limited to the company only.

"Small Company" means a company, other than a public company (i) paid-up share capital of which does not exceed fifty lakh rupees; and (ii) turnover of which as per its last profit and loss account does not exceed two crore rupees.

An association or partnership which is formed with more than fifty persons according to Section 464, Companies Act 2013 must be regarded as an illegal association. However, a joint Hindu family carrying on a business, a stock exchange and associations not for profit-marking are not illegal associations. Every member of an illegal association shall be personally liable for all liabilities incurred in such business.

An association not for profit is an association which is formed not for making profit by for the promotion of commerce, art, science, sports, education, research, social welfare, religion, charity protection environment or any such other object.

5.12 KEY WORDS

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

Chartered Company: A company which is incorporated under a special Royal Charter granted by the King or Queen of England.

Statutory Company: A company which is created by a special Act of Parliament of State Legislature.

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

Company limited by guarantee: A company having the liability of its members limited to such an amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound-up.

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

Private Company: A Company in which (a) restricts the right of transfer of shares; (b) limits the number of its members to 200 (not including the present of past employee members); (c) prohibits any invitation to the public to subscribe for any shares or debentures of the company and (d) prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives. The minimum number of members required to form a private company is 2.

Public Company: A public company is one which is not a private company and is a private company but subsidiary of a public company. The minimum number of members required to form a public company is seven.

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

Perpetual Succession: Continued existence irrespective of the life or sanity of its members.

Foreign Company: A company incorporated outside India but having a place of business in India.

Corporate Veil: A line of demarcation or a veil is drawn between the company and its members.

Producer Company: A company formed by any ten or more individuals, each of them being a producer or any two or more producer institutions or a combination of ten or more individuals and producer institutions.

One person Company: One-person Company is a one shareholder corporate entity, where legal and financial liability is limited to the company only.

Small Company: Small Company means a company, other than a public company,

i) paid-up share capital of which does not exceed fifty lakh rupees; and

ii) turnover of which as per its last profit and loss account does not exceed two crore rupees.

5.13 ANSWERS TO CHECK YOUR PROGRESS

A) 3) i) True, ii) True; iii) False, iv) False;

v) True; vi) True

B) 6) a) registered

b) wound up

c) fifty one

d) 8

7) i) False; ii) False; iii) True; iv) True;

v) False; vi)True vii) True; viii) True; ix) True

8) a) (iii)

C) 6) a) fifty one Comptroller and Auditor General of India

c) thirty

7) i) True; ii) True

8) a) (ii)

5.14 QUESTIONS FOR PRACTICE

1) Company is an artificial person by law with a perpetual succession and is different from the members constituting it. Comment.

2) Describe the main characteristics of a company.

3) Discuss the concept of corporate veil. Under what circumstances, can this veil be lifted?

4) Distinguish between a company and a partnership.

5) Distinguish between 'company' and 'body corporate'.

6) Write a note on Government Company.

7) Briefly discuss different types of companies.

8) What is a foreign company? Describe special provisions relating to foreign company.

9) Define a holding company and a subsidiary company. When can a company be called a subsidiary of another company? Explain.

10) What do you mean by an illegal association? What are the consequences of forming such an association?

11) Briefly discuss 'One Person Company' and 'Small Company'

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

REFERENCES

Avtar Singh, *Company law*, Eastern Book Company, Delhi Sixteenth edition.

Kucchal M.C., *Modern Indian Company Law*, Shri Mahavir Book Depot, Delhi

UNIT 6 FORMATION OF A COMPANY

Structure

6.0 OBJECTIVES

After studying this Unit, you should be able to:

- describe the stages in the formation of a company;
- explain the meaning and importance of promoter
- describe the functions of a promoter
- enumerate the documents to the filed with the Registrar of Companies;
- discuss the effects of registration;
- explain the meaning of the certificate of incorporation;
- explain the meaning of company meeting.
- discuss the importance of company meeting.
- explain the various types of company meetings.
- explain the meaning of winding up a company;
- distinguish between winding up and dissolution; and
- list the grounds for compulsory winding up.

6.1 INTRODUCTION

In Unit 5 you learnt that a company is an artificial person created by law and has a distinct separate legal entity of its own. In this Unit, you will learn that before a company is actually formed, certain persons known as 'promoters' make a detailed investigation and, after satisfying themselves about the viability of the business, take certain steps to complete formalities and bring the company into existence; a process referred to as promotion. In this unit, you will also learn about the various stages involved in the formation of a company and the documents which are required to be filed with the Registrar of Companies. You will also learn about the importance of meetings, different types of meeting and as well about the winding up of a company.

6.3 STAGES IN THE FORMATION OF A COMPANY

The formation of a company is a lengthy process. It involves the following three stages:

1) Promotion
2) Registration or incorporation, and
3) Commencement of business

Each of the above stages comprises specific activities to be undertaken let us study each stage one by one.

6.3 PROMOTION

You learnt that a company is an artificial person created by law. A company is born only when it is duly incorporated. For incorporating a company various documents are to be prepared and other formalities are to be completed. All this work is done by promoters.

6.3.1 Promoter: Meaning and Importance

Gerstenberg has defined promotion *as the discovery of business opportunities and the subsequent organisation of funds, property and managerial ability into a business concern for the purpose of making profits therefrom.* After the idea is conceived, the promoters make detailed investigation to find out the weakness and strong points of the idea, determine the amount of capital required and estimate the operating expenses and probable income. On being satisfied about the economic viability of the idea, the promoters take all the necessary steps for incorporating the company.

According to **L. J. Bowen,** *the term promoter is a term not of law but of business, usefully summing up in a single word a number of business operations familiar to the commercial world by which a company is generally brought into existence.*

Justice C. Cockburn described a promoter as "one who undertakes to form company with reference to a given project and to set it going, and who takes the necessary steps to accomplish that purpose".

Section 2 (69) of the Companies Act, 2013 defines the term promoter as a person-

a) who has been named as such in a prospectus or is identified by the company in the annual return referred to in section 92; or

b) who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or

c) in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act.

However, a person who is merely in a professional capacity shall not be treated as a promoter. The following description of promoter brings out the nature of activities that a promoter is usually associated with. These are:

1) He undertakes to from a company and see it going.
2) He undertakes a number of operations necessary to form a company
3) He advices, directs and instructs the Board of Directors.
4) He has a control over the affairs of the Company, directly or indirectly.

A Company may have more than one promoter. The promoter may be individual, firm, an association of persons or a body corporate. Even if a person has taken a very minor part in the promotion activities, he may still be a promoter. But a person cannot be held as promoter merely because he is a signatory to the memorandum or that he has provided money for the payment of formation expenses or has worked in a professional capacity, for example, in preparation of the documents to be filled for the registration of the company or even securing certificate of incorporation of the company. Thus, a solicitor who drafts the articles, or the accountant who values assets of a business to be purchased are merely giving professional assistance to the promoter. However, where he goes further than this, *for example,* by introducing his clients to a person who may be interested in purchasing shares in the proposed company, he would be regarded as promoter. A person cannot, however, become a promoter merely because he signs the memorandum as a subscriber for one or more shares **[Official Liquidator v. Velu Mudaliar].**

From the above, it should be clear that *a promoter is one who performs the preliminary duties necessary to bring a company into existence.* Thus the true test to describe a person as a promoter lies in finding out whether he is keen to form a company and takes steps to give it a concrete shape.

The promoters, in fact, render very useful services in the formation of a company. They render a very useful service to society and they play an important role in the industrial development of a country. A promoter has been described as a creator of wealth and an economic prophet. The promoters carry considerable risk because if the idea goes wrong then the time and money spent by them will be a waste.

6.3.2 Functions of a Promoter

You learnt that a promoter plays a very important role in the formation of a company. You have also noted that a promoter may be an individual, an association or a company. In their capacity as promoters, they perform the following functions in order to incorporate a company and to set it going:

i) **To originate the scheme for formation of the company:** Promoters are generally the first persons who conceive the idea of business. They carry out the necessary investigation to find out whether the formation of company is possible and profitable. Thereafter, they organise the resources to convert the idea into a reality by forming a company. In this sense, the promoters are the originators of the plan for the formation of a company.

ii) **To secure the co-operation of the required number of persons willing to associate themselves with the project:** The promoters, in accordance with whether they want to incorporate a private or public company, try to secure the co-operation of persons needed to from the company. Minimum number of members required to form a public company is seven and that for a private company the minimum number is two. Depending upon the form chosen, the promoters may decide upon the number of primary members.

iii) **To seek and obtain the consent of the persons willing to act as first directors of the company:** You have learnt that the company has a system of representative management and is managed by individuals appointed as directors. The first directors of the company however, are either the promoters themselves or are appointed by them. The promoters seek the consent of some individuals whom they consider appropriate so that they agree to be the first directors of the proposed company. Many a time promoters themselves become the first directors of the company.

iv) **To settle about the name of the company:** The promoters have to seek the permission of the Registrar of Companies for selecting the name of the company. The promoters usually give three to four names in order of preference. The promoters should ensure that the names selected are not identical with or too closely resemble the name of another existing company. They should also ensure that the suggested names also conform to the draft rules and other guidelines issued by the Ministry of Corporate Affairs in this regard. We shall discuss the provisions with respect to the name of the company in detail in Unit 7.

v) **To get the documents of the proposed company prepared:** You will study that certain documents like the Memorandum of Association and the Article of association are required to be filled with the Registrar of Companies before the company is registered and brought into existence. As the company itself does not exist before incorporation, this work of preparation of these documents has to be undertaken by the promoters. The promoters, on the advice of legal experts get the Memorandum and Articles of Association prepared and arrange for their printing. In case the proposed company is a public limited company, intending to issue shares to the public after incorporation, the promoters must also arrange to get the prospectus prepared and printed.

vi) **To appoint bankers, brokers and legal advisers for the company:** The incorporation of a company involves a lot of legal formalities. The promoters may need to consult the legal experts on several of these matters. They, therefore, appoint solicitors to assists them in the process of formation of the company. The company is formed for the purpose of formation of the company. The company is formed for the purpose of carrying on business and as such deals with funds and their management. The promoters must, therefore, also appoint bankers for the company who will receive share application money. If the proposed company is a public limited company and proposes to raise funds from the public, the promoters must also ensure the success of the first capital issue made by the company by appointing underwriters and brokers.

vii) **To settle preliminary agreements for acquisition of assets:** The promoters may be required to acquire a suitable site for the factory, make arrangements for plant and machinery and may even make tentative arrangements for key personnel. Sometimes, in order to run the business, the company may be required to take over property of a running business. Promoters fulfill the function of seeing that such property and business is acquired by the proposed company on justifiable terms.

vii) **To enter into preliminary contracts with the vendors:** In respect of the properties and assets mentioned above, the promoters would need to settle the term of contracts with the third parties from whom these properties are to be bought. These contracts are called preliminary contracts.

ix) **To arrange for filing of the necessary documents with the Registrar:** The promoters are required to pay the stamp duty, filling fee and other charges for registration of the company. The promoters are to see that the various legal formalities for incorporating the company are duly complied with.

As mentioned above, many activities carried out by promoters to bring a company into existence. After discovery of the business idea and judging its soundness, the promoters organise the necessary resources for giving shape to their business idea. They negotiate for, and obtain the required property, the necessary plant and machinery and arrange for the capital necessary for the company. The promoters will also talk to persons who are willing to take the responsibility of becoming the first directors of the company.

It should be noted that a company can be formed only for a lawful purpose. The purpose of the company may be unlawful if it is:

a) Against any provisions of the company law, or

b) Against the provisions of any other law, applicable in India.

Promoters may form the company with limited liability or with unlimited liability. In case of a company with limited liability, the liability of members may be limited either by shares or by guarantee.

The promoters then obtain the approval of the proposed name from the Registrar of Companies. Application can now be made online also. Normally, the promoters are supposed to have about 3 to 4 proposed names, so that there is a possibility that at least one of these may be approved.

Section 4 of the Companies Act, 2013 provides that no company shall be registered by a name which is:

a) identical with or resemble too nearly to the name of an existing company registered under this Act or any previous company law; or

b) be such that its use by the company-

   i) will constitute an offence under any law for the time being in force; or

ii) is undesirable in the opinion of the Central Government.

You will study in detail about this aspect in Unit 7 dealing with Memorandum of Association.

Before an application for registration is filed with the Registrar of Companies, the promoters shall take the necessary steps for preparing the important documents such as 'memorandum of association' and 'articles of association'. For this the promoters may seek the help of a legal expert, a solicitor, chartered accountant, cost account, or a company secretary. These documents should be duly printed. The memorandum and articles have to be stamped and the value of the stamp differs from State to State as per the respective Study stamp laws.

Section 7 and the rules framed by the Central Government require that Memorandum and Articles of association of the company shall be signed by each subscriber to the memorandum, who shall add his name, address, description and occupation, if any, in the presence of at least one witness who shall attest the signature and shall likewise sign and add his name, address, description and occupation, if any. The witness shall also verify his/their ID. However, it is not necessary that the promoters themselves should sign the memorandum and articles.

The written consent of directors to act as such is also to be filed. The directors are required to give a written undertaking to take up and pay for their qualification shares, if any, prescribed in the Articles.

Besides, there shall be filed an affidavit from each of the subscribers to the memorandum and from persons named as the first directors, if any, in the articles that he is not convicted of any offence in connection with the promotion, formation or management of any company, or that he has not been found guilty of any fraud or misfeasance or of any breach of duty to any company under this Act or any previous company law during the preceding five years and that all the documents filed with the Registrar for registration of the company contain information that is correct and complete and true to the best of his knowledge and belief.

A statutory declaration to the effect that all the requirements of this Act and the rules made thereunder in respect of registration and matters precedent or incidental thereto have been complied with; is also to be field. The aforesaid declaration is to be signed by:

i) an advocate, a chartered accountant, cost accountant or company secretary in practice, who is engaged in the formation of the company, **and**

ii) a person named in the articles as a director, manager or secretary of the company

Besides these steps, depending upon the peculiar nature of the company and its objects, the promoters may be asked to comply with certain other requirements. These may include (i) obtaining the licence under the Industries (Development and Regulation) Act, 1951, (ii) obtaining clearance from the Ministry of Environment, (iii) entering into preliminary contracts, and (iv) preparing prospectus.

Check Your Progress A

1) What is meant by promotion of a Company?

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2) What are the functions of a Promoter?

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3) Fill in the blanks:

i) For formation of a company, the promoters have to pass through ………………………………… stages.

ii) The three stages for the formation of a company are promotion, …………………………… and the commencement of the business.

iii) Promotion of a company begins with the …………………………

iv) A company may be formed only for a ………………………….. purpose.

v) A company not having any limit on the liability of its members is known as an …………………………………….. company.

vi) In accordance with Section 5 of the Act, no company shall be registered by a name which is ……………………........... in the opinion of the ……………………

vii) The rules framed for the internal management of the affairs of the company are termed as ……………………………

viii) Before delivering the memorandum and articles to the Registrar for registration of the company, these documents will be …………………….. by the …………………… of the proposed company.

ix) The subscribers to the memorandum of association shall sign in the presence of at least one ………………………

6.4 DOCUMENTS TO BE FILED WITH THE REGISTRAR

After the promoters have got the necessary documents prepared, these are required to be filed with the Registrar of Companies. The documents that are necessary for the purpose of registration are as follows:

1) **Memorandum of Association:** The Memorandum of Association is the charter of the company. It needs to be originally prepared for every company. It defines the objectives for which the company is being formed. The memorandum by its clauses, describes the whole character of the company. This includes its objectives, its name, the nature of liability of its members, the State in which its registered office shall be located, the capital which the company is authorised to have. Besides, Memorandum must also state the names, addresses and other prescribed particulars of persons who subscribe their names to the memorandum of association.

   The memorandum defines the powers of a company and its relations with third parties.

   The memorandum of a company has to be in respective forms specified in Tables A,B, C,D, and E in Schedule 1 as may be applicable to such company.

   For purposes of registration, the promoters have to file with the Registrar of Companies, a duly signed and properly stamped printed Memorandum of Association.

   You should note that in case of a private company the memorandum of association should be signed by at least two persons in contrast to seven in case of a public company.

2) **Articles of Association:** The Articles of Association contain the rules and regulations for managing the internal affairs of the company and, therefore, govern the relationship between the company and its members. All companies are required to have articles of association. However, any company may adopt all or any of the regulations contained in the model articles applicable to the company. Model articles in relations to different kinds of companies are contained in Tables F, G, H, I and J in Schedule 1 to the Companies Act.

   In case of any company, which is registered under the Act, in so far as the registered articles of such company do not exclude or modify the regulations contained in the model articles applicable to such company, those regulations shall be deemed to be the regulations of that company.

   The articles of association should also be signed separately by subscribers and they should also be attested by a witness. Once again, note that in case of a private company the articles of association should be signed by at least two persons as against seven persons in case of a public company.

3) **Affidavit by subscribers to the memorandum and first directors:** There shall be filed an affidavit from each of the subscribers to the memorandum and from persons named as the first directors, if any, in the articles that he is not convicted of any offence in connection with the promotion, formation

or management of any company, or that he has not been found guilty of any fraud or misfeasance or of any beach of duty to any company under this Act or any previous company law during the preceding five years and that all the documents filed with the Registrar for registration of the company contain information that is correct and complete and true to the best of his knowledge and belief (Section 7(1)(c).

4) **A list of persons who have agreed to become the first directors of the company should also be filed:** There shall be filed the particulars of the persons mentioned in the articles as the first directors of the company, their names, including surnames or family names, the Director Identification Number, residential address, nationality and such other particulars including proof of identity as may be prescribed.

   Besides, the particulars of the interests of the persons mentioned in the articles as the first directors of the company in other firms or bodies corporate along with their consent to act as directors of the company in such form and manner as may be prescribed, must also be filed with the Registrar of Companies.

5) **Address for communication:** Address for communication till the company acquires its registered office shall also be supplied.

   However, company must, as per Section 12, acquire its registered office within 15 days of its incorporation for the purpose of receiving and acknowledging all communication and notices as may be addressed to it.

   Section 12 and the rules made in this regard also require the company to furnish to the Registrar verification of its registered office within a period of 30 days of its incorporation in the prescribed Form No. 2.25.

6) **Statutory declaration:** Lastly, the promoters must file a statutory declaration to the effect that all the requirements of this Act and the rules made thereunder in respect of registration and matters precedent or incidental thereto have been complied with.

   The aforesaid declaration is to be signed by:

   i) an advocate, or

   ii) a chartered accountant, or

   iii) cost accountant, or

   iv) company secretary,

   In practice and engaged in the formation of the company; **And by** a person named in the articles as a director, manager or secretary of the company.

Check Your Progress B

1) List any three documents which are required to be filed with the Registrar for the purpose of incorporation of the company.

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   ....

   ....

2) State, whether the following statements are true or false:

   i) The memorandum of association of a company defines the objectives for which a company is formed.

   ii) The articles of association govern the relationship between the company and third parties.

   iii) The relations between the company and its members are regulated by its articles of association.

   iv) For the registration of a private company it is necessary that the articles of association are filed with the Registrar.

   v) The list of directors of a company along with their written consent to act as such must be filed with Registrar.

6.5 INCORPORATION

When the necessary documents have been delivered to the Registrar and the requisite fees paid, the Registrar shall scrutinize these documents and if he is satisfied that (a) all the documents are in order; (b) all the requirements of the Companies Act in respect of registration have been complied with, and (c) the object for which the company is to be formed are lawful; he shall enter the name of the company in the Register of Companies maintained by his office. He would then issue a Certificate in the prescribed form, under his signature, certifying that the company is incorporated. This certificate is called Certificate of Incorporation. The Certificate contains the name of the company, the date of its issue, and the signature of the Registrar with his seal. Certificate of Incorporation constitutes the company's birth Certificate and the company becomes a body corporate, with perpetual succession and a common seal. The company comes into existence on the date given in the Certificate of Incorporation.

If the Registrar is of the view that there are some minor defects in any document, he may require that the defects be rectified. But, if there are some material and substantial defects, the Registrar may refuse to register the company.

Allotment of Corporate Identity Number (CIN): As per Section 7(3), on and from the date mentioned in the certificate of incorporation, the Registrar shall allot to the company a corporate identity number (CIN), which shall be a distinct identity for the company and which shall also be included in the certificate.

6.5.1 Conclusiveness of Certificate of Incorporation

A Certificate of incorporation given by the Registrar of Companies in respect of any association shall be conclusive evidence that all the requirements of Companies Act have been complied with in respect of its registration as well as matters precedent and incidental thereto. This is also known as rule in *Peel's* case.

In this case, the memorandum was found materially altered after the signatories had signed but before registration. It was held that the corporate status remained unaffected and the Certificate of incorporation was valid. Highlighting the necessity of this rule, Lord Cairns observed as follows:

"When once the memorandum is registered and the company holds out to the world as a company undertaking business, willing to receive shareholders and ready to contract engagements, then, it would be of most disastrous consequence if, after all that has been done, any person was allowed to go back and enter into an examination of the circumstances attending the original registration and the regularity of the execution of the documents."

As is clear from the above statement once the Registrar has issued the Certificate of incorporation, nothing further is to be inquired into and the validity of this Certificate cannot be disputed on any ground whatsoever. In ***Moosa Goolam Arif v. Ebrahim Goolam Arif,*** the memorandum of association of a public limited company was signed by two adult persons. Other five members of the company were minors. Their guardian made separate signatures for each of the minors. The Registrar registered the company and issued the Certificate of incorporation. The incorporation of the company was challenged and the plaintiff prayed that the Certificate of incorporation should be declared void. The Privy Council rejected the plea of the plaintiff and held that he Certificate of incorporation was valid.

The certificate of incorporation is also a conclusive proof of the fact that the company came into existence on the date mentioned in the Certificate. In the case of ***Jubilee Cotton Mills Ltd. V. Lewis,*** the company delivered the Registrar of Companies documents required for the registration of the company on 6th January. On 8th January, the Registrar registered the company and issued the Certificate of incorporation but dated it January 6. The company allotted few shares to Mr. Lewis on 6th January. The allotment was challenged and the court was requested to declare the allotment as void. The court held that the Certificate of incorporation is conclusive evidence of all that it contains. Hence, the company shall be deemed to have been formed on 6th January and allotment of shares was valid.

You should note that sub-sections (5), (6) and (7) of Section 7 make furnishing of any false or incorrect particulars of any information or suppression of any material information punishable with a minimum six months imprisonment which may extend up to ten years **and also** fine which shall not be less than the amount involved in the fraud but which may extend to three times the amount involved in the fraud.

Besides the aforesaid penalty, the Tribunal may, on an application made to it, and on being satisfied that the situation so warrants, -

a) pass such orders, as it may think fit, for regulation of the management of the company including changes, if any, in its memorandum and articles, in public interest or in the interest of the company and its members and creditors; or

b) direct that liability of the members shall be unlimited; or

c) direct removal of the name of the company form the register of companies; or

d) pass an order for the winding up of the company; or

e) pass such other orders as it may deem fit.

However, before making any order, as aforesaid, -

i) the company shall be given a reasonable opportunity of being heard in the matter; and

ii) the Tribunal shall take into consideration the transactions entered into by the company, including the obligations, if any, contracted or payment of any liability.

You should also note that the Certificate of incorporation is not the conclusive proof with respect to the legality of the objects of the company mentioned in the objects clause of the memorandum of association. As such, if a company has been registered whose objects are illegal, the incorporation does not validate the illegal objects. In such a case the only remedy available is to wind up the company.

6.5.2 Effects of Registration

You have just learnt that the Certificate issued by the Registrar of Companies is called the 'Certificate of incorporation'. This Certificate is a very important document for the company because the company begins its corporate life from the date of the Certificate.

On filling of documents like memorandum of association, articles of association, the declarations, etc., the Registrar shall issue a Certificate of Incorporation to the company. In this Certificate, he shall certify that the company has been incorporated. If the company is a limited company, the Registrar shall further certify that the company is a limited company.

From the date of incorporation i.e. the date mentioned in the Certificate of incorporation the company becomes a legal person distinct from its members. Section 9 describes the effects of registration in the following words:

"From the date of incorporation mentioned in the certificate of incorporation, such subscribes to the memorandum and all other persons, as may, from time to time, become members of the company, shall be a body corporate by the name contained in the memorandum, capable of exercising all the functions of an incorporated company under this Act and having perpetual succession and a common seal with power to acquire, hold and dispose of property, both movable and immovable, tangible and intangible, to contract and to sue and be sued, by the said name".

Thus, on incorporation, the following effects follow:

i) From the date of incorporation, the original subscribers to the memorandum as well as the other persons who may, from time to time, become members of the company, shall constitute a body corporate by the name contained in the memorandum of association. You would recall from Unit 5 that a company after incorporation becomes a body corporate distinct from its members. It becomes a legal person. The company's life starts from the date of its incorporation.

ii) The company acquires a perpetual succession. The consequences of it may be understood better by an example. If a company had ten shareholders and all of them die at the same time in a train accident, the company's existence will not be affected. In other words, we may say that the members may come and members may go, but the company goes on till it is wound up.

iii) The company can sue and be sued in its own name.

iv) Liability and debts of the company are not the liability of the shareholders/ members. They are, however, liable to contribute to the assets of the company, in the event of its being wound-up, to the extent of the amount remaining unpaid on the shares held by them or amount guaranteed, as the case may be.

v) The company will hold its property in its own name. The property of the company cannot be said to be the joint property of the shareholders.

vi) The memorandum and articles of association become binding on the members and the company. Articles are deemed to be a contract between the company and its members and would, after incorporation, govern the rights (a) of members against the company; (b) of company against the members, and (C) between members *inter se, i.e, amongst themselves*.

6.6 COMMENCEMENT OF BUSINESS

According to the Companies (Amendment) Act, 2015 w.e.f. 25.05.2015 all companies whether public or private can commence their business immediately after obtaining certificate of incorporation. Section 11 of the Companies Act 2013 has been omitted under which a company having share capital was required to obtain a certificate to commence business.

According to the Companies (Amendment) Act, 2017, a company may not commence business, unless it (i) files a declaration within 180 days of incorporation, confirming that every subscriber to the Memorandum of the company has paid the value of shares agreed to be taken by him, and (ii) files a verification of its registered office address with the Registrar of Companies within 30 days of incorporation. If a company fails to comply with these provisions and is found not to be carrying out any business, the name of the Company may be removed from the Register of Companies.

6.7 MEETINGS

The business of the company is carried on by the elected representatives, called as directors. The decisions are taken by the directors at the meeting of the Board. But they cannot take decision on all matters relating to the working of the company. There are certain matters which are to be decided by the general body of shareholders. For this purpose, the meetings of the shareholders are held wherein decisions are taken by shareholders by means of passing resolutions. The provisions of the Companies Act lay down the rules regarding the holding and conduct of such meetings.

6.7.2 Meaning of Meeting and its Importance

'Meeting' may generally be defined as the gathering, assembly or coming together of two or more persons for transacting any lawful business. For proper working of the company, it is necessary that the shareholders meet as often as possible and discuss matters of mutual interest and take important decisions. Meetings provide a place for fruitful participation where free and frank discussion takes place. The decisions taken at the meetings generally become acceptable and are met with least resistance.

To constitute a valid meeting there must be at least two persons, because a meeting cannot be constituted by one person. But there are certain circumstances where one person can constitute a valid meeting, they are:

a) Where one person holds all the shares of particular class, he alone can constitute a meeting of that class;

b) Where the meeting is called by an order of the Tribunal, the Tribunal may direct that one member of the company present in person or by proxy shall constitute a valid meeting.

Company meetings play a significant role in decision making process. They provide an opportunity to shareholders to review the working of the company and take policy decisions, thereby controlling the Board of Directors. The directors are duty-bound to follow the decisions taken at the general meeting of shareholders. Meetings constitute a very important aspect in the management and administration in the company form of organisation.

6.7.3 Kinds of Meetings

Company meetings can broadly be classified as follows:

1) **Meetings of shareholders:** Such meetings are also known as genral meetings of the members which are held to exercise their collective rights. The meetings of the shareholders may again be of the following three types:

   a) Annual General Meeting;

   b) Extraordinary General meeting; and

   c) Class Meeting.

2) **Meetings of Directors:** The directors are to act collectively in the form of a Board, and the decisions are taken at the meetings of the Board of directors. These meetings may again be of two types:

   a) Meetings of the Board of directors; and

   b) Meetings of the committee of directors.

3) **Other Meetings:** These meetings may be any of the following:

   a) Meetings of debenture-holders;

   b) Meetings of creditors; and

   c) Meetings of creditors and contributories on the winding up of the Company.

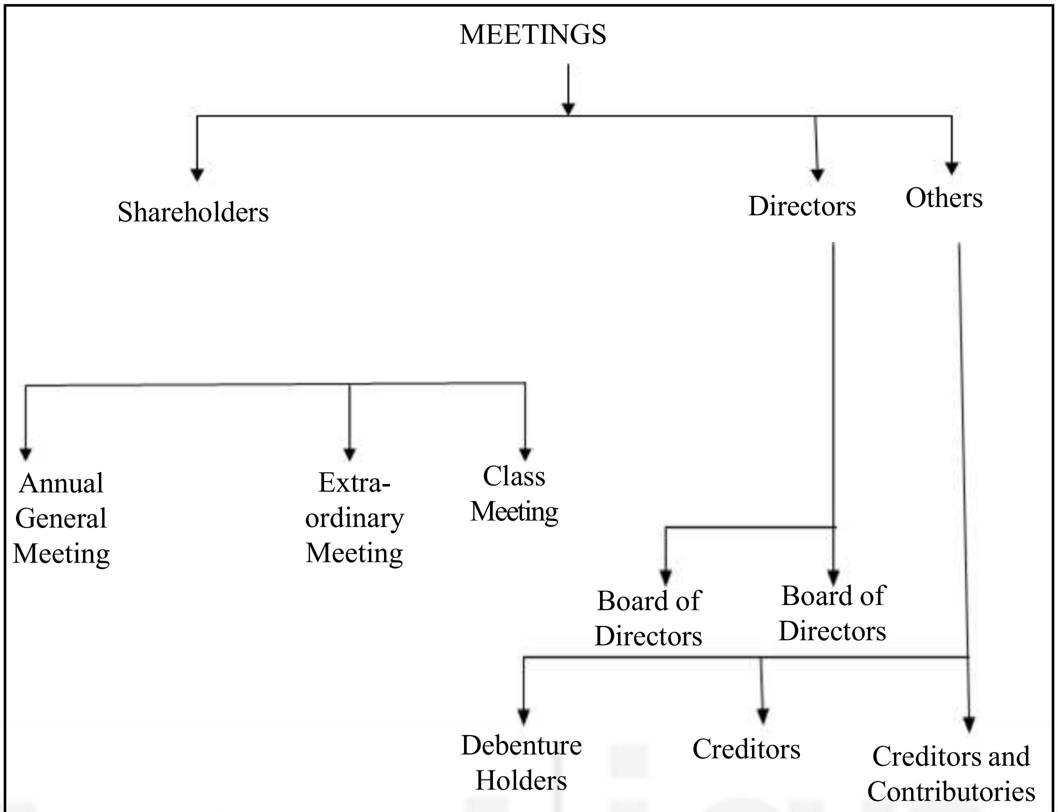

Figure 6.1: Types of Meetings

6.8 WINDING UP OF A COMPANY

A company is an artificial legal person created by law. Hence its life can be put to an end by the process of law.

The winding up is the process of putting an end to the life of the company. During this process the company ceases to carry on its normal business, the assets of the company are sold and the proceeds are utilised in paying off the debts and liabilities. If any surplus is left, it is paid back to the members in proportion to their contribution to the capital of the company. An administrator, called a liquidator, is appointed and he takes control of the company, collects its assets, pays its debts and distributes the surplus, if any, amount the members. Thus, with the winging up, a company ceases to be a going concern, all its operations come to a halt. You should note that the process of winding up begins only after the court passed the order for winding up, till such an order is passed there is no winding up.

Further, a company may be unable to pay its debts but it cannot be adjudicated insolvent as the law of insolvency does not apply to companies. Only individuals can be declared insolvent, not a body corporate. In such a case, a company can only be wound up.

Winding Up and Dissolution

Winding up and dissolution of the company are not the same thing. A company is not dissolved immediately on the commencement of winding up proceedings. Winding up is the prior stage and dissolution is the next, On dissolution, the name of the company is struck off by the Registrar from the Register of Companies i.e. it ceases to exist. While on winding up, the Company's name is not struck off from the register. The legal entity of a company remains even after the commencement of winding up and it can be sued in a court of law. Dissolution is the final stage of the Company's winding up process. But a company can be dissolved without winding up under certain circumstances such as when it merges with another company.

The main points of difference between winding up and dissolution are as follows:

i) In winding up the assets of the company are sold and the proceeds are utilised in paying off the debts and other liabilities of the company. It is the first stage of terminating the life of a company. While the dissolution is the next stage and after this the company ceases to exist.

ii) The winding up proceedings are carried out by a liquidator of the company while in case of dissolution no such proceedings are carried out.

iii) Creditors can prove their debts in the winding up but not in the dissolution of the company.

iv) In the cases of winding up it is not always necessary to obtain an order of the court because voluntary winding up may take place, but for dissolution of the company, the order of the court is essential.

It is clear from the above discussion that winding up and dissolution of a company is not the same thing. A company may be wound up in any one of the following two ways (Sec. 270(1), namely-

i) By the Tribunal making a winding up order (compulsory winding up);

ii) By passing of an appropriate resolution for voluntary winding up at a general meeting of members (voluntary winding up).

Check Your Progress C

1) What is meant by Certificate of incorporation?

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2) What are the effects of incorporation?

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3) What is winding up of a company?

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4) State, whether the following statements are true or false:

i) A company comes into existence from the date of incorporation, mentioned on the Certificate of incorporation.

ii) The Registrar issues the Certificate of incorporation under his signature.

iii) A Certificate of incorporation issued by a Registrar is conclusive evidence of the fact that all the requirements of Companies Act have been complied with in respect of registration.

iv) Only a public company acquires perpetual succession, after incorporation.

v) A company is entitled to commence business immediately after obtaining the Certificate of incorporation.

6.9 LET US SUM-UP

The incorporation of a company consists of three stages, viz., promotion, incorporation and commencement of business. In the promotion stage, the promoters of the company conceive the business idea and organize all the resources needed for forming the company. They also get the necessary documents prepared, printed and file them in the office of the Registrar of Companies, along with the prescribed fee for registration. On scrutiny of these documents, if the Registrar is satisfied that all the formalities prescribed by the Companies Act have been complied with, he issues to the company, under his signatures, a Certificate of Incorporation. From this date the company begins its corporate existence. A company is an artificial legal person and can be wound up a) by Tribunal making a winding up order and b) by passing an appropriate resolution for voluntary winding up at a general meeting of members.

6.10 KEY WORDS

Conclusive: Final, which does not require any other evidence.

Debenture: A document or certificate signed by the officer of a company acknowledging indebtedness for money lent and a guaranteeing repayment with interest.

Incorporated: Constituted as a body corporate legally authorised to act as a person.

Inter-se: Between or amongst themselves.

Promoter: Those who undertake the formation of a company.

Statutory declaration: A declaration made in compliance of a written law.

Winding up: A process by which the life of a company is put to an end

6.11 ANSWERS TO CHECK YOUR PROGRESS

A) 2) i) Three

ii) Incorporation

iii) Discovery of the business idea

iv) Lawful

v) Unlimited

vi) Undesirable, Central Government

vii) Articles of association

viii) Signed, subscribers or promoters

ix) Witness

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

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

6.12 QUESTIONS FOR PRACTICE

1) What are the different stages in the formation of a company? Discuss
2) List the documents that are required to be filed with the Registrar of Companies for the purposes of registration.
3) What do you mean by 'incorporation' of a company? What are the effects of registration of a company?
4) "The Certificate of incorporation is a conclusive proof that all the requirements of the Act in respect of formation of the company, have been complied with"? Explain.

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

REFERENCES

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UNIT 7 MEMORANDUM OF ASSOCIATION

Structure

7.0 OBJECTIVES

After studying this Unit, you should be able to:

- understand the meaning and purpose of Memorandum of Association;
- describe the different forms of Memorandum of Association relevant to different kinds of companies;
- list the different clauses of the Memorandum of Association;
- explain the doctrine of *ultra vires*; and
- describe the procedure for alteration of various clauses of Memorandum of Association.

7.1 INTRODUCTION

In the previous Units, you have learnt that company form of organisation offers certain distinctive advantages since limited liability and separation of management from ownership allows professionalism in handling large scale enterprises. Therefore, company form of organisation has become very popular particularly where huge funds are required. A company to be formed requires certain documents to be filed with the Registrar of Companies. The most important document to be filed is the memorandum of association. In this Unit, you will learn the meaning and purpose of the memorandum of association. You will also learn the contents of this document, different clauses and how these clauses can be altered.

7.2 MEANING AND PURPOSE OF MEMORANDUM

According to Section 2(56) of the Companies Act, 2013 "Memorandum" means "Memorandum of association of a company as originally framed or altered from time to time in pursuance of any previous company law or of this Act". This definition neither states the nature of this document nor is indicative of its importance. Therefore we study the definition of Memorandum of Association given by Jurists. ***According to Palmer,*** the memorandum of association is a document of great importance in relation to the proposed company. It contains the objects for which the company is formed and therefore identifies the possible scope of its operations beyond which its actions cannot go. It defines as well as confines the powers of the company. If anything is done beyond those powers, that will be *ultra vires* (beyond powers of) the company and so void.

In the famous case of **Ashbury Railway Carriage & Iron Co. Ltd. v. Riche (1875),** Lord Cairns observed:

"The Memorandum of Association of a company defines the limitation on the powers of the company … it contains in it both: that which is affirmative and that which is negative. It states affirmatively the ambit and extent of vitality and power which by law are given to the corporation and it states, if it is necessary to state, negatively, the nothing shall be done beyond that ambit …."

Thus, Memorandum of Association enables shareholders, creditors and all those who deal with the company to know what its powers are and what is the range of its activities. An intending shareholder can find out the purposes for which his money is going to be used by the company and what risk he is taking in making the investment. Likewise, anyone dealing with the company, say, the supplier of goods or money will know that the transaction he intends to make with the company is within the objects of the company and not *ultra vires* its objects. In short, Memorandum of Association is the constitution of a company. It is the edifice on which the structure of the company stands.

7.3 MEMORANDUM OF ASSOCIATION – WHETHER AN UNALTERABLE CHARTER

You have noted under **Para 7.2** that the Memorandum of Association not only defines the powers of the company but also confines them. A company cannot act beyond the powers given to it by the Memorandum. Any action outside the scope of Memorandum shall be void and inoperative. The purpose of the Memorandum is to enable the shareholders, creditors and those who deal with the company to know what its permitted range of activities is. It tells the shareholders the purposes for which their money is likely to be used.

Memorandum of Association is a document on the basis of which a company is formed. Therefore, it is but desirable that the clauses of this document should not be allowed to be changed frequently. It is for this purpose that the Companies Act has laid down elaborate rules for making alterations in the Memorandum, Section 13 of the Act provides that except the capital clause (which may be altered by passing an ordinary resolution), a company may, by a special resolution and after complying with the procedure specified in this section, alter the provisions of its memorandum, The provisions referred in section 13 relate to the name, registered office, objects, and liability clauses. These are deemed to be the conditions contained in the Memorandum. For making alterations in the name clause or shifting of the registered office from on State to another, it is necessary to obtain the approval of the Central Government. Again, for alteration of objects by a company which has raised money from public through prospectus and still has any unutilised amount out of the money so raised, shall not change its objects for which it raised the money through prospectus unless the dissenting shareholders have been given an opportunity to exit by the promoters and shareholders having control in accordance with regulations to be specified by the Securities and Exchange Board (SEBI)

Thus, we can state that though Memorandum of Association is the charter of the company, but it is not unalterable. The different clauses of this document can be altered by following the procedure laid down in the Act in this respect.

7.4 FORM OF MEMORANDUM

Section 4 (6) requires that the memorandum of a company shall be drawn up in such a form as is given in Tables A,B,C,D & E in Schedule 1 to the Act as may be applicable in the case of the company.

Sections 3 and 4 read with section 7 and the rules made thereunder require the memorandum to be signed by at least seven persons in case of a 'public company' (two in the case of 'private company' and only one person, in case of 'one person company') in the presence of at least one witness, who will attest the signature(s). Each of the subscribers must write opposite his name the number of shares he takes. The signatories to the Memorandum shall add their address, description and occupation. Similar particulars of the witness (es) should also be entered. Tables prescribe are:

Table A = Company Limited by Shares

Table B = Company Limited by Guarantee not having share capital

Table C = Company Limited by Guarantee having share capital

Table D = Unlimited Company and not having share capital

Table E = Unlimited Company and having share capital

You may note that the rules framed by the Central Government, in this regard further provide that the witness shall state that "I witness to subscriber/ subscriber(s) who has/have subscribed and signed in my presence (date and place to be given). Further I have verified his/their ID for their identification and satisfied myself of his/her/their identification particulars as filled in".

Where a subscriber to the memorandum is illiterate, he shall affix his thumb impression or mark which shall be describe as such by the person, writing for him, who shall place the name of the subscriber against or below the mark and authenticate it by his own signature. He shall also write against the name of the subscriber, the number of shares taken by him. Such person shall also read and explain the contents of the memorandum and articles of association to the subscriber and make an endorsement to that effect on the memorandum and articles of association.

Where the subscriber to the memorandum is a body corporate, the memorandum and articles of association shall be signed by directors, officer or employee of the body corporate duly authorised in this behalf by a resolution of the board of directors of the body corporate. Where the subscriber is a Limited Liability Partnership, it shall be signed by a partner of the Limited Liability Partnership, duly authorised by a resolution approved by all the partners of the Limited Liability Partnership, provided that in either case, the person so authorised shall not, at the same time, be a subscriber to the memorandum and Articles of Association.

For the first time detailed procedure has been provided in the rules for signing of the memorandum where subscriber to the memorandum is a foreign national residing outside India.

7.5 CONTENTS OF MEMORANDUM

Section 4 requires the memorandum of a company to contain the following:

a) the name of the company, with 'limited' or 'private limited' as the last word(s) of the name in the case of a public company or a private company, as the case may be. In case of one person company, Section 12 requires that the words 'One Person Company' must be mentioned in brackets below the name of the company; This does not apply to companies registered under section 8 (companies with charitable objects).

b) the name of the State, in which the registered office of the company is to be situated;

c) the objects for which the company is proposed to be incorporate and any matter considered necessary in furtherance thereof;

d) the liability of members of the company, whether limited or unlimited, and also state, -

    i) in the case of a company limited by shares, that liability of its members is limited to the amount unpaid, if any, on the shares held by them; and

    ii) in the case of a company limited by guarantee, the amount up to which each member undertakes to contribute-

        A) to the assets of the company in the event of its being wound-up while he is a member or within one year after he ceases to be a member, for payment of the debts and liabilities of the company or of such debts and liabilities as may have been contracted before he ceases to be a member, as the case may be; and

        B) to the costs, charges and expenses of winding-up and for adjustment of the rights of the contributories among themselves;

e) in the case of a company having a share capital-

    i) the amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount and the number of shares which the subscribers to the memorandum agree to subscribe which shall not be less than one share; and

    ii) the number of shares each subscriber to the memorandum intends to take, indicated opposite his name;

f) in the case of One Person Company, the name of the person who, in event of death of the subscriber, shall become the member of the company.

It may be noted that the memorandum of association of a company cannot contain anything contrary to the provisions of the Companies Act. If it does, the same shall be devoid of any legal effect (Section 6).

Now, let us discuss in detail, the various clauses of Memorandum of Association.

7.5.1 Name Clause [Sec. 4(1)(a)]

A company being a distinct legal entity must have a name of its own to establish its separate identity. The promoters are free to choose any suitable name for the company provided:

1) The last words(s) in the name of the company, if limited by shares or by guarantee is 'limited' or 'private limited', as the case may be. However, an "association not for profit", incorporated as a company and licensed by the Central Government, may not use the word 'limited' or 'private limited' as part of its name, even though the liability of its members is limited (Section 8).

2) The name stated in the memorandum is not-

    a) identical with or resembles too nearly to the name of an existing company registered under this Act or any previous company law; or

    b) such that its use by the company-

        i) will constitute an offence under any law for the time being in force; or

        ii) is undesirable in the opinion of the Central Government.

Further, a company shall not be registered with a name which contains-

a) any word or expression which is likely to give the impression that the company is in any way connected with, or having the patronage of, the Central Government, any State Government, or any local authority, corporation or body constitute by the Central Government or any State Government under any law for the time being in force. Thus, words like President, Prime Minister, Central, Municipal, Panchayat may not be allowed; or

b) such word or expression, as may be prescribed; unless the previous approval of the Central Government has been obtained from the use of any such word or expression.

Undesirable Names

Rule 2.4 framed by the Central Government under the Companies Act, 2013, in this regard, provides as follows:

- In determining whether a proposed name is identical with another, the differences on account of the following shall be disregarded. In other words, the proposed name cannot be merely different with respect to *inter alia*, the following:
  - the type and case of letters, spacing between letters and punctuation marks;
  - joining words together or separating the words;
  - using different phonetic spellings or spelling variations, for example, P.Q. Industries limited is existing then P and Q Industries or Pee Que Industries or P n Q Industries or P & Q Industries will not be allowed. Similarly if a name contains numeric character like 3, resemblance shall be checked with 'Three' also;
  - the addition of an internet related designation, such as .com, .net, .edu, .gov, .org, .in;
  - the addition of words like New, Modern, Nav, Shri, Sri, Shree, Sree, Om, Jai, Sai, The, etc;
  - different combination of the same words, e.g., if there is a company in existence by the name of "Builders and Contractors Limited", the name "Contractors and Builders Limited" will not be allowed unless it is change of name of existing company;
  - if the proposed name is the Hindi or English translation or transliteration of the name of an existing company or limited liability partnership in English or Hindi, as the case may be.
- Again, a name shall be considered undesirable if:-
  - it attracts the provisions of section 3 of the Emblems and Names (Prevention and Improper Use) Act, 1950;
  - it includes the name of a registered trade mark or a trade mark which is subject of an application for registration, unless the consent of the owner or applicant of registration, of the trade mark, as the case may be, has been obtained and produced by the promoters;
  - it includes any word or words which are offensive to any section of the people;
- A name shall also generally be considered undesirable if:-
  - the proposed name is identical with or too nearly resembles the name of a limited liability partnership;
  - the name reflects objects of the company and is not in consonance with the principal objects of the company as set out in the memorandum of association;
  - the company's main business is financing, leasing, chit fund, investments, securities or combination thereof, such name shall not be allowed unless the name is indicative of such related financial activities, viz., Chit Fund/Investment/Loan, etc.;

- it resembles closely the popular or abbreviated description of an existing company or limited liability partnership;
- the proposed name is identical with or too nearly resembles the name of a company or limited liability partnership incorporated outside India and reserved by such company or limited liability partnership with the Registrar:

But, if a foreign company is incorporating its subsidiary company in India, then the original name of the holding company as it is may be allowed with the addition of word India or name of any Indian state or city, if otherwise available;

- the proposed name implies association or connection with embassy or consulate or a foreign government;
- the proposed name includes or implies association or connection with or patronage of a national hero or any person held in high esteem or important personages who occupied or are occupying important positions in Government;
- the proposed name is vague or an abbreviated name such as 'ABC limited' or '23K limited' or 'DJMO' Ltd: abbreviated name based on the name of the promoters will not be allowed. For example:- BMCD Limited representing first alphabet of the names of the promoters like Bharat, Mahesh, Chandan and David.

An existing company may, however, use its abbreviated name as part of the name for formation of a new company as subsidiary or joint venture or associate company;

- the proposed name is identical to the name of a company dissolved as a result of liquidation proceeding and a period of two years have not elapsed from the date of such dissolution (since the dissolution of the company could be declared void within the period aforesaid by an order of the Tribunal under section 356 of the Act);
- it is identical with or too nearly resembles the name of a limited liability partnership in liquidation or the name of a limited liability partnership which is struck off up to a period of five years;
- the proposed name includes words such as 'Insurance', 'Bank', Stock Exchange', 'Venture Capital', 'Asset Management', 'Nidhi', Mutual fund' etc., unless a declaration is submitted by the applicant that the requirements mandated by the respective regulator, such as IRDA, RBI, SEBI, MCA, etc. have been complied with by the applicant;
- the proposed name includes the word "State", the same shall be allowed only in case the company is a government company;
- the proposed name is containing only the name of a continent, country, state, city such as Asia limited, Germany Limited, Haryana Limited, Mysore Limited;
- the name is only a general one, like Cotton Textile Mills Ltd, or Silk Manufacturing Ltd., and not Lakshmi Silk Manufacturing Co. Ltd;
- it is intended or likely to produce a misleading impression regarding the scope or scale of its activities which would be beyond the resources at its disposal:

- In case the key word used in the name proposed is the name of a person other than the name(s) of the promoters or their close blood relatives, 'No objection' from such other (s) shall be attached with the application for name.

Too similar names – In case of too similar names, the resemblance between the names must be such as is likely to deceive. A name is likely to deceive where it suggests some connection or association with an existing company.

Examples

In **Ewing v. Buttercup Margarine Co. Ltd. [1917]** the plaintiff who carried on business under the name of Butter Cup Dairy Co. succeeded in obtaining an injunction against the defendant on the ground that the public might think that the two businesses were connected since the word 'Buttercup' was an unnecessary and fancy one.

However, merely that few words are common may not render the name too identical and thus undesirable. Thus, in **Society of Motor Manufactures & Traders Limited v. Motor Manufactures & Traders Mutual Assurance Limited [1925],** the plaintiff company brought an action to restrain the defendant company from using the said name. But, Lawrence, J., held "anyone who took the trouble to think about the matter, would see that the defendant company was an Insurance company and that the plaintiff society was a trade protection society and I do not think that the defendant company is liable to have its business stopped unless it changes its name simply because a thoughtless person might unwarrantedly jump to the conclusion that it is connected with the plaintiff society".

Similarly, in **Asiatic Government Security Life Assurance Company Ltd. v. New Asiatic Insurance Company Limited [1939]**, the Court held the two names were not too identical and therefore, did not restrain the respondents.

Thus, whether a name is too similar or not and therefore it shall be allowed or not is question in each case, one of fact.

Publication of name (Sec. 12)

Sub-section (3) of Section 12 provides that every company shall-

a) paint or affix its name, and the address of its registered office, and keep the same painted or affixed, on the outside of every office or place in which its business is carried on, in a conspicuous position, in legible letters and in the language in general use in the locality. The words 'outside of every office' do not mean outside the premises in which the office is situated **– Dr. H. L. Batliwalla Sons & Company Ltd. v. Emperor [1941].** Where office is situated within a compound, the display outside the office room though inside the building is sufficient;

b) have its name engraved in legible characters on its seal;

c) get its name, address of its registered office and the Corporate Identity Number along with telephone number, fax number if any, e-mail and website addresses, if any, printed in all its business letters, billheads, letter papers and in all its notices and other official publications; and

d) have its name printed on hundies, promissory notes, bills of exchange and such other documents as may be prescribed.

However, where a company has changed its name or names during the last two years, it shall paint or affix or print, as the case may be, along with its name, the former name or names so changed during the last two years as required under clauses (a) and (c).

In case of 'one person company', the words "One Person Company" shall be mentioned in brackets below the name of such company, wherever its name is printed, affixed or engraved.

Penalty:

If a company does not paint or affix its name and the address of its registered office in the prescribed manner and if any default is made in complying with the requirements of this section, the company and every officer who is in default shall be liable to a penalty of one thousand rupees for every day during which the default continues but not exceeding one lakh rupees. [Section 12 (8))

7.5.2 Registered Office Clause {Sec. 4(1) (b)]

This clause states the name of the State in which the registered office of the company will be situated. Every company must have a registered office which establishes its domicile and is also the address at which the company's statutory books must normally be kept and to which notices and other communications can be sent. The Registrar of Companies, within 15 days from the date of incorporation (Section 12) (1).

The company must furnish to the Registrar verification of its registered office within a period of thirty days of its incorporation by filing any of the prescribed documents.

7.5.3 Objects Clause [Section 4(1) (c)]

The objects clause defines the objects of the company and indicates the sphere of its activities. As per Section 4 (1) (c), in this clause must be stated the objects for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof.

A company cannot do anything beyond or outside its objects and any act done beyond that will be *ultra vires* and void and cannot be ratified even by the assent of the whole body of shareholders. However, a company may do anything which is incidental to and consequential upon the objects specified and such act will not be an *ultra vires* act. Thus, a trading company has an implied power to borrow money and draw and accept bills of exchange.

The objects of the company must not be illegal, immoral or opposed to public policy or in contravention of the Act. For example, a public limited company cannot finance purchase of its own shares (Section 67 (2)).

7.5.4 Liability Clause [Sec. 4(1) (d)]

This clause states the nature of liability of the members **In the case of a limited liability company having share capital,** it must state that liability of members is limited to the amount unpaid on the shares. Thus, where a shareholder holding a 10 rupee share has paid of Rs.5 on it, he can be called upon to pay the balance of Rs.5. But if he has paid the full value of Rs. 10, he cannot be required to pay anything more even if the company owes huge debts to its creditors.

In the case of companies limited by guarantee, this clause will state the amount which every member undertakes to contribute to the assets of the company in the event of its being wound up.

In the case of unlimited liability company whether having share capital or not, this clause shall state that the liability of its members is unlimited.

7.5.5 Capital Clause [Sec. 4 (1) (e)]

This clause must indicate the amount of capital with which the company is registered and is known as Registered or Authorised or Nominal capital.

As per Sec. 4 (1) (e), in the case of a company having a share capital, the memorandum must state the amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount and the number of shares which the subscribers to the memorandum agree to subscribe which shall not be less than one share.

In the case of a public company having a share capital, a share may be either a Preference Share or an Equity share. Thus, a company's capital may be Preference share capital and Equity share capital. This clause shall state the number and value of shares into which the capital of the company is divided.

These shares are of a certain fixed or amount. This fixed value is known as the "Par" or "nominal" value of a share. Thus, the nominal value of an equity share may be, say, Rs. 10, and that of a preference share, say, Rs. 100.

The effect of this clause is that the company cannot issue more shares than stated under this clause without altering the Memorandum as per Section 61 of the Companies Act, 2013.

7.5.6 Association Clause of Subscription Clause [Sec. 4 (1) (e)]

At the end of the Memorandum of every company there is an association or subscription clause in which the subscribers to the Memorandum of Association make the following declaration:

"We, the several persons, whose names and addresses are subscribed, are desirous of being formed into a company in pursuance of this memorandum of association, and we respectively agree to take the number of shares in the capital of the company set against our respective names."

In case of 'one person company', the declaration made shall be as follows:

"I, whose name and address is given below, am desirous of forming a company in pursuance of this memorandum of association and agree to take all the shares in the capital of the company."

According to Section 3 of the Act, the Memorandum shall be signed by at least seven subscribers in case of a public company, at least two subscribers in case of a private company and one subscriber where the company to be formed is one person company.

The statutory requirements regarding subscription of memorandum are:

a) the memorandum must be signed by each subscriber in the presence of at least one witness who must attest the signature;

b) each subscribe must take at least one share;

c) each subscriber must write opposite his name the number of share he takes [Section 4 (1) (e)]

7.6 DOCTRINE OF *ULTRA VIRES*

The term '*Ultra*' means '*beyond*' and the term '*Vires*' means the '*powers*'. Thus, *ultra vires* a company means *'beyond the powers of a company*'. You have learnt that the objects clause of the Memorandum states the objects of the company, therefore, any act which is beyond the stated purposes in *ultra vires* the company and, therefore, null and void. The company shall not be bound by such acts which are *ultra vires* the company. The purpose of the doctrine of *ultra vires* is to protect the interest of members, outsiders and creditors. They are:

i) The members of the company know the purposes for which their money can be used by the company.

ii) The third parties dealing with the company know the purposes for which the company has been brought into existence and, therefore, restrict their transactions with the company to those purposes only. Similarly, the creditors are assured that the assets of the company shall not be risked in unauthorised business.

Thus, in order to protect the interests of the shareholders and the third parties which enter into contracts with the company, the company's activities are confined to the objects given in the Memorandum of Association. It cannot do anything beyond the objects clause and if it does, it will be considered *ultra vires* (beyond capacity) and void *ab-initio*.

Ultra vires acts can be divided into the following three categories:

1) *Ultra vires* the Companies Act,

2) *Ultra vires* the Memorandum of Association, and

3) *Ultra vires* the Articles of Association.

1) *Ultra vires* the Companies Act: Any act done contrary to or in excess of the scope of Companies Act will be *ultra vires* the Act. Such an act shall be void and cannot be ratified even by a unanimous resolution of all the shareholders. A few examples of such acts are as follows:

   a) Payments of dividend out of capital;

   b) Issue of bonus shares in lieu of dividend;

   c) Issuance of unauthorised capital;

   d) Reducing the share capital without complying with legal formalities.

2) *Ultra vires* the Memorandum of Association: The Memorandum defines and confines the powers of company. The object of the company is determined by the Memorandum. A company cannot do anything which is beyond the purview of the objects clause. Any act done in contravention of the object clause shall be *ultra vires* the Memorandum and shall be void and it cannot be ratified even by an unanimous resolution of all the shareholders. The doctrine of *ultra vires* was first applied in the famous case of **Ashbury Railway carriage and Iron Co. v. Riche.** In this case the company was incorporated to make, and sell, or lend on hire, railway carriages and wagons and to carry on the business of mechanical engineers and general contractors. The directors of the company entered into a contract with Riche, a firm of railway contractors to finance the construction of a railway line in Belgium. The contract was ratified by the company by passing a special resolution at a general meeting. Later, the contract was repudiated by the company on grounds of its being *ultra vires* and it was sued for breach of contract. The House of Lords held the contract was *ultra vires* the Memorandum and therefore void. It could not be ratified by the shareholders, as the contract was *ultra vires* the object clause.

The doctrine of *ultra vires* has been recognised in India as well. The doctrine has been affirmed by the Supreme Court in *A. L. Mudalir v. LIC of India.*

3) ***Ultra vires* the Articles of Association:** Acts which are *ultra vires* the articles of associations but are within the powers of the company are termed as *ultra vires* the articles. For example, payment of interest on 'advance calls' at a rate higher than allowed by the articles. Such act shall also be void, but the company in general meeting may alter the articles by a special resolution and ratify unauthorised acts

Effects of Ultra vires transactions:

1) **Void ab-initio**: An act which is *ultra vires* the company shall be null and void and it cannot be enforced against the company.

2) **No ratification:** An *ultra vires* the company transaction cannot be ratified even by the whole body of shareholders.

3) **Not enforceable:** Not only outsiders cannot enforce *ultra vires* transactions against the company, the company can also not enforce such transactions against third parties.

4) **Injunction:** Whenever an *ultra vires* act has been or its about to be done, any member of the company can approach the Court and get an injunction restraining the company from proceeding with the *ultra vires* acts.

5) **Personal liability of Directors:** The directors of the company can be held personally liable for any loss caused by an *ultra vires* transaction.

From the above it should be clear to you that if an act is *ultra vires* the company, then such act shall be null and void. Thus, if a company borrows money beyond its limit, it is *ultra vires* and the lender has no right in respect of the loan against the company.

You should note that if an act is *ultra vires* the directors, but it is within the powers of the company then such an act is not altogether void. It can be ratified by the shareholders in their general meeting and when it is so ratified, the company becomes liable for such acts. Now, if the company has power to borrow, but it restricts the authority of the directors to borrow upto a certain sum [Section 179

(4)], if the directors exceed their authority and borrow more than what they are authorised to borrow then the company may, if it wishes, ratify the directors' act, in which case the loan binds both the lender and the company as if it had been made with the company's authority in the first place.

Check Your Progress A

1) Mention the type of company against the Table in which its model form of Memorandum is given:

   Table A ....

   Table B ....

   Table C ....

   Table D ....

   Table E ....

2) Fill in the blanks.

   i) Memorandum of Association is to be signed by at least …………………….. persons in the case of a public company and by ……………………… persons in the case of a private company.

   ii) Every subscriber to the Memorandum has to take at least ………… share.

   iii) The purpose of the Memorandum of Association is to protect the interest of ……….. as well as outsiders.

3) State whether the following statements are True or False.

   i) Memorandum of Association limits the area of operation of a company.

   ii) The signatures of subscribers to the memorandum need not be witnessed.

   iii) Every company is not required to prepare and file its own Memorandum of Association at the time of incorporation.

   iv) Any act done by a company beyond its objects clause is ultra vires.

   v) In the case of a company limited by shares, a member is liable to pay only the unpaid amount on his shares.

   vi) In the case of a company limited by guarantee, a member can be called upon to pay the 'guarantee amount' at any time during the life time of the company.

7.7 ALTERATION OF DIFFERENT CLAUSES IN THE MEMORANDUM

Section 16 provides that the company cannot alter the conditions contained in memorandum except in the cases and in the mode and to the extent express provisions have been made in the Act. These provisions are explained herein below.

7.7.1 Change of Name

A) **Change of name at the instance of the company:** Section 13 provides that the name of a company may be changed at any time *by passing a special resolution* at a general meeting of the company and with the written approval of the Central Government. However, no approval of the Central Government is necessary if the change of name involves only the addition or deletion of the word "private" (i.e., when public company is converted into a private company or *vice versa*).

The company shall file with the Registrar:

a) The special resolution passed by the company; and

b) The approval of the Central Government.

When any change in the name of a company is made, as aforesaid, the Registrar shall enter the new name in the register of companies in place of the old name and issue a fresh certificate of incorporation in Form 2.27 with the new name and the change in the name shall be complete and effective only on the issue of such a certificate.

B) **Change of name on a direction from the Central Government:** If through inadvertence or otherwise, a company on its first registration or on its registration by a new name has been registered with a name which, in the opinion of the Central Government, is identical with or too closely resembles the name of an existing company, the company may change its name within a period of *three months* from the issue of such direction by passing an ordinary resolution and by obtaining the approval of the Central Government in writing [Sec. 16].

Again, the company may change its name by following the aforesaid procedure, where an application has been made to the Central Government by a registered proprietor of a trade mark within three years of incorporation or registration or change of name of the company and, in the opinion of the Central Government, the name is identical with or too nearly resembles a registered trade mark of such proprietor under the trade Marks Act, 1999. Where such a direction is made by the Central Government, the company shall change its name or new name, as the case may be, within a period of *six months* from the issue of such direction.

In cGMP Pharmaphan (P.) Ltd. v. Regional Director, Ministry of Corporate Affairs, [2011], NNE Pharmaplan (P) Ltd., filed a representation before Regional Director under section 22 (now Section 14) seeking a direction that petitioner-company incorporated on a later date with name cGMP Pharmaplan (P.) Ltd. should change its name. Regional Director concluded that use by petitioner of word "Pharmaplan" in its name would have a misleading effect in mind of general public and as such, it was a fit case for issue of direction under section 22(1) (b) [now Section 14] and directed petitioner to delete word 'Pharmaplan' from its existing name and change its name to some other name. The Delhi High Court held that since names of both companies structurally and phonetically too nearly resembled each other, Regional Director was right in directing petitioner to change its name.

As per Rule 2.25 framed by the Central Government, change of name shall not be allowed to a company which has defaulted in filing its Annual Returns or Financial Statements or any document due for filing with the Registrar or which has defaulted in repayment of matured deposits or debentures or interest on deposits or debentures.

You would have noted that the direction of the Central Government is required to be complied within a period of three or six months, as the case may be, from the date thereof.

If a company makes default in complying with any direction given under section 16 (1), the company shall be punishable with fine of one thousand rupees for every day during which the default continues and every officer who is in default shall be punishable with fine which shall not be less than five thousand rupees but which may extend to one lakh rupees [Section 16 (3)].

Where a company changes its name or obtains a new name under Section 16 (1), it shall within a period of *fifteen days* from the date of such change, give notice of the change to the Registrar along with the order of the Central Government, who shall carry out necessary changes in the certificate of incorporation and the memorandum.

The change of name becomes effective on the issue of fresh certificate of incorporation. The Registrar will also make the necessary alteration in the memorandum of association of the company.

Section 15 further requires that every alteration made in the memorandum or articles of a company shall be noted in every copy of the memorandum or articles, as the case may be.

In case of any default in this regard will make the company and every officer who is in default liable to a penalty of one thousand rupees for every copy of the memorandum or articles issued without such alteration.

C) Effect of change of name

i) The change of name shall not affect any rights/obligations of the company or render the same defective in legal proceedings by or against it. Moreover, any legal proceedings which might have been continued or commenced by or against the company by its former name may be continued by or against the company by its new name.

ii) However, if any legal proceeding is commenced, after change of name, against the company, in its old name, it is a case of mere misdescription and not a case of proceeding against a person not in existence. It is not an incurable defect and plaint can be amended to substitute the new name – **Pioneer Protective Glass Fibre (P.) Ltd. v. Fibre Glass Pilkington Ltd. [1986].**

iii) By change of name constitution of company does not change: **In Economic Investment Corporation Ltd. v. CIT [1970].** It was held that by change of name, the constitution of the company is not changed. The only thing that changes is its name; all the rights and obligations under the law of the old company pass to the new company. It is not similar to the reconstitution of a partnership, which in law means creation of a new legal entity altogether.

7.7.2 Change of Registered Office

This may include:

a) **Change of registered office from one premises to another premises in the same city, town or village [Sec. 12]** – A company can change its registered office from one place to another within the local limits of the city, town or village where it is situated, by passing a resolution of the Board of directors. However the company should inform the Registrar the new address within 15 days of the change who shall record the same.

b) **Change of Registered Office from one town or city or village to another town or city or village in the same State [Section 12]** – In this case the following procedure is to be followed:

   i) **Special resolution** – A special resolution is required to be passed at a general meeting of the shareholders.

   ii) **Confirmation of Regional Director –** Confirmation of the Regional Director is to be obtained where the change is from jurisdiction of one Registrar of Companies to the jurisdiction of another Registrar of Companies. The application to the Regional Director shall be made in Form INC – 23. The Regional Director shall communicate the confirmation within a period of thirty days from the date of receipt of application to the company.

   As per Rule 28 the shifting of registered office shall not be allowed if any inquiry, inspection or investigation has been initiated against the company or any prosecution is pending against the company under the Act.

   iii) **Copy of special resolution and confirmation by Regional Director to be filed with ROC –** A copy of the special resolution, as aforesaid, is to be filed with the Registrar within 30 days (Section 117). Copy of the confirmation by Regional Director shall be filed with the Registrar of Companies within 60 days of confirmation. The Registrar is required to register the same and certify the registration within 30 days from the date of filing of such confirmation (Section 12).

The certificate issued by the Registrar shall be conclusive evidence that all the requirements of this Act with respect to change of registered office have been complied with and the change shall take effect from the date of the certificate.

If any default is made in complying with any of the aforesaid requirements, the company and every officer who is in default shall be liable to a penalty of one thousand rupees for every day during which the default continues but not exceeding one lakh rupees.

c) **Change of Registered Office from on State to another State** – Section 13 contains provisions with respect to the shift of registered office from one

State to another, You should note that shift of registered office from one premises to another within the same city/town/village or even from one city to another but within the same State does not involve alteration of memorandum. It's because, in the memorandum only the name of the State where registered office shall be located is mentioned. Shift of registered office from one State to another will involve alteration of memorandum and, therefore, requires a more elaborate procedure to be followed. Registered office of a company can be shifted from one State to another by:

1) Passing special resolution;
2) Settlement of the list of creditors including debenture holders;
3) Obtaining the consent of the creditors and in case any creditor or creditors object, his debt or claim should be discharge or determined or secured to the satisfaction of the Central Government.
4) Obtaining confirmation from the Central Government.

Obtaining confirmation from the Central Government

For obtaining confirmation from the Central Government, Rule 30 of the Companies (Incorporation) Rules, 2014 provides that an application shall be filed with the Central Government in Form No. INC-23 along with the prescribed fee and specified documents.

The aforesaid information must, by way of an affidavit, be signed by the Company Secretary of the company, if any, and not less than two directors of the company, one of whom shall be a managing director.

Again, there shall also be attached to the application an affidavit from the directors of the company that no employee shall be retrenched as a consequence of shifting of the registered office from one State to another State.

There shall also be attached to the application a copy of the acknowledgment of service of a copy of the application with complete annexure to the Registrar and Chief Secretary of the State where the registered office is situated at time of filing the application.

The company must also keep a duly authenticated copy of the list of creditors at the registered office.

Where any objection of any person whose interest is likely to be affected by the proposed application has been received by the applicant, it shall serve a copy there of to the Central Government on or before the date of hearing.

Where no objection has been received from any of the parties, who have been duly served, the application may be put up for orders without hearing.

Order of Confirmation

Rule 30, read along with Section 13 (5) provides that before confirming the alteration, the Central Government shall ensure that, with respect to every creditor and debenture holder who, in the opinion of the Central government, is entitled to object to the alteration, and who signifies his objection in the manner directed by the Central government, either his consent to the alteration has been obtained or his debt or claim has been discharged or has determined, or has been secured to the satisfaction of the Central Government.

The Central Government may make an order confirming the alteration on such terms and conditions, if any, as it thinks fit, and may make such order as to costs as it thinks proper.

You may note that the shifting of registered office shall not be allowed if any inquiry, inspection or investigation has been initiated against the company or any prosecution is pending against the company under the Act.

Sub-section (5) of Section 13 provides that the Central Government shall dispose of the application under sub-section (4) within a period of sixty days.

Filling of order of the Central Government with the Registrar

Section 13 (7) read along with Rule 30 of **the Companies (Incorporation) Rules, 2014** requires a certified copy of the order of the Central Government approving the alteration to be filed by the company with the Registrar of each of the States within a period of 30 days, who shall register the same, and the Registrar of the State where the registered office is being shifted to, shall issue a fresh certificate of incorporation indicating the alteration.

7.7.3 Change in Objects Clause

Discussion on alteration of objects may be divided into:

1) Alteration of objects by a company which has not issued a prospectus
2) Alteration of objects by a company which has issued a prospectus

1) Alteration of objects by a company which has not issued a prospectus

A company which has not issued a prospectus may change its objects by passing a special resolution (Section 13 (1)).

2) Alteration of objects by a company which has issued a prospectus

Section 13 (8) read along with Rule 32 of the **Companies (Incorporation) Rules, 2014** provides that a company, which has raised money from public through prospectus and still has any unutilised amount out of the money so raised, shall not change its objects for which it raised the money through prospectus unless a special resolution through postal ballot is passed by the company.

Besides,

i) The notice in respect of the resolution for altering the objects shall contain the prescribe particulars including the unutilised amount out of the money so raised through prospectus, justification for the alteration/change in the objects, amount proposed to be utilised for the new objects.

ii) The advertisement giving details of each resolution to be passed for change in objects shall be published in the newspapers (one in English and one in vernacular language) which are in circulation at the place where the registered office of the company is situated.

iii) The advertisement shall be published simultaneously with the dispatch of postal ballot notices to shareholders.

iv) The notice shall also be placed on the website of the company, if any, indicating therein the justification for such change.

v) The dissenting shareholders shall be given an opportunity to exit by the promoters and shareholders having control in accordance with regulations to be specified by the Securities and Exchange Board.

vi) The Registrar shall register the alteration of the memorandum with respect to the objects of the company and certify the registration within a period of thirty days from the date of filing of the special resolution.

7.7.4 Change in Liability Clause

The Companies Act, 2013 or the Rules made there under do not contain any provisions with respect to the alteration of liability clause. However, since the relationship between a member and the company is a contractual relationship, the liability of a member of a company cannot be increased unless the member agrees in writing. The consent of the member may, however, be given either before or after the alteration. Increase in liability may be by way of subscribing for more shares than the number held by him at the date on which the alteration is made or in any other manner.

In case of unlimited liability company, the liability may be made limited or reduced by re-registration of the company (Section 18). The alteration will, however, not affect any debts, liabilities, obligations or contracts entered into by or with the company before the registration of the unlimited company as a limited company [Sec. 18 (3)].

7.7.5 Change in Capital Clause

Section 61 provides that, if the articles authorise, a company limited by share capital may, by an ordinary resolution passed in general meeting, alter the conditions of its memorandum in regard to capital so as:

1) to increase its authorised share capital by such amount as it thinks expedient;

2) to consolidate and divide all or any of its share capital into shares of larger amount than its existing shares e.g., 10 shares of Rs. 10 each may be consolidated into one share of Rs. 100 each;

3) to convert all or any of its fully paid-up shares into stock, and reconvert that stock into fully pad-up shares of any denomination;

4) to sub-divide its shares, or any of them, into shares of smaller amount than fixed by the memorandum, but the proportion of paid and unpaid on each share must remain the same;

5) to cancel shares which, at the date of the passing of the resolution in that behalf have not been taken or agreed to be taken by any person and thus diminish the amount of its share capital by the amount of the shares so cancelled.

Check Your Progress B

1) Fill in the-blanks.

   i) A company can shift its Registered Office to another State by passing a special resolution and with the permission of the ………………

   ii) The capital clause of Memorandum points out the ………………… capital of a company.

   iii) Capital clause can be altered by ………………….

   iv) Object clause can be altered by………………………..

2) Which of the following is correct:

   a) i) Memorandum of association is an unalterable charter.

      ii) Memorandum of association is an alterable charter.

      iii) Memorandum of association is not a charter.

   b) i) Authorised share capital of a company cannot be changed.

      ii) Authorised share capital of a company may be increased by passing an ordinary resolution.

      iii) Authorised share capital of a company may be increased by passing a special resolution.

      iv) Authorised share capital of a company may be increased by passing a special resolution and approval of the Central Government.

7.8 LET US SUM-UP

Memorandum of association of a company is a document of great importance. It defines as well as confines the powers of the company. Any act beyond the scope of the memorandum is *ultra vires* the company and thus unenforceable. Section 4 of the Companies Act, 2013 requires that the memorandum of a company must be drawn up in the form as given in Tables A,B,C,D & E in Schedule 1, as may be applicable in the case of a company. Further, Section 4 requires the memorandum of a limited company to contain information about its name (with 'limited' or 'private limited' as the last word(s), as the case may be); the name of the State in which registered office is to be situated; the objects with which the company is being registered; the liability being limited or unlimited; the amount of authorised share capital and its division into shares of fixed amounts. Memorandum of association has following clauses:

Name Clause: Promoters are free to choose any suitable name for the company provided: i) the last word/(s) is/are 'limited' or 'private limited', as the case may be (except in case of 'associations not for profit' if licensed by the Central Govt.); (ii) the name chosen is not undesirable. Central Govt. has framed certain rules in determining as to when a name may be considered undesirable.

Every company is required to paint or affix its name and address of its registered office outside of every office or place of business in a conspicuous position and in letters which are easily legible and in the language in general use in the locality.

Registered office clause: This clause sates the name of the State in which the registered office of the company will be situated. Registered office of a company establishes its domicile.

The Objects Clause: In this clause must be stated the objects for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof.

Any act beyond the objects stated in the memorandum is *ultra vires* the company and thus void.

Liability clause: This clause states the nature of liability of the members. In the case of a limited company, it must state that the liability of its members is limited by the amount remaining unpaid on the shares held by a member and in case of a guarantee company, by the amount guaranteed by him.

Association or Subscription Clause: At the end of the memorandum of every company there is an association or subscription clause. Each subscriber must write opposite his name the number of shares he undertakes to subscribe for.

Alteration of Memorandum: The contents of a memorandum can be altered only in the manner and to the extent provided in the Act.

Name of a company can be changed by passing a special resolution and obtaining the approval of the Central Government. However, approval of the Central Government is not necessary where in consequence of conversion of a private company into a public company or vice versa; the only change sought is deletion or addition of the word 'private'.

Where a company has been registered by an undesirable name, the Central Government may direct it to alter its name. In such a case, the company may change its name by passing an ordinary resolution and then obtaining confirmation of the Central Government for the new name.

Registered office of a company may be shifted from one premises to another premises by passing a resolution of the Board of directors and intimating the change to ROC within 15 days thereof. But, where the registered office is proposed to be shifted from one city to another city within the same state, special resolution at a general meeting of shareholders must be passed. However, if shift of registered office from one city/town, etc. to another but within the same state results in change of jurisdiction of one ROC to the other, approval of the Regional Director shall also be necessary. Copy of the confirmation by Regional Director shall be filed with the Registrar of Companies within 60 days of the date of confirmation. The registrar is required to register the same and certify the registration within 30 days from the date of filing of such confirmation. But, shifting of registered office from one state to another state requires passing of special resolution of shareholders as well as the approval of Central Government.

Alteration of objects by a company which has not issued a prospectus, may change its objects of passing a special resolution. But, if company has raised money through issue of prospectus and still has any unutilised amount out of the money so raised, shall not change its objects for which it raised the money through prospectus unless a special resolution through postal ballot is passed by the company.

Liability of a member cannot be increased unless the member agrees in writing.

Alteration of capital clause may involve increase of authorised capital of the company, or sub-division or consolidation of shares or cancellation of shares not taken or agreed to be taken by any person. Any of these changes can be done, as per Section 61, by passing an ordinary resolution in general meeting of shareholders.

7.9 KEY WORDS

Memorandum of Association: It is a fundamental document containing conditions on the bases of which a company is incorporated.

Limited Liability: It denotes that the liability of the members is limited by the amount remaining unpaid on their shares. In the case of a guarantee company, this phrase denotes the maximum amount up to which a member of a company can be called upon to pay at the time of winding up.

Par Value: A company limited by shares has a share capital which is divided into shares of a certain fixed value or amount. This fixed value amount is known as "Par Value".

Registered Office: The Registered Office of a company determines its domicile. Also, this is the office to which notices are served and communications are sent to the company.

***Ultra-Vires*:** Something which is beyond the powers of a company to do.

Unlimited Liability: The liability of the members of a company is termed as unlimited when their personal assets can be called to pay the liabilities of the company.

7.10 ANSWERS TO CHECK YOUR PROGRESS

A) 1) A A company limited by shares.

B) A company limited by guarantee and not having a share capital.

C) A company limited by guarantee and having a share capital.

D) An unlimited company and not having share capital.

E) An unlimited company and having share capital.

2) i) 7;2 ii)One iii)Members

3) i) True ii)False iii)False iv)True v)True vi)False

B) 1) i) Central Government

ii) Authorised/Registered/Nominal

iii) Passing an ordinary resolution at a general body meeting

iv) Passing a special resolution through postal ballot

2) a) (i) b) (ii)

7.11 QUESTIONS FOR PRACTICE

1) What do you understand by Memorandum of Association?

2) What is the purpose of Memorandum of Association?

3) Enumerate the different clauses which are included in the Memorandum of Association, and explain each of them.

4) Explain the Doctrine of *ultra vires* with suitable examples.

5) Describe the procedure for alteration of the objects clause of a company.

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

UNIT 8 ARTICLES OF ASSOCIATION

Structure

8.0 OBJECTIVES

After studying this Unit, you should be able to:

- explain the meaning and purpose of articles of association;
- describe the contents of articles of association;
- explain the procedure for alteration of articles of association;
- know the limitations on the power of the company to alter articles of associations;
- explain the relationship of and distinction between articles of association and memorandum;
- explain the legal effects of the memorandum and articles; and
- understand the doctrines of constructive notice and indoor management.

8.1 INTRODUCTION

You have learnt in earlier units that a company is an incorporated body. Therefore, rules have to be framed for the management of its internal affairs and the conduct of its business. The relationship between the company and the members constituting it is to be defined. The rights and duties of members vis-à-vis the company is to be described. All such rules and regulations are given in the articles of association. The Articles is the second important document which has to be filed with the Registrar of Companies.

\The Companies Act, 2013, in Tables F, G, H, I and J in Schedule I has given model regulations for the management of respective companies that may be formed under the Companies Act. As per the Companies Act, 2013, every company must have Articles of Association. However, a company has the freedom to adopt the applicable model Articles in whole or any of the regulations applicable to such company. In this Unit, you will learn about the significance of the Articles and its contents. You will also note the distinction between the Memorandum and the Articles. The procedure of altering the Articles has also been explained. You will also study the legal effects of these documents. The doctrines of Constructive Notice and Indoor Management have been explained in detail.

8.2 MEANING AND PURPOSE OF ARTICLES

The articles of association of a company are its bye-laws or rules and regulations that govern the management of its internal affairs and the conduct of its business.

According to Section 2(5) of the Companies Act, 2013 'Articles' means the articles of association of a company as originally framed or as altered from time to time in pursuance of any previous company law or of this Act".

The Articles regulate the internal management of the company. They define the powers of its officers. They also establish a contract between the company and the members and between the members *inter se*. This contract governs the ordinary rights and obligations incidental to membership in the company ***[Naresh Chandra Sanyal v. Calcutta Stock Exchange Association Ltd. (1971)]***.

Articles are like the partnership deed in a partnership. They set out provisions for the manner in which the company is to be administered. In particular, they provide for matters like the making of calls; forfeiture of shares; directors' qualifications; procedure for transfer and transmission of shares and debentures.

8.3 REGISTRATION OF ARTICLES

Documents to be filed for registration of a company include Articles of Association of the company. As per Section 5 of the Companies Act, 2013, the articles of a company shall be in respective forms specified in Tables, F,G,H,I and J in Schedule 1 as may be applicable to such company. You may note that Table F contains model articles for a company limited by shares. Table G, H, I and J contain model articles for a company limited by guarantee and not having a share capital, an unlimited company and having a share capital and an unlimited company but not having a share capital respectively.

A company may adopt all or any of the regulations contained in the model articles applicable to such company.

In case of any company, which is registered under the Companies Act, 2013, in so far as the registered articles of such company do not exclude or modify the regulations contained in the model articles applicable to such company, those regulations shall, so far as applicable, be the regulations of that company in the same manner and to the extent as if they were contained in the duly registered articles of the company. With respect to companies registered under any previous law, the existing articles may continue unless the company decides to change the same as per the model articles contained in the respective applicable table, as aforesaid.

Signing of the Articles of Association

As per Rule 13 of the Companies (Incorporation) Rules, 2014, the Memorandum and Articles of Association of the company shall be signed in the following manner.

- **Memorandum and articles of association of the company shall be signed by each subscriber to the memorandum,** who shall add his name, address description and occupation, if any, in the presence of at least one witness who shall attest the signature and shall likewise sign and add his name, address, description and occupation, if any.

  The witness shall state that "I witness to subscriber/subscriber(s) who has/ have subscribed and signed in my presence (date and place to be given). Further I have verified his/their ID for their identification and satisfied myself of his/her their identification particulars as filled in.

- ***Where a subscriber to the memorandum is illiterate,*** he shall affix his thumb impression or mark which shall be described as such by the person, writing for him, who shall place the name of the subscriber against or below the mark and authenticate it by his own signature. He shall also write against the name of the subscriber, the number of shares taken by him. Such person shall also read and explain the contents of the memorandum and articles of association to the subscriber and make an endorsement to that effect on the memorandum and articles of association.

- ***Where the subscriber to the memorandum is a body corporate,*** the memorandum and articles of association shall be signed by director, officer or employee of the body corporate duly authorised in this behalf by a resolution of the board of directors of the body corporate.

- ***Where the subscriber is a Limited Liability Partnership,*** it shall be signed by a partner of the Limited Liability Partnership, duly authorised by a resolution approved by all the partners of the Limited Liability Partnership.

- ***Where subscriber to the memorandum is a foreign national residing outside India,*** memorandum and articles of association shall be signed in the manner prescribe in the rules.

8.4 CONTENTS OF ARTICLES

You have learnt that the Articles of Association of a company contains the rules and regulations for the internal management of the company. As per Section 5 of the Companies Act, 2013, the articles shall also contain such matters, as may be prescribed. However, company may include such additional matters in its articles as may be considered necessary for its management.

Provisions for Entrenchment

For the first time Companies Act, 2013 contains provisions relating to entrenchment from Articles. Sub-section (3) of Section 5 provides that the articles may contain provisions for entrenchment. What it means is that Articles may provide that certain provisions of the Articles will not be alterable merely by passing a special resolution; they will require a more elaborate prescribed procedure to be followed.

The provisions for entrenchment referred to above shall only be made either on formation of a company, or by an amendment in the articles agreed to by all the members of the company in the case of a private company and by a special resolution in the case of a public company.

Where the articles contain provisions for entrenchment, whether made on formation or by amendment, the company shall give notice to the Registrar of such provisions in such form and manner as may be prescribed.

The Articles of Association of a company usually contain rules and regulations relating to the following matters:

i) The exclusion, wholly or in part, of the model articles as contained in respective Tables.

ii) Share capital- shares and their value and their division into equity and preference shares, if any.

iii) Rights of each class of shareholders and procedure for variation of their rights.

iv) Procedure relating to the allotment of shares, making of calls and forfeiture of shares.

v) Increase, alteration and reduction of share capital.

vi) Rules relating to transfer or transmission of shares and the procedure to be followed for the same.

vii) Lien of the company on shares allotted to the members for the amount unpaid in respect of such shares and the procedure in respect thereof.

viii) Appointment, remuneration, powers, duties etc. of the directors and officers of the company.

ix) Constitution and composition of Audit committee, Remuneration Committee, CRS Committee.

x) Procedure for conversion of shares into stock and vice versa.

xi) Notice of the meetings, voting rights of members, proxy, quorum, poll, etc.

xii) Audit of accounts, transfer of amount to reserves, declaration of dividend, etc.

xiii) Borrowing powers of the company and the mode of exercise of those powers.

xiv) Issue of share certificate including procedure for issue of duplicate shares.

xv) Issue of share certificate including procedure for issue of duplicate shares.

xvi) Winding up of the company.

The Articles of Association must be prepared carefully and it must contain rules in regards to all such matters which are required to be contained therein and which are necessary for the smooth functioning of the company.

But you must remember that the Articles must not contain anything which is against the provisions of the Companies Act or the Memorandum of Association. For example, Articles must not contain a rule permitting the payment of dividend out of example; Articles must not contain a rule permitting the payment of dividend out of capital, because according to Section 123, dividend can be paid only out of profits.

Regulations required in case of unlimited company, company limited by guarantee and private company limited by shares

Table G, H, I and J appended to Schedule 1 require the Articles of Association of a guarantee company having share capital and an unlimited liability company having share capital to mention the number of members with which the company proposes to be registered and in case of a guarantee company not having share capital and an unlimited liability company not having share capital, the Articles of Association should also state that the subscribers to the memorandum and such other persons as the Board shall admit to membership shall be members of the company.

A private company having a share capital must provide in the articles, the three restrictions specified in sub-clauses *(i), (ii)* and *(iii)* of sub-section (68) of Section 2, viz., *(i)* as to the right to transfer shares *(ii)* limit as to number of its members *(iii)* invitation to public to subscribe for any securities of the company. Any other private company (i.e., not having share capital) must provide in its articles, restrictions as given under *(i)* and *(ii)* as mentioned above.

8.5 ALTERATION OF ARTICLES

Section 14 provides that subject to the provisions of the Act and to the conditions contained in its memorandum; a company may, by special resolution alter its articles including alterations having the effect of conversion of-

a) A private company into a public company; or

b) A public company into a private company.

Where a private company alters its articles in such a manner that they no longer include the restrictions and limitations which are required to be included in the articles of a private company, that is, restrictions contained in Section 2 (68), the company shall, as from the date of such alteration, cease to be a private company.

In other words, a private company may convert itself into a public company by omitting the three restrictive clauses of Section 2 (68) [*Already discussed under definition of a private company in Unit 5*].

But, where alteration of the Articles shall have the effect of conversion of a public company into a private company, the same shall not take effect unless the approval of the Tribunal has been obtained. In other words, if a public company wants to convert itself into a private company by introducing the three restrictive clauses of Section 2 (68), merely passing of special resolution will not be sufficient; it will have to obtain the approval of the Tribunal also.

A copy of special resolution altering the articles must be filed with the Registrar within 30 days of the passing of the special resolution as required by section 117. The right to alter articles just by passing special resolution is so important that a company cannot, in any manner, deprive itself of this power – **Walker vs. London Tramway Company [1879].**

Sub-section (2) of Section 14 requires every alteration of the articles and a copy of the order of the Tribunal approving the alteration, where applicable, shall be filed with the Registrar, together with a printed copy of the altered articles, within a period of fifteen days in such manner as may be prescribed and the Registrar shall register the same.

Any alteration of the articles registered under sub-section (2) shall, subject to the provisions of this Act, be valid as if it were originally in the articles.

8.5.1 Limitation on Power to Alter Articles

You have noted that Section 14 of the Companies Act, 2013 allows companies to alter the articles of association of a company by passing special resolution and where alteration is to have the effect of converting a public company into a private company; the company shall have to obtain the approval of the Tribunal also besides passing special resolution. However, this right of the company to alter Articles is subject to certain limitation. These limitations include:

1) **Not to be inconsistent with Memorandum:** The alteration must not exceed the powers given by the memorandum or be in conflict with any provisions of the memorandum. In the event of conflict between the memorandum and the articles, it is the memorandum that will prevail.

2) **Not to be inconsistent with Companies Act or any other law:** The alteration must not be inconsistent with any provisions of the Companies Act or any other statute – for example, no public company can finance purchase of its own shares (Section 67) and if the articles of such a company are altered so as to have such a power then such power will be void.

   Similarly, where a resolution was passed expelling a member and authorising the director to register the transfer of his shares without an instrument of transfer, the resolution was held to be invalid as being against the provisions of the Act **[Madhava Ramachandra Kamath vs. Canara Banking Corporation [1941]]**

3) **Not be inconsistent with any alteration made by the Tribunal:** Where under Section 242, the Tribunal makes an order with respect to any alteration in the memorandum or articles of a company, then the company shall not have the power to make any alteration which is inconsistent with its orders except with approval of the Tribunal [Sec. 242 (5)].

4) **The altered articles must not include anything which is illegal or opposed to public policy or unlawful.**

5) **The alteration must be bonafide for the benefit of the company as a whole:** *It should not constitute a fraud on or oppress the minority.* The alteration will not, however, be bad merely because it inflicts hardship on an individual shareholder. In **Allen vs. Gold Reefs of West Africa Limited**

[1900], a company had a lien on all shares 'not fully paid-up' for calls due to the company. There was only one shareholder 'A', who owned fully paid-up shares. He also held partly paid shares in the company'. 'A' died. The company altered its articles by striking the words "fully paid up" and thus giving itself a lien on all shares – whether fully paid up or not. The legal representative of 'A' challenged the alteration on the ground that the alteration had retrospective effect. *Held that*, the alteration was good, as it was done *bona fide* for the benefit of the company as a whole, even though the alteration had a retrospective effect.

Again, in **Side Bottom vs. Kershaw Leese & Co. [1920],** a company was empowered by an alteration in the articles, to expropriate shares held by any member who was in business in competition with the company. At the time of alteration, there was only one member doing business in competition with the company. He challenged the alteration. *Held*, the alteration was valid being *bona fide* for the benefit of the company

6) **An alteration of articles of effect a conversion of a public company into a private company cannot be made without the approval of the Tribunal (Section 14).**

7) **A company cannot justify breach of contract with third parties or avoid a contractual liability by altering articles: In British Murac Syndicate Ltd. vs. Alperton Rubber Co. [1915],** an agreement provided that so long as the plaintiff syndicate should hold 5,000 shares in the defendant company, it should have the right of nominating two directors on the Board of the defendant company. A provision to the same effect was contained in 'Article 88' of the defendant company's articles. The plaintiff syndicate nominated two directors whom the defendant company refused to accept. An attempt was then made to cancel Article 88, but an injunction was granted to restrain it. The learned judge observed that the contract involved, as one of its terms that Article 88 was not to be altered.

   However, where the damage is capable of being measured in terms of money, the company may alter its articles, subject to payment of damages for breach.

8) **Retrospective operation of Articles:** The amended regulation in the articles of association cannot operate retrospectively, but only from the date of amendment **[Pyare Lal Sharma vs. Managing Director, J & K Industries Ltd. (1989)].**

8.5.2 Effect of Altered Articles

Alteration binds members in the same way as original articles. The provision of Section 10 providing that the articles shall bind the company and the members to the same extent as if they had been signed by the company and by each member, means the articles as originally framed, or as the may from time to time stand after they have been altered are valid under the provision of the Act. There is clear power to alter the articles, and as altered, they bind members just in the same way as did the original articles**. *(Malleson vs. National Insurance & Guarantee Corpn. [1894])*.**

Right of a shareholder to transfer his shares is always subject to provision in articles of association as well as Section 14. A transferee, therefore, cannot have a better right than the transferor. The rights of a transferee, until the transfer becomes effective, as against the company will again be subject to the provisions of the articles of association and the relevant provisions of the Act. The alteration affecting the articles of association in exercise of the said power cannot, therefore, be challenged by the transferee on the ground of being *mala fide* – **Mathrubumi Printing & Co. Ltd. v. Vardhaman Publishers Lt. [1992].**

8.6 RELATIONSHIP BETWEEN MEMORANDUM AND ARTICLES

The memorandum defines the company's objects and various powers it possesses; the articles determine how those objects shall be achieved and those powers exercised.

The articles of a company are subordinate and controlled by the memorandum of association which is the dominant instrument and constrains the general constitution of the company. The memorandum is fundamental and can be altered only under certain circumstances provided by the Act. But the articles are only internal regulations, over which the members of the company have full control and may alter them according to what they think fit. Care has to be taken to see that regulations provided for in the articles do not exceed the powers of the company as laid down by its memorandum – **Ashbury vs. Watson [1885]**. Articles going beyond the Memorandum are *ultra vires* – **Shyam Chand vs. Calcutta Stock Exchange [1947].**

Subject to the rule that the memorandum prevails in the event of a conflict, the memorandum and the articles are contemporaneous documents, must be read together, and ambiguity or uncertainty in the one may be removed by reference to the other. Thus, where the memorandum was silent as to whether the company's shares were to be all of one class or might be of different classes, it was held that a power given by the articles to issue shares of different classes resolved the uncertainty and enabled the company to do so **[Re, South Durham Brewery Company (1885)].** Where the memorandum of a trading company empowered to do all things incidental to achieving the object, it was held that provision in the articles empowering the company to lend money merely exemplifies the general words of the memorandum, and the company was, therefore, entitled to lend money to its employees **[Rainford vs. James Keith and Blackman Company Ltd. (1905)].** Again, where the memorandum empowered the company to borrow on the security of its assists or credit and the articles provided that it might mortgage its uncalled capital, it was held that the articles merely made specific the general words of the memorandum so that the company could have power to mortgage its uncalled capital **[Re Pyle Words (No. 2) (1891)].**

The relationship between memorandum and articles has been aptly summed up by Lord Cairns, L.C. in **Ashbury Railway Carriage & Iron Co. Ltd. vs. Riche [1875]** as follows:

"The articles play a part subsidiary to a memorandum of association. They accept the memorandum of association as a charter of incorporation of the company, and so accepting it, the articles proceed to define the duties, rights and powers of governing body as between themselves and the company at large, and the mode and form in which business of the company is to be carried on, and the mode and form in which changes in the internal regulations of the company may from time to time be made …. The memorandum is as it were …. The area beyond which the actions of the company cannot go; inside that area, the shareholders may make such regulations for their own government as they think fit."

8.7 DISTINCTION BETWEEN MEMORANDUM AND ARTICLES

The main points of distinction between memorandum and articles are following:

1) The memorandum contains the fundamental conditions upon which alone the company is allowed to be incorporate. They are conditions introduced for the benefit of the creditors, and the outside public, as well as the shareholders. The articles of association are the internal regulations of the company; they only regulate the relationship between company and the shareholders/members and amongst the members themselves.

2) Memorandum lays down the area beyond which the activities of the company cannot go. Articles provide for regulations inside that area. Thus, memorandum lays down the parameters for the articles.

3) Memorandum of association can be altered only under certain circumstances and in the manner provided in the Act. In most of the cases permission of the Central Government or Tribunal is required, besides the approval of the shareholders in a general body meeting either by way of an ordinary resolution or special resolution. Generally, articles can be altered by the members by passing a special resolution only.

4) Memorandum of association cannot include any clause contrary to the provisions of the Companies Act. The articles of association are subsidiary both to the Companies Act and the memorandum of association.

5) Acts done by a company beyond the scope of the memorandum are *ultra vires* and, thus, absolutely void. They cannot be ratified even by unanimous vote by all the shareholders. But the acts beyond the articles can be ratified by the shareholders provided the relevant provisions are not beyond the memorandum.

Check Your Progress A

1) Fill in the blanks.

   i) Articles of Associations are subsidiary to …………….

   ii) Articles of Association are the rules and regulations for the management of ………… ………… of the company.

2) State whether the following statements are True or False.

   i) Articles of Association regulate the relationship of the company with members.

   ii) Articles are the Charter of a company.

   iii) Every company is required to frame its own Articles of Association.

   iv) Articles of Association must be signed by subscribers to the Memorandum.

v) Articles of a company can contain matters inconsistent with the provisions of the Companies Act, 2013.

vi) Articles of Association are not required to be registered in case of a private company limited by shares.

8.8 BINDING EFFECT OF MEMORANDUM AND ARTICLES

Section 10 provides that the Memorandum and Articles, when registered, bind the company and its members to the same extent as if they had been signed by the company and by each member and contain covenants on its and his part to observe all the provisions of the Memorandum and of the Articles. Thus, the company is bound to the members; the members are bound to the company; and the members are bound to the other members by whatever is contained in these documents. But, in relation to Articles, neither a company nor its members are bound to outsiders.

The discussion on legal effect of the Memorandum and Articles may be made under the following heads:

a) Members bound to the company;

b) Company bound to the members;

c) Members bound to members;

a) Members Bound to the Company

Each member must observe the provisions of the Memorandum and Articles. Every member is bound by whatever is contained in the Memorandum and Articles.

In **Borland's Trustee vs. Steel Bros. Co. Ltd. [1901]** the articles of a company contained a clause that on the bankruptcy of a member, his shares should be sold to other person and at a price fixed by the directors. 'B', a shareholder was adjudicated bankrupt. His trustee in bankruptcy claimed that he was not bound by these provisions and should be at liberty to sell the shares at the market value. Held, that the trustee was bound by the articles, as a share was purchased by 'B' in terms of the articles.

Each member is not only bound by the covenants of memorandum and articles as originally framed but as altered from time to time in accordance with the provisions of the Companies Act.

b) Company Bound to Members

A company is bound to members by whatever is contained in its Memorandum and Articles of association. The company is bound not only to the "members as a body" but also to the individual members as to their individual rights. The members can restrain a company from spending money on *ultra vires* transaction. An individual member can make the company fulfill its obligation to him, such as to send the notice for the meetings, to allow him to cast his vote in the meeting.

In **Wood vs. Odessa Waterworks [1889],** the directors proposed to pay dividend in kind by issuing debentures. The articles provided for payment of dividends. The Court held that payment means payment in cash and therefore the company could be compelled to pay dividend in terms of the Articles.

c) **Members Bound to Members**

The Articles bind the members *inter se*, i.e., one to another as far as rights and duties arising out of the Articles are concerned.

It is well settled that the Articles of Association will have a contractual force between the company and its members as also between members *inter se* in relation to their rights as such members - **Ramakrishna Industries (P.) Ltd. vs. P.R. Ramakrishnan [1988].**

After the articles are registered, they not only constitute a contract between the association or company on the one hand and its constituent members on the other, but they also constitute a contract between the members *inter se*- **Shiv Omkar Maheshwari vs. Bansidhar Jagannath [1957].**

The Articles of a company provided that whenever any member wished to transfer his shares, he was under an obligation to inform the directors of his intention and the directors were under an obligation to take the said shares equally between them at a fair value. The directors refused to take shares of a particular member on the ground that the articles did not impose an enforceable liability upon them. *Held*, the directors were under an obligation to purchase the shares, as members of the company, in terms of the provision of the Articles. There was a personal liability of members *inter se* **[Rayfield v. Hand (1960)].**

However, Articles do not create an express contract among the members of the company. A member of a company has no right to bring a suit to enforce the Articles in his own name against any other member or members. It is the company alone which can sue the offender so as to protect the aggrieved member. It is in this way that the rights of members *inter se* are regulated.

A shareholder may, however, sue in his own name to restrain another, or others from doing fraudulent or *ultra vires* act. In **Jahangir R. Modi vs. Shamji Ladha [1866-67],** the Bombay High Court held: "a shareholder can maintain an action against the directors to compel them to restore to the company the funds of the company that have (by them) been employed in a transaction that they have no authority to enter into, without making the company a party to the suit".

Whether Company or Members Bound to the Outsiders

The Memorandum or Articles do not confer any contractual rights upon outsiders against the company or its members, even though the name of the outsider is mentioned in the Articles. An outsider (i.e., a non-member) cannot rely on Articles of Association for his action against the company.

The articles of a company provided that 'E' should be a solicitor for life to the company and should not be removed from office except for misconduct. Later on, he also became a member of the company. But, after employing him as a solicitor for a number of years, the company discontinued his services. He, being a member, sued the company for damages for breach of the contract contained in the Articles of Association. His case was dismissed on the ground that, he as a solicitor, was no party to the Article. He must prove a contract independent of the Articles. There was no infringement of his right as a member **[Eley vs. Positive Government Security Life Assurance Co. (1876)].**

Whether Directors are Bound by whatever is Contained in the Articles

The directors of a company derive their powers from the Articles and are subject to limitation, if any, applied on their powers by the Articles. If they contravene any provision of Articles, they render themselves liable to an action at the instance of the members. However, members may ratify the act of directors, if they so desire. But, if as a result of breach of duty, any loss has resulted to the company, the directors are liable to reimburse the company any loss so suffered.

8.9 CONSTRUCTIVE NOTICE OF MEMORANDUM AND ARTICLES

Section 399 provides that the Memorandum and Articles when registered with Registrar of Companies 'become public documents' and then they can be inspected by anyone by electronic means on payment of the prescribed fee. Again, Section 17 read along with **Rule 34 of the Company (Incorporation) Rules, 2014** provides that a company shall on payment of the prescribed fee send a copy of each of the following documents to a member within seven days of the request being made by him-

1) the memorandum;
2) the articles, if any;
3) every agreement and every resolution referred to in sub-section (1) of section 117, if and so far as they have not been embodied in the memorandum and articles.

Failure to supply the copy (ies), as above, will make the company as well as every officer in default liable to a fine @ Rs. 1,000 per day for each day of the default or Rs. 1,00,000, whichever is less.

Therefore, any person who contemplates entering into a contract with the company has the means of ascertaining and is thus presumed to know the powers of the company and the extent to which they have been delegated to the directors. *In other words*, every person dealing with the company is presumed to have read these documents and understood them in their true perspective. This type of presumed knowledge of these documents is termed as **"constructive notice of Memorandum and Articles of Association"**. Even if the party dealing with the company does not have actual notice of the contents of these documents it is presumed that he has an implied (constructive) notice of them. Where any charge or any property or assets of a company or any of its undertaking is registered under Section 77, any person acquiring such property, asset or undertaking or part thereof any share or interest therein shall be deemed to have notice of the charge from the date of such registration (section 80)

Example

One of the articles of a company provides that bill of exchange to be effective must be signed by two directors. A bill of exchange is signed only by one of the directors. The payee will not have a right to claim under the bill.

8.10 DOCTRINE OF INDOOR MANAGEMENT

The rule of constructive notice proved too inconvenient for business transactions, particularly where the directors or other officers of the company were empowered under the articles to exercise certain powers subject only to certain prior approvals or sanctions of the shareholders. Whether those sanctions and approvals had actually been obtained or not could not be ascertained because the investors, vendors, creditors and other outsiders could not dare ask the directors in so many words about those sanctions having been obtained or to produce the relevant resolutions. Quite naturally, suppose if you desire to buy a 'bond' or 'debenture' issued by company, you are not going to ask directors of the company to provide shareholders' resolutions authorising them to issue such bonds before you subscribe the same. Likewise, if a director approaches you to buy certain goods worth, say, a few thousands of rupees, you will not ask him for a power of attorney or other relevant document authorising him to make those purchases on behalf of the company.

And if you do, may be, you will lose a good customer once for all. Since there are no means to ascertain whether necessary sanctions and approvals have been obtained before a certain officer exercises his powers which, as per articles, can only be exercised subject to certain approvals, those dealing with the company can assume that if the directors or other officers are entering into those transactions, they would have obtained the necessary sanctions. This is known as the 'doctrine of indoor management' and was first laid down in the case of **Royal British Bank vs. Turquand [1856].**

The facts of ***Turquand's*** **case** were as follows:

The directors of a company were authorised by the articles to borrow on bonds such sums of money as authorised from time to time, by a resolution of the company in general meeting. The directors gave a bond to T without the authority of any such resolution. The question arose whether the company was liable on the bond. *Held*, the company was liable on the bond, as T was entitled to assume that the resolution of the company in general meeting had been passed.

You should note that the position would have been different if the sanction of general body of shareholders required was by way of special resolution. It's because all special resolutions are required to be registered with the ROC as per Section 117 and all those dealing with the company are deemed have knowledge of documents registered with ROC.

Thus, you would have observed from the foregoing discussion that the 'doctrine of constructive notice' throws a burden on people entering into contracts with a company by making a presumption that they would have read the company's memorandum and the articles even though they might not have actually read them. The 'doctrine of indoor management', on the other hand allows all those who deal with the company to assume that the provisions of the articles have been observed by the officers of the company. *In other words*, the persons dealing with the company are not bound to inquire into the regularity of internal proceedings.

Exceptions to the Doctrine of Indoor Management

The above noted 'doctrine of indoor management' is, however, subject to certain exceptions based on cases. In other words, relief on the ground of 'indoor management' cannot be claimed by an outsider dealing with the company in the following circumstances:

1) **Where the outsider had knowledge of irregularity** – The rule does not protect any person who has actual or even an implied notice of the lack of authority of the person acting on behalf of the company. Thus, a person knowing fully well that the directors do not have the authority to make the transaction but still enters into it cannot seek protection under the rule of indoor management.

   In **Howard vs. Patent Ivory Co**., the articles of a company empowered the directors to borrow up to one thousand pounds with the consent of the company in general meeting. Without such consent having been obtained, they borrowed 3,500 pounds from one of the directors who took debentures. The company refused to pay the amount. *Held*, the debentures were good to the extent of one thousand pounds only because the director had notice or was deemed to have the notice of the internal irregularity. Therefore the company was liable to them for £1000 only

2) **No knowledge of Articles** – Again, the rule cannot be invoked in favour of a person who did not consult the memorandum and articles and thus did not rely on them. In **Rama Corporation vs. Proved Tin & General Investment Co. [1952],** T was a director in the investment company. He, purporting to act on behalf of the company, entered into a contract with the Rama Corporation and took a cheque from the latter. The articles of the company (Proved Tin & General Investment) did provide that the directors could delegate their powers to one of them. But Rama Corporation people had never read the articles. Later, it was found that the directors of the company did not delegate their powers to T. Plaintiff (Rama Corporation) relied on the rule of indoor management. *Held*, they (Rama Corporation) could not, because they even did not know that power could be delegated.

3) ***Forgery* –** The rule of indoor management does not extend to transactions involving forgery or otherwise void or illegal *ab initio*. In the case of forgery it is not that there is absence of free consent but there is not consent at all. The person whose signatures have been forged is not even aware of the transaction and the question of his consent being free or otherwise does not arise. Since there is no consent at all there is no transaction. Consequently, it is not that the title of the person is defective but there is no title at all. Therefore, howsoever clever the forgery might be the person gets no rights at all. Thus, where the secretary of a company forged signatures of two of the directors required under the articles on a share certificate and issued certificate without authority, the applicants were refused registration as members of the company. The certificate was held to be a nullity and the holder of the certificate was not allowed to take advantage of the doctrine of indoor management – **Ruben vs. Great Fingal Consolidated [1906].**

4) ***Negligence* –** The 'doctrine of indoor management', in no way, rewards those who behave negligently. Thus, where an officer of a company does something which shall not ordinarily be within his powers, the person dealing with him must make proper enquiries and satisfy himself as to the officer's authority. If he fails to make an enquiry, he is stopped from relying on the Rule. In **Al Underwood vs. Bank of Liverpool [1924],** a person who was a

sole director and principal shareholder of a company paid into his own account cheques drawn in favour of the company. *Held*, that, the bank should have made inquiries as to the power of the director. The bank was put upon an enquiry and was accordingly not entitled to rely upon the ostensible authority of director.

Similarly, in **B. Anand Behari Lal vs. Dinshaw & Co. (Bankers) Ltd. [1942],** an accountant of a company transferred some property of a company in favour of Anand Behari. On an action brought by him for breach of contract, the Court held the transfer to be void. It was observed that the power of transferring immovable property of the company could not be considered within the apparent authority of an accountant.

5) ***Others*** *– Doctrine is also not applicable where a pre-condition is required to be fulfilled before company itself can exercise a particular power. In other words*, the act done is not merely *ultra vires* the directors/officers but *ultra vires* the company itself – **Pacific Coast Coal Mines vs. Arbuthnot [1917]**

Check Your Progress B

1) Fill in the blanks.

   i) Memorandum and Articles, when registered, bind a company and its …….

   ii) Every person dealing with a company is presumed to have notice of the contents of ……………

   iii) Any one dealing with the company is …………………. to assume that whatever was required to be done in the internal management of the company has been done.

2) State whether the following statements are True or False.

   i) Articles may explain any ambiguity included in the Memorandum.

   ii) Memorandum and Articles are deemed to contain terms upon which shares are sold by the company.

   iii) Any one dealing with the company is not entitled to assume that whatever was required to be done as regards internal management of the company has been done.

   iv) Articles of Association regulate the relations of company with its members.

   v) A person who could discover irregularity while dealing with a company cannot claim benefit of the doctrine of indoor management.

3) State which of the alternatives is correct in the following cases:

   i) Table F contains a model form of

      a) Regulations for management of a company limited by shares.

      b) Memorandum of a company limited by shares.

      c) Memorandum and Articles of Association of a company limited by guarantee and not having a share capital.

   ii) If the Articles conflict with the Memorandum

a) the Articles shall prevail.

b) the Memorandum shall prevail.

c) the directors will resolve the conflict.

d) the court will resolve the conflict

iii) The Articles of a company may be altered by

a) the directors.

b) any official of the company.

c) shareholders by passing an ordinary resolution.

d) shareholders by passing a special resolution.

8.11 LET US SUM-UP

The articles of association of a company are its bye-laws or rules and regulations that govern the management of its internal affairs and the conduct of its business. Articles define the powers of its officers. They also establish a contract between the company and the members and between members *inter se.*

In relation to 'memorandum', articles' occupy a position subordinate to 'Memorandum'. It is the memorandum that prevails in the event of a conflict between the two.

Articles contain provisions relating to matters like share capital of the company; rights of various shareholders; share certificates; lien on shares; calls on shares; transfer of shares; transmission of shares; conversion of shares into stock and *vice versa*; general meetings and proceedings thereat; directors including first directors, their appointment, qualifications, powers and proceedings of Board of directors' meetings.

Tables F, G, H, I and J to Schedule 1 give the model form of articles for various types of companies. A company may straightway adopt relevant model Articles.

As per Rule 13 of the Companies (Incorporation) Rules, 2014, the Articles of Association of the company shall be signed by each subscriber to the memorandum, who shall add his name, address, description and occupation, if any, in the presence of at least one witness who shall attest the signature and shall likewise sign and add his name, address, description and occupation, if any.

Articles may be altered by passing a special resolution of the shareholders. This power is, however, subject to certain limitations, namely, alteration must not be inconsistent with the provisions of the Companies Act, or any other statute; it must not include anything illegal or opposed to public policy, must be *bona fide* in the interest of the company as a whole; must not have the effect of converting a public company into a private company unless approval of the Tribunal has been obtained; should not result in breach of contract with third parties; the amendment should, generally, not be operative retrospectively. A valid alteration of articles binds members in the same way as original articles.

As per section 399, the memorandum and articles when registered with the Registrar become public documents and then they can be inspected by any one by electronic means on the payment of the prescribed fee. Since this facility of inspection has been made available to all those who deal with company, law presumes that they not only have knowledge of their contents but have also understood them. Thus, even if the party dealing with the company does not have actual notice of the contents of these documents, it is presumed that he has an implied notice of them. This is known as 'doctrine of constructive notice'.

However, the aforesaid rule of constructive notice has been held to be subject to the rule of indoor management. The 'rule of indoor management' was first laid down in the case of *Royal British Bank v. Turquand.* The 'rule of indoor management' offers protection to those dealing with the company through its officers who fail to follow the procedures prescribed under the articles before exercising those powers.

The persons dealing with the company are not bound to inquire into the regularity of internal proceedings.

However, the relief under 'indoor management' cannot be availed of by the directors who have the means of verifying the truth or those who did not read articles at all. Again, it is not available in case of forgery or even negligence.

8.12 KEY WORDS

Constructive Notice: Knowledge of the contents of documents on the part of those who are dealing with the company is presumed by law.

Inter se: Amongst themselves.

Public Document: Any document which is in possession of an officer of the government, and is open to inspection is known as a public document.

8.13 ANSWERS TO CHECK YOUR PROGRESS

A) 1) i) Memorandum of Association; ii) Internal Affairs

2) i) True; ii) False; iii) True; iv) True; v) False; vi) False;

B) 1) i) members ii) Memorandum and Articles of Association iii) entitled

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

3) i) a; ii) b; iii) d

8.14 QUESTIONS FOR PRACTICE

1) What are Articles of Association" How can they altered?

2) "The power of altering Articles of Association is wide, yet it is subject to a large number of limitations." Explain.

3) What are the usual contents of the Articles?

4) Explain the legal effect of the Articles of Association. How far they are binding on outsiders?

5) Explain briefly the relation between Memorandum and Articles of Association?

6) What is the distinction between a Memorandum and Articles of Association?

7) Explain the 'doctrine of indoor management'. Are there any exceptions to this doctrine?

8) Answer the following problems given reasons:

   i) The authorised signatory of a company issued a share certificate in favour of X, which apparently complied with the company's articles as it was purported to be signed by two directors and the secretary and it had the company's common seal affixed to it. In fact, the secretary had forged the signatures of the directors and affixed the seal without any authority. Will the certificate be binding upon the company?

   ii) The plaintiffs contracted with a director of the defendant company and gave him a cheque under the contract. The director could have been authorised under the company's articles, but was not in fact so authorised. The plaintiffs had not seen the Articles. The director misappropriated the cheque and the plaintiffs sued the company. Is the company liable?

   iii) Company 'A' lends money to Company 'B' on a mortgage of its assets and the procedure laid down in the articles was not complied with and the directors of the two companies were the same. Is the mortgage binding upon Company B?

   iv) A limited Company is formed with its Articles stating that one Mr. Anil shall be the solicitor for the company, and that he shall not be removed except on the ground of misconduct. Can the company remove Mr. Anil from the position even though he is not guilty of misconduct?

   v) A company, in which the directors hold majority of the shares, altered its Articles so as to give power to directors to require any shareholder, who competed with the company's business, to transfer his shares, at their full value, to any nominee of the directors. S had some shares in the company, and he was in competition with the company. Is S bound by the alteration?

Hints:

i) No; Forgery confers no protection, it is a nullity. Therefore, certificate is not binding on the company *(Refer to Ruben v. Great Final Consolidated Co. case).*

ii) No; the company is not liable. Once again, protection under indoor management cannot be claimed by those who have no knowledge of the Articles *(Refer to Rama Corporation v. Proved Tin and Investment Co. case)*

iii) No; the mortgage is not binding on company B. The directors had knowledge of the irregularity.

iv) Yes; the company can remove Mr. Anil because Articles of Association constitute no contract between the company and the outsiders (*Refer to Eley v. Positive Government Life Assurance Co. Ltd. case).*

v) Yes; S is bound by the alteration being in the interest of company as a whole *(Refer to the case of Side Bottom v. Kershaw Leese & Co.).*

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

UNIT 9 PROSPECTUS

Structure

9.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning and importance of prospectus;
- describe the contents of prospectus;
- explain the meanings of the deemed prospectus, shelf prospectus and information memorandum;
- understand the concept of minimum subscription;
- discuss the consequences of allotment of shares in fictitious name;
- describe the golden rule for framing of a prospectus; and
- explain the effects of misstatements in a prospectus and the remedies available.

9.1 INTRODUCTION

After incorporation of the company, the next step is to raise the necessary resources for carrying the business of the company. You have learnt that a private company is prohibited from inviting public to subscribe to its share capital. Thus, the need of inviting public to subscribe to the share capital arises only in the case of a public company. Even in case of a public company, if the directors are confident of arranging the required capital privately, they need not issue a prospectus. Generally, a public company raises its capital by issuing a prospectus. Besides, inviting the investors, the objective of issuing a prospectus is to inform them about the company's business, financial position, capital structure, future prospects, management, etc. In this unit; you will learn the meaning, need and importance of issuing a prospectus. You will also note contents of a prospectus, meaning of deemed prospectus, shelf prospectus and information memorandum. At the end, you will also know about golden rule for framing of a prospectus and allotment of shares in a fictitious name and also the various remedies available to an aggrieved investor in case prospectus contained misrepresentation.

9.2 MEANING AND IMPORTANCE OF A PROSPECTUS

A prospectus, as per Section 2(70), means any document described or issued as a prospectus and includes a red herring prospectus or shelf prospectus or any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate.

Thus, a prospectus is not merely an advertisement; it may be a circular or even a notice. A document shall be called a prospectus if it satisfies two things:

a) It invites subscription to, or purchase of, shares or debentures or any other security of a body corporate;

b) The aforesaid invitation is made to the public.

What constitutes an offer to the public?

As per Section 42 (4), an offer or invitation shall be deemed to be invitation to public, if it cannot be considered as private placement under sub-section (2) of Section 42. Explanation I to Section 42 (2) along with the rules framed thereunder provide that if a company, listed or unlisted, makes an offer to allot or invites subscription, or allots, or enters into an agreement to allot, securities to more than 200 persons in a financial year, whether the payment for the securities has been received or not or whether the company intends to list its securities or not on any recognised stock exchange in or outside India, the same shall be deemed to be an offer to the public. Thus, we may say that if any company invites subscription or allots any security to 200 or more persons *in a financial year*, it will be said to have made a public offer. However, while counting the aforesaid figure of 200 persons, the following shall not be taken into account:

1) Qualified institutional buyers;

2) Employees, who are offered securities under a scheme of employees stock option as per provisions of section 62 (1) (b).

To be a prospectus, it must be 'issued to the public'. Single private communication does not amount to issue to the public **[Nash v. Lynde (1929)].** In this case, several copies of a document marked "strictly confidential" and containing particulars of a proposed issue of shares, were sent by the managing director of a company to a co-director, who in turn sent a copy to a solicitor, who gave it to a client who, in turn, passed it on to a relation. Thus, a document was passed on privately through a small circle of friends of the directors. The House of Lords held that there had been no issue to the public.

Further, it may be noted that, as per the general law of contracts, an invitation shall not be an invitation to the public if it cannot be calculated to result, directly or indirectly, in the securities becoming available for subscription or purchase by persons other that those receiving the invitation, Thus, it will not be an invitation to public where 'B', a friend of 'A' who receives the invitation, also desires to subscribe, but his offer is refused because he was not invited to make the offer. On the other hand, it will become an invitation to public where his (B's) offer shall also be considered.

Again, the offering of shares to kith and kin of a director is not an invitation to the public to buy shares – **Rattan Singh vs. Managing Director, Moga Transport Co. Ltd. [1959].**

You must remember that a prospectus is not an offer by the company but it is only an invitation to offer. A company, by issuing a prospectus to the public, invites applications for the purchase of its shares, debentures or other securities. The persons who want to purchase share in the company would fill up the share application form and submit the same along with the share application money. This act of applicants amounts to making offers to the company to buy as many shares in the company as are mentioned in the share application forms. The Board of directors of the company will then make the allotment of shares in response to those share application forms. This act of Board of directors amounts to acceptance of the offer of the applicant to purchase shares. Thus, a contract between the applicant and the company is made with all the contractual rights and obligations.

Section 33 reads "(1) No form of application for the purchase of any of the securities of a Company shall be issued unless such form is accompanied by an ABRIDGED PROSPECTUS. However, abridged prospectus need not accompany an application form, if it is shown that the application form was issued:

a) in connection with a *bona fide* invitation to a person to enter into a contract of underwriting agreement with respect to such securities; or

b) in relation to securities which were not offered to the public.

2) A copy of the prospectus shall, on request being made by any person before closing of the subscription list and the offer, be furnished to him.

3) If a company makes any default in complying with the provisions of this section, it shall be liable to a penalty of fifty thousand rupees for each default.

According to Section 2 (1) an 'abridged prospectus' means a memorandum containing such salient features of a prospectus as may be prescribed by Securities and Exchange Board by making regulations in this behalf.

Note: The word memorandum here means a note, report or detailed statement and not memorandum of association.

9.3 CONTENTS OF A PROSPECTUS

As per the requirement of Section 26 of the Companies Act, 2013, contents of a prospectus shall comprise of:

i) Information to be given in a Prospectus

ii) Reports to be set out in Prospectus

iii) Declaration

iv) Other matters

9.3.1 Information to be Given in a Prospectus

Section 26 of the Companies Act, 2013 along with **Rule 3 of the Companies (Prospectus and Allotment of Securities) Rule, 2014** require a prospectus to state the following information namely:

i) names and addresses of the registered office of the company, company secretary, Chief Financial Officer, auditors, legal advisers, trustees, if any, the names, addresses and contact details of the corporate office of the issuer company, compliance officer of the issuer company, merchant bankers and co – managers to the issue, registrar to the issue, bankers to the issue, stock brokers to the issue, underwriters, credit rating agency for the issue, arrangers, if any, of the instrument, names and addresses of such other persons as may be specified by the Securities and Exchange Board in its regulations;

ii) dates of the opening and closing of the issue, and a declaration which shall be made by the Board or the Committee authorised by the Board in the prospectus that the allotment letters shall be issued or application money shall be refunded within fifteen days from the closure of the issue or such lesser time as may be specified by Securities and Exchange Board or else the application money shall be refunded to the applicants forthwith, failing which interest shall be due to be paid to the applicants at the rate of fifteen per cent annum for the delayed period;

iii) a statement by the Board of Directors about the separate bank account where all monies received out of the issue are to be transferred;

iv) disclosure of details of all monies including utilised and unutilised monies out of the previous issue in the prescribe manner;

v) details about underwriting of the issue including the names, addresses, telephone numbers, fax numbers and e-mail addresses of the underwriters and the amount underwritten by them;

vi) consent of the directors, auditors, bankers to the issue, trustees, solicitors or advocates, merchant bankers to the issue, registrar to the issue, lenders and experts;

vii) the authority for the issue and the details of the resolution passed therefor;

viii) procedure and time schedule for allotment and issue of securities;

ix) the capital structure of the company shall be presented in the following manner, namely:

i) a) the authorised, issued, subscribed and paid up capital (number of securities, description and aggregate nominal value);

b) the size of the present issue;

c) the paid up capital-

A) after the issue;

B) after conversion of convertible instruments (if applicable);

d) the share premium account (before and after the issue).

ii) the details of the existing share capital of the issuer company in a tabular form, indicating therein with regard to each allotment, the date of allotment, the number of shares allotted, the face value of the shares allotted, the price and the form of consideration.

x) The prospectus to be issued shall contain the following particulars, namely:-

a) main objects and present business of the company and its location;

b) the objects of the issue;

c) the purpose for which there is a requirement of funds;

d) the funding plan (means of finance);

e) the summary of the project appraisal report (if any);

f) the schedule of implementation of the project;

g) the interim use of funds, if any;

xi) particulars relating to:

a) management perception of risk factors specific to the project;

b) gestation period of the project;

c) extent of progress made in the project;

d) deadlines for completion of the project; and

e) any litigation or legal action pending or taken by a Government Department or a statutory body during the last five years immediately preceding the year of the issue of prospectus against the promoter of the company;

xii) minimum subscription, amount payable by way of premium, issue of shares otherwise than on cash;

xiii) details of directors including their appointments and remuneration, and such particulars of the nature and extent of their interests in the company, as may be prescribed; and

xiv) disclosures in such manner as may be prescribed about sources of promoter's contribution.

9.3.2 Reports to be Set out in the Prospectus

The prospectus shall set out the following reports for the purposes of the financial information, namely;

i) reports by the auditors of the company with respect to its profits and losses and assets and liabilities, amounts or rates of dividends, if any, paid by the issuer company in respect of each class of shares for each of the five financial years immediately preceding the year of issue of the prospects and such other matters as may be prescribed;

ii) reports made in the prescribed manner by the auditors upon the profits and losses for each of the five financial years immediately preceding the financial year of the issue of prospectus including such reports of its subsidiaries and in such manner as may be prescribed.

However, in case of a company with respect to which a period of five years has not elapsed from the date of incorporation, the prospectus shall set out in such manner as may be prescribed, the reports relating to profits and losses for each of the financial year immediately preceding the financial year of the issue of prospectus including such reports of its subsidiaries;

iii) reports made in the prescribed manner by the auditors upon the profits and losses of the business of the company for each of the five financial years immediately preceding the issue and assets and liabilities of the business on the last date to which the accounts of the business were made up, being a date not more that one hundred and eighty days before the issues of the prospectus:

Again, in case of a company with respect to which a period of five years has not elapsed from the date of incorporation, the prospectus shall set out in the prescribed manner, the reports made by the auditors upon the profits and losses of the business of the company for all financial years from the date of its incorporation, and assets and liabilities of its business on the last date before the issues of prospectus; and

iv) reports about the business or transactions to which the proceeds of the securities are to be applied directly or indirectly;

9.3.3 Declaration

There shall be included a declaration about the compliance of the provisions of this Act and a statement to the effect that nothing in the prospectus is contrary to the provisions of this Act, the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992 and the rules and regulations made there under.

9.3.4 Other Matters

Prospectus shall also such other matters and set out such other reports, as may be prescribed.

Further, SEBI Regulations, 2009 stipulate very elaborate disclosure requirements in relation to offer documents. Companies are required to comply with the same.

Statement of an Expert included in a Prospectus

A prospectus may contain a statement purporting to be made by an expert. The term "expert" includes an engineer, a valuer, a chartered accountant, a company secretary, a cost accountant and any other person who has the power to issue a certificate in pursuance of any law. The reports from and expert will be included in a prospectus if

i) such an expert is a person who is not and has not been engaged or interested in the formation or promotion or management of the company,

ii) he gives his written consent to the issue of the prospectus and had not withdrawn the consent until the prospectus is delivered to the Registrar for registration,

iii) a statement that he has given and not withdrawn his consent thereto is included in the prospectus.

Exemptions

The aforesaid requirements of Section 26, that is, with respect to the contents do not apply to:

a) ***Rights Issue, i.e.***, the issue to existing members or debenture-holders of a company, of a prospectus or form of application relating to shares in or debentures of the company, whether an applicant has a right to renounce the shares in favour of any other person or not.

b) ***Shares/Debentures Uniform in all respects:*** The provisions of Section 26 do not apply to the issue of a prospectus or form of application relating to share debentures which are, or are to be, in all respects uniform with shares or debentures previously issued and for the time being dealt in or quoted on a recognized stock exchange.

Variation in terms of contract or objects in prospectus (Section 27)

If, at any time, the company wants to vary the terms of a contract referred to in the prospectus or objects for which for which the prospectus was issued, it shall not be allowed to do so except by way of special resolution. The notice of the special resolution must clearly indicate the justification for such variation and the same should be published in the newspapers (one in English and one in vernacular language) in the city where the registered office of the company is situated.

Again, it may be noted that a company cannot use any amount raised by it through prospectus for buying, trading or otherwise dealing in equity shares of any other listed company.

Exit Option

The Companies Act, 2013 has for the first time given an exit option to shareholders who do not agree to the proposal to vary the terms of contracts or objects referred to in the prospectus. The exit option shall be given by promoters or controlling shareholders at such exit price and in such manner and conditions as may be specified by the Securities and Exchange Board by making regulations in this behalf.

Offer of sale of shares by certain members of company (Section 28)

You may note that, the Companies Act, 2013, for the first time, has incorporated provisions with respect to offer of sale of shares by certain members of company to be effected by the company on their behalf.

It provides that where certain members of a company (whether individuals or body corporate) propose, in consultation with the Board of Directors to offer whole or part of their holding of shares to the public, they shall collectively authorise the company to take all actions in respect of offer of sale for and on their behalf. They shall reimburse the company all expenses incurred by it on this matter.

Section 28, in this regard provides that any document by which the offer of sale to the public is made shall, for all purposes, be deemed to be a prospectus issued by the company and all laws and rules made thereunder as to the contents of the prospectus and as to liability in respect of misstatements in and omission from prospectus or otherwise relating the prospectus shall apply as if this is a prospectus issued by the company.

9.4 STATUTORY REQUIREMENTS IN RELATION TO A PROSPECTUS

1) ***Dating of Prospectus* –** As per section 26, a prospectus issued by or on behalf of a company or in relation to an intended company must be dated. The Section further provides that ***the date on the prospectus shall be deemed to be the date of the publication of the prospectus.***

2) ***Registration of Prospectus* –** Section 26 (1) requires the delivery of a copy of the prospectus to the Registrar on or before the date of its publication. The copy of the prospectus so delivered, should be signed by all the persons named there in as director or proposed director or by his duly authorised attorney. Every prospectus issued under sub-section (1) shall, on the face of it :

a) state that a copy has been delivered for registration to the Registrar as required under sub-section (4); and

b) specify any documents required by this section to be attached to the copy so delivered or refer to statements included in the prospectus which specify these documents.

The Registrar **shall not register a prospectus** unless the requirements of this section with respect to its registration are complied with and the prospectus is accompanied by the consent in writing of all the persons named in the prospectus.

The aforesaid requirements apply to existing company or any intended company.

No prospectus shall be issued after ninety days from the date on which a copy of it was delivered to the Registrar.

Refusal to Register the Prospectus

Section 26 (7) provides that the Registrar shall not register a prospectus unless the requirements of Section 26 with respect to its registration are complied with and the prospectus is accompanied by the consent in writing of all the persons named in the prospectus. Thus, the Registrar will refuse to register a prospectus if:

a) It is not dated;

b) It does not contain matters, reports and declaration to be set out in it;

c) It contains statements or reports of experts engaged or interested or in the formation or promotion or management of the company;

d) It includes a statement purported to be made by an expert without a statement that he has given his written consent to the issue of the prospectus and has not withdrawn such consent before the delivery of a copy of the prospectus to the Registrar for registration;

e) A copy delivered to the Registrar is not signed by every person who is named therein as a director or proposed director of the company or by his duly authorised attorney.

Penalty for non compliance

If a prospectus is issued in contravention of the aforesaid provision of Section 26, the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees and every person who is knowingly a party to the issue of such prospectus shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees, or with both [Section 26 (9)].

Prospectus in the form of Advertisement (Section 30)

Where an advertisement of any prospectus of a company is published in any manner, it shall be necessary to specify therein the contents of its memorandum as regards the objects, the liability of members and the amount of share capital of the company, and the names of the signatories to the memorandum and the number of shares subscribed for by them, and its capital structure.

9.5 WHEN PROSPECTUS IS NOT REQUIRED TO BE ISSUED

Issue of a prospectus by a company is not compulsory in the following cases:

1) A private company is not required to issue a prospectus.

2) Even a public company need not issue a prospectus if the promoters or directors feel that they can mobilize resources through personal relationships and contacts, and, therefore, the shares or debentures are not offered to the public.

3) Where the shares or the debentures are offered to existing holders of shares or debentures by way of right (*i.e.,* rights issue) with or without the right of renunciation in favour of other person [Section 26 (2) (a)].

4) Where the issue relates to shares or debentures which are, or to be, uniform in all respects with shares or debentures previously issued and dealt in and quoted on a recognised stock exchange [Section 26(2) (b)].

Check Your Progress A

1) Choose the correct alternative(s):

   i) Registrar of Companies shall refuse to register a prospectus:

      a) If it is not dated.

b) contains statement of an expert who has not signed it.

c) contains information which is six months old.

d) in all the aforesaid cases.

ii) A prospectus issued in the form of advertisement must state:

a) the objects for which the company has been formed.

b) the liability of members.

c) the amount of share capital of the company.

d) its capital structure.

e) all of the above

iii) The date of issue of the prospectus is:

a) the date appearing on the prospectus.

b) the date when the prospectus is actually published

c) the date of registration of the prospectus with the Registrar of companies.

iv) A public company need not issue a prospectus:

a) in case of rights issue of shares or debentures:

b) shares or debentures being offered are uniform in all respects with shares or debentures previously issued and dealt in and quoted on a recognised stock exchange.

c) where invitation is made by way of advertisement.

d) only in (a) and (b) above

e) in (a), (b) and (c) above

9.6 PROSPECTUS BY IMPLICATION/DEEMED PROSPECTUS

In general, the provisions of the Companies Act relating to prospectus are restricted to cases where the invitation is made by or on behalf of a company for subscription of its shares or debentures. As such it was possible at one time for a company to avoid the statutory provisions relating to prospectus by allotting shares or debentures to the public through the medium of Issue House. The shares or debentures will be allotted to these Issue Houses which will in turn invite subscription from the public through their own offer documents. Thus, the company could indirectly raise subscriptions from the members of the public without issuing an offer document or prospectus.

Section 25 covers documents issued by the Issue Houses. Accordingly, such an offer document is treated as a prospectus issued by the company. Section 25 has been essentially designed to check the by-passing of the provisions of Section 26 (Section 26 requires certain information to be disclosed and certain reports to be set out in the prospectus) by making an offer of sale of shares or debentures through the medium of Issue Houses.

Section 25(1) provides that where a company allots or agrees to allot any shares or debentures with a view to these being offered for sale to the public, any document by which the offer of sale to the public is made, shall for all purposes be deemed to be a prospectus issued by the company.

Further, sub-section (2) of Section 25 provides that unless the contrary is proved, an allotment of, or an agreement to allot, shares or debentures shall be deemed to have been made with a view to the shares or debentures being offered for sale to the public, if it is shown:

a) that the offer of the shares or debentures for sale to the public was made within six months after the allotment or agreement to allot; or

b) that at the date when the offer was made, the whole consideration to be received by the company in respect of the shares or debentures had not been received by it.

Additional Requirements Relating to Deemed Prospectus

In respect of a document deemed as a prospectus, section 25(3) requires that it must contain certain information in addition to the information required to be stated in a prospectus under Section 26. Additional information requirements are as under:

a) the net amount of consideration received or to be received by the company in respect of the shares or debentures to which the offer relates; and

b) the place and time at which the contract under which the said shares or debentures have been or are to be allotted may be inspected. Section 26, dealing with registration of prospectus applies to the deemed prospectus in terms of Section 25(3) (ii) and accordingly it renders the persons making the offer of sale to the public as deemed directors of the company.

Where the person making the offer is a company or a firm, the document (*i.e.*, deemed prospectus) must be signed by at least two directors or one-half of the partners, as the case may be [Section 26 (4)].

9.7 SHELF PROSPECTUS AND RED HERRING PROSPECTUS

9.7.1 Shelf Prospectus (Section 31)

"Shelf prospectus" means a prospectus in respect of which the securities or class of securities included there in are issued for subscription in one or more issues over a certain period without the issue of a further prospectus – Explanation to Section 31.

Sub section (1) of Section 31 provides that a 'shelf prospectus' may be issued by any class or classes of companies as the Securities and Exchange Board (SEBI) may provide by regulations in this behalf. Raising finance from the public by means of various securities is a time consuming process. Every time any such issue comes, a fresh prospectus is required to be filed. Although it is a repetitive matter, the procedural aspects take a lot of time. In order to minimise the burden on such institutions, 'shelf prospectus' has been introduced. The validity period of a 'shelf prospectus' cannot exceed one year from the date of opening of the first offering of securities under that prospectus. For subsequent offerings, information memorandum updating the information under the various heads will have to be filed and entire set comprising of shelf prospectus and the information memorandum shall constitute the prospectus and have to be circulated to the general public. *The provisions of Section 31, in this regard, are as follows:*

i) A shelf prospectus may be issued by any class or classes of companies as the Securities and Exchange Board of India (SEBI) may provide by regulations in this behalf.

ii) A company filing a shelf prospectus with the Registrar shall not be required to file prospectus afresh at every stage of offer of securities by it within the period of its validity which cannot be more than one year.

iii) A company filing a shelf prospectus shall be required to file an information memorandum on all material facts relating to new charges created, changes in the financial position as have occurred between the first offer of securities, previous offer of securities and the succeeding offer of securities within such time as may be prescribed, prior to making of a second or subsequent offer of securities under the shelf prospectus.

iv) An Information Memorandum shall be issued to the public alongwith shelf prospectus filed at the stage of the first offer of securities. Information memorandum together with the shelf prospectus shall be deemed to be a prospectus.

Note: The word memorandum here means a report, or detailed note or summary and not Memorandum of Association.

9.7.2 Red Herring Prospectus [Section 32]

Section 32 of the Companies Act, 2013 contains the following provisions with respect to 'red herring prospectus':

1) A company proposing to make an offer of securities may issue a red herring prospectus prior to the issue of a prospectus.

   "Red herring prospectus" means a prospectus which does not include complete particulars of the quantum or price of the securities included therein.

2) A company proposing to issue a red herring prospectus shall file it with the Registrar at least three days prior to the opening of the subscription list and the offer.

3) The red-herring prospectus shall carry same obligation as are applicable in the case of a prospectus.

4) Any variation between the red herring prospectus and a prospectus shall be highlighted as variations in the prospectus.

5) Upon the closing of the offer of securities, the prospectus stating therein:

   a) the total capital raised, whether by way of debt or share capital,

   b) the closing price of the securities, and

   c) any other details as are not included in the red herring prospectus shall be filed with the Registrar and the Securities and Exchange Board of India.

9.8 MINIMUM SUBSCRIPTION

No allotment of any securities of a company offered to the public for subscription shall be made unless the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on application for the amount so stated have been paid to and received by the company by cheque or other instrument (Section 39).

If the stated minimum amount has not been subscribed and the sum payable on application is not received within a period of thirty days from the date of issue of the prospectus, or such other period as may be specified by the Securities and Exchange Board, the amount received under sub-section (1) shall be returned within such time and manner as may be prescribed.

As per Rule 11 of the Companies (Prospectus and Allotment of Securities) Rules, 2014 the application money shall be repaid within a period of 15 days from the closure of the issue. In case of failure to repay, the directors of the company who are officers in default shall jointly and severally be liable to repay that money with interest at the rate of fifteen per cent per annum.

The application money to be refunded shall be credited only to the bank account from which the subscription was remitted.

In case of company's failure to return the amount, the company and its officer who is in default shall be liable to a penalty, for each default, of one thousand rupees for each day during which such default continues or one lakh rupees, whichever is less [Section 39(5)].

9.9 MISSTATEMENT IN A PROSPECTUS AND ITS CONSEQUENCES

The prospective shareholders are entitled to true and faithful disclosures in the prospectus. The persons issuing the prospectus are bound to state everything accurately and not to omit material facts.

9.9.1 What is an Untrue Statement/Misstatement?

According to section 34(1) of the Act, a statement included in a prospectus shall be deemed to be untrue:

a) if the statement is misleading in the form or context in which it is included; or

b) where any inclusion or omission from a prospectus of any matter is likely to mislead.

Thus, in regard to considering a prospectus as fraudulent, it is not necessary that there should be false representation in it; even if every word included in the prospectus is true, the suppression of material facts may render it fraudulent. To judge its effect, it should be read as a whole.

In ***Rex v. Kylsant*** [1932], all the statements included in the prospectus issued by the company were literally true. One of the statements disclosed the rates of dividends paid for a number of years. But, dividends had been paid not out of trading profits but out of realised capital profits. This material fact was not disclosed. *Held*, that the prospectus was false in material particular and Lord Kylsant, the managing director and chairman, who knew that it was false, was held guilty of fraud.

A mere silence cannot be a sufficient foundation of setting aside the allotment of shares. The withholding of facts should be such that if not stated it makes that which is stated absolutely false. In ***Peek v. Gurney* [1873],** the prospectus issued did not mention about certain liabilities. This created a false impression about the company being very prosperous. The prospectus was held to be untrue.

9.9.2 Liability and Defences

An allottee of shares, who had applied for shares, on faith of a prospectus (i) containing untrue statement; or (ii) including or omitting material facts which have the effect of what is stated as false has remedies against the company, its promoters and directors and experts.

It should be noted carefully that the right to claim compensation for any loss or damage is available only to a person who has 'subscribed' for shares, debentures or any other security on the faith of the prospectus containing untrue statements. Thus, a subsequent buyer of shares in the open market has no remedy against the company or the directors or promoters. If there is any misrepresentation of material fact in a prospectus, there may arise (i) civil liability, and (ii) criminal liability.

Civil Liability

Section 35 (1) provides that where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who:

a) is a director of the company at the time of the issue of the prospectus;

b) has authorised himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;

c) is a promoter of the company;

d) has authorised the issue of the prospectus; and

e) is an expert referred to in sub-section (5) of section 26,

shall, besides punishment under section 36, be liable to pay compensation to every person who has sustained such loss or damage.

You should note that Section 36 provides for Punishment for fraudulently inducing persons to invest money. We shall discuss the provisions of Section 36 a little later.

Defences available to avoid Civil Liability

No person shall be liable under Section 35 (1) if he proves-

a) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, or

b) that it was issued without his authority or consent; or

c) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

However, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus (Section 35 (3).

Criminal Liability

According to Section 34, where a prospectus, issued, circulated or distributed includes any statement which is untrue or misleading in form or context in which it is included or where any inclusion or omission of any matter is likely to mislead, every person who authorises the issue of such prospectus shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

Defences available to avoid Criminal Liability

The aforesaid criminal liability will not be attracted if the person proves that such statement or omission was immaterial or that he had reasonable grounds to believe, and did up to the time of issue of the prospectus believe, that the statement was true or the inclusion or omission was necessary.

Punishment for fraudulently inducing persons to invest money

Section 36 provides that any person who,

i) either knowingly or recklessly makes any statement, promise or forecast which is false, deceptive or misleading, or

ii) deliberately conceals any material facts, to induce another person to enter into, or to offer to enter into specified agreements, shall be punishable with imprisonment for a term with shall not be less than six month but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

Agreements covered under Section 36 include:

a) any agreement for, or with a view to, acquiring, disposing of, subscribing for, or underwriting securities; or

b) any agreement, the purpose or the pretended purpose of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities; or

c) any agreement for, or with a view to obtaining credit facilities from any bank or financial institution.

Action by Affected Persons (Section 37)

A suit may be filed or any other action may be taken under section 34 or section 35 or section 36 by any person, group of persons or any association of persons affected by any misleading statement or the inclusion or omission of any matter in the prospectus.

Thus, Section 37, not only provides for individual action but also for class action.

9.10 GOLDEN RULE FOR FRAMING OF PROSPECTUS

The 'Golden Rule' for framing of a prospectus was laid down by Justice Kindersely in *New Brunswick & Canada Rly. & Land Co. v. Muggeridge (1860).* Briefly, the rule is:

Those who issue a prospectus hold out to the public great advantages which will accrue to the persons who will take shares in the proposed undertaking. Public is invited to take share on the faith of the representations contained in the prospectus. The public is at the mercy of company promoters. Everything must, therefore, be stated with strict and scrupulous accuracy, nothing should be stated as fact which is not so, and no fact should be omitted the existence of which might in any degree affect the nature of quality of the principles and advantages which the prospectus holds out as inducement to take shares. In a word, the true nature of the company's venture should be disclosed.

In ***Rex v. Kylsant*** *(1932),* the prospectus stated that dividends of 5 to 8 per cent had been regularly paid over a long period. The truth was that the company had been incurring substantial losses during the seven years preceding the date of the prospectus and dividends had been paid out of the realised capital profits. *Held*, the prospectus was false and misleading. The statement though true in itself was rendered false in the context in which it was stated.

A half truth, for instance, represented as a whole truth may tantamount to a false statement [Lord Halsbury in ***Aarons Reefs v. Twisa***].

Thus, the persons issuing the prospectus must not only include in the prospectus all the relevant particulars specified in Section 26 of the Act, which are required to be stated compulsorily but should also voluntarily disclose any other information within their knowledge which might in any way affect the decision of the prospective investor to invest in the company.

9.11 ALLOTMENT OF SHARES IN FICTITIOUS NAMES

Section 38 provides that any person who:

a) makes or abets making of an application in a fictitious name to a company for acquiring, or subscribing for, its securities; or

b) makes or abets making of multiple applications to a company in different names or in different combinations of his name or surname for acquiring or subscribing for its securities; or

c) otherwise induces directly or indirectly a company to allot, or register any transfer of, securities to him, or to any other person in a fictitious name, shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less that the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

The aforesaid penal provisions must be prominently reproduced in every prospectus issued by a company and in every form of application for securities.

Further, where a person has been convicted under this section, the Court may also order disgorgement of gain, if any, made by, and seizure and disposal of the securities in possession of, such person (Subsection (3)).

The amount received through disgorgement or disposal of securities shall be credited to the Investor Education and Protection Fund.

9.12 ANNOUNCEMENT REGARDING PROPOSED ISSUE OF CAPITAL

It is very common for companies to get an announcement regarding proposed issue of share/debentures inserted in the leading newspapers. It is not required by company law to do so. But it is done in order to invite the attention of the public to the proposed issue. On the top of the insertion it is given that, "It is only an announcement and not a prospectus", in order to avoid penal provisions under Sections 34 and 35 for publishing an incomplete prospectus.

Section 30, in this regard, provides that where an advertisement of any prospectus of a company is published in any manner, it shall be necessary to specify therein:

i) the objects as stated in the Memorandum;

ii) the liability of members;

iii) the amount of authorised share capital of the company;

iv) the name of the signatories to the memorandum and the number of shares subscribed for by them; and

v) the capital structure of the company.

Check Your Progress B

1) Fill in the blanks.

   i) A company should not issue a prospectus to the public unless a copy thereof has been delivered to the ....

   ii) Shelf Prospectus remains valid up to ....

   iii) A prospectus containing statement by experts, must contain ....

   iv) A prospectus must be issued within .... of its registration.

2) State whether the following statements are True or False.

   i) A public company may allot shares without issuing a prospectus.

   ii) A document is not a prospectus unless it is an invitation to the public to subscribe for shares in, or debentures of, or any other security with a body corporate.

iii) A prospectus must be dated.

iv) A public company issuing shares among friends and relatives need not issue a prospectus.

v) A person can avoid the contract to purchase shares in the company even if he has purchased shares in the open market and has not gone through the prospectus containing untrue statements.

vi) An allottee of shares can retain the shares and can sue the company for damages in case he finds that the prospectus contained untrue statements.

vii) A director can avoid criminal liability for misstatements in the prospectus if proves that he had reasonable ground to believe that the statement alleged to be untrue is true.

viii) Where a prospectus contains untrue statements, the persons who authorised its issue are punishable with fine upto Rs. 50,000.

ix) Red herring prospectus is a prospectus filed with RoC after the filing of the Prospectus.

9.13 LET US SUM-UP

Unlike a private company which arranges its share capital primarily, from friends and relatives, a public company normally invites public to subscribe to its share capital. In such a case the public company issues a prospectus inviting subscription. In fact, before the prospectus is issued, the company is required to take certain steps which include the appointment of bankers, auditors, underwriters, brokers, making arrangements for listing of shares on stock exchanges, drafting the prospectus, etc.

Thereafter, the Board of directors has to decide about the time of issue of prospectus. For this purpose, the Board considers the condition of the capital market, the investors' mood, fiscal and monetary policies of the Government and the state of business conditions.

Meaning and definition of a prospectus: Prospectus means any document described or issued as a prospectus and includes a red herring prospectus or shelf prospectus or any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchases of any securities of a body corporate.

As to what constitutes an offer to the public, Section 42 (4) states that an offer or invitation shall be deemed to be invitation to public, if it cannot be considered as private placement. Explanation I to Section 42 (2) along with the rules framed thereunder provide that if a company, listed or unlisted, makes an offer to allot or invites subscription, or allots, or enters into an agreement to allot, securities to more than 200 persons in a financial year, the same shall be deemed to be an offer to the public.

Contents of a prospectus: As per the requirement of Section 26 of the Companies Act, 2013, contents of a prospectus shall comprise of:

1) Information to be given in a Prospectus
2) Reports to be set out in the Prospectus
3) Declaration to be made
4) Other matters

Although most of the public companies do issue a prospectus to meet their financial requirements, the issue of a prospectus by a company is not compulsory. In the following cases, a company is not required to issue a prospectus:

1) In the case of a public company where the promoters or directors propose to mobilise resources through personal relationships and contacts and, therefore, do not propose to approach public for subscription.
2) Where the shares or debentures are offered to existing holders of shares or debentures by way of right.
3) Where the issue relates to shares or debentures which are uniform in all respects with shares or debentures previously issued and dealt in and quoted on a recognised stock exchange.
4) Where invitation is made by way of advertisement.

If, at any time, the company wants to vary the terms of a contract referred to in the prospectus or objects for which the prospectus was issued, it shall not be allowed to do so except by way of special resolution. Besides, the company must give exit option to those shareholders who do not approve of the variations.

Statutory requirements in relation to prospectus: As per section 26, a prospectus issued by or on behalf of a company or in relation to an intended company must be dated. The Section further provides that *the date on the prospectus shall be deemed to be the date of the publication of the prospectus.*

Further, Section 26 requires the delivery of a copy of the prospectus to the Registrar on or before the date of its publication.

The Registrar will not register a prospectus unless the requirements of this section with respect to its registration are complied with and the prospectus is accompanied by the consent in writing of all the persons names in the prospectus.

No prospectus shall be issued after ninety days from the date on which a copy of it was delivered to the Registrar.

Deemed prospectus: In order to check the by-passing of the provisions relating to prospectus, section 25 declares that all documents containing offer of shares or debentures for sale shall be included within the definition of the term prospectus. Therefore, offer of shares or debentures through the medium of Issue Houses shall require the provisions relating to prospectus to be duly complied with if certain conditions are satisfied.

Besides, any company proposing a public issue may issue a red-herring prospectus before it issues prospectus. A 'red-herring prospectus' is prospectus which does not have complete particulars on the price of securities offered and quantum of securities offered.

Misstatement in a prospectus: In order to ensure that the prospective investors are not subjected to frauds by making certain positive misrepresentation in the prospectus or by deliberately omitting certain material information, certain remedies have been provided to the aggrieved parties who may subscribe on the faith of any misrepresentation or omissions calculated to deceive. The remedies proved for the right to rescind, a claim for damages and also prosecution of the company and the guilty officers in terms of imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

Prohibition of allotment of shares in fictitious name: Section 38 prohibits making of an application for acquiring shares of a company under a fictitious name. The section makes the act punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and the person guilty of such fraud shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

9.14 KEY WORDS

Minimum Subscription: It is an amount so mentioned in the prospectus and, as per SEBI regulations, 2009, can in no case be less than 90% of the Issue. In the event of company's failure to raise minimum subscription, the entire application money has to be refunded back.

Prospectus: It is a document issued by a company inviting members of the public to subscribe to its share capital.

Abridged Prospectus: It means a memorandum containing such salient features of a prospectus as may be prescribed by SEBI

Shelf Prospectus: A company which proposes to make more than one public issue of securities in a period of one year, may file 'shelf prospectus' which will remain valid up to one year. Such a company need not issue a prospectus every time it offers securities to public; it shall only need to file an 'information memorandum' with respect to changes in the financial position, new charges created, etc.

Red-Herring Prospectus: It is a prospectus which does not have complete particulars on the price of securities offered and quantum of securities offered.

Deemed Prospectus: The document that offers shares or debentures of a company through the medium of Issues Houses

Issue Houses: An investment banking firm whose business is to underwrite share or debenture issue and offer the securities to the public.

Information Memorandum: It is issued along with self prospectus and contains all material fact relating to new charge created, changes in financial position between various offers of securities and other changes as may be prescribed.

9.15 ANSWERS TO CHECK YOUR PROGRESS

A) 1) i) (d); ii) (e); iii) (a); iv) (d)

B) 1) i) Registrar of Companies;

ii) one year;

iii) a statement about the consent of the expert;

iv) 90 days.

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

vi) True; vii) True; viii) False; ix) False

9.16 QUESTIONS FOR PRACTICE

1) Explain the provisions of the Companies Act, 2013, with regard to the registration of prospectus of a public company going for public issue of equity shares. What are the documents required to be submitted by the company to the Registrar of Companies for the above purpose?'

2) When and by whom can the allotment of shares be rescinded on the ground of a false and misleading prospectus under the Companies Act, 1956?

3) When is a company not required to issue prospectus in connection with issue of shares or debentures? When can the invitation for offer to subscribe for shares be treated as not having been made to the public?

4) Who is an 'Expert'? Explain his liability, relating to publication of prospectus, for any misstatement in the report given by him?

5) Define 'Prospectus'. Discuss briefly the contents of 'Prospectus'.

6) State the liability of the company and the directors with respect to misstatements included in a prospectus. When a director of a company is not liable to an aggrieved party for the issue of a prospectus containing a 'misstatement'?

7) Write a note on:

i) 'Shelf Prospectus'.

ii) Red herring Prospectus.

8) What is a 'Deemed Prospectus'? State the provisions of the Companies Act, 2013 with respect to 'Deemed Prospectus'.

9) Answer the following problems giving reasons:

i) X Co. Ltd., intended to buy a rubber estate in Peru. Its prospectus contained extracts from an experts report giving the number of rubber trees in the estate. The report was inaccurate. Will any shareholder buying the shares of the company on the basis of the above representation have any remedy against the company? Can the persons authorising the issue of the prospectus escape from their liability?

ii) A prospectus issued by a company contained a promise of subscription of a substantial amount by some persons so as to induce the public to subscribe. The plaintiff who was allotted 10 shares alleged material misrepresentation. Decide?

iii) 'A' purchased from 'B' 1000 shares of a company on the basis of prospectus containing wrong statement. What remedies are available to 'A' against the company?

iv) A company issued a prospectus. All the statements contained therein were literally true. It also stated that the company had paid dividends for a number of years, but did not disclose the fact that the dividends were not paid out of trading profits, but out of capital profits. An allottee of shares wants to avoid the contract on the ground that the prospectus was false in material particulars. Decide.

Hints:

i) The allottee shall have the right to claim damages from the company. Persons authorising the issue of prospectus shall not be liable since they made the statement on the basis of report of an expert. However, expert can be proceeded against.

ii) The allottee shall be entitled to return back shares and claim refund of price as well as damages. Company as well as persons responsible for issue of prospectus can be charge with criminal liability.

iii) 'A' shall have no remedy against the company since shares were not purchased from the company.

iv) Yes, the allottee will succeed. See *Rex v. Kylsant* case.

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

SUGGESTED READINGS

Avtar Singh, Company Law, Eastern book book Company, 2016 Edition

MC Kucchal Modern India Companies Law. Delhi, Shri Mahavir Book, 2015 edition.

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BTMC-132
Fundamentals of Management

Block

3

MANAGEMENT CONCEPT-I

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*BTMC – 132 was adopted / adapted from Three Courses, namely – **BCOE 108, ECO – 01** and **ECO – 03** of School of Management Studies. (SOMS)

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January, 2019

ISBN :

Further information on Indira Gandhi National Open University courses may be obtained from the University's office at Maidan Garhi. New Delhi-110 068 or visit University's web site http://www.ignou.ac.in

Printed and published on behalf of the Indira Gandhi National Open University, New Delhi by Prof Jitendra Kumar Srivastava, Director, School of Tourism,

Laser Typeset by : Tessa Media & Computers, C-206, A.F.E.-II, Okhla, New Delhi

Printed at :

BLOCK 3 MANAGEMENT CONCEPTS-I

Management is the art of getting things done through others. It has been practiced since the dawn of civilization. Its importance has increased manifold in business with the emergence of large scale enterprises. Management has been able to simplify successfully the complexities of today's business environment. In fact, in the present day world, management is indispensible to all organisations whether business, social, political or religious. Block 3 and 4 of this course will acquaint the students with the Principles, functions and practice of management.

This block has five Units (Unit 10 to Unit 14) and provides an overview of the nature and scope of management, approaches to management thought and discusses in detail some of the basic functions and sub-functions of Management-Planning, Organising, Delegation of Authority and the concept of Centralisation and Decentralisation

Unit 10 deals with the concept of management, difference between management and administration, functions of management and social responsibility of management

Unit 11 explains the evolution of management thought and the various approaches adopted by different authorities.

Unit 12 deals with the nature and importance of planning, the process of planning, types of planning and essential principles of planning

Unit 13 describes the importance and structure of organisation, the concept of formal and informal organisation, the span of control, organisational charts and manuals.

Unit 14 explains the process and principles of delegation of authority, and the concept of centralisation and decentralisation

UNIT 10 NATURE AND SCOPE OF MANAGEMENT

Structure

10.0 OBJECTIVES

After studying this unit, you should be able to:

- explain different meanings of the word management
- distinguish between management and administration
- define management and list out its features
- state the hierarchy of management as a profession
- describe the hierarchy of managers and their skill requirements
- enumerate the activities under each managerial function

- describe the direct and indirect elements of corporate environment and barriers to social performance.

10.1 INTRODUCTION

We often come across the word management referring to people who run enterprises organised as either sole trading or partnership or corporate firms. These organisations are either owner–managed or managed by professional managers. But in the evolutionary process all organisations having passed through certain phases of growth should require professionally trained people to manage them. The extent of success these managers achieve depends on their knowledge of management theory and its skilful application. In the transition from owner – managed enterprises to professional–managed enterprises, profit is no longer the sole indicator of success. The management is obligated to put up performance in areas which are concerns of groups other than owners. In this introductory Unit you will learn the different meanings of the word management, how it differs from administration, nature and scope of management, how management is both a science and art, the characteristic features of management as a profession. You will further learn managerial levels and the skill requirements of each level, managerial activities classified under functions and undertaken by all levels, and social responsibilities of management.

10.2 CONCEPT OF MANAGEMENT

Management is essential at all levels of an organisation. But the word management has been given different interpretations. It is used as a noun, a process, and a separate discipline.

10.2.1 Management as Noun

In general and popular usage, management refers to a distinct group of people who direct the activities of other people and material resources toward the attainment of predetermined goals. Giving a broader meaning to it, one can look at management as a resource, a system of authority, and class or elite.

1) **Management as an economic resource:** The economist's view of management is that it is a factor of production just like entrepreneurship, capital and labor .The managerial resource, to a large extent, determines organisational effectiveness and efficiency. Hence in a dynamic environment, managerial development is more important and its use must be more intensive.

2) **Management as a system of authority:** Management is a system of authority in the sense that it consists of a team of managers who are responsible for making decision and supervising the work of others. Managers at different levels possess varying degrees of authority. Higher level mangers manage managers at middle levels. Middle and lower level managers supervise and control their subordinate managers and workers.

3) **Management as a class or elite**: Sociologist's view management as a class and status system. Increasing complexity of management in the modern complex organisation has led to managers being regarded as a distinct class

in society, who possess knowledge and skill of a high order. Access to managerial positions is based on achievement criteria (i.e., on intellect and knowledge), rather than on ascriptive criteria (i.e.; on family and social origins). This development is viewed by some as managerial revolution in which the managerial class threatens to become autonomous group with increasing amount of power. Others view this development not with alarm because increase in power of managers attracts more of them, which prevents managerial autocracy.

10.2.2 Management as a Process

Interpreted as a process, management consists of a series of inter-related managerial activities classified into various function like planning, organising, staffing, leading and controlling. Managers undertake these functions with a systematic approach, so as to integrate physical and human resources into an effective operating unit. Management is, thus, regarded as the process by which a co-operative group direct action towards common goals.

10.2.3 Management as a Discipline

Another connotation of management is that it is a separate discipline having a systematized body of knowledge which managers use in performing their jobs. As a separate field of study, management includes the principles and practice of general management as well as of the various functions of management. It has developed its own techniques and approaches. The theoretical foundations of management have evolved on the basis of experience, observation and scientific investigations.

10.3 MANAGEMENT AND ADMINISTRATION

Management and administration are two terms which are given different interpretations as well as used as synonyms.

10.3.1 Management and Administration as Two Distinct Terms

Distinction between the terms management and administration is often attempted with references to the nature of enterprises and managerial levels.

1) **Distinction based on nature of enterprises:** According to one view, it is more appropriate that the term management be used with respect to enterprise having an economic orientation. In other words, the term management should relate to economic enterprises (business enterprises) whose primary goal is generation of surplus. The term administration is preferred with respect to government enterprises pursuing social and political activities and whose primary objective is other than surplus generation.

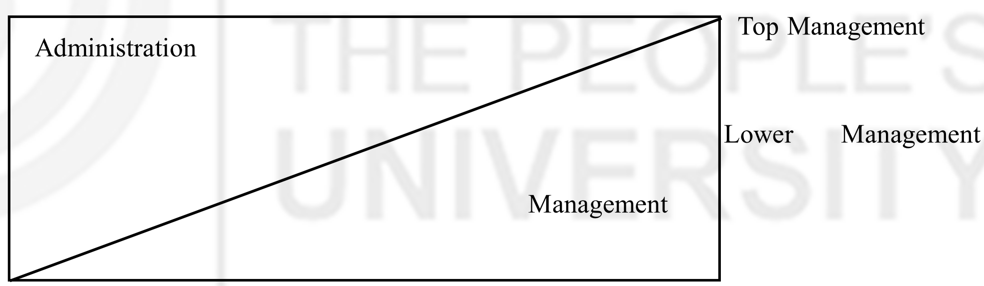
2) **Distinction based on managerial levels:** Management and administration are used as two separate terms in the context of the single enterprise keeping in view managerial functions and hierarchy. Subscribing to this view, there are two schools of thought; (i) American School of Thought and (ii) British School of Thought.

   i) **American School of Thought:** According to this school of thought, administration is a broader concept than management. It sets objectives which management strives to realise, and lays down policies under which management operates. Management, on the other hand, is the force that leads, directs and guides the organisation in the accomplishment of predetermined objectives. Thus, according to this school, administration is a thinking function or a top level function involved in planning, setting objectives and policies. Whereas management is a doing function or lower level function engaged in execution of the plans.

ii) **British School of Thought:** According to this school of thought, management is a wider concept than administration. Management is the rule making and rule enforcing body. It performs top level functions of the organisation. Whereas administrations handles the current problems which arises in carrying out the policies laid down by the management. This school emphasizes that management is an all-encompassing and operative term and administration is part of it.

iii) **Reconciling the two Schools of Thought:** In an attempt to solve the terminological problem, management is categorised as administrative management and operative management. Administrative management is top management in-charge of planning function. Operative management is middle and lower level managements responsible for execution of the plans. Look at Figure 1.1 which shows both administration and operative functions of the management.

Figure 1.1: Title: Administration Vs Management



10.3.2 Management and Administration as Synonyms

Another viewpoint is that administration and management are synonymous terms. Any attempt to distinguish between them is misleading. All managers, irrespective of their level in the organisation, perform the same managerial functions. Hence no two sets of personnel are required to discharge administrative and managerial functions in a single enterprise. In fact, top management is chiefly concerned with performing administrative activities, whereas managers at lower are predominantly concerned with executive functions.

10.4 DEFINITION OF MANAGEMENT

Management is the art of getting things done through people. In a broader sense, it is the process of planning, organising, leading and controlling the efforts of organisation members and of using all other organisational resources to achieve stated organisational goals. The definition of management can be broadly classified into four groups: 1) Process school, 2) Human Relations School, 3) Decision school, and 4) System and Contingency school.

1) **Process School:** The Process School defines management in term of functions undertaken by the manager in an integrated way to achieve organisational purposes. According to Henri Fayol, **to manage is to forecast and plan, to organise, to command, to coordinate and to control.** All other definitions of management related to this school are either marginal additions, or elaborations of the functions listed out in the above definition

2) **Human Relations School:** This school emphasises the human aspect of organisation and conceives it as a social system. It is a social system because managerial actions are principally concerned with relations between people. In fact, management is concerned with development of people and not the direction of things. The essence of this school is well reflected in the definition of Lawrence Appley to whom **management is the accomplishment of results through the efforts of other people.**

3) **Decision School:** The Decision School defines management as rule-making and rule-enforcing body. In fact the life of a manager is a perpetual choice making activity and whatever a manager does, he does through his decisions. Moreover, decision making power provides a dynamic force for managers to transform the resources of business organisation into a productive and cooperative concern.

4) **System and Contingency School:** According to this School, organisations like any living organism must adapt themselves to their environments for survival and growth. Thus, management involves designing organisations adaptable to changing markets, technology and other critical environmental factors. The systems theory of organisations are organic and open systems consisting of interacting and interdependent parts and having a variety of goals. Managers are supposed to maintain balance among the conflicting objectives, goals and activities of members of the organisation. He must achieve results efficiently and effectively. According to Contingency School there is no best way to design organisations and manage them. Managers should design organisations, define goals and formulate policies and strategies in accordance with the prevailing environmental conditions.

Different school of thought defined management differently due to three reasons:

1) difference in perspectives of management and organisation theories,

2) shifts in emphasis in the study of the organisation from economic and technical aspects to conceptual and human aspects, and

3) focus on internal and external environments of the organisation.

10.5 NATURE AND SCOPE OF MANAGEMENT

So far you have learnt the definition of management, management as a noun, process and discipline and difference between administration and management.

Let us now discuss the nature and scope of management.

10.5.1 Nature of Management

The essential features of management reveal its nature and importance. These are discussed below.

1) **Universality:** Management is an universal phenomenon in the sense that it is common and essential element in all enterprises. Managers perform more or less the same functions irrespective of their position or nature of the organisation. The basic principles of management can be applied in all managerial situations regardless of the size, nature and location of the organisation.Universality of managerial tasks and principles also implies that managerial skills are transferable and managers can be trained and developed.

2) **Purposeful:** Management is always aimed at achieving organisational goals and purposes. The success of management is measured by the extent to which the desired objectives are attained. In both economic and non-economic enterprises, the tasks of management are directed towards effectiveness (i.e, attainment of organisational goals), and efficiency (i.e, goal attainment with economy of resource use).

3) **Social process:** Management essentially involves managing people organised in work groups. It includes retaining, developing and motivating people at work, as well as taking care of their satisfaction as social beings. All these interpersonal relations and interactions make the management as a social process.

4) **Coordinating force:** Management coordinates the efforts of organisation members through orderly arrangement of inter-related activities so as to avoid duplication and overlapping. Management reconciles the individual goals with the organisational goals and integrates human and physical resources.

5) **Intangible:** Management is intangible. It is an unseen force. Its presence can be felt everywhere by the results of its efforts which comes in the form of orderliness, adequate work output, satisfactory, working climate , employees satisfaction, etc.

6) **Continuous process:** Management is a dynamic and an on-going process. The cycle of management continues to operate so long as there is organised action for the achievement of group goals.

7) **Composite process:** Functions of management cannot be undertaken sequentially independent of each other. Management is a composite process made up of individual ingredients. All the functions are performed by involving several ingredients. Therefore, the whole process is integrative and performed in a network fashion.

8) **Creative Organ:** Management creates synergetic effect by producing results which are more than the sum of the individual efforts of the group members. It provides sequence to operations, matches jobs to goals, connects work to physical and financial resources. It provides creative ideas, new imaginations

and visions to group efforts. It is not a passive force adopting to external environment but dynamic life giving element in every organisation.

10.5.2 Scope of Management

Management, like any other subject, deals with clearly defined activities without which its progress is impossible. It confines to concepts, principles and theory related to managerial functions. Enterprise functions which vary from organisation to organisation are excluded from its purview. So typical enterprise functions viz., productions, finance, marketing and personal are out side the scope of management.

Check Your Progress A

1) What is the concept of management as a process?

....

....

....

....

....

2) What is concept of management as a discipline?

....

....

....

....

....

3) Against each statement given below, write the name of the management school.

	Statement	School of Management Thought
i)	Management is a rule-making and rule enforcing body.	....
ii)	Defines management in terms of functions	....
iii)	Designing the organisations to keep them fit to the changing environment.	....
iv)	Conceives organisation as a social system.	....

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

i) Administrative management executes plans. ....

ii) Operative management formulates plans. ....

iii) Henri Fayol belongs to Process School ....

iv) In mature organisations the decisions are made by owner-managers. ....

v) Universality of management means management is the subject that studies universe. . ...

vi) Economic enterprises are non-profit oriented. ....

10.6 MANAGEMENT AS A SCIENCE AND ART

Management has characteristics of both science and art. It is through scientific methods of observations and experiments that a systematised body of knowledge has grown in the field of management. There are principles, techniques and theories of management.

A science explains phenomena, events and situations as well as establishes cause and effect relationship between two or more variables. So do management theories and principles seek to explain organisational phenomena of human conduct and behaviour. The usefulness of the techniques of management is derived from cause and effect relations between variables. But management is a social science as it deals with people and their behaviour. Thus, management is not as perfect or exact as natural sciences like physics and chemistry. Human behaviour cannot be subjected to laboratory experiments in the same way as possible in physics and chemistry. It is not possible to predict human behaviour with complete accuracy under all circumstances. Moreover, business conditions are liable to frequent changes. Therefore, principles of management cannot be regarded as absolute truths; they are flexible guides.

However, management theory provides a board framework for training in management and practice of management. Management principles are capable of wide applications and improve managerial performance. They serve as guides to practicing managers in solving the problems, by obviating the need for laborious trial and error method. Besides, principles serving as hypotheses are of a great help to researchers in developing new theory and improving and integrating the existing theory. The art of management, like any other art, is application of theory of management in the light of realities to attain the desired result. The essential functional difference between science and art is that the former explains the events of the past and the latter accomplishes ends, effects results, and produces situations which would not come about without it. Art is essentially concerned with the application of scientific knowledge and skill to achieve concrete results. But it also requires an insight and judgment to be exercised, which are involved in the process of management.

In short, managing may be regarded as the art of doing, and management as the body of knowledge that underlies the art. At the same time, it must be noted that science and art of management are not mutually exclusive but complementary. Improvement in one facilitates the other. Since every thing is not proved in management science, it cannot be a comprehensive tool for manager. When faced with conflicting principles in a given situation, managers have to work out compromises between principles to get practical result with least cost.

10.7 MANAGEMENT AS A PROFESSION

Louis Allen defined profession as “a specialised kind of work practiced through and by use of classified knowledge, a common vocabulary, and requiring standard of practice and code of ethics established by a recognized body.” Whether management can be called a profession or not will be clear if we compare its features with the characteristics of recognized professions like medicine, law accountancy, etc., which are discussed below:

1) **Systematic knowledge:** Every profession has a well defined area of organised knowledge. Management also deals with distinct area of knowledge which is developed around functions of management. Techniques of management developed by drawing knowledge from other branches like economics, mathematics and so on, facilitate managers to perform their job better. Coordinated decision making in organisation is made possible by application of the same theory by all managers in their decision making. Managers should possess experimental attitude in acquisition of new knowledge so as to prove successful in an ever-changing organisational environment.

2) **Formalised method of acquiring knowledge:** For present day managers, formal education and training are important sources of education of knowledge. Transfer of Knowledge gained through experience from one living mind to another or intuitive knowledge are no longer considered adequate for practicing managers.

3) **Performance-based status:** Manager’s status in the present day organisation is linked to its performance rather than other extraneous factors like family or political connections. This way management is exacting philosophy with performance orientation.

4) **Code of ethics:** Professionals must be governed by a strict code of ethics formulated and enforced by professional bodies to protect their members integrity. Since it is difficult to identify clearly the membership of management associations and their role, managerial codes of ethics has not yet evolved so as to be acceptable to all practicing managers.

5) **Dedication and commitment:** True professionals through dedication and commitment serve their clients interest. Financial reward is not the measure of their success. Managers today are expected to serve the long-run interest of the organisation but they are also conscious of their social responsibilities. Besides, they are entrusted with wealth producing resources of society which they are expected to put to the most effective use.

We may conclude from the above discussion that management cannot be regarded as a profession in all respects but it has some of the characteristic of a profession

10.8 LEVELS OF MANAGEMENT AND SKILL REQUIREMENTS

Managers are classified on the basis of range of activities for which they are responsible. Functional managers are responsible for a single function whereas general managers have profit responsibility and coordinate different functions of the enterprise. Another major classification of managers is their vertical division into three levels of management viz., top, middle and lower levels.

10.8.1 Hierarchical Classification of Managers

The vertical division of managerial work in the organisation leading to specialization in hierarchy is supported by three reasons viz., need for expertise in managerial decision making, need for coordination and need for accountability of operative employees.

1) **Top managers:** The top management includes the Board of Directors, the Chief Executive and Senior Executives and in-charge of functional departments. They comprise a small group which is responsible for the overall management of the orgnisation. They make and communicate policies and strategies guiding the middle and lower level managers. Their primary task is that of relating the organisation to the external environment.

2) **Middle managers:** The middle level management consists of departmental managers and branch managers. These groups direct activities to implement the organisational plans and policies. This middle management balances the demand of top management with the capabilities of lower level management.

3) **Lower level managers:** Supervisors and foremen belong to this category. They belong to the operating level of management and are responsible for the work of operative employees i.e., non-managers. They are directly responsible for the production of goods and services.

10.8.2 Classification of Managerial skills

We have discussed the classification of managers and the major activities each group performs. Now let us discuss about the skill required by the managers. At all levels, managers require three types of skills. They are 1) technical skills, 2) human skills, and 3) conceptual skills.

1) **Technical skill:** It is the ability of a manager to use the equipments, methods and techniques involved in performing specific tasks. Technical skill is required more at the lower level of management i.e., at the supervisory level. At higher levels, the technical skill is less important as managers can rely upon others for technical information.

2) Human skill: The ability of a manager to work with, understand, and motivate people in the organisation is known as human skill. It also involves the ability to build effective work teams. The human aspect of management requires individual as well as group relations to be maintained and developed for achieving maximum efficiency. Human skills are important at all levels of management.

3) **Conceptual skill**: This consists of the manager's ability to coordinate all organisational activities and varied interests involved in it. It involves viewing the organisation in its totality and understanding the inter-dependence of its individual parts. Of all the skills, this conceptual skills is the most difficult skill to acquire. Conceptual skill is very important for top management in formulating long-range plans, board policies and relating the business enterprise to the industry and economy.

10.8.3 Skill-Mix for Different Levels of Management

Though all the three types of skills discussed earlier are essential for effective management, the relative importance of each type of skill varies according to the level of management. Technical skills assume grater importance at the lower level management, while they become less important as one moves upwards in the hierarchy. Human skills are important at all three levels of management as managerial success primarily lies in getting things done through people. The higher the level of management, the greater is the need for conceptual skill. The important implication of analyzing levels of management and skill requirements is for managerial training through which skills are imported to meet the specific needs of managers of each organisational level.

10.9 MANAGERIAL FUNCTIONS

Enterprise functions vary according to the nature of enterprise. Functions like production, marketing, finance, and personnel are noticed in typical industrial undertakings. If you take a transport undertakings, the main function are operations, traffic and finance. However, the managerial activities grouped into functions are basic for all managers at all levels in all types of enterprises.

The functions which describe managerial job, when put together make up the management process. This process is analyzed into key functions of management viz., planning, organising, staffing, directing and controlling. Planning, organising and controlling which deal mostly with non-human aspects are known as mechanics of management, whereas staffing and directing which are primarily concerned with human aspects constitute dynamics of management. In the conceptual scheme, though the functions are listed out in a sequence, in practice they are interlocked as a system. As all functions are not equally important for all managers, time spent by them for each of these functions various according to their levels in the organisation. These functions have been discussed below.

1) **Planning**: Planning refers to anticipating the future conditions and choosing from among the alternative future courses of actions. The planning process generally includes the following activities.

   i) **Forecasting** is looking ahead to anticipate the opportunity, problems and conditions in a future period of time.

   ii) **Establishing objectives means** setting the end results to be accomplished by directing organisational efforts.

   iii) **Programming** is establishing the sequence and priority of actions to be followed in the attainment of the objectives.

   iv) **Scheduling** is deciding on time sequence for programme steps.

   v) **Budgeting** is allocation of resources to minimise costs.

   vi) **Establishing procedures** means developing and applying standardised methods of performing a specific work.

   vii) **Developing policies** involve establishment and interpretation of standing decisions that apply to repetitive questions and problems of significance to the organisation as a whole.

2. **Organising function:** The organising function of management is the process of defining and grouping of activities and creating authority relationship among them.

   It consists of:

   i) **Developing the organisation structure** which involves identification of task and grouping them into units or departments for performance

   ii) **Delegating authority** to the managers and making him responsible for group performance.

   iii) **Establishing relations** creating conditions necessary for mutually cooperative efforts of people in the organisation.

3) **Staffing**: Planning the organisation with suitable personnel constitutes the staffing function. It involves selection, training and development, compensation, and appraisal of subordinates by the manager. Manpower planning and manpower management looks after these activities and try to ensure suitable methods of remuneration and performance appraisal of the employees.

4) **Directing Function:** Directing involves managing people and the work through the means of motivation, proper leadership, effective communication and coordination. A manager must develop ability to command. He should issue orders and instructions without arousing any resentment among the subordinates. He must be able to secure willing obedience from his subordinates without destroying their imitative and creativity. Moreover, it requires a sound communication system to enable exchange of ideas and information for common understanding

5) **Controlling function:** Controlling enables management to ensure that achievement is in accordance with the established plans. It involves:

   i) **Establishing performance standards** for evaluating results.

   ii) **Performance** on the basis of records and reports on the progress of work.

   iii) **Performance evaluation** against the standards set.

   iv) **Corrective action** to regulate operations, remove deficiencies and improve performance.

10.10 SOCIAL RESPONSIBILITIES OF MANAGEMENT

The term social responsibilities may be defined as the obligation of management towards the society and others concerned with the activities of the organisation.

10.10.1 Reasons for Social Responsibilities

As you know, the business enterprises are creatures of society and should therefore respond to the demands of society. If the management does not react to changes in social demands, the society will either force them to do so through laws or will not permit the enterprise to survive. Hence the long-run interests of business are best served when management assumes social responsibilities. The image of a business firm is often linked with the quality of its products and customer service and the extent to which it fulfils the expectations of owners, employees, consumers, government and the community at large. For long-run success it maters a great deal if the firm has a favorable image in the public mind. Finally, every business enterprise is an organ of society and its activities have an impact on the social scene. It is thus important for management to consider whether their policies and actions are likely to promote the public good, advance the basic values of society, and constitute to its stability, strength and harmony.

10.10.2 Stakeholders of the Organisation

As the outcome of the increasing concern for the social responsibility of management, it is now recognized that, besides taking care of the financial interest of owners, managers of business firms must also take into account the interest of various other groups such as employees, consumers, the government and the community as a whole. These interested groups are directly or indirectly affected by the pursuit of business activities and they are the stake-holders of the business enterprise.

Let us briefly outline the social responsibilities of management towards each of the interested groups' viz., owners (shareholders), employees, consumers, the government and public at large.

1) **Responsibility towards owners:** The primary responsibility of management is to assure a fair and reasonable rate of return on capital and fair dividend to the shareholders as investors and risk bearers. What is a fair return on investment can be determined on the basis of difference in the risks of business in different fields of activity. With the growth of business the shareholders can also expect appreciation in the value of their capital. These may be regarded as the legitimate expectations of the shareholders not high rate of return earned through black marketing and unfair trade practices.

2) **Responsibility towards employees:** Management responsibility towards employees relate to the fair wages and salaries, satisfactory work environment, labour- management relations and employee welfare. Fair wages should be fixed in the light of labour productivity, the prevailing wage rates in the same or neighboring areas and relative importance of jobs. Manager's salaries and allowances are expected to be linked with their responsibility, initiative and skill. But the spread between minimum wages and highest salaries should be reasonable. Managers are expected to build up and maintain harmonious relation between superior and subordinates. Management and union relations should be harmonious and cooperative. Another aspect of management responsibility towards employees is the provision of welfare amenities like safety and security of working conditions, medical facilities, housing, canteen leave and retirement benefits

3) **Responsibility towards consumers:** In a competitive market, serving consumers is supposed to be a prime concern of management. But in reality perfect competition does not prevail in all product markets. In the event of shortage of supply there is no automatic correction. Besides consumers are often victims of unfair trade practices and unethical conduct of business.

Consumer interests are thus protested to some extent with laws and pressure of organised consumer groups. Management should anticipate these developments, satisfy consumer needs and protect consumer interests. Goods must be of appropriate standard and quality and be available in adequate quantities at reasonable prices. Management should avoid resorting to hoarding or creating artificial scarcity as well as false and misleading advertisements.

4) **Responsibility towards the governments:** As a part of their social responsibility, management must conduct business affair in lawful manner, honestly pay all the taxes and dues, and should not corrupt public officials for selfish ends. Business activities must also conform to the economic and social policies of the government.

5) **Responsibility towards the community and society:** The socially responsible role of management in relation to the community are expected to be revealed by its policies with respect to the employment of handicapped persons, and weaker sections of the community, environment protection control, setting up industries in backward areas, and providing relief to the victims of natural calamities.

Check Your Progress B

1) Classify the following managerial activities into functions:

Managerial Activity	Managerial Function
i) Forecasting	....
ii) Communication	....
iii) Establishment of performance standards	....
iv) Selecting managers	....
v) Budgeting	....

2) State whether the following statements are True or False.

   i) Lower level management is otherwise called strategic management.

   ii) Conceptual skill implies ability to use tools, procedures and techniques

   iii) Profit-making responsibility lies with functional managers.

   iv) Staffing means manning the organisation structure.

   v) Motivating belongs to planning function.

   vi) Employees of the enterprise are stake-holders.

10.11 LET US SUM UP

Various meaning assigned to the word 'management' add up consistently. Management is a distinct decision-making group which makes use of systematised body of knowledge relating to functions that make up the process. Distinction between management and administration can be drawn by preferring the usage of the former term in commercial enterprises and the latter term in government enterprises engaged in social and political activities. But in practice both the terms are used as synonyms and there is no evidence that two sets of people called administrators and managers are required for running an enterprise.

Definitions of management can be grouped under four different schools. The Process School analyses the job of a manager and classifies managerial activities into distinct functions viz., planning, organising, staffing, leading and controlling. Human Relations School, while emphasising human aspect of an organisation, gives more importance to managing people. The Decision School focuses on decision -making involving the managerial activity of developing and choosing from among alternatives. Managerial responsibility of relating organisation to external environment is the subject matter of Systems and Contingency School. Essential features that make up the nature of management are also derived from the concepts and definitions of management.

Management as a distinct branch of knowledge with clearly defined boundaries, confines itself to the managerial job conceptually divided into functions. While managerial functions are common to all enterprises, enterprise functions derived from the purposes of the enterprises vary according to their nature. Management though not an exact science, is progressing towards perfection. Art of management, which is an application of management science for achieving practical results, depends on the latter for its improvement. Thus science and art of management are not mutually exclusive, but complementary to each other. Management is increasingly being regarded as a profession, as it has a body of knowledge, the acquisition of which is compulsory for gaining access to managerial jobs in the modern complex organisations. Skill requirements for all levels of managers are identified as conceptual, human and technical. Human skill is important at all levels. Higher the managerial level the greater the need for conceptual skill. Technical skill which assumes grater importance at lower levels is of less significance at higher levels.

The term 'social responsibilities' may be defined as the obligations of management towards the society and others concerned with the activities of organisation. Business enterprises are creatures of society and should therefore respond to the demands of society. Otherwise management will be forced to conform to social demands through laws or the enterprise may not be permitted to survive. It is in the long run interest of business if the management assumes social responsibilities. Managers of business firms must not only take care of the financial interest of owners but also take into account the interest of other stake-holders of the firm including employees, consumers, the government and the community at large.

10.12 KEY WORDS

Administration: A thinking function concerned with overall determination of objectives and policies to be executed by the management.

Art of Management: Application of science in the attainment of practical results.

Conceptual Skill: Ability of a manager to visualize and coordinate the activities of, and varied interests in the organisation as a whole.

Controlling: A process of evaluating results against predetermined standards and correcting deviations, if any

Forecasting: Anticipating future environment.

Management: Process of attainment of predetermined objectives by directing activities of group of persons and employing other resources.

Organising: Process of identifying and grouping the work to be performed and establishing relations between persons and granting necessary authority to them.

Planning: Determining future course of action.

Profession of Management: Practice of a specialized kind of job, applying systematised body of knowledge and guided by code of ethics set by a recognized body.

Staffing: Manning the organisation structure and keeping it manned.

Science of management: A body of knowledge consisting of concepts, principles and techniques organised around managerial functions.

Social Responsibilities: Obligation of management and enterprise towards stake-holders.

10.13 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress A

3) (i) Decision School (ii) Process School (iii) Systems and Contingency Schools, (iv) Human Relation School

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

Check Your Progress B

1) (i) Planning (ii) Leading (iii) Controlling (iv) Staffing (v) Planning

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

10.14 QUESTIONS FOR PRACTICE

1) What is management? How is it Defined?
2) Do you agree with the view that management is both a science and art? Substantiate.
3) What is profession? Is management a profession? Why?
4) Explain the skill requirements of managers at different levels.
5) Discuss various functions of management.
6) Define social responsibilities. Explain the social responsibilities of management towards a) Employees b) Consumers and c) community.
7) Distinguish between:
   a) Management and Administration.
   b) Management as a process and system of authority.
   c) Administrative management and operative management.

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

UNIT 11 APROACHES TO THE STUDY OF MANAGEMENT

Structure

11.0 OBJECTIVES

After studying this unit, you should be able to:

- distinguish between different stages in the evaluation of management thought
- explain the concept of 'scientific management' and enumerate the principles of scientific management
- analyse Fayol's administrative theory of management
- describe the features of human relations approach to management
- outline the main element of the behavioural approach
- explain the decision theory of management
- describe the characteristics of the modern (systems) approach to the study of management
- explain the contingency approach to management.

11.1 INTRODUCTION

In unit 10 you have studied the concept of management, its nature and scope. Although the practice of management is as old as civilisation, systematic thinking on various aspects of management started only from the beginning of the last century. With the passage of time, different thinkers viewed the task of management in the light of their own experience and understanding of the process of management. In this Unit, we shall discuss the more important stages in the evaluation of management thought, different approaches to the study of management and theories developed in that context.

11.2 EVOLUTION OF MANAGEMENT THOUGHT

How to manage activities involving large number of people must have been known even in the ancient past. There are evidences all over the world about the practice of management since the dawn of civilisation. Without proper management it would have been impossible to undertake construction of the Egyptian Pyramids, or the Great Wall and the irrigation canals of China. However, organised activities in earlier times mainly required engaging people for manual operations and getting work done under strict supervision. On the other hand, work in cottage industries which flourished during the middle ages mainly involved engagement of family members and apprentices and application of traditional skills with simple tools and implements.

Far reaching changes took places in the organisation of economic activities with the industrial revolution at the turn of the 18th century. Scientific and technical inventions paved the way of large scale factories using mechanical power and employing hundreds of people. The systems of transport and communication were also transformed in the process and enabled producers to undertake distribution of goods in ever widening markets. With the growth in size and increasing complexity of organisations, the nature and scope of managerial function have also undergone considerable changes. The task of management no longer consists of supervising simple operations and taking routine decisions. It involves procurement of physical, human and monetary resources as well as their effective use for achieving the organisational objectives. The process of management and the various functions involved have thus received increasing attention of management experts over time.

Early Thinkers

Thinking on management as a separate field of learning and practice began early in the 19th century. It was at this time that persons like Robert Owen, Charles Babbage, Metcalf and Towne expressed their ideas on the ways and means of making management practices more effective and efficient.

Robert Owen, who owned and managed several textile mills in Scotland, emphasized the importance of human relations in management. He was very much against the existing practices of workers being employed in factories to perform manual work for as long as thirteen hours per day, employment of child workers even below the age of ten, absence of housing facilities, etc. He introduced many reforms in his own factories, reducing working hours, improving working conditions, providing housing facilities, and arranging supply of goods at cheaper rates through company stores. On the basis of his own experiences, he advocated that investment in human resources was more profitable than investment in machinery and the other physical resources. He therefore, recommended that industrialists should change their attitude towards the workers and devote more attention to their well-being.

Charles Babbage was a professor at Cambridge. Having studied the management of factories in the United Kingdom and France, he observed that employees and owners were totally ignorant of the basic tools of scientific methods, they were guided purely by tradition, estimates and imagination and the owner-managers never took decisions on the basis of factual analysis. According to Babbage, it is essential to apply scientific principles to work processes for increasing productivity and reducing expenses. In his writings, Babbage emphasized the importance of division of labour on the basis of skills, and also stressed the necessity of replacing manual operations by machinery.

As the manager of an army arsenal, **Henry Metcalf** held the view that the science of administration ought to be based on principles evolved by recording observations and experiences. The art of management, according to him, should be based on accumulated observations which are on record and are presented systematically. His book on cost of manufactures and administration of workshops suggested a system of control with the help of work records maintained in Time Cards and Material Cards and a method of automatic actions.

Henry Robinson Towne was the chief executive of a manufacture company. His contribution to management lay in defining the role of a manager as a combination of the roles of an administrator, an engineer and a statistician. Management of industrial work, according to Towne, required combination of different qualities of good businessman and good engineers. He succeeded in motivating engineers to study management and advised them to be cost-conscious. At the same time, he emphasized that the process of management has multiple dimensions and engineer-managers must be aware of it.

Early thinker on management made an attempt to suggest improvements in the functioning of manufacturing organisations by different means. In that process the thinkers also provided a new background for management in practice. Growth of business and industry proceeded at a rapid pace in the Western European countries and the USA throughout the 19th century. Increased competition in the domestic and international markets during this period drew the attention of management towards the necessity of improving productivity and efficiency of their undertakings.

11.3 SCIENTIFIC MANAGEMENT

The concept of scientific management was introduced by **F.W. Taylor** in the USA early in the 20th century as an alternative to the prevailing system of management by initiative and incentives. Taylor started his career as machine shop worker at Midvale Steel Works. In course of time he acquired additional qualifications and became foreman and than chief engineer. Subsequently he acted as consultant of another steel company which had serious production problems. Based on observations and large numbers of experiments on methods of work at the shop floor and the attitude of management towards the workers, Taylor formulated the principles of scientific management.

Taylor's concept of scientific management essentially consisted of a scientific approach to management. Its primary objective was to replace methods based on trial and error and rule of thumb. The new approach rested on the following principles:

1) Development and use of scientific methods in setting work standards, determining a fair day's work and the best way of doing work.

2) Scientific selection and placement of workers best suited to perform the various tasks and provision of their training and development for maximum efficiency.

3) Clear cut division of work and responsibility between management and workers.

4) Harmonious relations and close corporation with workman to secure performance of work in accordance with the planned jobs and tasks.

A number of techniques were developed to facilitate scientific management. Taken together the following techniques constituted the mechanism of the new approach:

1) Time Study to analyse and measure the time taken in doing the various elements of a job, and to standardise the operation as well as determining a fair day's work.

2) Motion Study involving close observation of the movements required to perform a job with a view to eliminate wasteful motions and decide on the best way of doing the job.

3) Standardization of tools, equipments and machinery and working conditions.

4) Incentive wage plan with differential piece rate of wages for efficient and inefficient workman

5) Functional foremanship involving different specialist foreman supervising machine speed, group work, repairs, etc.

Taylor presented his ideas on scientific management as a systematic body of thought. His main contribution to management practices included the following aspects:

a) The importance of applying scientific methods of enquiry, observation and experimentation to the problems of management

b) Separation of planning of work from its execution so as to enable workers to perform at his best and earn accordingly.

c) Emphasising the aim of management to be the maximum prosperity of the employer along with the maximum welfare of each employee.

d) The necessity of a complete mental revolution on the part of both workmen and management to derive the benefits of scientific management through harmony and cooperation rather than individualism and discord.

Merits: The primary benefit of scientific management was conservation and proper use of every ounce of energy. Moreover specialization and division of labour have brought about the second industrial revolution. Time and motion techniques are improved tools to organise the tasks in a more efficient and rational way. In short, scientific management is not only a rational approach to solve organisational problems but it also facilitates the professionalisation of management.

Although the basic principles of scientific management were originally developed by Taylor, several associates of Taylor like Gantt, Frank and Lillian Gilbreth, and Emerson further elaborated the ideas, developed new techniques and improved upon the new approach to management. In practice, scientific management proved to be so fruitful in increasing productivity and efficiency of operation that it was widely accepted in the USA and Western Europe.

Limitations: Scientific management had its limitations and was criticised on several grounds. Some critics, argue that scientific management is concerned with the efficiency of workers in the technical sense, and it emphasises only the importance of production. It assumes that workers are inherently lazy and they require strict supervision and exercise of authority by managers. It is believed that workers can be motivated by monetary rewards alone. No importance is attached to social and psychologically aspects of work environment. Other critics have called it unscientific, antisocial, psychologically unfair and anti-democratic. It is unscientific because there is no valid and reliable method to measure the efficiency and wages of the workers. It is antisocial because workers are treated as glorified economic tools only. It is psychologically unfair because each worker is pitted against every other worker in an unhealthy competitive scheme to make more and earn more. It is anti democratic because it overshadows the workers independence. Trade unions have been opposed to scientific management on the ground that it leads to autocratic management, and raises the workload of employees with a corresponding adverse impact on employment of men.

11.4 FAYOL'S ADMINISTRATIVE THEORY

Scientific management was primarily concerned with increasing the productive efficiency of individual workers at the shop floor. The role of managers and their functions in the total organisation were not given adequate attention. Around the same time, that is the first quarter of the 20th century **Henri Fayol,** director of a coal mining company in France, made a systematic analysis of the process or Functional Approach.

According to Fayol, business activities in any organisation consist of six inter-dependent operations viz,: technical, commercial, financial security, accounting and administrative or managerial operations. He analysed the nature of managerial activities and skill requirements which were so far given little attention by thinkers. He considered the process of management to be of universal application and distinguished between five elements of the process viz., to forecast and plan, to organise, to command to coordinate, and to control. The concept of management was, thus, defined as the process of performing certain functions like planning, organising, etc These functions were expected to be performed by managers at all levels in the organisation as well as in all types of industries and in all countries.

Fayol emphasised that management involved the application of certain skills which could be acquired by persons on the basis of systematic instruction and training. Once acquired. The skills could be applied to all types of institutions including the church, schools, political as well as industrial organisations.

Besides a systematic analysis of the management process and management functions, Fayol formulated a set of fourteen principles as guidelines for implementing the process of management. These principles were stated in flexible terms and expected to be of use to managers under all circumstances. The skill and abilities required for effective management were stated to be dependent on the manager's positions at different levels of the organisation.

According to Fayol, administrative skills were more essential for higher levels managers, while technical abilities were required more at the lower level positions. He also believed that managerial training was essential for people in all walks of life. He also stressed, for the first time the necessity of formal education and training in management. In short, Fayol's analysis provides a set of means (viz., Planning organising, commanding, coordinating and controlling) for viewing the management process, and guidance (i.e., the principles for implementing the process).

The Administrative Theory of Management and Functional Approach to management may be said to have developed on the foundations laid by Fayol. He provided a conceptual framework for analyzing the process of management. At the same time, he isolated and analysed management as a separate, distinct activity. Management as a body of knowledge gained immensely from Fayol's analysis of managerial skills of universal relevance, and principles of general management developed by him. Although some critics called it inconsistent, vague and pro-management based theory, still this theory excerts considerable influence on the practice as well as teaching of management the world over.

Check Your Progress A

1) State which of the following statements are True and which are False.

   i) Thinking on management as separate field of study began with the dawn of civilization. ....

   ii) Henry Metcalf suggested a method of control with the help of work records and automatic action. ....

   iii) The concept of scientific management is based only on the application of scientific techniques like time and motion study. ....

   iv) Taylor developed the principles of scientific management in the light of his observations and experiments on methods of work. ....

   v) Taylor was concerned mainly with the management of work at the shop floor. ....

   vi) The abilities required by a manager depend on his position and rank in the organisation. ....

   vii) Fayol distinguished between five elements or functions related with the process of management. ....

   viii) Fayol's approach to the study of management is known as administrative approach. ....

2) Fill in the blanks:

   i) The importance of workers' well being was emphasised by ...., an early thinker on management.

   ii) Supervision of work by different specialist foreman is known as ....

iii) The concept of management was defined by Fayol as the process of performing certain. …………………..

iv) Trade unions are opposed to scientific management because it leads to increased …………….. of employees.

v) According to Towne, a manager should combine the roles of ……………… an ……………. and ………………….

11.5 HUMAN RELATIONS APPROACH

We have discussed earlier the elements of scientific management concerned with the efficiency and productivity of workman at the shop floor. We have also discussed Fayol's functional approach to management which aimed at improving the managerial activities. Between 1925 and 1935, opinions of many experts were directed towards the human aspects of organisational activities. It was felt that earlier approaches to management were incomplete as there was little recognition of the importance of workers as human beings, their attitudes, feelings and needs. Indeed, the technical approach to work methods in scientific management did not produce durable results in all case. Individual and group relationships in the work place often prevented maximum benefits to be derived from planning and standardisation of work or monetary rewards offered for efficiency.

The human relations approach to management developed as a result of the series of experimental studies conducted by **Elton Mayo** and his associates at the Hawthorne Plant of the Western Electric Company in the USA. The Hawthorne studies were aimed at finding out what factors really influenced the productivity and work performance of labourers. The findings were as follows:

1) Physical environment at the work place do not have any material impact on the efficiency of work.

2) Favorable attitudes of workers and work-team towards their work were more important factors determining efficiency.

3) Fulfillment of the workers' social and psychological needs had a beneficial effect on the morale and efficiency of workmen.

4) Employee groups based on social interaction and common in the rests exercised a strong influence on workers' performance.

5) Workers cannot be motivated solely by economic rewards. More important motivators are security, recognition by superiors and right to express their opinion on matters which are of concerns to them.

The human relations approach to management problems is based on the view that the **modern organisation is a social system, in which the environment and interpersonal relations govern the behaviour of employees,** It emphasizes that the authority responsibility relationship between superiors and subordinates should relate to the social and psychological satisfaction of employees. It is only by making employees happy that an organisation can secure their full cooperation and thus increase efficiency. Management should encourage the development of social groups on the job and provide opportunities for free expression of the employees' viewpoints. Managers should recognize the importance of democratic leadership, so that there is free flow of communication and subordinates may participate in decision-making.

It must be noted that the objective of human relation approach was to make workers more productive. But it was emphasised that employee satisfaction was the best means of achieving the goals of higher productivity and efficiency. For this purpose, it was necessary that managers must know why employees act as they do and what social and psychological factors motivate them. Attempt should be made to create a satisfying work environment in which people may fulfill their own needs as well as contribute to the achievement of organisational goals.

11.6 BEHAVIOURAL APPROACH

The behavioural approach to management developed as a corollary to the human relations approach. But it also reflected the findings intensive research carried out by behavioural scientists' belonging to the discipline of sociology, social psychology, and anthropology, as well as management experts. **The behavioural approach was concerned with the social and psychological aspects of human behaviour in organisations.** Many of the conclusions of the Hawthorne studies were reaffirmed by subsequent research studies, but certain ideas were extended and others highlighted by the behavioural scientists.

Some of the more important elements of the behavioural approach are outlined below:

1) Individual behavior is closely linked with the behavior of the group to which he belongs. A person may be inclined to resist pressure to change its behavior as an individual. But he will readily do so if the group decides to change its behavior. With work standards laid down by the group, individuals belonging to that group will resist change more strongly. Moreover, what workers believe to be the management's expectation to output often determines or influence the level of production. This is because management generally does not have any specific level of production it considers proper, and workers often believe that if they work harder their pay rates would be reduced.

2) Informal leadership, rather than the formal authority of foreman and supervisors, is more important for setting and enforcing group standards of performance. As a leader manager may be more effective and acceptable to the subordinates if he adopts the democratic style of leadership. If the subordinates are encouraged to participate in establishing the goals, there will be positive effect on their attitude towards work. Changes in technology and methods of work, which are often resisted by employees, can be brought about more easily by involving the employees in planning and designing the jobs.

3) By nature most people enjoy work, and are motivated by self – control and self-development. It is for the managers to identify and provide necessary conditions for the human potential to be used in the service of the organisation. The managers, attitude towards human behavior should be positive. They should know that the average man is not lazy by nature. But he is ambitious. Everyman likes to work and prefers to assume responsibilities.

11.7 DECISION THEORY

Decision-making is defined as the process by which a choice is made from among various alternative course of action to achieve goals. Thus, decision-making involves establishing objectives or goals, defining the problems, searching for available alternatives, evaluating them, selecting one, and implementing the decision. All organisational activities require decisions to be taken preceding action. Every manager has to take decision to direct action at different intervals. At lower level, managers have to take routine decisions for day-to-day action under their limited jurisdiction. At higher levels of management, decisions are taken having wider impact and long-term significance. Positions held by managers are known as decision centers.

According to the decision theory of management, the process of management essentially consists of human problem–solving on the basis of analysis and reasoning followed by appropriate decision. This involves individuals making choices and behaving on the basis of their understanding of the environment and their needs. The key to an understanding of the organisational functioning lies in the identification of decision centers and the channels of communication. The objective of managerial decision-making is to secure and co-ordinate effectively the contributions of others in the decision-making process. This can be accomplished by influencing as far as possible, the viewpoints of participants on various alternatives before making a choice, so that the resulting decisions may fit the requirements of objectives.

The decision theory admits that it is not always possible for managers to make perfect decisions. This is due to several reasons. The basic requirement in the decision process is the availability of all information relevant to the decision situation. But data collection, analysis and evaluation often prove to be too costly and time consuming. Secondly, the decision-maker may not have complete knowledge of available alternatives and their potential outcomes under conditions of uncertainty and risk. Thus, decisions are actually based on individual judgment.

11.8 MODERN (SYSTEMS) APPROACH

In simple words, a system may be defined as a set of interdependent parts forming an organised unit or entry. These parts, known as sub-systems, interact with each other and are subject to change. They are interrelated as well as interdependent. Thus changes in any sub-system lead to changes in others. Any working organisation may be said to consist of three board sub-systems:

a) Technical sub-system which represent the formal relationships among the members of an organisation,

b) Social sub-system which provides social satisfaction to members through informal group relations, and

c) Power sub-system which reflects the exercise of power or influence by individuals and groups.

The total system emerges as a result of the interaction of the various sub-systems. The total system and its sub-system also interact with the environment, which may influence or be influenced by the system or the sub-systems.

The systems approach has the following features:

1) System is a group of interrelated but separate elements.
2) The arrangement of all the elements must be orderly.
3) There must be proper communication facilitating interacting between the elements.
4) Finally the interaction should lead to achieve a common goal.

The enterprise operations are viewed in terms of basic elements engaged in procuring and transforming inputs into outputs. Money, employees and the managers themselves are parts of the system. Inputs are the materials, information and energy, flowing into the organisation. The outputs are products, services and satisfaction provided by the organisation. The organisation transforms input into a variety of outputs (in the form of products, goods and services) and offers the same to the external environment. Sale of the outputs provides the necessary energy which is called feedback to repeat this systems cycle. Look at Figure 2.1 which shows this cycle.

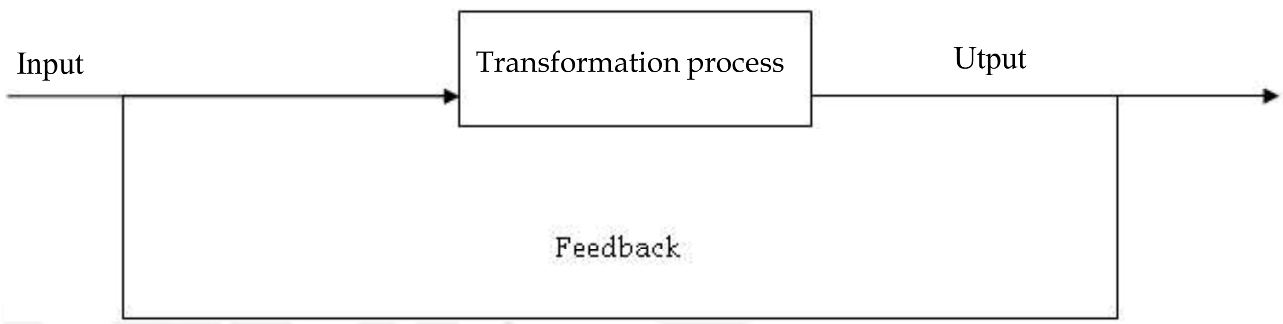


Figure 2.1: Cycle of Systems Approach

This systems approach to management views organisations as extremely complex entities subject to changes from within and outside. To meet various needs of such an organisation, a balanced and integrated approach to management is required. At the heart of the systems approach lie a Management Information System and communication network for collection, analysis and flow of information and quantitative data so as to facilitate planning and control. It emphasises the importance of decision- making as the primary means of balancing the different parts of the organisation. Modern thinkers consider management as a system of integrating activities aimed at making the best use of scarce resources. Management is viewed also as a sub-system of the social system. As a sub-system management is required to adopt and cope with environmental changes.

This system approach has the following advantages:

1) It provides a unified focus to organisational efforts.
2) It provides managers an opportunity of looking at the organisation as a whole which is greater than the sum of its parts.
3) This theory treats the organisation as an open system. Moreover, the process of interaction between subsystems is dynamic.
4) Modern theory is based on multilevel and multidimensional approach i.e., it includes both micro and macro aspect. It is micro within the nation's industrial network and macro with respect to its internal units.

5) The system is based on multiple variables because an event may be the product of many factors which in turn may be interrelated and interdependent.

6) The feedback mechanism provides an opportunity to organisation to rearrange its parts according to the change in the environment. Although system theory has given fascinating appeal still it has some limitation.

In fact, this is not the complete explanation of the whole organisational system. It does not explain how the subsystems of a specific organisation are uniquely related in a given environment.

11.9 CONTIGENCY APPROACH

Contingency approach is based on the view that there is no one best way to manage. In fact there are many effective ways to perform various management functions. This theory emphasizes that the best way to lead, plans, organise and conduct managerial activities varies with the situation. A particular method may yield fruitful results in one situation but may drastically fail in other situations. There is no universal principle to be applied in all situations. Managers must analyse different situation and use the best approach which is best suitable in that particular situation. For example to improve productivity, supporters of scientific management may prescribe work simplification and additional incentives, the behavioural scientist may recommend job enrichment and democratic participation of employees in the decision-making process. But the supporters of contingency approach may offer a solution which is responsive to the characteristics of the total situation being faced. Work simplification would be ideal where there is limited resources, unskilled labour, limited training opportunities and limited products offered to the local markets. Job enrichment would be ideal for that organisation where there are abundant skilled labour forces. This shows that managerial action depends upon circumstances within a given situation. In this approach managers are supposed to diagnose a given situation and adopt to meet the conditions present. In short contingency approach emphasizes on two aspects. 1) It focuses attention on specific situational factors that influence the appropriateness of one managerial strategy over another. 2) It highlights the importance of developing skills for managers in situational analysis. Such skills will help managers find out important contingency factors that influence their approach to managing.

The main advantage of this contingency approach is that it compels us to be aware of the complexity in every situation and forces us to take an active and dynamic role in determining what best would work in each case. Like a system theory it does not only examines the relationships between subsystems of a specific organisation in a given environment, but also offers solution to particular organisational problems.

This theory is critisised on the ground of heavy theoretical complexity. For example a simple problem has to be analysed on a number of organisational components, each of which having innumerable dimensions. So its empirical testing becomes very difficult.

Check Your Progress B

1) Which of the following statements are True and which are False?

   i) The objective of human relation approach to management was only to make people happy.

   ii) Scientific management did not attach any importance to workers attitudes, feelings and needs.

   iii) Individual behavior is closely linked with group behaviour.

   iv) All decisions are taken by higher level managers.

   v) Systems approach to management emphasises management as an integrating activity.

   vi) Contingency approach emphasises that there is no universal principles to be applied in all situations.

2) **Fill in the blanks:**

   i) Human relations ensure the fulfillment of the workers ……………… and …………..needs.

   ii) Workers are not motivated solely by …………..incentive.

   iii) Decision-makers do not have complete knowledge of the potential outcomes of various alternatives, hence decisions are based on………………..

   iv) The technical sub-system represents the……………………among members of the organisation.

   v) Human relation approach is based on the view that the modern organisation is a………………….system.

11.10 LET US SUM UP

There are evidences all over the world about the practice of management since the dawn of civilization. However thinking on various function in the process of management received increasing attention of management experts only after the industrial revolution. Early thinking on management started with Robert Owen, Charles Babbage, Metcalf and Towne, who suggested ways and means of improving upon the existing practices of managing industrial organisation.

The concept of scientific management was introduced by F.W. Taylor as an alternative to the prevailing system of management by initiatives and incentives. Its primary objective was to replace rule of thumb methods by scientific methods of enquiry, observation and experimentation in management. Scientific management was concerned with increasing the productive efficiency of individual workers at the shop floor. The role of managers and their functions in the total organisation were not given adequate attention.

Henry Fayol made a systematic analysis of the process of management and the functions of managers. He formulated a set of principles as guidelines for implementing the process of management. The Administrative theory of management was developed on the foundations laid by Fayol.

The Human relations approach to management developed as a result of the series of experimental studies conducted in the USA. It is based on the view that the modern organisation is a social system and that employee's satisfaction is the best means of achieving the goals of higher productivity and efficiency. For this purpose management should create a satisfying work environment, in which people may fulfill their social and psychological needs as well as contribute to the achievement of organisational goals.

The behavioural approach to management was an extension of the human relations approach. It reflected the extensive research carried out by behavioural scientists belonging to the disciplines of sociology, social psychology and anthropology. It recognised that individual behavior is governed by the behavior of the group to which he belongs. It emphasized that informal leadership and democratic style are more effective means of setting and enforcing group standards.

According to the decision theory of management, the key to an understanding of the organisational functioning lies in the identification of decision centers and the channels of communication.

The systems approach to management views organisations as extremely complex entities subject to changes from within and outside. To meet the various needs of such an organisation requires a balanced and integrated approach to management. Management is regarded as a system by itself as well as a sub-system of the social system. Here, the organisation transforms various inputs into a variety of outputs and offers the final products to the environment which in turn provides necessary energy called feedback to repeat the cycle. Contingency model emphasizes that there is no universal principle to be applied in all situations. It focuses attention on specific situational factors that influence the appropriateness of one managerial strategy over another and highlights the importance of developing skills for managers in situational analysis.

11.11 KEY WORDS

Administrative Approach: Analysis of the process of management in terms of management functions and skill requirements.

Behavioural Approach: Understanding individual and group behaviour in organisations.

Differential Piece Rate : Piece rates of wages which apply differently to efficient and inefficient workers

Functional Foremanship: Supervision of work by different specialist foreman.

Hawthorne Studies: Experimental studies conducted to find out what factors motivate workers on the shop floor for improved performance.

Human Relation Approach: Motivating employees with a satisfying work environment and fulfillment of their social psychological needs.

Motion Study: Observation of the movements required to perform a job so as to eliminate wasteful motions and decide on the best way of doing the job.

Scientific Management: Application of scientific methods to resolve management problems in place of rule of thumb or trial and error methods.

System Approach: Understanding management as a balancing and integrating system.

Time Study: Technique used to analyse and measure the time taken in doing the various elements of job.

11.12 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress A

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

2) (i) Robert Owne, (ii) Functional Foremanship, (iii) Functions, (iv) Workload, (v) administrator, engineer, statistician.

Check Your Progress B

1) (i) False (ii) True (iii) True (iv) False (v) True (vi) True.

2) (i) social, psychological, (ii) economic, (iii) judgment, (iv) formal relationship, (v) social.

11.13 QUESTIONS FOR PRACTICE

1) Give a brief outline of the evaluation of management thought during the 20^{th} century.

2) What is meant by scientific management? Discuss its main principles, merits and limitations.

3) Explain the significance of the behavioural approach to management. What are its main features?

4) Describe the main elements of the human relations approach to management.

5) Explain Fayol's contribution to management thought.

6) Explain the systems approach of management. Discuss with example how does it provides feedback mechanism to continue the whole cycle.

7) Critically evaluable contingency approach to management.

8) What are different approaches to management? Discuss about each of them briefly.

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

UNIT 12 FUNDAMENTALS OF PLANNING

Structure

12.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning, nature and importance of the managerial function of planning
- gain familiarity with the various steps of the planning process
- describe the major types of planning - such as Strategic Planning, Tactical planning, Long-range Planning and Short-range Planning
- enumerate and explain the principles on which Planning is based.

12.1 INTRODUCTION

In Unit 10 you have been introduced to the key functions of management. Planning is one of the critical functions of managers, which is closely related to the other functions. Indeed planning is always recognised as a key function of managers at all levels in the organisation. Of late, there has been a vigorous surge of interest in planning all over the world – especially corporate, long-range and strategic planning.

In this Unit, you will learn the fundamentals of planning – its meaning, nature, characteristics, importance and limitations. You will also learn the elements and steps in the planning process, and the role of forecasting in planning. You will further learn the concepts of strategic planning, tactical planning, long-range planning, short-range planning and the essential principles of planning.

12.2 WHAT IS PLANNING?

Most of us are fairly familiar with the meaning of 'Planning' in our everyday life. We do often decide in advance about the things to be done on a busy working day. Parents make advance decision on the education of their children. As students, you may think in advance how to go ahead with the preparation for your examination, how to make use of your time in the best possible manner and so on. Laymen understand planning as some systematic way of deciding about and doing things in a purposeful manner.

However, in the context of formal organisations and their management, the concept of planning has a specific connotation. It means deciding in advance what is to be done in the future for a specific period and then taking the necessary steps to do the things decided upon. It means looking ahead into the future and trying to anticipate what it is likely to be, how it will affect the organisation, what direction the organisation should take, and how to cope with the future events. Planning also implies determination of courses of action from among alternatives to achieve the goals of the organisation, both in the immediate future and in the long run. The very notion of planning brings to mind such images as neat, orderly and disciplined approach to work, goal-oriented behaviour, thinking about and arranging things in advance, careful allocation of scarce resources, and so on. In short, planning may be defined as the process of setting future objectives and deciding on the ways and means of achieving them.

12.3 NATURE AND CHARACTERISTICS OF PLANNING

The managerial function of planning has certain unique characteristics of its own, which distinguish it from the other managerial functions. It also shares a few characteristics with other managerial functions. All the characteristics together reflect the nature of the planning function. They are discussed as below:

i) **Primacy of Planning:** Planning precedes all other managerial functions. The process of management begins with planning. Planning provides the basis for the subsequent functions of organising, staffing, directing and controlling, though all the functions are highly interrelated and are equally important. Planning is the prime function from which the other functions get the necessary base.

ii) **Planning as a process:** Planning is a process involving a few stages or steps. It is a sub-process of the process of management. The planning process begins with identification of mission and goals of the organisation and ends with making arrangement for implementation of plans.

iii) **Pervasiveness of planning:** Planning is a pervasive function of managers at all levels of the managerial hierarchy, right from the chief executive down to the first line supervisor. However, the content and quality of the function differ from level to level. The time developed to planning also differs. Typically, the chief executive and other, top level managers concentrate on corporate-wide planning function. Their decision on planning have far-reaching effects on the organisation. Managers at middle and lower levels have more limited planning functions.

Planning is also pervasive across the various organisational function areas. In a manufacturing enterprise, for example, we come across such activities as production planning, materials requirements planning, manpower planning, financial planning, and so on.

iv) **Future orientation:** Planning is invariably future-oriented. Henri Fayol defined planning as the process of looking ahead (thinking ahead) and making provision to tackle future events and situations. The concern for future makes sense to the extent that planning is intended to cope with uncertainties and unknowns which unfold themselves as one march into the future.

It is needless to state that planning cannot be anything other than future-oriented: one does not plan for the past and the present. Of course, while planning for the future, managers consider the relevant events and situations of the past and the present within and outside the organisation.

v) **Information base:** Planning is backed by information. Without information planning exists in a vacuum. Information on the past trends, current conditions and future possibilities are essential for planning. Information needed to diagnose planning issues and problems, to develop alternative courses of action to evaluate them and to make final choice of plans.

vi) **Rationality:** Planning is a rational managerial activity. It implies that planning is a purposeful and conscious managerial function. It is backed by adequate information, knowledge and understanding. Managers who are planners are somewhat objective and unemotional in their approach to planning. They make planning decisions with some awareness of their consequences.

vii) **Formal and informal nature:** Planning has both formal and informal elements. Formal planning refers to a systematic and rigorous process of arriving at planning decision through investigation and analysis of the various factors. Formal planning is more explicit, and open; responsibility for various aspects of planning is pinpointed among managers. Plans are put into writing and are communicated through the organisational channels of communication to the various managerial levels.

Informal planning is done by managers through an intuitive process. Managers carry plans in their heads in the form of specific but flexible intentions and communicate them to others through word of mouth. Informal planning may also be viewed as a trial and error, fragmented, intermittent process as against a systematic step-by-step and logical process of formal planning.

viii) **Intellectual process:** Planning is an intellectual process and requires certain conceptual skills. It requires abilities to think both in abstract and concrete terms, to visualize and look ahead into the future and to form ideas and images of future expectations and desires. Planning also calls for intellectual abilities to anticipate opportunities and threats in the environment, to diagnose problems, develop alternative courses of action, and analyse them for choosing the right course.

ix) **Pragmatic, action-orientation:** Although planning is an intellectual thinking activity, it is primarily pragmatic and action–oriented. Planning precedes action and is often described as action laid out in advance. To think before acting and to decide before doing are part of the discipline and culture of planning. The focus is on actionability of plans, i.e., their quality of being implementable. Planning is also reality-oriented.

x) **Planning as a form of decision making:** Planning involves problems solving and decision making. It is a process of identification of issues and problems needing decision, collection of relevant information, evaluation of alternative courses and choices of the most appropriate alternative. Decisions are made on organisational objectives, strategies, policies, programmes, procedures and other plans. They are all choices from alternatives. They also involve mobilisation, allocation and commitment of resources and efforts in specific ways.

xi) **Planning premises:** Planning is based on certain assumption and estimates about the future behaviours of events and situations in the environment. These are formally known as 'planning premises' which are derived through the process of forecasting. Without such assumptions planning becomes an empty speculative exercise. Managers make promises or assumptions about the future events for purposes of planning in order to have a sense of security and certainty in the midst of grave uncertainties and complexities of the environment.

xii) **Dynamism:** Planning is a dynamic process. It is process of making the organisation selectively move and change in tune with relevant changes in the external environment. It is a process of building flexibility and adaptability into the functioning of the organisation. It is a process of making continuous assessment and reassessment of the goals, resources, direction opportunities and problems of the organisation and converting them to serve its needs.

xiii) **Levels of planning:** Planning is often divided into a few levels on the basis of their scope, significance and time span. On the basis of scope, there are two levels: (1) corporate planning covering the entire organisation, and (2) sub-corporate or functional planning carried on within the various functional units or divisions. On the basis of significance, we may divide planning into strategic planning and tactical or operational planning. On the basis of time span, there are two levels:

1) Long-range planning covering periods of more than one year in general, and

2) Short-range planning covering a period of one year or less.

The division of planning into various levels facilitates analysis of the dimensions and critical elements of planning. Even so, planning is an integrated function. Thus, different levels of planning should be balanced and coordinated so that they support one another.

xiv) **Types of plans:** The process of planning produces several types of 'plans' which may be viewed as a series or hierarchy of decisions and 'action packages'. They include: objectives or goals, strategies, policies, programmes budgets, schedules, procedures, methods, rules and so on. Some of the plans such as objectives and budgets serve as integral elements of the planning process while others such as policies, procedures, rules and methods serve as facilitating tools for smooth planning. All the plans are categorised into two broad groups; (i) single use plans, and (ii) standing plans. Single use plans are those which are designed to meet specific, non-repetitive and unique situations, while standing plans are those which are fairly stable and are meant to handle a wide range of repetitive situations over a period of time.

12.4 IMPORTANCE OF PLANNING

The importance of the planning function should have been clear after all that you have read about it till now. We may outline the importance of planning function as follows:

i) **Provides directions:** Planning provides a clear sense of directions to the activities of the organisation and to the job behaviour of managers and others. It strengthens their confidence in understanding where the organisation is heading and what for, how best to make the organisation move along the chosen path, and when should they take what measures to achieve the goals of the organisation.

ii) **Provides opportunity to analyse alternative courses of action:** Another source of importance of planning is that it permits managers to examine and analyse alternative course of action with a better understanding of their likely consequences. If managers have an enhanced awareness of the possible future effects of alternative courses of action, for making a decision or for taking any action, they will be able to exercise judgment and proceed cautiously to choose the most feasible and favorable course of action.

iii) **Reduces uncertainties:** Planning forces managers to shake off their inertia and insular outlook; it induces them to look beyond those noses, beyond today and tomorrow, and beyond immediate concerns. It encourages them to probe and cut through complexities and uncertainties of the environment and to gain control over the elements of change.

iv) **Minimises impulsive and arbitrary decisions:** Planning tends to minimise the incidence of impulsive and arbitrary decisions and ad hoc actions; it obviates exclusive dependence on the mercies of luck and chance elements; it reduces the probability of major errors and failures in managerial actions. It injects a measure of discipline in managerial thinking and organisational action. It improves the capability of the organisation of assume calculated risks. It increases the freedom and flexibility of managers within well-defined limits.

v) **King-pin function:** As stated earlier, planning is a prime managerial function which provides the basis for the other managerial functions. The organisational structure of task and authority roles is built around organisational plans. The functions of motivation, supervision, leadership and communication are addressed to implementation of plans and achievement of organisational objectives. Managerial control is meaningless without managerial planning. Thus, Planning is the king-pin function around which other functions are designed.

vi) **Resource Allocation:** Planning is a means of judicious allocation of strategic and scarce resource of the organisation in the best possible manner for achieving strategic goals of the organisation. The strategic resources include funds, highly competent executives, technological talent, good contacts with government, exclusive dealer network and so on. If the organisation enjoys a distinct advantage in possession of such resources, a careful planning is essential to allocate them into those lines which would strengthen the overall competitive position of the organisation.

vii) **Resource use efficiency:** For an ongoing organisation, planning contributes towards a more efficient functioning of the various work units. There is better utilisation of the organisations existing assets, resources and capabilities. It prompts managers to close gaps, to plug loopholes, to rectify deficiencies, to reduce wastage and leakages of funds, materials, human efforts and skill so as to bring about an overall improvement in resource use efficiency.

viii) **Adaptive responses:** Planning tends to improve the ability of the organisation to effectively adapt and adjust its activities and directions in response to the changes taking place in the external environment. An adaptive behaviour on the part of the organisation is essential for its survival as an independent entity. For a business organisation, for example, adaptive behaviour is critical in technology, markets, products and so on.

ix) **Anticipative action:** While adaptation is a behaviour in reaction and response to some changes in the outside world, it is not enough in some situation. In recognition of this fact, planning stimulates management to act, to take bold initiatives, to anticipate crises and threats and to ward them off, to perceive and seize opportunities ahead of other competitors, and to gain a competitive lead over others. For the purpose, some enterprises establish environmental scanning mechanism as part of their planning systems. Thereby such enterprises are able to direct and control change, instead of being directed and controlled by the pervasive external forces of change.

x) **Integration:** Planning is an important process to bring about effective integration of the diverse decisions and activities of the managers not only at a point of time but also over a period of time. It is by reference to the framework provided by planning that managers make major decisions on organisational activities in an internally consistent manner.

Check Your Progress A

1) Which of the following statements are True and which are False?

i) Among other things, Planning implies determination of concern of action from among alternatives.

ii) Planning follows all other managerial functions.

iii) Planning cannot be future-oriented as the future is always uncertain.

iv) Planning has both formal and informal elements.

v) Planning reduces the probability of major errors in management.

2) Fill in the blanks:

   i) Planning is the process of setting ………………………objectives.

   ii) ....and …………………………of planning function differ from level to level of management hierarchy.

   iii) Informal planning is done through the ………………………….. process.

   iv) As planning requires certain conceptual analytical skills, it is regarded as an…………………….. process.

   v) Assumptions and estimates about the future events are known as planning……………………………….

   vi) Plans which are drawn to meet specific, unique situations are known as…………………………….

   vii) Planning is a means of judicious ………………………of resources.

   viii) Planning stimulates management to take ………………………..

12.5 LIMITATIONS OF PLANNING

You have learnt the nature and importance of planning. Let us now discuss its limitations.

i) **Based on certain assumptions:** Planning is based on certain assumption or premises derived from forecasts about the likely behaviour or relevant future events and variables. If such assumptions or premises turn out to be wide off the mark, the very basis of plans gets affected. Afterall, forcasting is not an exact science.

ii) **Incomplete information:** The information needed for planning is often incomplete. It may not be available in time and its reliability tends to be doubtful. In several situation, managers are forced to make planning decisions on the basis of partial knowledge because of time lags and credibility gaps in information.

iii) **Lack of control:** Managers have little knowledge and less control over several elements of external environment. There is often no way to bring external situation under the discipline of planning. Several external events tend to influence organisational activities and plans in random and perverse ways, as for example natural calamities, sudden strikes, government policy changes, and so on.

iv) **Difficult to change with the changing environment:** Planning, under conditions of rapid changes in the external environment tends to be a tough job; plans would become quickly outdated and irrelevant even before they are implemented. Though flexible plans would be of some help under such conditions, there are also limits on injecting flexibility into organisational plans.

v) **Fluid process:** Planning is essentially a 'fluid' process in the sense that it is always in a state of flux. This is because of the march of the times and subtle changes which characterise the future as it unfolds. Future is always a moving target. It is not easy to visualise an integrated composite view of the past, present and future for planning purposes.

vi) **Delay in action:** Since planning means thinking and deciding before doing things, it is likely to delay action. For one thing, thinking and deciding are somewhat slow intellectual exercises. Many managers may not have the time or taste for such exercises. For another, managers attach more importance to action and that too timely action wherein lies much activism and dynamism.

vii) **Rigidity:** The plans produced through the planning process tend to introduce rigidity into the functioning of the organisation. Managers are likely to insist on strict compliance with pre-determined pans. This may sometimes mean foregoing new opportunities and better options. A faithful conformity with plans would stifle initiatives beyond the established ways and routines.

viii) **Plans might remain on paper:** At the other extreme it is also likely that plans remain on paper as some sacred documents worthy to be respected and preserved and not followed or implemented. They may be far removed from realities such that managers regard them as 'untouchables'. Alternatively, managers may be too busy in struggling with crises to find time for going along planned courses.

ix) **Difficult to implement at unit level:** It may be easy to formulate broad plans at the corporate level. Problems are likely to arise when managers try to prepare more detailed plans in physical and financial terms at functional and unit levels for purposes of implementations. The detailed plans, if and when prepared, may not reflect the intents of the broad plans in a consistent manner.

12.6 THE PROCESS OF PLANNING

We have stated earlier that planning is a process consisting of certain steps or series of sequential activities. There is no generally accepted or standard format of the planning process. Different authors have their own ways of conceptualising the planning process. Let us discuss one of the conceptual schemes of the process of planning.

i) Planning to plan: Planning does not just occur on its own or with the issue of an order from the chief executive. It has to be properly and carefully decided upon and planned. The management of the organisation has to inject a culture of planning at all the levels of management by highlighting the imperatives and virtues of planning as also the philosophies and techniques embedded in it. It has to educate the managers in various departments by arranging training programmes and conferences on the methodology of planning so as to improve their competence to plan. The required planning system has to be designed and activated. This is especially so with regard to a new organisation.

ii) Appraisal of internal situation: In this step, top management in collaboration with other managers, have to make an analyses of the current state of affairs with the organisation – its existing plans, processes, activities, performance levels, achievements and problems. It is essential to review in detail the specific strengths and weaknesses of the organisation in its sphere of operations. For example, products and services it supplies, financial position, manpower and managerial resources, competitive position, profitability levels, market image, manufacturing and other facilities, R&D advantages, capital structure, and so on. Management has also to make forecasts and projections of the likely future positions and trends of the organisations activities in all the above areas.

iii) **Appraisal of the external environment:** Top management of the organisation is vitally concerned with the analysis of external environmental conditions for planning purposes. This facilitates them in understanding the elements and events in the world outside the organisation which effect its present and future functioning. Appraisal of environmental trends in economic, social, technological and other means of relevance for the organisation is to be continuous process. Not only the present but also the likely future trends have to be appraised though systematic scanning and forecasting mechanisms. This will enable the organisation to identify the present and future opportunities and threats in the various external elements with which the organisation is directly concerned.

iv) **Definition of key areas and issues for planning:** The appraisal of internal and external environmental conditions gives to the management an idea about what tentative planning the organisation needs. Managers have to ask themselves whether, in the light of external appraisal, the existing businesses, products, markets, processes and practices are relevant, and which aspects of them have to be retained, strengthened, refined and modified. The analysis also may reveal the need for new directions to strengthen the competitive position of the organisation, and to bring about a better alignment between the organisation and the external environment. It may also unearth the possibilities of going into new businesses, new technologies, new products and new markets. An important outcome of the above appraisal is identification of possible measures necessary to cope with environmental opportunities and threats, which are likely to help or hinder, as the case may be, the performance and progress of the organisation.

v) **Development of alternative plans for evaluation and choice:** In this stage, manager have to apply their creative and innovative skills to generate alternative plans-mission, objectives, strategies, policies and programmes – on the basis of assessment of planning needs. They are generally of corporate-wide and long–range in character, ranging from 5 to10 years ahead, depending on circumstances. Devlopment of alternative plans calls for an intensive thinking and search on the part of managers. For example, a business enterprise has several options to increase its economic power and profitability —— by increasing the sales of its existing products in the existing markets, by exploring new markets, by going in for new products, by acquiring outside enterprises and so on. The objective of improving its economic power could be achieved by one or a combination of some of the above alternative strategies.

An important part of this stage is the evaluation of alternative plans by reference to their comparative merits and demerits whereupon choices have to be made from among the alternative on the basis of certain predetermined selection criteria.

The choices are the decision of managers which will chart the long-range directions of the organisation for a specified period of time.

vi) **Formulation of medium range and short-range plans:** The long-range set of organisational plans provides the basis for formulation of more specific medium–range and short-range plans. Medium– range plans have a time span of more than one year but up to three years in general. Short-range plans are progressively more specific than long-range plans. Short-range plans are called operational plans and the process of formulating them is called 'Operational Planning'. Medium-range plans and short-range plans are generally formulated in such functional management areas like manufacturing, marketing, purchase, personnel finance, R&D and so on. They are further 'de-composed' into more detailed sectional and unit plans valid for basic units of operations in the organisation.

vii) **Arrangements for implementation of plans:** Effective implementation of plans and decision is the crux of the planning process. Since plans are implemented by managers and others at various levels of the organisation, it is essential for top management to enlist their co-operation, participation and commitment for the purpose. Authority and accountability have to be pinpointed specifically among the various managers for implementation of plans, for acquiring and allocation of resources and tasks, for making day-to-day decision and taking initiatives and for activating the communication system in the organisation.

12.7 FORECASTING AS AN ELEMENT OF PLANNING

We have stated earlier that forecasting is an essential element of the planning process. The term forecasting refers to the process of making systematic but tentative appraisal of future conditions and events for a specified period of time – whether for a few months or, a few years ahead. It is a process of predicting relevant future situations which are likely to affect the activities of the organisation. It is an attempt to look ahead and make tentative estimates and projections of the behavior of relevant variables in the environment.

Since planning is future–oriented, forecasting is a basic ingredient of the planning process. Forecasting provides vital clues to managers on what the future problems and prospects are likely to be for the organisation. By means of forecasting, managers generate information on several dimensions and aspects of the environment –economic, social technological and political –which are directly relevant to the functioning and fortunes of the organisation and which directly influence the planning and other decision, initiatives and responses of managers. Forecasting is necessary to enable managers to get important inputs for planning and make informed judgment about the likely impact of the external forces on the organisations present and the future courses of action. Organisational plans are based on proper and reliable information generated by managers through forecasting and other means.

For a business enterprise, for example, several aspects of future trends should be understood through forecasting. They include: future sales trends of the products and series of the enterprise, based on an assessment of future demand, supply cost and competitive conditions, likely levels and trends of profitability, future technological changes, general economic and industry trends, likely emergence of new products, new processes and new markets, probable changes in population characteristics, their levels of income, life styles and buying patterns and so on.

The individual enterprises may be able to get part of the above information on the basis of forecasts made but other agencies –say government, trade associations, academic and research organisation, consultancy firms and so on. But forecasts on internal variables like sales, profits, markets share, cost trends etc. have to be made by the enterprise itself.

Forecasting and Premising: For purposes of formulating plans, managers have to convert the appraisals, estimates and projections about the future events into certain meaningful assumptions, which are known as planning 'Premises'. This conversion process is called premising which is an essential follow–up action after forecasting. Planning premises form the foundation of organisational plans. They are in the nature of informed guesses of managers with respect to specific future trends. A few examples of planning premises are given below:

a) The enterprise will maintain its competitive strength over the next four years.

b) There will be revolutionary developments in TV technology during the next five years.

c) There will be future liberalization in the economic and industrial policies of government with respect to big business enterprises.

Planning premises are categorised in various ways. **External premises** relate to general economic and business condition, social, political technological and other trends. **Internal Premises** are confined to the enterprise's activities – as for example, cash flow, cost of products and services, profitability and so on. **Tangible premises** are qualitative, as sales volume of Rs.50 crores, for example. **Intangible Premises** are qualitative, as for instance the competence and character of managerial personnel in the organisation. **Controllable Premises** are those which are manageable by the enterprises (example: advertising expenditure). **Uncontrollable Premises** relate to acts of god or man about which little can be done by the industrial enterprise (example: A big fire in the plant, government policies etc.)

Forecasts and planning premises are different from plans. The former outline what the future is likely to be. The latter underline what the enterprise should do in future. Further, forecasts and planning premises do not reduce the complexity and uncertainty of the behaviour of future events and in going ahead with confidence to cope with them.

It is true that forecasting is most unlikely to be perfect and that it is in fact a hazardous exercise especially in a situation of rapidly changing external conditions. Forecasts are only approximations and estimates. Future events may not behave exactly according to forecasts and premises made by managers. But still forecasting before formulating plans is an inescapable exercise. Without intelligent and systematic forecasting organisational plans would be mere expectation and pious wishes.

Check Your Progress B

1) Fill in the blanks :

i) The information needed for planning is often …………………… and may not be ………………………………

ii) One of the limitations of planning is that it is essentially a ……………… process.

iii) Appraisal of the external …………………is an essential requirements in the planning process.

iv) Forecasting provides vital ……………………..to manager about the future problems and prospects.

v) The estimated sales of the future is an example of ……………… …………….. premises for the managers of a company.

2) Which of the following statements are True and false?

i) Planning leads to delayed action as it involves prior thinking.

ii) Development of alternative plans is most essential for planning at the functional level.

iii) Forecasting and premising for planning are one and the same thing.

iv) Planning premises and forecasting reduce the uncertainties and complexities of the future.

v) Medium–range plans have a duration of more than one year

12.8 TYPES OF PLANNING

Planning may be categorised into several types on the basis of certain variables. Here we will divide the function of planning into four categories on the basis of two variables –degree of comprehensiveness and time span. On the basis of degree of comprehensiveness, planning is divided into strategic planning and tactical planning. On the bases of time span, we may divide planning into long-range planning and short- range planning. Let us have a brief idea of the four types of planning.

Strategic Planning: The term strategic planning refers to the process of determining the integrated organisation —— wide courses of action to achieve the major objective of the organisation. The term has a military origin where it is used to describe the process of formulation of military campaigns to achieve military goals of defending the home territory and defeating the enemy forces. In military parlance, strategic planning covers such aspects as how to attack the enemy and from how many fronts, the size and combination of ground forces, air forces and naval forces, the amount or resources to be developed, the timing of the various moves, the areas to be fortified and defended and so on. The term acquired great significance in non–military situations also. We often hear of strategies to achieve the goals of Five Year Plans at the national and regional levels, strategies for solving rural drinking water problems, strategies to reduce the growth rate of population and so on. In the context of business enterprises, **strategic planning consists of formulation of strategies which are in the nature of critical and intelligent courses of action to gain upper hand over competitive and other complex external forces in the environment.** It involves tentative chalking out of the major measure and moves necessary to perceive and exploit opportunities and to tackle threat and constraints, in the light of distinctive strengths and inevitable weaknesses of the enterprises.

The kinds of questions that top management of the enterprise asks itself and finds answer in strategic planning include: what are the most significant market and other opportunities and in what way they are relevant to the enterprise? What are the kinds and complexities of external problems, threats and constraints forced by the enterprise? How should the enterprise take advantage of relevant opportunities and to tackle the threats and constraints (as for example: price cuts, aggressive advertising campaigns, introduction of new or improved products, and so on initiated by rival enterprises) in order to achieve the objectives. In what specific areas and businesses did the enterprise concentrate its efforts to gain or retain its competitive dominance? Into what new businesses should the enterprise extend its activities?

Strategic planning is a means of improving the enterprises' competitive position in relation to other existing and potential rivals in the industry. It is an attempt to design an action plan on how, where and when the strategic resources of the enterprise (investment funds, customer goodwill, and loyalty, distribution network, R&D facilities and so on) have to be developed, and the combination sequence and timing of various major decision and initiatives necessary to achieve the enterprise goals of growth, diversification, high profitability, competitive power, good market share and so on.

Tactical Planning: Tactical planning refers to the process of formulating more specific, functional, sub-plans to implement the strategies of the enterprise. Tactical planning is more limited in its scope and consists of detailed decisions and actions initiated at lower managerial levels to exploit situations as and when they arise and to cope with local, operational problems. It is sub–corporate wide in nature. Tactical plans take the form of small, successive steps or moves taken in a concerted manner. Tactical decision are concerned with what and how activities are to be carried out, what performance criteria are to be established, how scare resources are to be utilised efficiently and so on.

Tactical planning is carried out on the basis of more information under less risky conditions and in a more structured manner than strategic planning. Tactical planning provides the basis for detailed specification of various activities to be carried out by the enterprise in a coordinated and time-bound basis.

To take an example, a major objective set by the top management of an enterprise manufacturing industrial goods is rapid growth by doubling the sales volume within a period of next four years. To achieve this objective, one of the strategies formulated by the enterprise is diversification into manufacture of consumer goods. To implement this strategy the enterprise formulated specific polices on ‘make or buy,’ internal growth vs acquisitions or mergers, foreign collaboration and so on. Within the framework of the above strategy and policies, tactical plans and decision on such aspects as size of operations, product types, sizes, quality ranges customer services, distribution channels and so on are designed.

The distinction between strategic planning and tactical planning is one of scope and impact. In many cases, the two types of planning become indistinguishable. They are however, inter-dependent.

Long-range Planning: The term 'long-range planning' refers to the process of formulating the long-range objectives of an organisation and of determining the ways and means of achieving such objectives. The term 'long-range' indicates the extent of future time horizon, the fairly long period of time which can be visualized and verbalized into tentative objectives by the organisation. The duration and limit of long-range differs from enterprise to enterprise and from situations to situation. For some enterprises, 3 to 5 years is a fairly long time horizon, while for others, 25 to 30 years and even beyond is the relevant planning time frame. The long-range planning period is determined keeping in view the nature of the enterprise's business, its size and growth rate, the extent of variability of the environment, the time required for converting major decision into tangible results and so on.

Long-range planning provides a frame work for determination of such critical goals as the desired growth rate of the enterprise's assets or sales and profitability, new activities in the future, major new investments, areas of development, and disinvestment, and so on. As Peter Drucker stated, every enterprise should ask itself these and similar questions in the context of complex and dynamic nature of external environment. Business and other organisations cannot expect that their present business, product lines and activities, technology, profit levels and markets will continue to remain relevant in the future. Long–range planning is intended to induce such awareness and to enable managers to make current major decision with a fairly good sense of future outlook.

Short-range Planning: The term 'short-range planning' refers to the process of formulating short-range objectives and of deciding on the courses of action or plans, to achieve them. Short-range planning is done for a time span of one year or less. In general, it is carried out within the framework of long-range planning, and for achieving long-range objectives, in a step–by-step manner. A short-range plan is an attempt to breakdown a long-range plan into compact and actionable programmes. Short-range planning is more action-oriented, more detailed, specific and quantitative. For example, if the long-range goal of an enterprise is to increase its sales volume by 50% during the course of next five years, it has to formulate its short-range plan for the next one year to bring about an increase of say 20% in its sales turnover. It has to formulate a detailed budget of short-range goals, targets of performance, activities, and resource requirements in a time-bound manner. Short-range planning provides the basis for a coordinated performance of activities, allocation of resources, assignment of tasks and design of appropriate plane, implementation and programme evaluation system. Long-range plans are implemented in this manner by programming, budgeting and scheduling efforts and activities needed to achieve organisations goals.

It may be noted that tactical planning and short-range planning are also referred to as **Operational Planning,** because they represent planning of detailed operations at the lower levels of management at middle and supervisory levels.

12.9 PRINCIPLES OF PLANNING

Since planning is a function of management, it must be based on certain principles to serve as guidelines for undertaking the function in right earnest. We may outline the principles of planning as below.

1) **Principle of top management interest:** The chief executive of the organisation must show genuine interest in planning, submit himself to the discipline of planning and must inspire his team to do the same.

2) **Principle of long-range view:** Every managers must plan decisions after a full analysis and understanding of their long-term future effects, and after objectively considering all the available facts.

3) **Principle of contribution to objective:** Planning should be purposeful. It should directly contribute to the achievement of organisational objectives or desired ends.

4) **Princeple of primacy of planning:** As stated earlier, planning holds the prime position in the process of management. It is logically regarded as the first function of managers from which all other function flow.

5) **Principle of flexibility:** The principle suggest that flexibility in planning helps the organisation to cope with rapid and unforeseen changes in the external events. This can be achieved without abandoning the pre-determined plans or without inviting adverse consequences even if drastic.

6) **Principle of navigation change:** This principle is related to the principle of flexibility. It indicates that a regular process of monitoring the course of external events is to be combined with a review and revision of plans in order to achieve desired goals just as a navigator negotiates his ship's way by making changes in his route in response to behaviour of the water mass.

7) **Principle of commitment:** This principle helps in the determination of the planning period. Planning should cover a period of time necessary to fulfil the commitments involved in a decision. For example, if a student makes a decision to join a three years B.Com Course, his planning period is three years.

8) **Principle of the limiting factor:** A limiting factor is one which stands in the way of achieving the desired objective. Managers should pay due attention to tackle those limiting factor which hinder the smooth progress in achievement of objectives.

Check Your Progress C

1) Which of the following statements are True and which are False?

   i) Strategic Planning consists of formulation of strategies for the organisation as a whole.

   ii) Tactical planning is carried out under more risky condition than strategic planning.

   iii) Operational planning includes both long-range and short-range planning.

iv) The principle of flexibility of planning suggests that plans should be changed as frequently as possible.

v) The principle of commitment helps in the determination of the planning period.

2) Fill in the blanks:

i) Strategic and tactical planning are defined on the basis of ……………………….

ii) Courses of action planned to gain upper hand over competitive and other external forces are known as ………………………………….

iii) Tactical planning involves a more ………………………………… approach than strategic planning.

iv) Long-range planning provides a ……………………………….. for determining critical goals.

v) Any factor which stands in the way of achieving desired goals may be called a ……………………………………..factor.

12.10 LET US SUMUP

Planning is the process of setting future objectives and deciding on the ways and means of achieving them. It means deciding in advance what is to be done in the future for a specific period and then taking the necessary steps to do the things decided upon.

Planning precede all other managerial functions. It is a sub-process of the process of management. It pervades all levels and all branches of management. Planning is invariably future-oriented but is backed by information relating to the past trends, current conditions and future possibilities. It is a purposeful conscious managerial function. It has both formal and informal elements. At the same time, planning is an intellectual process and requires certain analytical and conceptual skills. Even then, it is primarily a pragmatic and action-oriented function. Planning involves problem solving and decision–making. It is based on certain assumptions and is a dynamic process.

Planning may be divided into certain levels on the basis of scope, significance, and time span, e.g. corporate planning and functional planning; strategic planning and tactical planning; long-range planning and short-range planning. All types of plans may be broadly categorised into two groups. Single use plans and Standing plans.

The importance of planning functions stems from the following benefits of planning. Planning provides a clear sense of direction to the activities of the organisation and the job behaviour of managers and others. It permits managers to examine alternative courses of action with a better understanding of their likely consequences. Planning forces managers to shake of their inertia and induces them to look beyond the immediate concerns. It minimizes the incidence of impulsive and arbitrary decisions and ad hoc actions. Planning provides the basis for all other managerial functions. It is a means of judicious allocation of strategic and scarce recourses of the organisation, and also brings about an over all improvement in the efficiency of resource use. Further, planning improves the ability of the organisation to adopt effectively and adjust its activities in response to changes in the external environment. It stimulates management to take bold initiatives to anticipate crises or threats and to prevent them and to perceive and seize opportunities ahead of competitors. It is also an integrative process at a point of time as well as over a period of time.

The limitations of planning arise out of the following elements. The assumptions and forecasts which form the basis of planning may be wide off the mark. Information requird may not be reliable or may not be available in time. Changes in external environment are often beyond the knowledge and control of management, particularly in the case of rapid changes. Further, planning is always in a state of flux, due to the continuous and subtle changes taking place in the environment. Besides, planning may delay action as it involves prior thinking and deciding. Often the plan formulated introduces rigidity in the functions of managers. On the other hand, plans may be far removed from reality and thus become difficult to implement, particularly with respect to detailed plans.

The process of planning involves: Planning to plan, appraisal of internal conditions and external environment, defining key areas and issues for planning, development of alternative plans for evaluation and choice, formulation of medium-range and short-range plans and implementation of plans.

Forecasting is an essential element of the planning process. It provides vital clues to managers through the generation of information on several dimensions of economic, social and technological environment. It also provides estimates and projections about the future events.

The appraisals, estimates and projections provided by forecasting are converted into meaningful assumptions known as planning premises. The premises may be of different categories: external, internal, tangible, intangible, controllable and uncontrollable.

Planning may be divided into four categories on the basis of degree of comprehensiveness and time span. These are: Strategic Planning, Tactical Planning, Long-range Planning and Short-range Planning. Tactical and Short-range planning are also referred to as Operational planning.

As a function of management, planning is best carried out on the basis of certain principles viz., of top management interest, long-range view, contribution to objectives, primacy of planning, flexibility, navigational change, commitment, and limiting factor.

12.11 KEY WORDS

Forecasting: Estimating the future behavior of variables affecting the business unit.

Long-range Planning: Formulating the long-run objectives and determining the ways and means of achieving those objectives.

Objectives: Goals or purposes towards which business activities and operations are directed.

Operational Planning: Planning of detailed operations at the middle and supervisory levels of management.

Planning: The process of setting future objectives and deciding on the ways and means of achieving them**.**

Policies: Guidelines for decision-making and action.

Strategic Planning: The process of planning which involves product, market decisions in the light of environmental changes and internal resources.

Strategy: Courses of action to gain upperhand over competitive and other environmental forces.

Tactical Planning: The process of formulating specific, functional sub-plans to implement the strategic plan.

12.12 ANSWERS TO CHECK YOUR PROGRESS

A) 1) i) True ii) False iii) False iv) True v) True

2) i) future ii) content, quality iii) intuitive iv) intellectual v) premises vi) single use plans vii) allocation viii) bold initiative

B) 1) i) incomplete , reliable ii) fluid iii) environment iv) clues v) tangible

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

C) 1) i) True ii) False iii) False iv) False v) True

2) i) comprehensiveness ii) strategies iii) structured iv) framework v) limiting

12.13 QUESTIONS FOR PRACTICE

1) Define the concept of planning and explain its salient characteristics.
2) Comment on the following statements :
   a) Planning is a pervasive process.
   b) Planning is a useless exercise in a situation of rapidly changing environment.
   c) Planning and decision making are two sides of the same coin.
3) Do you think that planning is a guarantee for organisational success? Give reasons.
4) Is there any need for planning a plan? Explain.
5) The limitations of planning are too serious to make planning a credible function. Do you agree? Why?
6) What is the difference between strategic and long –range planning?
7) Discuss the process of planning.

8) Why is forecasting so important for planning?

9) What are planning premises? How are they relevant to planning?

10) Explain the principles of planning.

11) 'Long-range planning is concerned with making today's decision with a better sense of futurity'.Comment.

12) What is the role of top management in the planning process?

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

UNIT 13 ORGANISING: BASIC CONCEPTS

Structure

13.0 OBJECTIVES

After studying this unit, you should be able to

- narrate the importance of organising :
- describe the different interpretations of the word organising;
- distinguish between the different types of organisation structure viz. functional, divisional and adaptive
- analyse the formal and informal dimensions of any organisation, and
- explain the significance of span of supervision, organisational charts and manuals.

13.1 INTRODUCTION

In the preceding Unit, you have learnt about the managerial function of planning. The present Unit relates to the organising function of management and its integral aspects such as organisation structure, charts, manuals, formal and informal organisations, forms of organisation and span of control.

13.2 NATURE OF ORGANISING FUNCTION

As a function of management, organising refers to the proces involving the identification and grouping of activities to be performed, defining, and establishing the authority responsibility relationships. This enables people to work most effectively together in achieving the enterprise objectives. In a general sense, organising consists of determining and arranging for men, materials, machines and money required by an enterprise for the attainment of its goals. In a restricted and operational sense, the term organising means defining the duties and responsibilities of the people employed, and determining the manner in which their activities are to be interrelated. The end result of organising is the creation of a structure of duties and responsibilities of people in different positions, grouped according to the similarity and interrelated nature of activities. In other words, the outcome of the organising process is an 'Organisation' consisting of a group of people working together for the achievement of one or more common objectives.

13.2.1 Characteristics of Organisation

The characteristics of an organisation are:

a) **Group of people**: An Organisation comes into existence when a group of people combine their efforts for some common purpose and willingly contribute towards their common endeavor.

b) **Division of work**: Setting of an organisation involves division of the total work into various activities and functions, and assigning the tasks to different persons according to their skill, ability and experience.

c) **Common purpose:** Every organisation comes into existence on the basis of goals of the enterprise which are separate from the personal goals of the people employed. It is the common purpose of the organisation which provides the basis of co-operation among the members of the organisation.

d) **Vertical and horizontal relationships:** An organisation creates cooperative relationship between different departments and divisions as well as between superiors and subordinates. Different functions and activities like production, marketing, financing etc. are integrated for the achievement of proper coordination. The duties and responsibilities of superiors and subordinates in each department or division are also unified so as to serve the purpose of their joint efforts.

e) **Chain of command:** The superior-subordinate relationships established in an organisation are based on the authority which flows from the higher levels of management to the next lower levels, thereby forming a hierarchical chain. This is known as the chain of command, which also determines the line of communication.

f) **Dynamics of organisation:** Besides the structural relationships among people which are based on their activities and functions, there exists an organising interactions based on sentiments, attitudes and behavior of individuals and groups. These aspects of relationship provide a dynamic element to the organisational functioning. They are subject to change from time to time.

13.2.2 Importance of Organisation

Sound organisation contributes greatly to the continuity and success of the enterprise. Its importance can be discussed below.

i) **Facilitates administration:** Sound organisation facilitates management to relate resource flows continually to overall objectives. It provides an appropriate platform from where management can perform the functions of planning, direction, coordination, motivation and control.

ii) **Facilitates growth and diversification:** It helps in organisational elaboration. Growth and diversification of activities is facilitated by clear division of work, proper delegation of authority etc. As the organisation expands to a reasonable proportion, the functional type can be replaced by a more flexible decentralised organisation.

iii) **Permits optimum use of resources:** Sound organisation permits optimum use of technological and human resources. The organisation can incorporate the latest technological improvements like computers, electronic data processing machines etc. It permits optimum use of human efforts through specialisation. It also develops people by creating appropriate training and promotion opportunities. Thus, organisation gives a company the greatest possible strength for meeting predicted needs – changing conditions.

iv) **Stimulated creativity:** Specalisation provides individuals with well-defined duties, clear lines of authority and responsibility. Sound organisation structure enables managers to turn over routine and repetitive jobs to supporting positions and concentrate on important issues where they can exploit their potential better. Thus, it encourages the creativity of the people.

v) **Encourages humanistic approach:** People can work in team and not like robots or machines. Organisation provides job rotation, job enlargement. Jobs are designed to suit human needs and are made meaningful and interesting. Organisation adopts efficient methods of selection, training, remuneration and promotion of employees.Proper delegation and decentralization, conductive working environment and democratic and participative leadership provide higher job satisfaction to the employees. It employees. It enhances the inter-action among different levels of the management.

Although we have discussed the importance of the organisation, a sound organisation structure by itself does not guarantee success. According to Prof. Drucker good organisation structure does not by itself produce good performance just as a good constitution does not guarantee great presidents, or good laws or a moral society. But a poor organisation structure makes good performance impossible no matter how good the individuals may be.

13.3 ORGANISATION AS A SYSTEM

Systems concept recognises that organisations are made up of components, each of which has unique properties, capabilities and mutual relationships. It further recognises the significance of system and emphasises that a whole composed of various parts may be quite different from the simple sum of its parts. The are many and varied definitions of the term 'system' Most definitions involve such phrases as 'complex whole', 'set of entities', 'set of relationships', 'resources network', and 'conglomeration of interrelated parts'. For the purpose of our analysis, we may define system as an arrangement of relationships among multiple parts operating as a whole. An organisation viewed as system is composed of many interdependent and interrelated parts known as sub-systems. Every sub-system is itself a system composed of smaller interrelated parts of sub-systems.

13.3.1 Components of an Organisational System

An organisation as a social system consists of the following components:

a) **Inputs:** As depicted in Fig.13.1, the system takes certain inputs from its environment. These inputs are human resources, material resources, energy and information.

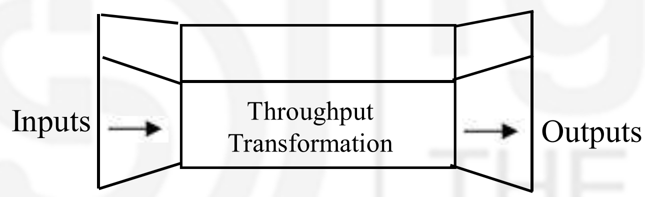


Figure 13.1 Organisation as a System

b) **Processor**: The processor or throughput involves the utilisation of inputs within the organisation to produce the desired outputs. A number of sub-systems such as production, marketing, finance, personnel and research and development must be created for processing or transformation. There are further sub-systems within each sub-system. The individual employee is also a sub-system. Interrelatedness among all the sub-systems must be kept in mind all the time.

c) **Output:** The output of an organisation may be both intended and unintended. Intended outputs are usually labeled objectives. For instance, high productivity is an intended objective. The output may consist of goods and services. An unintended output may be informal relation among the group members.

d) **Management:** The management component of the system is concerned with the determination and implementation of processor activities in order to achieve intended output. Managing involves planning, organising, staffing, directing and controlling. For managing, feedback of information concerning the quality, quantity, cost and time of system outputs is necessary. Standards concerning desired results must be established and enforced by management through the feedback initiation activity. If output are named improper or inadequate according to the predetermined standards, corrective measures such as guidance and warning of workers, improvement of planning and organising, revision of standards, etc. are initiated.

13.4 STEPS IN THE ORGANISATION PROCESS

Organisation involves the following interrelated steps:

1) **Determination of objectives:** Organisation is always related to certain objectives. Therefore, it is essential for the management to identify the objectives before starting any activity. It will help the management in the choice of men and materials with the help of which it can achieve its objectives. Objectives also serve as the guidelines for the management and the workers. They will bring unity of direction in the Organisation.

2) **Identification and grouping of activities:** If the members of the groups are to pool their efforts effectively there must be proper division of the major activities. Each job should be properly classified and grouped. This will enable the people to know what is expected form them as members of the group and will help in avoiding duplication of efforts. For instance, the total activities of an individual industrial organisation may be divided into major functions like production, purchasing, marketing, and financing, and each such function is further subdivided into various jobs. The jobs then may be classified and grouped to ensure the effective implementation of the other steps.

3) **Allotment of duties:** After classifying and grouping the activities into various jobs, they should be allowed to the individuals so that they could perform them effectively. Each individual should be given a specific job to do according to his ability and made responsible for that. He should also be given the adequate authority to do the job assigned to him.

4) **Developing relationships:** Since so many individuals work in the same organisation, it is the responsibility of management to lay down structure of relationships in the organisation. Everybody should clearly know to whom he is accountable. This will help in the smooth working of an enterprise by facilitating delegation of responsibility and authority.

5) **Integration of these groups of activities :** Integration can be achieved in all activities in following ways- (a) through authority relationships-horizontally, vertically, and laterally and (b) through organised information or communication systems, i,e, with the help of effective coordination and communication. We can achieve unity of objectives, team work and team spirit by integration of different activities.

13.5 ORGANISATION STRUCTURE

Organisation structure may be defined as the established pattern of relationships among the component parts of the organisation. Organisation structure in this sense refers to the network of relationships among individuals and positions in an organisation. It describes the organisation framework. Just as human beings have skeletons that define their parameters, organisations have structures that define theirs. It is like the architectural plan of a building. Just as the architect consider various factors like cost, space, special features needed etc. While designing a good structure, the managers too must look into factors like benefits of specialization, communication problems, problems in creating authority levels etc, before designing the organisation structure.

The manager determines the work activities to get the job done, writes job descriptions, and organises people into groups and assigns them to superiors. He then fixes goals and deadlines and establishes standards of performance. Operations are controlled through a reporting system. The whole structure takes the shape of a pyramid. The structural organisation implies the following things:

i) The formal relationships with well-defined duties responsibilities :

ii) The hierarchical relationships between superior and subordinates within the organisation;

iii) The tasks or activities assigned to different persons and the departments;

iv) Coordination of the various tasks and activities;

v) A set of policies, procedures, standards and methods of evaluation of performance which are formulated to guide the people and their activities.

The arrangement which is deliberately planned is the formal structure of organisation. But the actual operations and behavior of people are not always governed by the formal structure of relations. Thus the formal arrangement is often modified by social and psychological forces and the operating structure provides the basis of the organisation.

13.5.1 Significance of Organisation Structure

The organisation structure contributes to the efficient functioning of organisation in the following ways.

a) **Clear-cut authority relationships:** Organisation structure allocates authority and responsibility. It specifies who is to direct whom and who is accountable for what results. The structure helps and organisation member to know what his role is and how it relates to other roles.

b) **Pattern of Communication:** Organisation structure provides the patterns of communication. By grouping activities and people, structure facilitates communication between people centered on their job activities. People who have joint problems to solve often need to share information.

c) **Location of decision centres:** Organisation structure determines the location of centres of decision making in the organisation. A departmental store, for instance may follow a structure that leaves pricing, sales promotion and other matters largely up to individual departments to ensure that various departmental conditions are considered.

d) **Proper balancing** Organisation structure creates the proper balance and emphasises on coordination of group activities. Those more critical aspects for the success of the enterprise may be given higher priority in the organisation. Research in a pharmaceutical company, for instance, might be singled out for reporting to the general manager or the managing director of the company. Activities of comparable importance might be given, roughly equal levels in the structure to give them equal emphasis.

e) **Stimularing creativity:** Sound Organisation structure stimulates creative thinking and initiative among organisational member by providing well defined patterns of authority. Everybody knows the area where he specializes and where his efforts will be appreciated.

f) **Encouraging growth:** An organisation structure provides the framework within which an enterprise functions. If it is flexible, it will help in meeting challenges and certain opportunities for growth. A sound organisation structure facilitates growth of the enterprise by increasing its capacity to handle increased level of activity.

g) **Marking use of technological improvements**: A sound organisation structure which is adaptable to change can make the best possible use of latest technology. It will modify the existing pattern of authority-responsibility relationships in the wake of technological improvements.

In short, existence of good organisation structure is essential for better management. Properly designed organisation can help in improving team work and productivity by providing a framework within which the people can work together most effectively. Therefore, an organisation structure should be developed according to the needs of the people in the organisation.

13.5.2 Types of Organisation Structure

Different types of organisation structure can be distinguished on the basis of arrangement of activities. Accordingly, three broad types of structural forms are:

1) Functional,
2) Divisional, and
3) Adaptive

Functional structure: When units and sub-units of activities are created in an organisation on the basis of functions, it is known as functional structure. Thus, in any industrial organisation specialized functions like manufacturing, marketing, finance and personal are constitute as separated units of the organisation. All activities connected with each such function are placed in the same unit and the number of persons under each manager at various levels get added. This results in the interrelated positions taking the shape of a pyramid. The figure below shows the functional structure of a medium-size organisation.

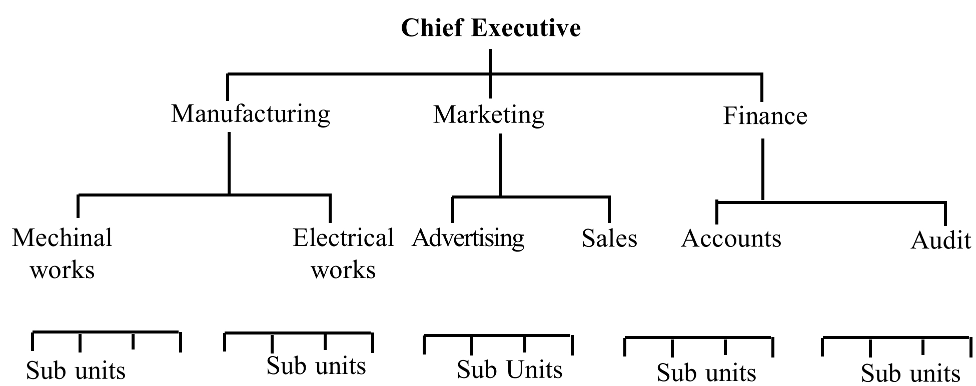


Figure 13.2 Functional structure

The main advantage of the functional structure of organisation is that there is functional specialisation in each unit, which leads to operational efficiency of people engaged, and the organisation as a whole derives the benefit of specialised operations. The head of the functional units are in direct touch with the chief executive who can sort out inter-functional problems, if any, and also coordinate the interrelated functions. The chief executive is also able to be in direct touch with lower level subordinates and thereby have full knowledge of the state of affairs in the organisation.

However, while the functional arrangement may be well suited to small and medium size organisation, it is incapable of handling the problems of an organisation as it grows in size and complexity. Problems of sub-units at lower levels do not receive adequate attention of higher level managers while some of the activites tend to be over-emphasised.

Functional units become unwieldy and difficult to manage when there are diverse kinds of activities performed in large number of sub-units. Personal contact between superiors and subordinates becomes rare, and flow of communication is slow leading to problems of coordination and control.

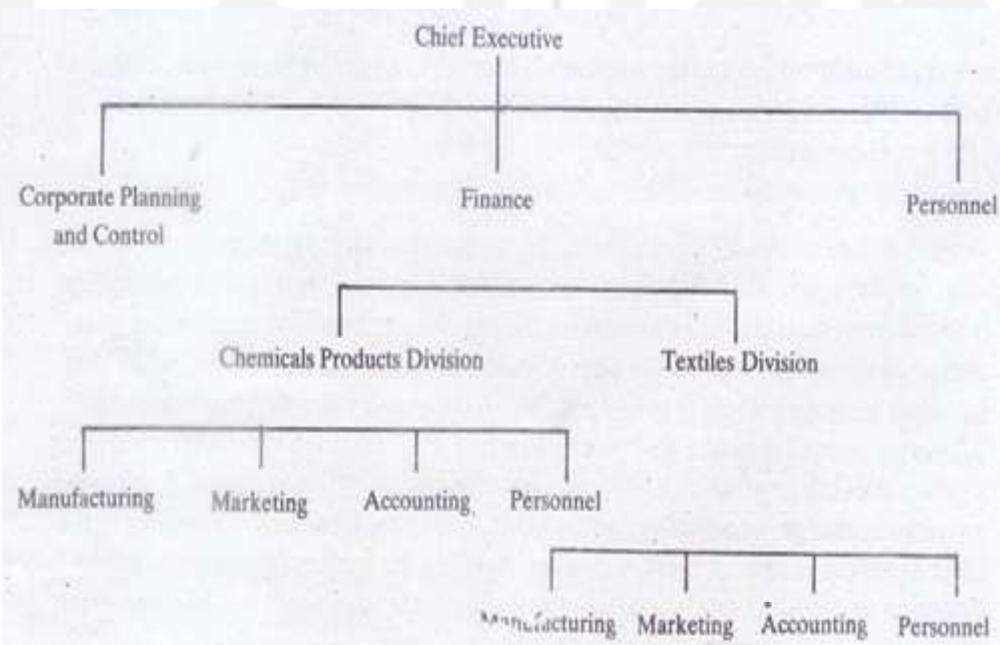


Figure 13.3 Product Divisionalisation

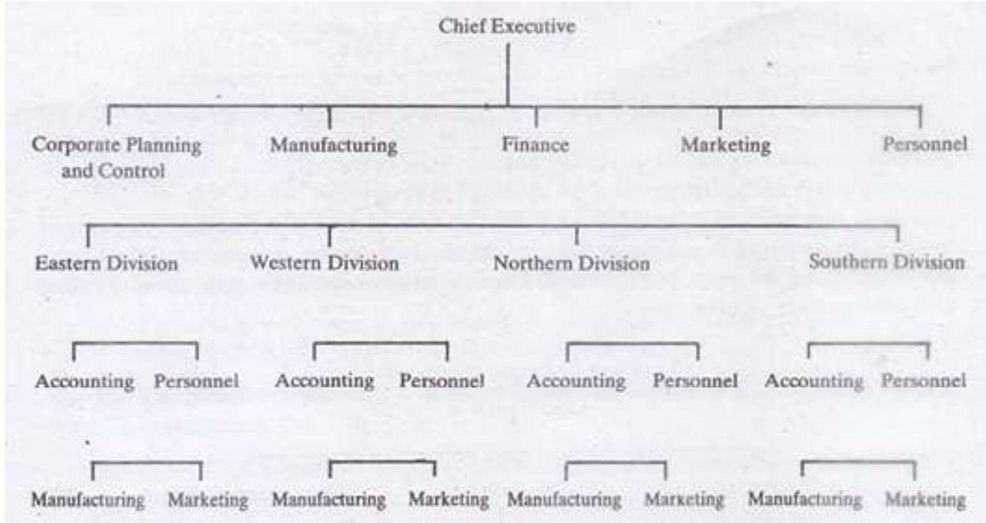


Figure 13.4 Territorial Divisionalisation

Divisional structure: The divisional organisation structure is more suited to very larget enterprise particularly those which deal in multiple products to serve more than one distinctive markets. The organisation is then divided into smaller business units which are entrusted with the business related to different products or different market territories. In other words, independent division (product divisions or market division) are created under the overall control of the head office. Each divisional manager is given autonomy to run all functions relating to the product or market segment or regional market. Thus, each division may have a number of supporting function to undertake.

A divisional structure may consist of two or more product divisions or market or territorial divisions as depicted in the diagrams 13.3 and 13.4.

In a divisional structure each division contributes planned profits to the organisation, but otherwise operates as an independent business. The functional units are headed by managers while the final authority vests in the divisional manager, who coordinates and control the activities of the various functional units in the division. The top management of the organisation, besides providing funds, determines the organisational goals and formulates policies.

The divisional structure is characterised by decentralisation of authority. Thus it enables managers to take decisions promptly and resolve problems appropriate to the respective divisions. It also provides opportunity to the divisional managers to take initiative in matters within their jurisdiction. But such a structure involves heavy financial costs due to the duplication of supporting functional units for the divisions. Moreover, it requires adequate number of capable managers to take charge of the respective divisions and their functional units.

Adaption structure: Organisation structures are often designed to cope with unique nature of the undertaking and the situation. This type of structure is known as adaptive structure. There are two types in structures.

i) Project Organisation and

ii) Matrix Organisation

i) **Project organisation:** When an enterprise undertakes any specialized, time-bound work involving one-time operations for a fairly long period, the project organisation is found most suitable. In this situation the existing organisation creates a special unit so as to engage in a project work without disturbing its regular business. This becomes necessary where it is not possible to cope with the special task or project. Within the existing system, the project may consist of developing a new project, installing a plant, building an office complex, etc. A project organisation is headed by a project manager in charge who holds a middle management rank and reports directly to the chief executive. Other managers and personnel in the project organisation are drawn from the functional departments of the parent organisation. On completion of the project they return to their parent departments.

The main advantage of such a structural arrangement is that it leaves regular business undisturbed. It is exclusively concerned with the task of completing the project work on time and in conformity with the standards of performance relevant to its goal. There is better management control over the project activities as the project manager enjoys necessary authority and is alone responsible for the results. But project organisations may create problem as well. Functional managers often resent the exercise of authority by the project manager in the functional areas and hence conflict arises. The stability of the functional departments is disturbed by transfer of personnel to project work from time to time. Shifting of personnel from project to project disrupts their developments in the specialised fields.

ii) **Matrix organisation**: This is another type of adaptive structure which aims at combining the advantages of autonomous project organisational and functional specialisation. In the matrix organisation structure, there are functional departments with specialised personnel who are deputed to work full time in different projects sometimes in more than one project under the overall guidance and direction of project managers. When a project work is completed, the individuals attached to it go back to their respective functional department to be assigned again to some other project. This arrangement is found suitable where the organisation is engaged in contractual project activities and there are many projects to manage, as in a large construction company or engineering firm.

Matrix organisation provides a flexible structure ideally suited to the requirements of changing conditions. It facilitates pooling of specialized and technical personnel from different functional departments, who can be deputed to a number of projects. They acquire valuable experience of handling varied and complex problems in project work. There is speedy exchange of information and decision-making as they work under the coordinating authority of project managers.

The major drawback of matrix organisation is that the personnel drawn from specialized functional departments are subjected to dual authority, that of the functional head and the project managers. The principles of unity of command is thereby sacrificed. This generates stresses and strains in project management, because there is simultaneous engagement of the same individual in a number of projects.

Check Your Progress A

1) Which of the following statements are True and which are False.

   1) The outcome of the process of organising is an 'organisation' consisting of a group of people working together for the achievement of common goals.

   2) The chain of command does not indicate the time of communication.

   3) The formal structure of an organisation is not affected by social or psychological forces.

   4) The divisional structure of organisation is characterised by decentralisation of authority.

   5) Project organisation is concerned with time bound one-time operations.

2) Fill in the blanks:

   i) Viewed as a system, an organisation consists of ……………………… parts known as sub systems.

   ii) It is through the process of organising that the …………………………and ……………………….. of people are determined.

   iii) The structure of organisation established hierarchical relations between ………………………and …………………………..

   iv) As the volume of activity increases, a functional organisation requires addition of sub-units at ………………..units.

   v) The divisional structure of organisation is more suited to …………………… enterprises.

13.6 PRINCIPLES OF ORGANISATION

The principles of organisation are guidelines for planning an efficient organisation structure. Let us discuss the important principles of organisation:

1) **Unity of objectives:** An enterprise strives to accomplish certain objectives. The organisation and every part of it should be directed towards the attainment of objectives. Every member of the organisation should be familiar with its goals and objectives. There must be unity of objectives so that all efforts can be concentrated on the set goals. The principle requires objectives to be clearly formulated and well-understood.

2) **Division of work and specialisation:** The entire work in the organisation should be divided into various parts so that every individual is confined to the performance of a single job. This facilitates specialisation which in turn leads to efficiency and quality However, each area of specialisation must be interrelated to the total integrated system by means of coordination of all activities of all departments.

3) **Definition of jobs:** Every position in the organisation should be clearly defined in relation to other positions in the organisation. The duties and responsibilities assigned to every position and its relationship with other positions should be so defined that there is no overlapping of functions.

4) **Separation of line and staff functions:** Whenever possible, line functions should be separated from staff activities. Line functions are those which accomplish the main objectives of the company. In many manufacturing companies, the manufacturing and sales departments are considered to be accomplishing the main objectives of the business and so are called the line functions. Other functions like personnel, plan maintenance, financing and legal are considered as staff functions.

5) **Chain of command or scalar principle:** There must be clear lines of authority running from the top to the bottom of the organisation. Authority is the right to decide, direct and coordinate. The organisation structure should facilitate delegation of authority. Clarity is achieved through delegation by step or levels from the top positions to the operating level. From the chief executive, a line of authority may proceed to departmental managers, to supervisors or foremen and finally to workers. This chain of command is also known as scalar principle of organisation.

6) **Parity of authority and responsibility or principle of correspondence:** Responsibility should always be coupled with corresponding authority. Each subordinate must have sufficient authority to discharge the responsibility entrusted to him. This principle suggests that if a plant manager in a multiplant organisation is held accountable for all activities in his plant, he should not be subject to seek orders from company headquarters for his day to day activities.

7) **Unity of command:** No one in the organisation should report to more than one line supervisor. Everyone in the organisation should know to whom he reports and who reports to him. Stated simply, everyone should have only one boss. Receiving directions from several supervisors may result in confusion, chaos, conflicts and lack of action.

8) **Unity of direction:** According to this principle a group of activites that have a common goal should be managed by one person. There should be one head and one plan for a common objective of different activities. This facilitates smooth progression towards the achievements of overall organisational goals.

9) **Exception principle:** This principle suggests that higher level managers should attend to exceptional matters only. All routine decisions should be taken at lower level, whereas problems involving unusual matters and policy decisions should be referred to higher levels.

10) **Span of supervision:** The term 'span of supervision' means the number of persons a manager or a supervisor can direct. No manager should be required to supervise more subordinates than he can effectively manage within the limits or available time and ability. The exact number may vary according to the nature of the job and the frequency or intensity of supervision needed.

11) **Principle of balance:** There should be proper balance between various parts of the organisation and no function should be given undue importance at the cost of others. Balance should be maintained also between centralisation and decentralisation, span of supervision and lines of communication, and authority allocated to department and personnel at various levels.

12) **Communication:** A good communication network is essential to achieve the objectives of an organisation. No doubt the line of authority provides channels of communication downward and upward, still some blocks in communication occur in many organisation. The confidence of superior in his subordinates and two-way communication are the factors that unite an organisation into an effectively operating system.

13) **Flexibility:** The organisation structure should be flexible so that it can be easily and economically adapted to the changes in the nature of business as well as technological innovations. Flexibility of organisation structure ensures the ability to change with the environment without disrupting the basic design.

14) **Continuity:** Change is the law of nature. Many changes take place outside the organisation. These changes must be reflected in the organisation. For this purpose the form of organisation structure must be able to serve the enterprise to attain its objectives for a long period of time.

13.7 SPAN OF CONTROL

The term 'span of control' is also known as 'span of supervision' or 'span of authority'. Simply stated it refers to the number of individuals a manager can effectively supervise. Thus, it is expected that the span of control, that is the number of subordinates directly reporting to a superior should be limited so as to make supervision and control effective. This is because executive have limited time and ability.

It is sometimes suggested that the span of control should neither be too wide nor too narrow. In other words, the number of subordinates should not be too large or too small. According to some experts, the ideal span is four at higher levels and eight to twelve at lover levels. But the number of subordinates cannot be easily determined because the nature of jobs and capacity of individuals vary from one organisation to another. Moreover, the actual span of supervision affects the organisation in different ways. A wide span results in fewer levels of supervision and facilitates communication. But it permits only general supervision due to the limited availability of time. Narrow span, on the other hand, requires multiple levels of supervision and hence longer time for communication. It is more expensive and complicates the process of communication. A narrow span, however enables managers to exercise close supervision and control.

Factors affecting Span of Control

Although there are certain limits to the span of control, the tendency in recent years has been to avoid specifying absolute numbers because it has been recognised that the ideal span depends on number of factors. Some of the more important of these factores are discussed below:

i) **Nature of the work:** If the work is simple and repetitive, the span of control can be wider. However, if the work requires close supervision the span of control must be narrow.

ii) **Ability of the manager:** Some managers are more capable of supervising large numbers of people than others. Thus for a manager who possesses qualities of leadership, decision-making ability, and communication skill in greater degree the span of control may be wider.

iii) **Efficiency of the organisation:** Organisations with efficient working systems and competent personnel can have larger span of control.

iv) **Staff assistants:** When staff assistants are employed, contact between supervisors and subordinates can be reduced and the span broadened.

v) **Time available for supervision:** The span of control should be narrowed at the higher levels because top managers have less time available for supervision. They have to devote the major part of their work time in planning, organising, directing and controlling.

vi) **Ability of the subordinates:** Fresh entrants to job take more of a supervisor's time than trained persons who have acquired experience in the job. Subordinates who have good judgment, initiative, and a sense of obligation seek less guidance from the supervisor.

vii) **Degree of decentralisation:** An executive who personally takes many decisions is able to supervise fewer people than an executive who merely provides encouragement and occasional direction.

It should be clear that the size of the span of control is related to numerous variables, and no single limit is likely to apply in all cases. A variety of factors can influence the resulting number of employees comprising the optimum span of control in any particular organisation.

Check Your Progress B

1) Fill in the blanks:

i) The chain of command is based on the ……………………… principle of organisation.

ii) Principle of correspondence suggests ………………...................... of authority and responsibility.

iii) Higher level managers should be required to attend to ……….. ………………. matters only.

iv) The organisation structure should be ……………………………so that it can be adapted to change.

v) A wide span of control results in ………………………… levels of supervision.

2) Which of the following statements are True and which are False.

   i) A narrow span is less expensive than a wide span.

   ii) Unity of command means that a manager must issue the same instruction to all his subordinates.

   iii) Personal functions are not line, but staff functions.

   iv) The size of the span of control can be broadened if there are more staff assistants.

   v) A department with all freshly recruited personal must have a wide span.

13.8 ORGANISATION CHART

An organisation chart shows a diagrammatic representation of important aspects of an organisation including the major functions and their relationships. It is a blue print of company organisation, its functions lines of authority and way positions. In other words it is a graphic portrayal of positions in the enterprise and of the formal lines of accountability among them. It provide a birds eye view of the relationship between different departments of divisions of an enterprise as well as the relationships between the executives and subordinates at various levels. It enables each executive and employee to understand his position in the organisation and to know to whom he is accountable. Thus it is obvious that an organisation chart has the following characteristics.

1) It is diagrammatic presentation.
2) It shows principle lines of authority in the organisation.
3) It shows the interplay of various functions and relationships.
4) It indicates the channels of communications.

The organisation chart should not be confused with the organisational structure. An organisation chart is merely a type of record showing the formal organisational relationships which management intends should prevail. It is therefore, primarily a technique of presentation. It presents diagrammatically the lines of authority and responsibility among different individuals and positions. It may be either a personnel chart or functional chart. Personnel organisation chart depicts the relationship between positions held by different persons. Functional organisation chart depicts the functions or activities of each unit and sub-unit in the organisation.

Advantages of Organisation Chart

Following are the advantages of an organisation chart:

i) It is a tool of administration which indicates graphically to the employees how their positions fit into the total organisation and how they relate to each other.

ii) It shows at a glance the lines of authority and responsibility. It is a reliable blue print of how the positions are arranged. From it, the individuals can have a sense of the limit of their authority, and can see who their associates are, to whom they have to report, and from whom they are to receive instructions.

iii) It serves as a valuable guide to the new personnel in understanding the organisation structure and the inter relationship between its units and sub-units.

iv) It provides a framework of personnel classification and evaluation systems.

v) It plays a significant part in organisational improvement by reflecting inconsistencies and deficiencies.

With an overview of the total organisation depicted in the chart management may discover unintended gaps, overlaps, etc, in the distribution of tasks and functions.

Limitations of Organisation Chart

While the organisation chart is an important tool of management, its existence alone does not ensure effectiveness of organisation because of the following limitations:

i) Organisation chart shows only the formal relationships and fails to show the informal relations within the organisations. In modern enterprises, informal relationships significantly effect the functioning of organisations.

ii) It shows the lines of authority, but it is not able to answer questions like the degree of authority that can be exercised by a particular executive, how far he is responsible for his functions, and to what extent he is accountable.

iii) It introduces rigidity in the relationships. Updating is not possible without disturbing the entire set up.

iv) Faulty organisation chart may cause confusion and misunderstanding among the organisational members. Moreover it gives rise to a feeling of superiority and inferiority which causes conflicts in the organisation.

v) It does not show the relationship which actually exist in the organisation, but shows only the 'supposed relationships'.

13.9 ORGANISATIONAL MANUAL

An organisation chart shows who has authority over whom, but it does not show the extent of authority of the duties each person in the organisation is expected to perform, except in so far as duties are implied by job titles. For this reason, big undertakings prepare organisation manual that include job description and other information in addition to the charts. A job description includes factual statements of job contents in terms of its duties and responsibilities. An organisation manual is an authoritative guide to the organisational members. It consists of records of top management decisions, standard practices and procedures and the description of various jobs. With such information available in the manual, employees are not required to approach their superiors for instruction and guidance, causing interruption of work and resulting in wastage of time and energy of the superior and the subordinates.

13.9.1 Importance of Manuals

A manual can be a valuable aid to management which more than justifies the amount of work and money involved in its complication. The availability of good manual helps individuals to determine the responsibilities of their jobs and their relationship with other jobs in the organisation. Jurisdictional conflicts and overlapping can be avoided. The sources and degree of authority are also made clear. Thus it can help to make instructions definite and shows how each employee and his job fits into the total organisation and how he can contribute to the achievement of organisational objectives as well as maintain good relationships with other employees. A reference to the manual can quickly remove misunderstanding. It relieves managers the necessity of repeating the same information time and again. It provides uniformity and consistency of procedures and practices. It facilitates training of new employees as it contains in writing the established routines and practices with respect to the jobs. Since manuals are revised periodically or after every major changes, they serve as effective refreshers for employees who have been on the payroll for some time. Both delegation of authority and management by exception are promoted by the use of manuals.

13.9.2 Types of Manual

Manuals may be prepared by an organisation with different contents and purposes in view, such as, (1) Policy manual, (2) Operation manuals, (3) Organisation manual, (4) Rules and Regulations manual, and (5) Departmental manual. These are discussed below:

1) **Policy manual:** It is prepared to state the policies of the enterprise. It is a basic guide to action. Policy manual describes the overall framework within which activities are to take place and thus reveals the board courses of managerial action likely to take place under certain conditions. It contains decision, resolutions and pronouncements of the management of the enterprise

2) **Operations manual:** The purpose of manual is to inform the employees of established methods, procedures and the desired standards of performance of work. It lists the authorised steps and supplements them by the use of diagrams sketches, charts etc. of each department and division.

3) **Organisation manual:** It describes the organisational setup indicating the duties and responsibilities of various departments and their respective sub-divisions. It is portrayal of the formal chain of responsibilities and authorities among different persons working in the enterprise. The levels of authority and responsibility of each executive is indicated in the manual so as to avoid conflicts in the organisation. Promotional charts may be included in the organisation manual showing the possible promotional avenues throughout the entire organisation.

4) **Rules and Regulations manual:** This manual provides information relating to the operating rules and employment regulations. It contains regulations governing hours of work, timings, procedure for taking leave, etc. It is actually a handbook of employment rules. It may also indicate the various

benefit plans for employees including rules regarding the use of library, cafeteria, recreation club, etc.

5) Departmental manual: This manual includes procedures to be adopted with regard to departmental work. It gives in detail the internal policies and operating rules of the department. It shows with the help of charts and diagrams the inter-departmental relationships. For instance, the filing manual contains the organisation of filing department, responsibilities of various jobs, relationship between the employees, and the standard procedures for different operations. Similarly, other departments may also have such manuals.

13.9.3 Advantages of Manual

1) It contains procedural rules and regulations and various other information in a written form. These need not be explained to the employees time and again.

2) It provides a ready reference with regard to all important decisions relating to the internal organisation of the enterprise.

3) It presents jurisdictional conflicts by clear indication of the sources of authority.

4) It enables new employees to learn the standard procedures and practices in the shortest possible time. They have a clear understanding of the responsibilities of their jobs and their relationship with other jobs.

5) It enables quick decisions as instruction and policies are stated in definite terms.

13.9.4 Drawbacks of Manual

1) Small enterprises cannot afford to have a manual because its preparation is costly and a time-consuming process.

2) Manuals may cause rigidity of operations in the organisation by putting the standard procedures and practices in writing. It leaves little scope for individual initiative and discretion.

3) Manuals may put on record those relationships which no one would like to see exposed.

13.10 FORMAL AND INFORMAL ORGANISATIONS

Formal organisation is a planned structure which represents the officially established pattern of relationships among individuals, groups, sections, units, departments and divisions so as to accomplish the goals of the enterprise. Typically, it is represented by a chart and set forth in organisation manuals, position descriptions, and other formalised documents. The formal organisation provides a board framework and delineates certain prescribed functions and the relationships between them. Formal organisation may be defined as a system of consciously coordinated activities of two or more persons towards a given objective. It is a group working together cooperatively under authority toward goals that mutually benefit the participants and the organisation. Moreover, stable and consistent relationships promote order and facilitate planning and controlling functions. Formal organisation may also be defined as (i) the pattern of formal relationships and duties, the organisation charts, job descriptions and positions guides; and (ii) formal rules, policies, work procedures and similar devices adopted by management to guide employee behaviour in certain ways within the structure of formal relationships.

The formal organisation facilitates the determination of objectives and policies. Communication, delegation of authority, and coordination take place according to a prescribed pattern. In fact, formal structure restricts and circumscribes the area of operations of individuals working within an organisation based on interest, personal attitudes, emotions, prejudices, likes, dislikes, physical location, similarity of work, etc. The informal organisation comes into existence because of the limitations of the formal structure. It represents natural grouping of people in working situation. The birth of small groups in an organisation is a natural phenomenon. The informal groups may overlap also because an individual may be a member of more than one informal group. In many cases, informal groups came into being to support and supplement the formal organisation. Indeed, the formal and informal organisations are inextricably interlinked. The difference between the two aspects of organisational life is only analytical and it should not be given undue emphasis.

13.10.1 Difference between Formal and Informal Organisations

The formal and informal organisations differ from each other in the following respects:

1) **Origin:** Formal organisations are created by conscious managerial decisions. But informal organisations arise spontaneously within the formal organisation because of the natural tendency of the individuals to associate and interact. Management has no hand either in the emergence or abolition of informal groups.

2) **Purpose:** Formal organisations are created for realizing certain well-defined objectives. But informal organisations are created by organisational members for their social and psychological satisfaction.

3) **Activities:** Activities in case of formal organisation are differentiated and integrated around the objectives of the enterprise and are formalized into work-units or departments on a horisontal basis. In case of informal organisation, there are no specific activities. They arise from time to time as a result of interactions and sentiments of the individuals. Informal groups may be based on common values, language, culture or any other factor.

4) **Structure:** Formal organisation is hierarchical, pyramid shaped in structure with well defined positions, roles and superior-subordinated relationships. It involves enforcement of organisational order through a set of polices, procedures and rules, emphasises on status differentiation based on authority, upward and downward oriented communication system, etc. On the other hand, informal organisation is non- hierarchical; it looks like a complicated social network of interpersonal relationships. Informal organisation is loosely structured, with only unwritten norms of behaviour enforced by consent. Communication is informal and multidimensional. There are no rigid status differentials.

5) **Membership:** In a formal organisation every individual belongs to one work group only and works under one superior. But in case of an informal organisation, a person can be a member of more than one group, according to his choice. He may be a leader in one group and a follower in another. There is no rigidity about group membership.

6) **Orientation:** In case of formal organisation, values, goals and tasks are dominantly economic and technical, and they concern productivity, profitability, efficiency, survival and growth. But in case of informal organisation values, goals, and tasks are predominantly psycho-social, centered around individual and group satisfaction, affiliation cohesiveness and friendship.

7) **Norms of behaviour:** In a formal organisation individuals are required to behave in the prescribed manner in their work situation. They are expected to behave in a rationale manner. Deviations from the standard are dealt with according to the organisational rules and regulations. There is also a system of rewards and punishments. But in case of informal organisation, individual behaviour and group behaviour influence each other. Moreover, behaviour is more natural and socialized. Informal groups develop their own norms of behaviour and system of rewards and punishments. Reward takes the form of a continuous membership of the groups, social status, recognition etc. While punishment includes censure by the group, isolation from the group, etc.

13.10.2 Characteristics of Informal Organisation

In the informal organisation, authority-responsibility relationship, channels of communication, pattern of coordination, etc. are not predetermined. Such as, organisation operates without any structured set up. The informal organisation interacts with formal organisation quite frequently. It affects and is affected by the formal organisaton. Following are the characteristics of the informal organisation:

1) **Authority:** There is a network of relationships in an informal organisation which may cut across the formally prescribed pattern of relationships. An informal organisation has its own code of conduct, system of communication, and system of reward and punishment. The authority in an informal organisation is personal rather than positional as in case of formal organisation. Power in informal organisation is earned or given by group members, rather than delegated; therefore, it does not follow the official chain of command. It is more likely to come from peers (equals) than from superiors in the formal hierarchy; and it may act across authority, since it is subject to the sentiments of people. Because of its subjective nature, informal organisation cannot be controlled by management, in the way as formal organisation.

2) **Objectives:** Groups evolve their own goals reflecting their own special interests. Group members are dedicated to group goals. Group cohesiveness results in the group acting in a unified manner. This cohesiveness is the result of the degree to which the group goals help the satisfaction of individual needs. Therefore, the group objectives should be related to the individual needs of the members of the group.

3) **Communication:** Informal organisation comes into existence because of the deficiencies of the formal channels of communication. The formal channels of communication may be inadequate and they may be slow. The need for speedier communication may give birth to informal channels of communication. Informal communication is very fast but the greatest danger is that it may give rise to rumours. Rumours may prove to be detrimental to the interests of the organisation.

4) **Leadership:** The informal group has its own leader. An informal leader may not be the superior under whom the group members are working. An informal group leader performs the following functions: (i) he facilitates consensus among the group members, (ii) he initiates action, and (iii) provides a link with the outside world. If the formal leader is able to perform these functions, he may be accepted as an informal leader also. Workers will go to him for their personal problems, counseling, etc. The important factors which determine informal leadership are age, seniority, work location, technical competence, etc. It may be noted that persons who emerge as informal leaders are perceived by other group members as being the best people who can satisfy the goals of the group. The group may have a number of leaders for different purposes. For instance, the group may have a task leader whose function is to drive the group towards its goals and a human relations leader who helps in promoting co-operation among the members.

13.10.3 Functions of Informal Organisation

Informal organisation is a psycho-social system and helps the organisation in the following ways:

1) **Filling in gaps in managerial abilities:** Informal organisation may fill in gaps, if any, in the abilities of managers. For example, if a manager is weak in planning his subordinates may help him informally in such a situation.

2) **Solving work problems:** Informal organisations help in solving work problems of members. It allows sharing knowledge and taking decisions which may affect a number of jobs.

3) **Better coordination:** Informal groups evolve short cuts and eliminate red-tapism. They facilitate smooth flow of information and quick decision making. All these ensure better coordination among various individuals and departments.

4) **Channel of communication:** Informal groups often fill up communication gaps which might arise in the organisaton. Informal communication cuts across the hierarchical and departmental boundaries and transmits information with greater speed. Management can use informal channels to share information with the workers and get their reaction to management proposal.

5) **Restraint on managers:** Informal groups do not allow managers to cross the limits of authority. They resist them from exercising unlimited power and form using their power unjudiciously.

6) **Better relations:** A manager can build better relations with his subordinates through informal contacts. He can consult the informal leaders and seek their cooperation in getting the things done from the workers.

7) **Norms of behaviour:** Informal groups develop certain norms of behaviour which differentiate between good and bad conduct and between legitimate and illegitimate activities. These bring discipline and order among the employees of the organisation.

8) **Developing future executives:** Informal groups recognise talented workers as their leaders. Such leaders can be picked up by the management to fill vacancies at the junior executive level in future.

13.10.4 Problems of Informal Organisation

Informal group have negative aspects too. They may create problems for the organisation as outlined below:

1) **Negative attitude of informal leaders:** The informal leader may turn out to be a trouble shooter for the organisation. In order to increase his influence, he may work against the policies of management, and manipulate the behaviour of his followers. Thus, he can be a source of conflict between the management and workers. He may induce the followers to work against the interests of the organisation. If such a leader is promoted to the rank of an executive, he may prove to be work shirker and an arrogant and autocratic boss.

2) **Conformity:** The informal group exerts strong pressure on its members for conformity. The members may become so loyal to their group that following the group norms becomes a part of their life. This implies that members become subject to willful control of the group leader who may lead the group toward selfish ends. This may lead to dilution of the effect of organisational policies and practices on the group members.

3) **Resistance to changes:** Informal groups generally have a tendency to resist change. Change requires new skills but groups want to maintain status quo. Sometimes, groups react violently to the changes proposed by management. This creates obstructions in implementing new ideas and thus organisation's growth.

4) **Rumour:** Informal communication may give rise to rumours which may create conflict and misunderstanding among the people. Rumour tends to change as it passes from person to person. Its general theme may be maintained, but not its details. The rumour gets twisted and distorted always when it passes from one mouth to another. It may originate due to employee's anxiety, insecurity and poor communication of the organisation. Rumours may prove very dangerous for the organisation.

5) **Role conflict:** Every member of the informal group is also a member of the formal organisation. Sometimes role conflict may arise because the ideas, expectation and requirement of both the organisation may be opposite to each other. For example an individual wants to follow the formal instructions of his boss; he may be compelled by the informal leader to follow informal norms. Thus organisational interests are likely to suffer in case of conflicts between formal and informal roles.

Check Your Progress C

1) Which of the following statements are True and which are False.

   i) An organisation chart indicates the lines of communication as well as lines of authority.

   ii) Both formal and informal relationships are depicted in the organisation chart.

   iii) The existence of organisation manual totally relieves managers of their responsibility of issuing instructions to subordinates.

   iv) Informal organisation is created by conscious managerial decision.

   v) Informal groups in an organisation consist of members drawn from the same department.

2) Fill in the blanks:

   i) Organisation manuals enable employees to quickly learn the standard .... and..............

   ii) An organisational chart shows the .... of authority but not the .... of authority with respect of the various managerial positions.

   iii) Formal organisation is typically reflected in the organisational ....

   iv) Informal organisation cuts across.................................... and.................................... boundaries.

   v) In a formal organisation every individual belongs to only one ....

13.11 LET US SUM UP

As a function of management organising refers to the process involving the identification and grouping of activities to be performed and defining and establishing the authority responsibility relationships. This enables people to work most effectively together in achieving the enterprise objectives. The outcome of the organising process is the 'organisation' consisting of a group of people working together for the achievement of one or more common goals. The characteristics of an organisation thus are: Willingness of a group of people to willingly contribute their efforts towards a common endeavour, division of work, common purpose, vertical and horizontal relationships, chain of command and dynamic functioning.

An organisation provides the framework within which co-operative work can be carried out without friction, and people can perform their tasks more effectively. Organising is the process by which managers bring order out of chaos and create proper conditions for effective team-work. An organisation viewed as a system is composed of many inter-dependent and interrelated parts known as sub-systems. As a social system, components of an organisation consist of : inputs of human and material resources along with information, the processor (also known as throughput); and output consisting of goods and services.

Organising involves: (i) determination of objectives, (2) identification and grouping of activities; (3) allotment of duties; (4) developing relationships. The structure of organisation refers to the pattern of relationships formally established by top-management among various parts or components of the organisation. Three different types of organisation structure can be distinguished on the basis of arrangement of activities as follows:

1) Functional, 2) Divisional, 3) Adaptive.

Principles of organisation which have been enunciated by management experts, are guidelines for planning an efficient organisation structure. These include: (a) unity of objectives; (b) division of work and specialization, (c) definition of jobs; (d) separations of line and staff functions; (e) chain of command; (f) principle of correspondence; (g) unity of command; (h) exception principle; (i) span of supervision; (j) principle of balance; (k) communication; (l) flexibility; and (m) continuity.

Span of control refers to the number of individuals a manager can effectively supervise. The ideal span depends on a number of factors like nature of work, ability of the manager, staff assistance, ability of subordinates, etc.

An organisation chart gives a diagrammatic view of the major functions, their relationships, as well as the positions and formal lines of accountability among them. It serves as a valuable aid to management and personnel. An organisation manual consists of records of top management decisions, standard practices and procedures, and job descriptions in terms of duties and responsibilities.

Formal organisation is a planned structure which represents the officially established pattern of relationships among individual groups, sections, units, departments and divisions. Informal organisation refers to relationship between individuals based on their social and psychological needs.

13.12 KEY WORDS

Chain of Command: The line of authority running from the top to the bottom of the organisation.

Departmentation: Grouping of various activities on some well defined basis.

Formal Organisation: A planned structure which represent the officially established pattern of relationship among individuals, groups, sections, units, departments and divisions.

Informal Organisation: A network of relationship among the participants of an organisation which arises spontaneously on the basis of social and psychological needs.

Organisaton Chart: A graphical portrayal of positions in the enterprise and of the formal lines of accountability among them.

Organisational Manual: A recorded document containig job descriptions and other information in addition to the organisation chart.

Organisation Structure: The authority and responsibility relationships between various positions in the organisation showing who reports to whom.

Span of Control: The number of subordinates a manager can effectively supervise.

Structure: A framework of relationship among parts

System: An arrangement and act of relationship among multiple parts operating as a whole

Unity of Command: The principle of every subordinate being under one supervisor.

13.13 ANSWERS TO CHECK YOUR PROGRESS

A) 1) i) True, ii) False, iii) False, iv) True, v) True

2) i) Interrelated ii) tasks, responsibilities iii) superior, subordinates iv) lower, v) large

B) 1) i) Scalar, ii) parity , iii) False, iv) flexible, v) fewer,

2 i) False, ii) False, iii) True, iv) True v) False.

C) 1) i) True, ii) False, (iii) False, iv) True, v) False.

2) i) Procedures, practices, (ii)line, extent, iii) chart, iv) hierarchical, departmental v) workgroup.

13.14 QUESTIONS FOR PRACTICE

1) What do you understand by organising? What are the important principles of sound organisation?

2) Explain the components of organisational system.

3) Discuss the important steps involved in organisation process.

4) Under what circumstances is a divisional structure of organisation superior to the functional structure? Compare their relative merits.

5) What do you mean by span of control? Discuss factors affecting span of control

6) "Organisation chart provides a broad picture of positions of authority and their relationships in the organisation structure " Explain this statement and point out limitations of organisation chart.

7) What is meant by organisational manual? What are its uses? What information should it contain?

8) 'Beneath the cloak of formal relationship in every institution there exists a more complex system of social relationships, called the informal organisation". Elucidate this statement and explain the nature of informal organisation.

9) Distinguish between formal and informal organisation. What should be the attitude of management towards informal organisation?

10) Write notes on:

    a) Organisation structure

    b) Project organisation

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

UNIT 14 DELEGATION AND DECENTRALISATION

Structure

14.0 OBJECTIVES

After studying this unit you should be able to:

- explain the concept and process of delegation of authority and importance of delegation
- describe the principle of delegation
- identify the barriers to delegation and suggest how to make delegation effective
- analyse the implication of centralisation and decentralisation and differentiate between delegation and decentralisation
- appreciate the merits and demerits of decentralisation
- describe the factors determining the extent of decentralisation of authority in an organisation.

14.1 INTRODUCTION

Delegation is one of the important requirements of successful management. Delegation is a concept as well as a process. As a concept, it refers to manager's sharing of work with his subordinates. However, the manager's sharing of the burden of his work with subordinates is different from division of labour. It is also different from the routine of giving order. The special kind of work sharing in delegation involves planning, assessment of subordinates, interpersonal communication and relationship of trust between the managers and his subordinates. In this Unit we shall discuss the meaning and process of delegation, its importance, the principles of delegation, and how delegation can be made effective. You will also learn the concepts of centralisation and decentralisation of authority, the difference between delegation and decentralisation, and the merits and limitations of decentralisation.

14.2 DELEGATION

In any organisation no individual can perform all duties and accomplish all tasks by himself. It is physically impossible for a single individual to look after the affairs of a large business. His skill lies in his ability to get things done through others. As an organisation grows in size and the managers job increases beyond his personal capacity, his success lies in his ability to multiply himself by training his subordinates and sharing his authority and responsibility with them. The only way he can achieve more is through delegation —through dividing his work load and sharing responsibilities with others. Thus, the sharing of power or authority with another for the performance of certain tasks and duties is known as delegation.

To delegate means to grant or confer; hence the manager who delegates grants or confers (authority) on others (subordinates) to accomplish certain duties in the form of work.

According to O. Jeff. Harris, it is an authorisation to a subordinate managers to act in a certain manner independently. The delegation of authority is the delivery by one individual to another of the right to act, to make decisions, to acquire resources and to perform other tasks in order to fulfill job responsibilities.

L.A. Allen has defined delegation as the entrustment of a part of the work, or responsibility and authority to another and the creation of accountability for performance. Responsibility is the work assigned to a position. Authority is the sum of powers and right entrusted to make possible the performance of the work delegated. Accountability is the obligation to carry out responsibility and exercise authority in terms of performance standards established. It is the obligation of an individual to render an account of the fulfillment of his responsibilities to the boss to whom he reports.

14.2.1 Delegation of Authority

Just as no one person in an enterprise can do all the tasks necessary for accomplishment of goals so it is impossible, as an enterprise grows , for one person to exercise all the authority for making decision. There is a limit to the number of persons, managers can effectively supervise and for whom they can make decision. Once this limit is passed, authority must be delegated to subordinates, who will make decision within the area of their assigned duties.

Then the question is how authority is delegated when decision-making power is vested in a subordinate by his superior. Clearly, superiors cannot delegate authority they do not have. It is equally clear that superiors cannot delegate all their authority without, in effect, transferring their position to their subordinates the entire process of delegation involves four steps. They are

1) The determination of results expected from persons in a position;
2) The assignment of tasks to persons;
3) The delegation of authority for accomplishing these tasks;
4) The holding of people responsible for the accomplishment of these tasks.

Thus, delegation is the process that managers follows in dividing the work assigned to him so that he performs that part, which because of his position he can perform effectively.

But there is a difference between delegation and work assignment. Delegation constitutes a master agent relationship while work assignment constitutes master servant relationship. An employee's work assignment may be reflected in his job description while delegated duties may not form the part of the employee's normal duties.

Delegation is legitimate authorization to a manager or employee to act in specified ways. It enables him to function independently without reference to the supervisor but within the limits set by the supervisor and the normal framework of organisational objectives, policies, rules and procedures.

From the above discussion, it is clear that delegation involves; a) entrustment of work to another for performance b) grant of power, right or authority to be exercised to perform the work, c) creation of an obligation on the part of the persons accepting delegation.

14.2.2 Elements of Delegation

There are three distinct elements of delegation: a) assignment of task or duties, b) conferment of powers or authority, and c) creation of obligation, responsibility or accountability.

a) **Assignment of task or duties:** In the first step, the delegator (superior) assigns duties to delegate (subordinate). While assigning the duties, the delegator must be clear in his mind as to what tasks he should assign to subordinates. Thus the work or task to be assigned is identified and clearly defined before it is assigned. For example, when a sales manager asks his subordinate to set up a divisional sales office, he must explain clearly the objectives, the sales territory, etc.

b) Conferment of power of authority: Granting of authority is the second step in delegation. Authority may be defined as the powers and rights granted to another to perform the delegated work. These powers may include the authority to acquire necessary resources for the performance of the assigned work. Without adequate authority, the subordinate (delegatee) cannot be expected to perform his task or duties. For example, in the above case when the sales manager asks his subordinate to set up a divisional office he has to give him the right to procure and use necessary resources.

c) Accountability: Once the duties are assigned and authority is given to a subordinate, the delegator creates an obligation/accountability to perform the tasks. The obligation to carry out the task and bear responsibility in terms of the standards established and specified is known as accountability. Thus, accountability is the obligation of an individual to render an account of the fulfillment of his responsibilities to the principal to whom he reports. The subordinate is always answerable to the superior for the task assigned to him. He cannot shift his responsibility to anyone else, that is accountability is fixed to the position. Thus the superior can control the performance of his subordinate through accountability. The delegatee is accountable to his delegator through reports, meetings and evaluation.

Check Your Progress A

1) Which of the following statements are True or False?

   i) Delegation takes place when one person gives another a free hand to perform all types of work on his behalf with no responsibility

   ii) The purpose of delegation is to share work with another, which means division of work.

   iii) Delegation involves entrustment of work, grant of authority and creation of obligation.

   iv) A manager can control the performance of his subordinate through his accountability.

   v) Delegated duties are always a part of the subordinate's normal duties.

2) Fill in the blanks choosing the appropriate word from those given within brackets.

   i) Delegation constitutes a ....relationship (master-servant/master-agent/master-worker)

   ii) As a process delegation implies the transfer of a portion of superior's ....to his subordinate (activities/authority/ obligation)

   iii) The obligation to carryout the delegated task in terms of specified standards in known as......................(responsibility/ accountability)

   iv) Accountability is fixed to the ....(person/ position/superior)

   v) The delegate must function within the limits set by the .... (job description/superior/ subordinate)

14.2.3 Principles of Delegation

Delegation is of the most important elements in the organising process. It is through delegation that interrelationships are created in any organisation. There are certain principles which may be followed as guidelines for effective delegation. These principles are:

Principle of delegation by results: The purpose of delegation is to get work done through another more effectively and efficiently than it may be accomplished by the delegator himself in a given situation. It is therefore, essential that the assignment of task or duty and the entrustment of authority should be done keeping in view the results expected. Delegation by result implies that goals have already been set and properly communicated to the delegate and understood by him and that the job assigned fits the objectives.

Principles of competence: The person selected as a delegatee should be competent for the task assigned to him.

Principle of trust and confidence: It is necessary that there is an atmosphere of trust and confidence in the organisation as a whole and that there is feeling of trust between the delegator and the delegatee. The delegatee should enjoy mental freedom in his work. He would be able to use his initiative and drive in work if he is mentally free.

Principle of parity between authority and responsibility: Authority delegated should be adequate in relation to the responsibility. It is logical that the responsibility for actions cannot be greater than authority delegated, nor should it be less.

Principle of unity of command: The principle of unity of command describe the authority-responsibility relationships. The principle stresses that each subordinate should have only one boss to whom he should be accountable to avoid confusion and conflict. In delegation, it is assumed that the right of discretion over a particular activity will flow from a single superior to a subordinate.

Principle of absolute responsibility: Responsibility is an obligation which can neither be delegated nor be temporarily shifted. No superior can escape the responsibility for the activities of his subordinates through delegation, because it is the superior who has delegated the authority and has assigned duties. Similarly, the responsibility of the subordinate to his superior for performance of the delegated duties is absolute and cannot be shifted.

Principle of adequate communication: There should be free flow of information between superior and subordinate to enable the latter take decisions and interpret correctly the nature of the task to be completed with the nature and degree of authority vested in him.

Principle of effective control: As the delegator delegates his authority but not the responsibility, he should ensure that the authority delegated is properly used.

Principle of reward: Effective delegation and proper exercise of authority should be rewarded. A rational rewarded system of reward would act a an incentive to subordinates to willingly take the responsibility and assume authority and also create a healthy environment within the organisation.

Principle of receptiveness: Delegation needs and it also creates an understanding between the superior and subordinate. Decision-making involves some discretion. This means that no two decision or two persons can exactly be the same. It is therefore necessary that the superior who delegates authority accommodates the ideas of his subordinates.

14.2.4 Importance of Delegation

Delegation of authority is one of the most important elements in the process of organisation. Organisations are characterised by a network of activities and roles.

Delegation is the process through which the interrelationships are created among individuals in their different roles in the organisation.

Delegation is necessary because it is physically impossible for a single man to look after the affair of a large organisation. The success of a manager lies in his ability to multiply himself through other people. The organisations of today are not only large but also complex in character. No manager can claim to have all the skills and expertise to perform all the diverse kinds of jobs. Again, large scale business activities are not confined to one place. It may have several branches and units at several places. Delegation becomes a necessity for running these branches.

An organisation is a continuity. Managers may go and come but the organisation continues. Delegation provides continuity of operations in the organisation. The process of delegation helps managerial development in an organisation.

Thus, delegation is important for any organisation because it reduces the burden of the manager and leaves him free to look after important matters o the organisation. It is a method by which subordinates can be developed and trained to take up higher responsibilities. It provides continuity to the organisation and creates a healthy organisational climate by creating better understanding among the employees.

Check Your Progress B

1) Fill in the blanks with appropriate words from those given within brackets:

   i) Delegation by result implies that goals have been properly .... (assigned /communicated/discussed)

   ii) Responsibility can be neither delegated nor shifted. It is .... (fixed/absolute/rigid)

   iii) Subordinates often avoid responsibility due to fear of .... (penalty/criticism for mistakes /discharge)

   iv) Subordinates should be ....to accept delegation (forced /ordered /trained)

   v) Managers are reluctant to delegate when they have no confidence in the ....of subordinates (morality/sense of responsibility/integrity)

2) Which of the following statements are True or False?

   i) The responsibility of the delegatee cannot be greater than the authority delegated to him.

   ii) Delegation is not possible if the managers are younger than the subordinates.

   iii) Delegation provides continuity of operations in the organisation.

   iv) Objectives have nothing to do with effectiveness of delegation.

   v) For effective delegation managers must have trust in their subordinates.

14.2.5 Barriers to Effective Delegation

The problem of delegation is essentially one of human leadership. 'Delegation is not only a technique of management; it is a part of the attitude of business itself.' As such what is necessary is the atmosphere of giving and taking responsibility in the organisation. This is possible by creating an atmosphere of mutual trust and confidence. The reluctance of the superior to delegate and the reluctance or avoidance of the subordinates to accept delegation are the major barriers to delegation which are discussed below.

Why are managers reluctant to delegate

Managers are sometime reluctant to delegate authority due to the following reasons:

1) **Lack of confidence in the capability of subordinates:** A manager may not have confidence in the capability and competence of subordinates. He may consider that he can do the job better than his subordinates.

2) **Lack of confidence in the subordinate's sense of responsibility:** The manager's lack of confidence in the sense of responsibility of subordinates may also stand in the way of delegation of authority to others.

3) **Fear of loss of power:** Managers who feel insecure and fear that if the subordinates perform well they may lose their power, are usually reluctant to delegate.

4) **Lack of self confidence:** Some manager may lack self-confidence or may be too conscious of their own incompetence, and therefore, reluctant to delegate authority. This is true in organisations where professional management is lacking.

Why subordinates avoid delegation?

Subordinates are also found to avoid delegation under certain circumstances discussed as below:

2) **Reluctance to bear responsibility:** Researches have shown that many subordinates prefer controlled existence with minimum responsibility. Such employees are unwilling to accept responsibility which goes with delegation of authority.

3) **Fear of criticism:** Another factor which prompts subordinates to avoid responsibility is the fear of criticism for inefficiency or mistakes.

4) **Fear of inadequacy of resources:** Many subordinates hesitate to accept responsibility for fear of inadequacy of necessary resources for completion of the task and uncooperative attitude of the delegator.

5) **Lack of motivation:** In many cases, the organisational climate is not motivating enough. It prevents subordinates in accepting responsibility. Some studies undertaken in India show that delegators love for authority, the tendency on the part of the superiors to hold back information needed by subordinates and delegators' lack of confidence of the subordinate in taking up delegated tasks.

14.2.6 Means of Effective Delegation

Effectiveness of delegation is governed largely by the general attitude of business which depends on various factors, like management policies, organisational culture, professional outlook and willingness on the part of key managers to delegate authority and the willingness as well as competence of the subordinates to accept delegation. The studies undertaken have shown that poor or inept delegation is one of the most prominent causes for the lack of delegation or failure of delegation. For effective delegation, the following measures may be taken.

1) **Improvement in the organisational climate and general management policies:** The organisational climate depends on several factors, the most important of which is the general attitude of the key managers and the overall personal policy of the organisation. A forward looking, progressive organisation believes in the development of its people and such throws open more and more oppurtinitites for the younger managers to develop.

2) **Trust in subordinates:** If the key managers create an atmosphere of trust and repose their confidence in the subordinates, the subordinates will be motivated to take responsibilities. Once trust prevails, the feeling of fear disappears.

3) **Establish clear objectives:** Effective delegation depends on clarity of objectives. The delegatee should clearly know what he has to achieve.

4) **Define responsibility and authority:** The delegatee should know the degree of authority he enjoys to perform the job, and its adequacy in relation to his responsibilities.

5) **Motivate subordinates:** Motivation is the moving force in delegation. About the best leader, the Chinese philosopher Lao-tzu said "when their task is accomplished, their work done, the people feel 'we have done this ourselves'." It is difficult to say what would motivate people. The true motivation is internal. What clicks in motivating an individual is not easy to know. Yet it is for the superior to know as to what the urgent needs of their subordinates are. Research studies have shown that group recognition and group cohesiveness encourage participative management. The introduction of participative management in the organisation must be encouraged at all levels ——lower, middle and top levels.

6) **Improve communication:** Communication is an effective tool promoting better understanding and improving the organisational climate. There should be a free flow of information about the policies and programmes of the organisation.

7) **Provide necessary training:** Subordinates should be trained to accept delegation and the manager should master the skill of delegation.

8) **Establish adequate controls:** Effective delegation requires a system of controls to free the manager from routine inspections and yet enable him to maintain accountability.

14.3 DECENTRALISATION

Delegation of authority is closely related to the concepts of centralisation and Decentralisation of authority.

Centralisation

Centralisation is the reservation or withholding of authority by individual managers within the organisation. According to Henry Fayol, 'everything that goes to increase the importance of the subordinates' role is decentralisation, everything which goes to reduce it is centralisation.' In centralisation, little delegation of authority is the rule; power and discretion are concentrated in a few executives. Control and decision –making reside at the top levels of management. However, absolute centralisation is untenable because it would mean that subordinates have no duties, power or authority.

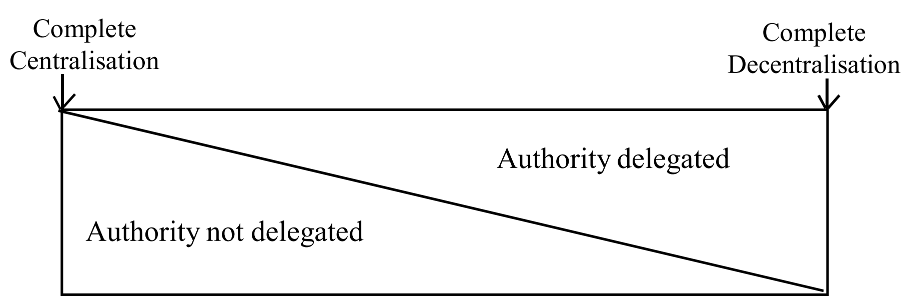
Centralisation may be essential in small organisation to servive in a highly competitive world. But as the organisation becomes more complex in terms of increasing size, interdependence of work-flow, complexity of task and spatial physical barriers within and among groups, a function requisite for efficiency is to move decision-making centers to the operating level. Thus the larger the size of an organisation, the more urgent is the need for decentralisation. This does not mean that decentralisation is good and centralisation is bad.

Decentralisation

Decentralisation is the systematic effort to delegate to the lowest levels all authority except that which can be exercised at central points. It is the pushing down of authority and power of decision-making to the lower level of organisation. The centres of decision-making are dispersed throughout the organisation. The essence of decentralisation is the transference of authority from a higher level to a lower level. It is a fundamental principle of democratic management where each individuals is respected for his inherent worth and constitution.

As you know, decentralisation is a correlate of delegation; to the extent that authority is not delegated, it is centralised. Abbsolute centralisation decreases the role of subordinate managers which in turn encourages decentralisation. Absolute decentralization is also not possible because managers cannot delegate all their authority. If he does so, his status as managers would cease and his position would be eliminated. The degree of centralisation and decentralisation is shown in figure 14.1

Fig. 14.1: Degree of Centralisation and Decentralisation



14.3.1 Distinction between Delegation of Authority and Decentralisation

Although decentralisation is closely related to delegation, there are some differences between decentralisation and delegation which are discussed below:

1) Delegation is a process of systematic transfer of authority while decentralisation is the end result of planned delegation.

2) Delegation refers to the transfer of authority from one individual to another. Decentralisation refers to the systematic delegation of authority to all units in an organisation-wide context.

3) Delegation can take place from one person to another and be a complete process. But decentralisation is complete only when the fullest possible delegation is made to all or to most of the people.

4) Delegation is between a superior and a subordinate while decentralisation is company-wide delegation as between top management and divisions or departments.

5) Delegation is necessary for effective management because no individual manager can afford to look after everything. But decentralisation is optional, necessitated by the growth of the organisation.

6) In delegation, operational control is exercised by the delegatee but in decentralisation the overall control is by the top management.

14.3.2 Merits and Limitations of Decentralisation

Centralisation and decentralisation are extensions of delegation. The belief that complete decentralisation is always desirable is fallacious. Equally fallacious is the belief that complete centralisation is good. The merits and limitations of decentralisation are discussed below.

Merits

1) **Facilitates growing and complex organisation:** Centralisation of authority may be desirable under certain special circumstances to accomplish specific results or when the company is small. But when organisation grows in size and became complex even a hardcore autocratic manager is forced to delegate some authority and bring about decentralisation.

2) **Reduces the burden of executives:** Decentralisation is always preferable when an organisation has grown in size and complexity, and there is a need to reduce the burden of the top executives.

3) **Facilitates diversification:** Decenteralisation is required when business needs to be expanded by diversifying its activities or product lines.

4) **Quick decision making:** Decenteralisation facilitates consultative as well as quick decision-making at the action point. This promotes interaction among the different functionaries giving them an opportunity for self development and training and stimulating them to put in their best effort in the growth and development of the organisation as whole.

Limitations

1) **Leads to disintegration:** Extreme decentralisation, however, is a cure. It may lead to looseness and also ultimately to the disintegration of the organisation. It may bring about the diseconomy of scale with the increase in the overhead expenses of each decentralised unit. The duplication in functions may further add to the total cost.

2) **Dose not suit specialised services:** For specialised services like accounting personal, research and development etc., decentralisation is unwarranted. Moreover, there are certain areas of control and responsibility like setting up overall organisational objectives, long-term planning, formulation of policy, capital investment etc. which need to be under central control only.

3) **Conflict:** Decentralisation puts increased pressure on divisional heads to realise profits at any cost. This encourages the managers to become department conscious. Sometime the top management deliberately encourages competition between different departments to increase the profitability. This competition results in bitter inter-divisional rivalries and conflict.

Thus neither extreme centralisation nor decentralisation is desirable. What is requird is a golden means —a balance between centralisation and decentralisation. The question before managers, therefore is not whether an organisation should be decentralised but to what extent it should remain centralised.

14.3.3 Factors Determining the Degree of Decentralisation

Decentralisation helps in achieving the organisational objectives more efficiently. Following factors are usually considered in determining the degree of decentralisation.

1) **Size of operations:** As an organisation grows in size and complexity, need for decentralisation tends to increase. More decision are taken at different places and coordination of a large number of departments becomes difficult. Thus as the size increases, decentralisation becomes inevitable.

2) **Cost and risks of decision-making:** As the organisation grows in size the decisions involving heavy costs also multiply. With decentralisation of authority the high cost and high-risk decisions may be taken at the top level but routine decisions can be taken at lower levels. Thus decentralisation helps and quickens decisions-making process.

3) **Top management philosophy:** The attitude of top executives and their philosophy have an important influence on the extent to which authority is decentralised.

4) **Availability of management resources:** The extent of decentralisation is limited to the extent of availability of trained and competent managerial personnel.

5) **Environmental influence:** The most important environmental forces affecting the degree of decentralisation are: Government controls, tax polices, and unionism

For example where prices of a product are controlled, the sales manager's freedom is curtailed. Similarly, labour legislation and the decision of workers unions may limit the authority of managers.

Check Your Progress C

1) Which of the following statement are True or False?

   i) Decentralisation of authority and delegation of authority are closely interrelated.

   ii) Delegation is essential for management but decentralisation is optional.

   iii) Decentralisation of authority is not good for large organisations.

   iv) Decentralisation of authority is bad under all circumstances.

   v) Delegation is not possible in all units of an organisation.

2) Fill in the blanks

   i) Decentralisation is the ……………………………….. or planned delegation in the organisation-wide context.

   ii) Centralisation may be desirable when the organisation is ………………………

   iii) When business needs expansion by diversifying the product line, the organisation should be ………………………………….

   iv) As ……………………of a business increases centralisation is not preferable.

   v) For specialized services like accounting …………………….. is unwarranted.

14.4 LET US SUM UP

Delegation may be defined as assigning formal authority and responsibility to another person for the performance of certain activities. As a process it is followed by managers in dividing up work with subordinates by entrusting a part of their duty and assigning them the necessary authority to accomplish it. Delegation involves entrustment of duties and responsibilities, assignment of authority and creation of accountability.

Delegation facilitates effective utilisation of resources, relieves top executives of their extra work-load, improves decision–making and encourages initiative and self-development.

The superior executives are often reluctant to delegate and the subordinates hesitate to take responsibility. These constitute barriers to effective delegation.

Managers may be reluctant to delegate authority due to: lack of confidence in the capability of subordinate's or in the subordinate's sense of responsibility, fear of loss of power, or lack of self- confidence. Subordinates are often reluctant to accept delegation on account of their preference to avoid responsibility, fear of criticism for mistakes or inefficiency, inadequacy of resources, and lack of motivation.

Effective delegation can be possible by improving the organisational climate, creating an atmosphere of trust in the subordinates, establishing clear objectives, precisely defining authority and responsibility, motivating the subordinates to accept delegation, improving communication, providing necessary training and establishing adequate a golden mean –a balance between the two.

Centralisation is the withholding or reservation of authority by individual managers within an organisation. Decentralisation refers to the systematic delegation of authority to all units in an organisation-wide context. It is complete only when the fullest possible delegation is made to all or most of the people lower down the level in an organisation.

Centralisation of authority may be desirable under special circumstances to accomplish specific results or when the company is small in size. Decentralisation is always preferable when an organisation has grown in size and complexity and there is a need to reduce the burden of the top executives.

Delegation is closely related to decentralisation. Delegation leads to decentralisation. The degree of decentralisation in any organisation is determined by several factores like the size of organisation, the rate of growth and the nature of organisation.It is influenced by the management philosophy and the environment in which an organisation operates. Whatever may be the size of the organisation there is nothing like a complete centralisation nor complete decentralisation in an organisation. Neither complete centralisation nor complete decentralisation is desirable. What is required is a golden mean —a balance between the two.

14.5 KEY WORDS

Absoluteness of responsibility: The principle that responsibility can neither be delegated nor shifted to another person.

Accountability: Subordinates responsibility to account for the performance of the task delegated to him.

Chain of command: Superior-subordinate relationship in an organisation which follows a hierarchical order of ranks from top to bottom.

Centralisation: The systematic and consistent reservation of authority to make major policy decisions at one or a vary few central points within the organisation.

Decentralisation: Systematic delegation of authority pushing down the decision-making process to lower levels in the organisation.

Delegation: The act of assigning formal authority and responsibility to a subordinate for the achievement of specific objectives.

Parity of authority and responsibility: The principle that grant of authority should be at par with the responsibility of the delegatee.

Responsibility: The obligation owed by subordinates to their superiors for exercising authority delegated to them to accomplish a given task.

Unity of command: The principle of each subordinates being responsible to only one superior.

14.6 ANSWERS TO CHECK YOUR PROGRESS

A) 1) i) False ii) False iii) True iv) True v) False

ii. i) master-agent ii) authority iii) accountability iv) position v) superior.

B) 1) i) Communicated ii) absolute iii) criticism for mistakes iv) trained v) sense of responsibility.

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

C) 1) i) True ii) True iii) False iv) False v) False

2) i) end result ii) small iii) decentralised iv) size v) decentralisation.

14.7 QUESTIONS FOR PRACTICE

1) Define delegation. What are the elements of delegation?
2) Discuss the principles of delegation of authority.
3) What are the barriers to effective delegation? How can they be overcome?
4) Distinguish between delegation and decentralisation.
5) What do you understand by the terms centralisation and decentralisation? What are the advantages of the decentralisation?
6) Extreme decentralisation is as bad as extreme centralisation. Discuss.
7) What are the factors that determine the degree of decentralisation of authority in an organisation?
8) What is the importance of delegation of authority? How is it related to decentralization of authority?

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

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BTMC-132
Fundamentals of Management

Block

4

MANAGEMENT CONCEPTS-II

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*BTMC – 132 was adopted / adapted from Three Courses, namely – **BCOE 108, ECO – 101** and **ECO – 103** of School of Management Studies. (SOMS)

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January, 2019

ISBN :

Further information on Indira Gandhi National Open University courses may be obtained from the University's office at Maidan Garhi. New Delhi-110 068 or visit University's web site http://www.ignou.ac.in

Printed and published on behalf of the Indira Gandhi National Open University, New Delhi by Prof Jitendra Kumar Srivastava, Director, School of Tourism,

Laser Typeset by : Tessa Media & Computers, C-206, A.F.E.-II, Okhla, New Delhi

Printed at :

BLOCK 4 MANAGEMENT CONCEPTS-II

You have learnt in detail about the planning and organising functions of management in Block 3. This block discuses the function and process of Staffing, the process of Staffing and Control, the role of motivation and its theories and the theories and styles of leadership.

Unit 15 deals with the meaning and importance of staffing function, the process of staffing, recruitment, training, and management development programmes

Unit 16 explains the nature and importance of control, stages in the control process, requisites of effective control and various types (areas) of control.

Unit 17 explains the concept and process of motivation, the different theories of motivation, the importance of job enrichment, and the various types of motivation.

Unit 18 deals with nature and importance of leadership, the various theories and styles of leadership, the functions of leadership and the qualities of an effective leader. It also discusses the significance of morale and the factors determining morale.

UNIT 15 STAFFING

Structure

15.0 OBJECTIVES

After studying this Unit, you should be able to:

- explain the meaning and importance of staffing function
- describe the process of staffing
- explain the concept and steps of human resource planning
- describe different sources of recruitment
- explain different steps in the selection process
- describe the purpose and methods of training
- explain different management development programmes.

15.1 INTRODUCTION

In Unit 13, you have learnt how managers perform their function of organising and how the structure of an organisation is designed. Once the most suitable structure of activities and job positions are shaped, efforts should be made to find out and hire the right type of individuals to fill in the various job positions. This managerial function is known as Staffing.

In this Unit, you will learn the meaning and importance of staffing, major staffing activities such as human resource planning, recruitment, selection, placement and orientation and training and development.

15.2 MEANING OF STAFFING

"Staffing" may be defined as the managerial function of employing and developing human resources for carrying out the various managerial and non-managerial activities in the organisation. The function is concerned with attracting, acquiring and activating the human resources for achieving organisational goals. Staffing also involves upgrading the quality and usefulness of members of the organisation with a view to get higher performance from them.

The staffing function includes such activities as manpower or **human resources planning, recruitment, selection, placement, training and development, remuneration, performance appraisal, promotion, transfers** and so on. In many organisations, most of the above activities are handled by the personnel management or human resources management department. The basic responsibility for staffing decisions and initiatives is that of line managers. However, the personnel management department provides the needed expert advisory services to line managers in order to enable them to do their function more effectively. Often, the personnel management department also handles the administrative aspects of staffing.

Staffing is a continuous function of managers. This is because the organisation's need to retain and maintain its personnel is a never-ending process. Managers have to keep a regular watch on the size and composition of personnel needed by the organisation. They have also to take care of the staffing needs as the organisation expands its activities and as new departments and work units are added. The on-going nature of the staffing function is self-evident to the extent that the nurturing and development of people is a constant concern of managers. Also, at any point of time, some people will be leaving, retiring, getting promotions or transferred. The vacancies thus caused have to be filled up.

15.3 IMPORTANCE OF THE STAFFING FUNCTION

The importance of the staffing function stems from its relationship with other functions, without people or personnel, organisations are empty entities which cannot move a bit in the achievement of their objectives. The function of planning, organising, direction and control become non-starters without managers and other members of the organisation. The effectiveness of the other managerial functions depends on the efficiency with which staffing function is done. An organisation which is in a position to hire, retain and develop the right quality of people will be in a position to take full advantage of opportunities of growth and verification. An organisation is strong to the extent that its members are strong in their abilities, skills and efforts to do things and to get things done.

It is a well recognised fact that all the physical, financial and other resources of the organisation have to be efficiently allocated and utilised by the managers and others who form part of its staff. Indeed, human resources of an organisation are its most valuable assets and give it a distinct advantage over other organisations.

The staffing function takes care of the need for building a sound organisation. Organisations greatly differ in the quality and competence of their members. This reality is to be traced to the staffing function. It is the staffing functions which injects life and action into the organisation and make its functioning possible.

Some organisations may somehow be able to attract right talent because of such factors as high remuneration, perquisites, security of tenure and so on. But the talent so attracted has to be properly preserved and developed through the staffing function. Otherwise, human assets will turn into liabilities and burdens on the organisation.

The Staffing Process: Just like the other managerial functions, the function of staffing may also be viewed as a process consisting of certain well recognised activities. These activities (also called elements) include human resource planning, recruitment, selection, placement, and orientation, training and development, promotions and transfers, remuneration, performance evolution and so on. All these elements, when arranged sequentially may be regarded as the steps or phases of the staffing process.

We shall now discuss the major steps one by one.

Check Your Progress A

1) Which of the following statements are True and which are False.

   i) Staffing means recruitment, selection and placement of staff.

   ii) Staffing decisions are the responsibility of line managers.

   iii) All staffing activities are carried out in the personnel management division.

   iv) The staffing process involves a number of sequential activities.

   v) Staffing is a onetime function.

2) Fill in the blanks.

   i) Personnel Management Department provides .... to line managers.

   ii) The staffing function takes care of the need for building a sound ………………… organisation.

   iii) The human resources of an organisation are its most valuable ……… ....…………

   iv) Staffing is a …………………. function of managers.

   v) The staffing function is concerned with .....………………… and …………….. human resources.

15.4 HUMAN RESOURCE PLANNING

The first major element of the staffing function is human resource planning. **It is concerned with the determination of the size and composition of personnel needed by the organisation over a specific future period.** Planning for human resource requirements is also concerned with formulation of relevant policies, strategies and programmes for meeting such requirements in an efficient manner.

The objective of human resource planning is to ensure that the organisation gains full freedom and control over the size and quality of its personnel requirements on a continuous basis. Human resource planning provides a sound basis for making timely managerial decisions on hiring the various categories of personnel – skilled, unskilled, technical, clerical, administrative and professional needed at various levels of the organisation. It clears the way for the subsequent staffing functions of recruitment, selection, training, promotion and so on. Planning for human resource requirements also aids in formulation of action plans to optimise the contribution and satisfaction of the organisation's work force. It also keeps the investment and expenditure on staff at a reasonable level. The organisation is also likely to be free from situations of surpluses and shortages of staff at any point of time. In short, the objectives of human resource planning may be listed below:

i) It helps in obtaining and retaining the quality and quantity of manpower.

ii) It ensures the best use of manpower resources.

iii) It helps in anticipating the problems arising from potential surpluses or deficits of manpower.

Human resource planning involves several activities. The management has to prepare a comprehensive account of the current size and composition of its personnel – their positions, qualifications, skills, experience, age and so on. Such an account of the present status of the personnel provides the basis for forecasting the future human resources requirements. The organisation has to take a close look at its future plans of expansion, possible changes in the technology of operations, and reforms contemplated in the organisational structure. All these give a partial idea of the future human resources needs. It will also have to make rough estimates and assumptions about the likely turnover of employees and workers, likely retirement and termination of services in the normal course, and so on. Projections are to be made about the likely promotions and transfers of its present personnel. The end-product of all these activities is a tentative plan of the intentions of the organisation about its manpower requirement. It is true that the plan so devised is to be implemented keeping in view the behavior of employment market and other external factors as relevant to the organisation.

Steps in Human Resource Planning

Human resource planning consists of five basic steps as listed below:

i) Determination of organisational objectives.

ii) Determination of the skills and expertise required to achieve the organisational and departmental objectives.

iii) Determination of the additional human resource requirements in the light of the organisation's current human resources.

iv) Developing action plans to meet anticipated human resource needs.

As a part of human resource planning, the organisation has also to do job analysis to determine the qualifications, skills, experience and expertise required for major categories of jobs. In short, job analysis includes: (i) identification of each job in terms of duties and responsibilities; (ii) determination of the nature of work and work conditions, and (iii) determination of the requirements as to abilities and skills that are prescribed for the persons holding it.

Thus, there are two major aspects of job analysis as discussed below.

1) **Job description** refers to a narration of the activities and duties to be performed in a job, the relationship of the job with other jobs, the equipment and tools involved, the nature of supervision, working conditions and hazards of the job and so on. All major categories of jobs have to be described clearly and comprehensively in order to determine the qualifications and skills required.

2) **Job specification** is a statement of the minimum levels of qualifications, skills, physical and other abilities, experience, judgement and attributes required for performing a job well. It sets forth the qualities required for performing the job.

   Job description and job specification are useful in recruitment and selection of employees so as to find the right persons for the jobs. They are also useful to establish proper wage and salary structure and to provide proper orientation and training for new employees.

15.5 RECRUITMENT

After determining of the requirements of staff, the next step is recruitment. **Recruitment is the process of searching for and securing applicants for the various job positions which arise from time to time in the organisation.** For this purpose, the organisation is to locate the sources and availability of prospective candidates and publicise the specific personnel needs so as to inform and induce the people to apply for the job positions. The purpose of recruitment is to get as many potentially suitable applicants as possible in order to have wide choice for the organisation. The organisation has to cast the net wide enough through proper communication and contact with the reservoirs of manpower.

There are two sources of recruitment internal and external. The **internal sources** are obviously the employees of the organisation. Some organisations largely rely on internal sources while others do not. It is a matter of organisational policy, preferences, the nature of job requirements, the level of calibre of employees and the bargaining power of their unions.

15.5.1 Internal Sources

Internal recruitment generally consists of exploration of possibilities for promotion and transfer of the organisation's employees for filling up vacancies. Many organisations maintain an inventory of qualifications, skills and experience of their existing employees so as to have a rough idea of their promotability and transferability.

Advantages: The advantages include the following:

1) **Familiarity with own employees:** The organisation has more knowledge and familiarity with the strengths and weaknesses of its own employees then of unknown outsiders.

2) **Better use of the talents:** The policy of internal recruitment provides an opportunity to the organisation to make a better use of the talents internally available and to develop them further.

3) **Inexpensive Recruitment:** Internal recruitment is inexpensive. The organisation does not have to spend much effort, time and money to locate possible candidates and to attract their applications.

4) **Improves the morale:** In this process employees are sure that they would be preferred over the outside competitors. This feeling helps in boosting the morale of the employees.

5) **A source of motivation:** The opportunity of promotion implicit in internal recruitment is a source of motivation for employee to improve their career and income levels. It is also a means of attracting and retaining competent employees, who are likely to feel that the organisation is the place where they can build up their life long career.

Limitations: The drawbacks associated with internal recruitment are as follows:

1) **Restricts the options:** It restricts the options of the organisation for tapping the talent available in the vast outside employment market. The organisation denies itself fresh talent from outside. Internal recruitment means 'inbreeding' which is not healthy for the future of the organisation.

2) **Lack of availability of suitable candidates:** Suitable candidates may not be available internally. In such situation the organisation may have to compromise its quality requirements for the job positions by taking mediocre people from within.

3) **Discourage competition:** In this process internal candidates are protected from the element of competition from outside candidates. Therefore, they may develop tendencies to take their promotions for which they need not put in any extra performance.

4) **Creates controversies:** Conflicts and controversies are likely to arise among the internal employees who desire promotion, whether or not they deserve it.

5) **Stagnation of skills:** In the long run the skill of internal employees may become stagnant or obsolete which decreases the productivity and efficiency of the organisation.

15.5.2 External Sources

In the external sources of recruitment a vast mass of skilled, semi-skilled and unskilled people are recruited from the outside of the organisation. There are various methods of external requirement like **public employment agencies, private employment agencies, labour unions, educational institutions, professional associations, former employees**, etc. Organisation may also adopt informal approaches to get the employment aspirants through various contacts.

The success of recruitment from external sources depends upon the scales of wages/salaries offered, the general conditions of service, employment conditions in the market, the image of the organisation, availability of suitable conditions and so on.

Advantages: The advantages of external recruitment include the following:

1) **Open process:** It is a more open process and the organisation is likely to get a large number of applicants, thereby widening its options of selection.

2) **Availability of talented candidates:** The organisation can expect to get talented candidates from outside. It means injection of new blood into the organisation.

3) **Opportunity to select the best candidates:** The selection process would be characterised by competition. The prospects that the organisation can pick up the best candidate for the jobs are high.

4) P**rovides healthy competition:** External candidates are supposed to be trained and efficient. As they join the new organisation they work with great vigour and put their best effort to achieve the objectives. This creates healthy competition and congenial work environment in the organisation.

Limitations: The external recruitment suffers from some limitations. They are:

1) **Expensive and time consuming:** It is expensive and time consuming. There is no guarantee that the organisation will get good candidates.

2) **Unfamiliarity with the nature of the organisation:** External candidates, being new to the organisation cannot be expected to be familiar with the tasks, job nature and the internal conditions in the organisation. The process of orienting them into the organisation will be time consuming.

3) **Generates feeling of discontent and frustration among existing employees:** External recruitment is likely to generate feelings of discontent and frustration among the existing employees. They may feel ignored by the organisation.

4) **Discourage the existing employees:** Existing employees are not sure to get promotion. Hence they feel discouraged from working hard. This decreases the productivity and efficiency of the organisation.

Check Your Progress B

1) Fill in the blanks.

   i) Human resource planning is concerned with determination of …………….. and ………………….. of personnel needed over a specified period of time.

   ii) Job description and job specification are two aspects of ....
   ....

   iii) There are two sources of recruitment, ... and
   ....

   iv) .... and .... are implicit in internal recruitment.

v) The selection process in external recruitment is characterised by …………………

2) Which of the following statements are True and which are False

i) Job specification is a narration of the duties to be performed in a job.

ii) Surplus or shortage of staff can be avoided by means of human resource planning.

iii) External recruitment is more time consuming than internal recruitment.

iv) Internal recruitment is an open process.

v) Before recruitment there must be job analysis.

15.6 SELECTION

Selection is the process of choosing the most suitable candidates from applicants for the various jobs. It follows recruitment. Much information has to be obtained, analysed and evaluated from the prospective candidates to facilitate the selection process. The information relates to the qualifications, work experience, age levels of skills and other accomplishments, family background, aptitudes and interests, physical mental fitness and so on.

Steps in the selection process: Following are the steps in the selection process:

Filling in application form: This may be regarded as the first stage of the selection process. Candidates are supposed to provide complete information about themselves in a written form. The applications of candidates provide the basis for further analysis and examination of their suitability.

Preliminary Screening: This refers to initial assessment of basic suitability of candidates for the job positions. They see whether the applicants meet the basic academic and other minimum requirements as regards age, work experience and so on. The basic objectives of preliminary screening is to eliminate the unsuitable candidates and to reduce the overall cost of selection.

Holding of tests: Candidates who are filtered through the initial screening submit themselves to certain test, formal or informal. Test is a means of evaluating their knowledge, skills, experience, attitudes, personality, and so on. In some cases, as for example typing shorthand, computer knowledge, etc. Tests are the only way to determine the suitability of candidates for the jobs.

There are several types of tests which are widely used for selection purposes. They include: intelligence tests, aptitude tests, personality tests, performance tests and so on. These and other similar tests are meant to measure the major dimensions of the suitability of right candidates. Tests provide a more objective, authentic and consistent basis for selection of right candidates. They held the organisation in arriving at a judgement on the likely work behaviours and performance of candidates. However, it should be remembered that tests are not fool proof methods of selection.

Interview: The personal face-to-face interview with the candidates by a panel of selectors is a widely used method of selection. Interview enables the selectors to get a first hand idea of the personality of candidates, their poises and poses, their communication, other related skills and their general behavior. The interviewers typically ask candidates several searching questions to elicit their responses and to evaluate them. Questions may be spontaneously asked or pre-planned in some way. Candidates may be interviewed either individually or in groups. In the latter case, a small group of five or six candidates is observed and evaluated in group discussions and interactions, by the selectors. For certain types of jobs, especially managerial jobs, candidates may be required to go through a series of interviews of a progressively rigorous nature. Conducting employment interviews is a delicate and difficult task. It requires much planning, restraint, maturity and understanding on the part of interviewers. They should have a very clear perspective of the job requirements and should be able to judge the process of matching the candidates and the jobs.

In combination with other methods of selection, interviews are useful for making sound decisions on hiring. While tests are impersonal, interviews are interactional in nature. If conducted properly, they open up ways of sizing up the competence and calibre of the candidates for the job positions for which they offer themselves. They also provide an opportunity to the candidates to get more information from the interviewers about the nature of the job, prospects of promotion and about other conditions of service.

The other aids of selection, apart from the above are (i) physical examination of the candidates to assess their general fitness and health, and (ii) making references to previous employers and others so as to verify some information provided by the candidates.

The climax of all the above processes of selection is the final choice of the candidates for the job. A final ranking of the short-listed candidates is often made on the basis of their scores in the tests and interviews. Appointment offers are made to the top one or more candidates depending on the number of vacancies. The decision on selection may be made by members of the interview board. Alternatively, the interview board makes only recommendations on the right candidates and leaves it to concerned top authority to take the final decision.

15.7 PLACEMENT AND ORIENTATION

Once the selected candidate eventually joins the organisation, he is to be, placed in the job for which he is selected. In some cases, when two or more alternative positions are to be filled, the selected candidate is sought to be placed in the job to which he is more suited by virtue of his qualifications, experience, aptitudes and so on. It is partly a process of matching jobs and the selected candidates. Placement may be tentative in some cases; the final placement will be done after the incumbent is tested on alternative jobs, in actual practice.

Orientation is the process of introduction of the new employee to the organisation. He is given information on matters such as under whom and with whom he should work, requirements of job performance and behaviour, facilities and benefits available, hours of work and so on. Orientation is also a process of socialisation of the new employee with his fellow employees, superiors, seniors and subordinates. The purpose of orientation is to expedite the process of familiarisation of the new employee to the work culture of the organisation. Proper orientation of the new employees is likely to reduce their anxieties on how to cope with the job requirements, how to become acceptable to the work group and how to become a part of the organisation. A planned orientation programme for new employees is an essential requirement to make employees feel at home and to minimize their initial problems of adjustment with the organisation during the first few critical weeks.

Check Your Progress C

1) State whether the following statements are True or False .
   i) Selection is the process of eliminating unsuitable applicants for jobs.
   ii) The purpose of interview and tests is to get as much information from the applicants as possible.
   iii) Interviews are useful for making sound decision on hiring.
   iv) Orientation of a new employee is complete when he is acquainted with the rules and regulations of the company.
   v) Candidates are always interviewed individually never in groups.
2) Fill in the blanks.
   i) Interview enables selectors to get a first hand idea of the …………of candidates.
   ii) Selection tests provide a more ……………… basis of selecting the right candidates.
   iii) Orientation is the process of …………….. new employees to the organisation.

15.8 TRAINING AND DEVELOPMENT

Training is the process of helping employees to acquire more knowledge of the job and to learn or sharpen the needed skills, attitudes and values associated with efficient performance of their jobs. New employees as also existing employees often need training as a means of their progress in their jobs and careers. It is an important element of the staffing function. Many organisations make formal or informal arrangements for providing training to their managerial and non-managerial personnel. Typically, a separate training department under the charge of an expert in training techniques is established for the purpose.

A distinction is often made between training and development. Training is more concerned with immediate work skills and knowledge of new or existing employees. It is rather narrowly oriented to upgrade skills for the specific purpose of improving the job-behaviours and performance of employees and workers. On the other hand, development focuses on the general improvement of the overall personality of the employee. The aims of development tend to be more general and sometimes unclear. Another point of distinction between training and development is the term training is used with reference to non-managerial employees and workers while the term development is reserved with reference to managers and executives.

15.8.1 Purpose and Importance of Training

The need for training and development, their purposes and importance are outlined as follows:

1) **Provides adequate training to new employees:** Training is very essential for new employees who are often raw hands. Training make them more well-versed in the complexities of their jobs. It quickly helps the employees to reach the required level of efficiency in their work.

2) **Provides new skills to the existing employees:** For existing employees also, training is generally helpful to gain more job knowledge and skills. There are always better ways of doing jobs which can be transmitted by the former to the latter.

3) **Provides the knowledge of new technological development**: In some cases, new ways of performing jobs emerge as a result of work studies and also as a result of technological developments. Employees and workers may be required to acquire new skills, techniques, job knowledge and new attitudes. In such cases also, employees should be exposed to training so as to enable them to catch up with the new job demands. Employees who do not update and upgrade their knowledge and skills will become misfits in their jobs.

4) **Prepares employees for their promotion**: Training is also essential to prepare employees for their promotion and for assuming higher job responsibilities. It makes them more eligible for promotion. Also, when employees are transferred from one job to another of a different nature, they should be trained in order to enable them to get quickly acquainted and adjusted with their jobs.

5) **Improves the attitudes and behaviours of the employees**: Another way in which training is useful is orientation and re-orientation of employees with their jobs and with their work environment. Here the focus of training is to improve the attitudes and behaviours of employees in such matters as discipline, regular attendance, good relations with superiors and co-employees, careful use of equipment, materials, facilities, and so on.

Advantages: Following are the advantages of training:

i) It enriches the quality of personnel and the quality of their working life, in conjunction with other conditions of their service.

ii) It broadens their perspectives and problem solving abilities.

iii) It makes them more competent, confident and adaptive so as to cope with the complex and changing conditions of their environment.

iv) It improves their relations with their jobs and prepares them for upward mobility.

v) It helps in reducing employees absenteeism and turnover.

vi) Trained people need less supervision. They become capable of self-direction and self-control.

vii) It improves their level of motivation and job satisfaction.

15.8.2 Features and Requirements of Training

Certain typical features and requirements of training are listed as follows:

1) Training, like education, is based on certain principles of learning, such as **motivation to learn, reward for learning, feedback of training performance** and so on.

2) Training is a continuous process and includes programmes for retraining of people.

3) Training is a specialised function and should generally be handled by experts who are proficient in training techniques.

4) Training is to be tailored to the needs of jobs, job holders and the organisation.

5) It should be functional and practically useful to employees who undergo it.

6) The objectives of each training programme should be clearly spelt out.

7) The costs of training should be kept within reasonable limits. The benefits of training should commensurate with the costs.

8) Training programmes need to be reviewed and evaluated at periodic intervals to ascertain the extent of their effect on the job behaviour and performance of those who have undergone training.

15.8.3 Types and Methods of Training

There are several types and methods of training, suitable to different categories of employees and to different training needs. Management training, supervisory training and employee worker training may be categorised separately, based on the hierarchical status of the personnel. The techniques of training and treatment of training differ among these categories.

There are several methods of training which are discussed below:

On the job training: As the terms suggest themselves, **on the job training involves imparting of training to employees/workers in the course of their jobs**. Experienced workers, first line supervisors and specially qualified instructors serve as trainers in on the job training. The techniques of on the job training include job rotation coaching or job instruction, creation of assistant to or under study positions, temporary promotions, and so on. In general, on the job training methods have the merit of **learning by doing**. Trainees are in face-to-face interaction with their jobs and work environment. They quicken the process of self-learning and self-correction and are highly practice oriented. They are also relatively inexpensive.

Off the job training: So far as off-the job training is concerned, the techniques associated with them include class room lectures, conferences and discussions, films and TV shows, case studies and discussions and so on. These methods are intended to impart training at places away from the atmosphere of the work place. **The chief merit of off-the job training is that it helps trainees to learn things in a steady and systematic manner without any job pressure.** The focus is more on leaning than doing. The quality of training tends to be high because it is generally handled by experts.

Vestibule training: Vestibule training is intended to train workers and employees in specially designed workshops in which an attempt is made to duplicate as closely as possible the actual conditions of the work place. A large number of employees and workers could be trained in a relatively short period of time through vestibule training. It combines the advantages of on-the-job and off-the-job training approaches.

15.8.4 Management Development Programme

In many organisations, the training programmes as also the methods and techniques of training for development of their managers at various levels are referred to as management development programmes. The techniques of management development are outlined as follows:

Creation of 'assistant to' position: In some cases, it is possible to create assistant to positions to allow opportunities to junior managerial personnel to work under senior personnel. Senior personnel provides job-related insights and experiences to the junior personnel.

Temporary promotions: It is also possible to expose junior managers to higher responsibilities by offering promotions to them on a purely temporary basis. It helps them to acquire the needed skills and perspective.

Membership in committees: Committees often serve as training grounds to managers. Membership in or association with a formal or informal organisational committee is a valuable opportunity to individuals for meaningful interaction with other members. This provides them an opportunity for the development of communication and inter-personal skills and for understanding the diverse points of view expressed in committee deliberations.

Under study: This is a method adopted for specific individuals who are designated to take over certain job responsibilities from those who are to retire shortly or otherwise leave the organisation. The incumbent is to work with the current job holder for a period of time say 3 months, and get to know the job.

Job rotation: In this, the trainees are rotated on different but related assignments to broaden their perspectives and to make them well-rounded, before assuming permanent positions. The method permits the trainees to gain a systems view of their jobs.

Sensitivity training: The objective of sensitivity training is to develop the sensitivity of trainees to the views, feelings and reactions of others. This helps him to develop capability for behaving in an authentic manner and absorbing tensions and stresses. It makes the trainees understand their own behaviours self-awareness and to impart diagnostic and problem solving skills among them.

Sensitivity training is given to small groups of people (called T-Groups) from the same organisation. A trainer or consultant will be present in the session which begins without any agenda. The trainer functions as a **catalyst or facilitator**. He induces interactions and discussions among member who are allowed total freedom to express their views on one another – about attitudes, behaviours, mannerisms, pitfalls and so on. It is natural to expect violent out-bursts and emotional reactions from members. These very process are regarded as rich learning and training experiences. The duration of T-groups sessions ranges from a few days to a few weeks and the sessions are held outside the organisational work setting.

Transactional analysis: It is a technique of training developed by Eric Berne and popularised by Thomas Harris of U.S. **It is a tool of improving human relations and interactions (transactions) and of promoting rational, mature behaviours among superiors, subordinates and peers in an organisation**. Its basic proposition is that people have to behave as adults, although sometimes parent-like and child-like behaviour are also useful. Adult-like behaviour is characterised by objectivity, problem solving orientation, mutual respect, understanding, and so on. Parent-like behaviour takes the form of authoritarianism, protective and patronizing stances. Child-like behaviours pertains to rebellious, angry, dependence-oriented moods and tantrums, though creative, spontaneous, obedient stances are not ruled out.

Lectures and courses: The trainees are provided with oral instruction of concepts, principles, processes and practices, supported by relevant material and readings. The trainees are given assignments to test their acquisition of knowledge.

Conferences and discussions: Seminars, workshops and similar interaction sessions belong to this category. It permits multilateral communication, exchange and feedback of ideas and experience, broadening of knowledge and insights and so on. Conferences and discussions need to be guided and moderated by competent trainers.

Films and TV shows: These devices demonstrate to the trainers the ways of doing things. They are also effective in transmitting information and in enriching the knowledge of trainees. They generate interest among the trainees by dramatising usually certain events, incidents and realities.

Case studies: They provide opportunities for the trainees to study and understand actual problem situations. They aim at improving conceptual, problem-solving and judgemental skills of personnel. Discussions and interactions permit enrichment of knowledge on actual organisational problems and situations.

Simulation: This technique seeks to duplicate the real life environmental setting in which the trainees will eventually work. **Role playing, business games and in-basket technique** are some of the simulation methods. In role playing, the trainees are assigned different roles in a case study and are expected to play the roles. Business games are spread over several sessions or sittings in which the trainees are required to make a series of decicsions and tackle problems of a duplicated business situation.

Check Your Programme D

1) State whether the following statements are True or False.

   i) All employees and managers do not need training.

   ii) Training provides valuable learning experience to the trainees.

   iii) The techniques of training for managers are different from those applicable to non-managers.

   iv) The focus of on-the-job training is more on learning than doing.

   v) Sensitivity training is organised within a real work setting.

2) Fill in the blanks.

   i) Training is more concerned with immediate ……………. while development focuses on the improvement of overall.

   ii) Training is essential for preparing employees for …………….

   iii) In sensitivity training, the trainer act as a …………………

15.9 LET US SUM UP

Staffing refers to the managerial function of employing and developing human resources for carrying out the various managerial and non managerial activities in an organisation. Staffing also involves upgrading the quality and usefulness of members of the organisation with a view to get higher performance from them. The function includes such activities as **human resource planning, recruitment, selection, placement and orientation training and development, remuneration, performance appraisal, promotion and transfer.** The importance of staffing function stems from its relationship with other functions. Without people or personnel organisations are empty entities which cannot move a bit in the achievement of their objectives.

The staffing function, like other managerial functions, may be viewed as a process consisting of certain well recognised steps or activities. These include manpower planning, recruitment, selection, placement and orientation, training and development, promotion, transfer, remuneration, performance evaluation, etc.

Human resource planning is concerned with the determination of the size and composition of personnel needed by the organisation over a specified period of time. The objective of human resource planning is to ensure that the organisation gains full control over the size and quality of its personnel requirements on a continuous basis. It requires job-analysis which comprises two aspects: job description and job specification.

Recruitment is the process of searching for and securing applicants for the various job positions which arise from time to time. There are two sources of recruitment – internal (consisting of promotion and transfer of existing employees) and external (consisting of recruitment from outside the organisation).

Selection is the process of choosing the most suitable candidates from applicants for various jobs. The steps in the selection process include: filling in application forms, preliminary screening, holding of tests, interview, and final choice. Selection is followed by placement and orientation of the selected personnel.

Training and development refer to the process of helping employees to acquire more knowledge of the job and to learn or sharpen the needed skills, attitudes and values associated with efficient performance of their jobs. While training is concerned with the immediate work skills and knowledge of new or existing employees, development focuses on the general improvement of the overall personality of the employee.

There are several types and methods of training suitable to different categories of employees and to different training needs: **on-the-job training, off-the-job training, and vestibule training.** The techniques of management development include: creation of assistant to position, temporary promotions, membership of committees, under study, job rotation, sensitivity training, transactional analysis, lectures, conferences and discussions, films and TV shows, case studies, simulation which may consist of role-playing, business games, and in-basket techniques.

15.10 KEY WORDS

Development: The process of improving the overall personality of an employee.

Human Resource Planning: Planning for determining the size and composition of personnel needed by an organisation over a specified period.

Job Analysis: Identifying the elements of jobs to determine the qualifications, skill, experience and expertise required for the job.

Job Description: Narration of the activities and duties to be performed in a job, equipment involved, working conditions, etc.

Job Specification: Statement of the minimum level of qualifications, skill, experience, etc. required for performing a job well.

Off-the-job Training: Training of workmen at places other than their actual workplace.

On-the-job Training: Training of workmen in the course of their job.

Orientation: Process of introduction of new employees to the organisation and a process of their socialisation.

Placement: The managerial task of placing new employees in the jobs for which they are most suited.

Recruitment: The process of searching for and securing applicants for positions.

Selection: The process of choosing the most suitable candidates from among the applicants for jobs.

Sensitivity training: Training of employees to develop their sensitivity to the views, feelings and reactions of others.

Simulation: The technique of duplicating real life situation for training purpose.

Transactional training: Technique of training by analysing human interactions in terms of parent, adult and child behaviour patterns.

Vestibule Training: Training in specially designed workshop replicating the actual working conditions.

15.11 ANSWERS TO CHECK YOUR PROGRESS

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

2) (i) Export, advisory, services (ii) human (iii) assets (iv)continuous (v) attracting, acquiring, activating

B) 1) (i) Size, competition (ii) Job analysis (iii) internal, external

(iv) promotion, transfer (v) competition

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

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

2 (i) Personality (ii) objective (iii) introduction

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

2 (i) Work skills, personality (ii) promotion (iii)Catalyst

15.12 QUESTIONS FOR PRACTICE

1) Describe the importance of staffing function in an organisation.
2) There is no more important resource than human resources. Do you agree? Why?
3) What are the different sources of recruitment? Discuss its advantages and limitations.
4) Explain in detail the process of selection.
5) Do you agree that combinations of written test and interview provide better result?
6) Explain the importance of proper placement and orientation for effective job performance of a new employee.
7) Why is training so important for manpower development?
8) What do you mean by management development programmes? Explain the major techniques of management development programmes.

NOTE: These questions will help you to understand the Unit better. Try to write answers for them. But do not submit your answers to the university. These are for your practice only.

UNIT 16 PROCESS OF CONTROL

Structure

16.0 OBJECTIVES

After studying this Unit, you should be able to:

- explain the nature and characteristics of control function
- describe the importance of control in management
- enumerate and analyse the stages in the control process
- explain the requisites of effective control, and
- outline the various types of control.

16.1 INTRODUCTION

In the preceding units you have learnt in detail, the planning, organising, staffing and directing functions of management. Controlling is another very important function of management. The study of management practices cannot be complete unless the function is also examined in detail. In this unit we shall discuss the nature and importance of the control function of management, analyse the stages in control process, outline the types of control, and explain the requisite of an effective control system.

16.2 DEFINITION OF CONTROL

Control may be defined as the process of analysing whether actions are being taken as planned and taking corrective measures to make them conform to the plan of action. Control is the essence of good management. It is concerned with ascertaining that planning, organising and directing functions result in attainment of organisational objectives. In fact control precipitates bad decisions and their consequences and restores effectiveness and efficiency. It is a continuous process which helps a manager to get the performance of his subordinates correspond to the standard fixed. It also detects the variations as soon as they occur and takes corrective steps to prevent them in future.

According to Henri Fayol: "Control consists in verifying whether everything occurs in conformity with the plan adopted, instructions issued and principles established."

The control function of management involves determining what is to be accomplished (the standard); what is being accomplished (the performance), and, if necessary, applying corrective measures so that performance takes place according to plans i.e. in conformity with the standard.

In other words controlling involves:

a) Knowing exactly what work is to be done as to quantity, quality and time available

b) Checking whether work has been or is being carried out with the resources available, within the time available, at a reasonable cost and in accordance with the required standard of quality

c) Analysing deviations, if any, from the planned targets and standards to ascertain the causes thereof

d) Adopting remedial measures to correct the deviations, and

e) Suggesting revision of plans and targets, if necessary.

16.3 CHARACTERISTICS OF CONTROL

Control is a device or a procedure which keeps the manager informed as the activities for which he is responsible and which assures him that his plans and policies are being carried out according to schedule. The nature of control function will be clearly understood from the following characteristics of control:

1) **Control is all pervasive function:** Control is essential at all levels of organisation. It is a follow-up action to the other management functions. Every manager performs the control function irrespective of his rank and nature of job. Control is the essential counterpart of planning. It is the control function which completes the management process.

2) **Control is a continuous process:** Control is an ongoing and dynamic function of management. It involves continuous review of performance and revision of standards of operations. As long as an organisation exists, control continues to exist. It is amenable to change with the external environment. Therefore it is a highly flexible process.

3) **Planning is the basis of control:** Control can be exercised only with reference to and on the basis of plans Effective control is not possible unless the management spells out clear objectives of the organisation. In fact, measurement of performance requires certain standards which are laid down under planning. Planning sets the course and control ensures that actual conforms to the planned action.

4) **Action is the essence of control:** Control is an action-oriented process. A manager initiates action which guides the operation within the sphere of

plans. In order to prevent a recurrence of deviations a manager modifies or improves the existing plans.

5) **Control is a forward looking process:** Control aims at future. Although past experience is the criteria for future standards, control is concerned with checking the current performance and providing guidelines for the future. Therefore, control is both backward-looking and forward-looking. It looks at future through the eyes of past.

6) **Delegation is the key to control:** Effective control requires adequate delegation of authority. An executive can perform the control function properly if he enjoys the authority to take remedial action and is to be held accountable for results.

7) **Control allows the organisation to cope with uncertainty:** Control helps in regulating the uncertain events of the organisation. It anticipates any shift in task and preference of consumers and directs the organisation to modify its process in order to meet the contingencies of the future.

16.4 IMPORTANCE OF CONTROL

The necessity of control in business organisation cannot be over-emphasised. Proper control smoothens the working of an organisation. Absence of control leads to lowering of efficiency of the employees, since there is no check on their performance. Existence of an efficient system of control creates an atmosphere of order and discipline, and helps greatly in minimizing the chances of work being defective or being delayed. The importance of control function also arises from the following benefits derived from it.

1) **Adjustment in operations:** A control system acts as a device for adjustment of organisational operations. There are various objectives which serve as the basis of control. It is through the control function that these objectives are achieved. Control provides the means of determining whether plans are being implemented and there is progress towards the achievement of objectives. It facilitates measures to be taken, if necessary, to correct any deviations.

2) **Managerial responsibility:** In every organisation, managerial responsibility is created through assignment of activities to various individuals. This process starts at the top level and then goes to the lower level. While manager assigns work to be carried out by his subordinates, he remains responsible for the performance of their activities. It is quite natural that when a person is responsible for the performance of his subordinates, he must exercise some control over them. Thus, controlling enables managers to discharge their responsibilities.

3) **Psychological effect:** The process of control induces individuals towards better performance. The performance of individuals is evaluated in the light of targets set for them. A person is likely to act according to the plan, if he is aware that his performance will be evaluated against the planned targets. Thus, he is more inclined to achieve the results according to the standards fixed for him, particularly when there is provision of reward or punishment on the basis of the performance. Since performance measurement is one of the basic elements of the process, it ensures that every person in the organisation contributes to his maximum ability.

4) **Coordination in action:** Though coordination is the essence of management and is achieved through the proper performance of all managerial functions, control affects this aspect significantly. Controls are designed in such a way that they focus not only on the operating responsibility of a manager, but also on his ultimate responsibility. So this forces a manager to coordinate the activities of his subordinates in such a way that each of them contributes positively towards the objectives. Since this follows throughout the organisation, coordination is achieved in the organisation as a whole.

5) **Organisational efficiency and effectiveness:** If the control function is carried out properly, it results in organisational efficiency and effectiveness. By making manager responsible, motivating them for higher performance, and achieving coordination in their performance, control ensures that the organisation works efficiently. As regards effectiveness, the organisation is effective if it is able to achieve its objectives. Since control focuses on the achievement of organisational objectives, it necessarily leads to organisational effectiveness.

16.5 STAGES IN THE CONTROL PROCESS

Controlling is the final step in the process of comparing actual performance with the plans and taking steps to initiate correction action. The basic control process, wherever it is found and whatever it controls, involves the following steps:

1) **Setting standards:** The total workload of the business is broken down into departments, sections and individuals. Each of them has specific objectives for detailed operation. These objectives are set in physical terms, such as quantities of products, units of service, labour-hours, speed or volume of rejections or they may be expressed in monetary terms, such as volume of sales, costs, capital expenditures or profits or it may be expressed in any other verifiable qualitative terms. These standards must be clear so that the checking of performance becomes possible. At the same time it is essential that the responsibility should be identified with definite individuals in the organisation and he is accountable for the lapse, if the performance varies from the standard laid down.

   Establishment of standards may be discussed with S-O-G-P Chain. Standard is a measuring rod for the attainment of organisational objectives. These objectives aim at accomplishing the organisational goals, which is the ultimate purpose of every organisation.

   Standards - Objectives - Goals - Purpose

   As shown above, standards are used to control objectives, objectives are used to control goals, and goals are used to control purpose.

2) **Measurement of performance:** The second step is to measure actual performance of various individuals, groups or units in the light of standards. Management should not depend upon the guess that standards are being met. It should measure the performance and compare it with the standards. Quantitative measurement is done in those cases where standards have been set in numerical terms. This makes evaluation easy and simple. In all other cases, the performance is measured in terms of qualitative factors. For

instance, performance of Industrial Relations Manager may be measured in terms of attitudes of workers, frequency of strikes, and morale of workers. Attitude and morale of workers are not capable of being measured quantitatively. They have to be measured qualitatively. If standards are appropriately drawn and if means are available for determining exactly what subordinates are doing, appraisal of actual or expected performance is fairly easy.

3) **Comparing performance with standards and ascertaining the causes of difference, if any:** The responsibility of a manager does not end with measuring the performance. Deviations from the standard, if any, must be noted and the causes of deviation ascertained. Comparing performance with the standard and ascertaining the causes of deviation involve the third stage of control. The causes of factors responsible for deviations may be defective materials, machinery, process, slackening of efforts, etc. The comparative analysis should be done as close to the point of performance as possible. It assists in quick location of defects and results in correction with minimum losses.

4) **Adopting corrective measures:** The final step in the control process consists of remedial actions so that deviations may not occur again and the objectives of organisation are achieved. Towards that end, managers must take appropriate decisions so as to meet immediate needs, or revising the existing targets and standards, or changing the methods of selection and training of workmen, or even drawing up revised plants.

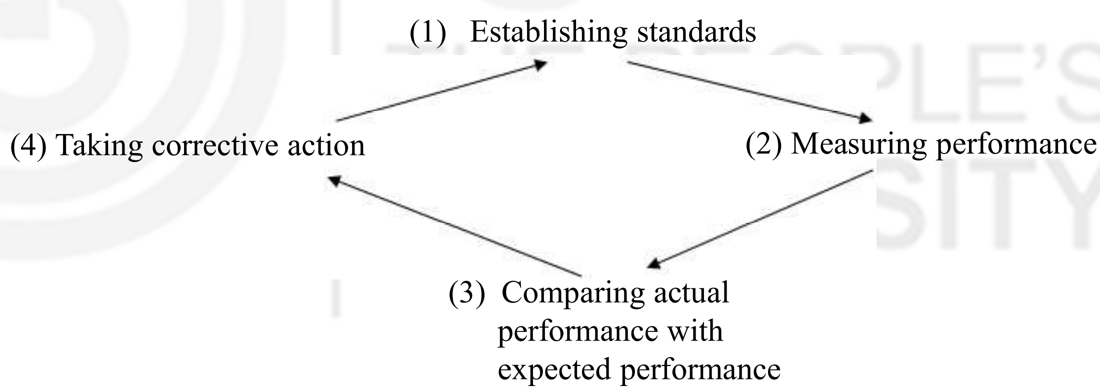

Fig. 16.1: Control Process

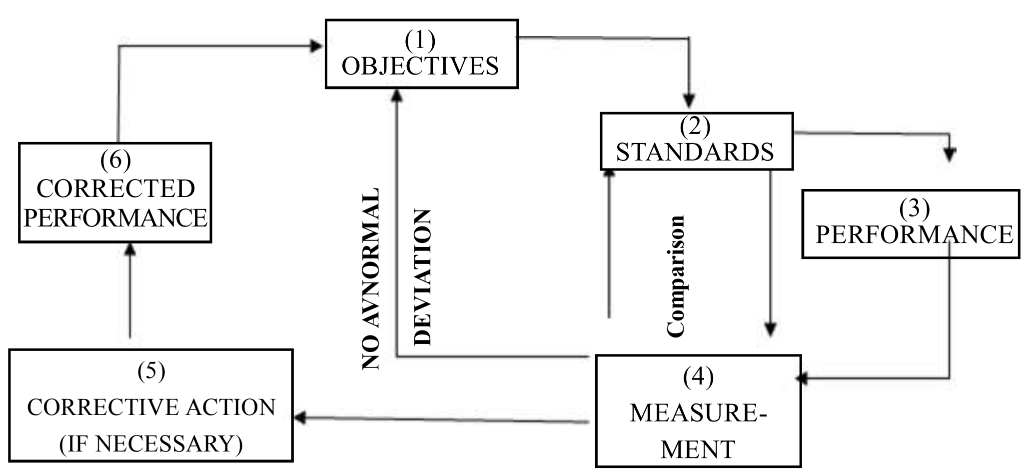

Figure 16.2: The Control Process

Check Your Progress A

1) Define 'Control' as a function of management.

....

....

....

....

....

2) Which of the following statement are True and which are False

   i) Control relieves managers of their responsibilities.

   ii) Control is necessary only when there is deviation of performance from standards.

   iii) Organisational efficiency is ensured with the help of controls

   iv) Controlling mainly involves punishing people and putting pressure on employees for efficient performance.

   v) The process of control is relevant at all levels of management.

3) Enumerate the stages in control process.

   i) ....

   ii) ....

   iii) ....

   iv) ....

16.6 REQUISITES OF EFFECTIVE CONTROL

To be effective and to serve its purpose, the system of control must satisfy certain requirements. These may be regarded as the prerequisites of effective control. The requirements of an effective control system may be enumerated in brief as under:

1) Definition of objectives: Before planning a control system, it is essential to clearly define the objectives of the organisation. The control system must be directed towards the potential or actual deviations towards the potential or actual deviations from plans early enough to permit corrective action.

2) Efficiency of control techniques: Control techniques are said to be efficient when they detect deviations from plans and make possible corrective action at an early stage with the minimum of unsought consequences.

3) Responsibility of control: The primary responsibility for the exercise of control should rest with the manager charged with the implementation of plans.

4) **Direct control:** Any control system should be designed to maintain direct contact between the controller and the controlled.

5) **Organisation suitability:** Controls should be tailored to fit the organisation. The flow of information concerning current performance should correspond with the organisational structure. If superior is to control overall operations, he must find a pattern that will provide control for individual parts.

6) **Flexibility:** A good control system must keep pace with the continuously changing pattern of a dynamic business world. It must be responsive to changing conditions. It should be adaptable to new developments including the failure of the control system itself. Plans may call for an automatic system to be backed up by a human system that would operate in an emergency; likewise, an automatic system may back up a human system.

7) **Self-control:** Units may be planned to control themselves. If a department can have its own goals and control system, much of the detailed controls can be handled within the department. These sub-systems of self-control can then be tied together by the overall control system.

8) **Strategic point control:** Effective and efficient control can be achieved if critical key or limiting points can be identified and close attention can be directed to adjustment at those points. This is known as **'Control by exception'**. It is called control by exception because according to this principle only significant deviations from standard, whether positive or negative, require management's attention as they constitute exceptions. An attempt to go through all deviations tends to increase unnecessary efforts and to decrease attention on important problems.

9) **Corrective action:** Merely pointing out deviations is not sufficient in a control system. It must lead to timely corrective action to be taken to check deviations from standards through appropriate planning, organising and directing.

10) **Forward-looking control:** The control system should be directed towards future. It should report the deviations from the plans quickly in order to safeguard the future. If the control reports do not relate to the future, then the reports are of no use as they will not be able to suggest the type of measure to be taken to rectify the past deviations.

11) **Human factor:** A good system of control should be **worker centered** rather than work centred as the control is exercised on the workers who do the work. It must find the persons accountable for results whenever large deviations take place and they must be directed accordingly. So the human factor must be given proper attention while controlling. A technically well-designed control system may fail because the human beings may react unfavorably to the system.

12) **Economical:** The system of control must be worth its cost. The controls must justify the expenses involved. A control system is justifiable if the savings anticipated from it exceed the expected costs in its working. Small-scale production units cannot afford elaborate and expensive control system.

13) **Objective standards:** As far as possible, standards should be objective, that is based on factual information. If they are subjective, a manager's or subordinate's personality may influence judgement of performance inaccurately. Effective control requires objective, accurate and suitable standards. Objective standards may be quantitative or qualitative. However, in either case, the standard should be factually determinable and verifiable. Although we have explained how the 'Control Function' can be effective with various requirements as mentioned above, even then there are some limitations of control. Let us now examine the limiting factors.

16.7 LIMITATIONS OF CONTROL

1) **No control over external factors**: Controls is intended to be exercised on factors which are internal to an enterprise. But there are external factors like government action, change of market conditions, discovery and invention of new techniques and material of production, innovation and so on, which are often beyond the control of management. So, controls may be ineffective in the face of changing external factors.

2) **Want of satisfactory standards:** Satisfactory standards help control operations. But there are many areas and activities with intangible nature of performance which do not permit accurate measurement. No satisfactory standards can be established for them, e.g. results of management development, public relations, human relations, advice of staff service, loyalty of workmen, and such other human behaviour.

3) **Measurement of imperfections:** Intangible performance presents difficulties in setting up standards. It is also a complicated matter to measure its results in quantitative or qualitative terms. It is then left to managerial judgement and interpretation which cannot be taken as perfect measurement. Moreover, results of day-today activities involving uneconomic expenditure cannot be evaluated or measured properly on grounds of economy.

4) **Limitations of corrective actions.** Business can be run on an even **keel** if all deviations and mistakes can be corrected properly in time. This will guard against losses. Control operations are carried out in assumption of fixed personal responsibility and the person concerned is expected to adopt necessary corrective and remedial actions. It is not uncommon that many deviations occur, but nobody in particular can be held responsible for them. Control becomes ineffective in such cases.

5) **Adverse reaction against control:** Control operations as a rule are not liked by the subordinates over whom they are exercised. Such operations curtail their freedom of action and interfere with their individual thinking and initiative. Control thus invites opposition and adverse reaction of the subordinates.

6) **Practical impediments to application:** Control involves analysis of deviations to find out their causes. But it faces great obstacles in such analytical work. First of all, it involves considerable expenditure. Secondly, it requires skilled and experienced staff to cope with the situation. Thirdly, corrections and deviations may require some time and even stoppage of work which may result in loss to the concern.

16.8 AREAS OF CONTROL

For effectiveness, it is important to decide on the critical areas where control should be exercised. There are many advantages of identifying these areas of control (also known as types of control) so as to enable management to:

i) Delegate authority and fixing responsibility;

ii) Reduce the burden of supervising each activity in detail; and

iii) Secure means of achieving satisfactory results.

Controls are actually needed in every area where performance and results directly and vitally affect the survival and prosperity of the organisation. These areas need to be specially mendtioned. In this connection, Peter Drucker has identified eight key result areas where objective should be set and **controls** should be exercised. These are:

1) Market standing
2) Innovation
3) Productivity
4) Physical resources
5) Financial resources
6) Profitability
7) Manager performance and attitude
8) Public responsibility

Apart from the identification of key areas, control may be distinguished on the basis of their nature and purpose. Let us discuss them one by one.

1) **Physical and Financial Control**

   Physical controls refer to controls over the safety and maintenance of properties and assets, stocks of materials, stores, spare parts, and other articles on the task of quantitative and numerical measures. Financial controls include control over cash receipts and payments, fixed and working capital, income and expenditure as well as profits and the value of assets and liabilities.

2) **Control Over Actual and Anticipated Performance**

   Day-to-day operations need to be controlled to achieve the short-run objectives, targets and standards as well as continuing goals. This is another category of controls.

3) **Control over Activities or Areas of Operations**

   i) **Control over policies and procedures:** Policies are formulated, procedures laid down to govern the behaviour and action of personnel in the organisation. These are generally controlled through manuals which are prepared by top management. Each individual in the organisation is expected to function according to manuals.

   ii) **Control over organisation:** Organisation Charts and Manuals are used to keep control over organisation structure. Organisation manuals attempt at solving organisational problems and conflicts, making long-range organisational planning possible, enabling rationalisation of the organisation structure, helping in proper designing and clarification of each part of the organisation, and conducting periodic check on facts about organisation practice.

iii) **Control over personnel:** Generally the Personnel Manager or Head of the Personnel Department, whatever his designation maybe, keeps control over personnel in the organisation. Sometimes, a personnel committee is constituted to act as an instrument of control over key personnel.

iv) **Control on wages and salaries:** Control over wages and salaries is exercised through job analysis and job evaluation. The functions are carried out by personnel and industrial engineering departments. Often, a wage and salary committee is constituted to provide help to these departments.

v) **Control over costs:** Control over costs is exercised through making comparison between standard costs and actual costs. Standard costs are set in respect of different elements of costs. Cost control is also supplemented by budgetary control system which includes different types of budgets. The Controller's department provides information for setting standard costs, calculating acting actual costs, and pointing out differences between these two.

vi) **Control over methods and manpower:** Control over methods and manpower is required to ensure that each individual is working according to schedule. For this purpose periodic analysis of activities of each department is conducted. The functions performed, methods adopted, and time consumed by every individual are studied to eliminate non-essential functions, methods and time. Many organisations create a separate department or section known as 'Organisation and Methods 'to keep control over methods and manpower.

vii) **Control over capital expenditure:** Control over capital expenditure or acquisition of fixed assets exercised through the system of evaluation of projects and ranking of projects on the basis of their importance, generally on the basis of their earning capacity. A capital budget is prepared for the business as a whole. The budget is reviewed by the budget committee or appropriation committee. For effective control over capital expenditure, there should be a plan to identify the realisation of benefits from capital expenditure and to make comparison with anticipated results. Such comparison is important in the sense that it serves as an important guide for future capital budgeting activities.

viii) **Control over service departments:** It is effected:

a) through budgetary control within operating departments,

b) through putting limits upon the amount of service an individual department can ask for, and

c) through authorising the heads of service departments to evaluate the request for service made by other departments and to use discretion about the quantum of service to be rendered to a particular department. Sometimes, a combination of the methods may be used.

ix) **Control over line of products:** Control over line of products is exercised by a committee whose members are drawn from production, sales and research departments. The committee controls the product-mix on the basis of studies about market needs. Efforts are made to simplify and rationalise the line of products.

x) **Control over research and development:** Control over research and development is exercised in two ways:

1) by providing a budget for research and development, and
2) by evaluating each project keeping in view savings, sales or profit potentialities.

Research and development being a highly technical activity is also controlled indirectly. This is done by improving the ability and judgement of the research staff through training programmes and other devices.

xi) **Control over foreign operations:** Foreign operations are controlled in the same way as domestic operations. The tools and techniques applied are the same. The only difference is that the chief executive of foreign operations has relatively greater amount of authority.

xii) **Control over external relations:** External relations are regulated by the public relations department. This department may prescribe certain measures to be followed by other departments while dealing with external parties.

xiii) **Overall control:** Control over each segment of the organisation contributes to overall organisational control. However, some special measures are devised to exercise overall control. This is done through budgetary control, project profit and loss account and balance sheet. A master budget is prepared by integrating and coordinating budgets prepared by each segment. The budget committee reviews such budget. This budget acts as an instrument for overall control. Profit and loss account and balance sheet are also used to measure the overall results.

Check Your Progress B

1) Which of the following statements are True and which are False.

i) Control techniques may be said to be efficient if subordinates like them.

ii) Past deviations can be corrected only if controls are forward looking.

iii) Expenses on control should not matter because control relieves the manager of their worries.

iv) Manager having no control over external factors should not try to control internal disturbances.

2) Enumerate the critical or key result areas where control should be exercised by managers.

i)	v) ....
ii)	vi) ....
iii)	Vii) ....
iv)	viii) ....

16.9 LET US SUM UP

The study of management practices cannot be complete unless the controlling function is clearly understood. Control may be defined as the process of analysing whether actions are being taken as planned and taking corrective measures to make these conform to the plan of action. It is a continuous process which helps a manager to get the performance of his subordinates correspond to the standards fixed, to detect the variations as soon as they occur, and to take corrective steps to prevent them in future.

The characteristic features of control include: Control is all pervasive function, control is a continuous process, planning is the basis of control, action is the essence of control, control is a forward-looking process, delegation is the key to control and control allows the organisation to cope with uncertainty.

Proper control smoothens the working of an organisation. Existence of an efficient system of control creates an atmosphere of order and discipline and helps greatly in minimizing the chances of work being defective or being delayed. The importance of control function also arises from the various benefits derived from it. Like adjustment in operations, managerial responsibility, psychological effect, coordination in action and organisational efficiency and effectiveness.

The process of control involves (1) establishing standards (2) measurement of performance (3) comparing performance with the standards and ascertaining the causes of differences, if any, and (4) correcting deviations by remedial action.

To be effective and to serve its purpose, the system of control must satisfy certain requirements, which includes; (1) Definition of objectives in clear terms; (2) Efficiency of control techniques; (3) Assigning responsibility for control; (4) Direct contact; (5) Suitability of the system to the organisation; (6) Flexibility; (7) Encouragement of self-control; (8) Strategic point control' (9) Timely corrective action; (10) Forward-looking control; (11) Attention to human factor; (12) Economical; and (13) Specifying objective standards.

Despite all precautions, controls are not always perfect since there are several limiting factors which restrict the effectiveness of controls.

Controls may be distinguished on the basis of the key result areas where controls should be exercised. Controls may also be distinguished on the basis of their nature and purpose. Thus, controls may be divided into several categories, such as: (1) Physical and financial controls (2) Control over actual and anticipated performance, and (3) Control over activity or areas of operation.

16.10 KEY WORDS

Control: Process of verifying whether performance of work is in conformity with plan and correcting it where necessary.

Control by exception: Attending only to significant or exceptional deviations in the process of control.

Financial Control: Control over cash flows, capital, income, expenditure and profits.

Forward-looking Control: Correcting deviations to safeguard the future operations in the concern.

Physical Control: Control over the safety and maintenance of properties, assets and physical quantifiable objects.

Standards: Norms of work performance.

Strategic Point Control: Identifying and directing closer attentions to key or limiting factors and points in the process of control.

16.11 ANSWERS TO CHECK YOUR PROGRESS

A) 1) The controlling function of management may be defined as the process of determining what is to be accomplished, what is being accomplished, and, if necessary, applying corrective measures so that performance takes place according to plans.

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

3) i) Establishing standards of performance.

ii) Measuring performance.

iv) Comparing performance with standards and ascertaining the causes of differences, if any.

v) Adopting corrective measures.

B) 1) i) False ii) True iii) False iv) False v) True

2) i) Market standing ii) Innovation iii) Productivity

iv) Physical resources

v) Financial resources vi) Profitability

vii) Manager performance and attitudes

viii) Public responsibility

16.12 QUESTIONS FOR PRACTICE

1) What do you mean by controlling function of management? Describe salient characteristic features of control.

4) "Control is a fundamental management function that ensures worth accomplishment according to plans." Discuss.

5) Explain the importance of control in a business enterprise. What are the requirements of an effective control system?

6) Explain in detail various stages in the control process.

7) Enumerate the various requisites of an effective control system and outline the limitations of control.

8) Discuss various types of control or control areas.

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

UNIT 17 MOTIVATION

Structure

17.0 OBJECTIVES

After studying this Unit, you should be able to:

- explain the concept of motivation and the process of motivation
- describe the significance of motivation in present day organisations
- analyse some of the theories of motivation
- compare Maslow's Need Hierarchy Theory with Herzberg's Motivation Hygiene Theory
- explain the importance of job enrichment and its limitations in work motivation.
- classify different types of motivations – positive and negative, extrinsic and intrinsic and financial and non-financial
- explain the relative importance of financial and non-financial incentives

17.1 INTRODUCTION

In the previous Units you have read about some of the major Management functions. Directing is another important management function. Direction is telling people what to do and seeing that they do it to the best of their ability. It is the managerial function of guiding, motivating, leading and supervising the subordinates to accomplish desired objectives. It is the process around which all performance revolves. In fact it is a pervasive function of management. It exists at every level, location and operations throughout the enterprise. Direction provides an opportunity to the subordinates to perceive the organisational goals properly and to act efficiently to achieve them. The basic principle of directing constitutes harmony of objectives, unity of command, direct supervision, effective communication and effective leadership. The process of directing function consists of four elements viz: Supervision, Motivation Leadership and Communication.

Supervision is a part of the directing function of every manager. It means observing the subordinates at work to ensure that they are working according to plans and schedules and to help them in solving their work problems. The qualities of a good supervisor includes: technical knowledge and managerial ability, adequate authority, human orientation, knowledge of rules and regulations, communication skills, leadership, decision-making skill, and ability to cope with non-supervisory duties.

Motivation guides, directs and activates the behaviour of the people to achieve the goal. Leadership influences the behavior of the people to work willingly, while communication provides a proper interaction between manager and subordinates. Manager has to coordinate all these elements to achieve the desired results. Motivation and leadership are the key performance areas of any manager and lead to the growth of both the employees and organisation in the long run.

In any organisation, all employees do not perform their work with equal efficiency. Some are found to be more efficient that others. The difference in their performance can be attributed either to difference in their abilities or in their urge or willingness to perform as best as possible. Given the ability and skill, it is the motive of employees which determines whether they will be more or less efficient. Employee motivation i.e. bringing about an inner urge or desire in employees to work to the best of their ability is an important function of management. Considering the important role of motivation and leadership in an organisation, in this Unit we shall deal with the concept and process of motivation - its importance, theories of motivation, and the types of incentives which may be provided to motivate people.

17.2 CONCEPT OF MOTIVATION

Motivation may be defined as the complex of forces inspiring a person at work to intensify his willingness to use his maximum capabilities for the achievement of certain objectives. Motivation is something that motivates a person into action and induces him to continue in the course of action enthusiastically. It determines the behaviour of a person at work. According to Dalton E. McFarland

"Motivation refers to the way in which urges, drives, desires, aspirations, striving, or needs direct, control or explain the behaviour of human being."

The term 'motivation' is derived from the word 'motive'. Motive may be defined as needs, wants, drives or impulses within the individual. Motives are expressions of a person's needs and hence they are personal and internal. In this context, the term 'need' should not be associated with urgency or any pressing desire for something. It simply means something within an individual that prompts him to action. Motives or needs are 'whys' of behaviour. They start and maintain activity and determine the general direction of the person. Motives give direction to human behaviour because they are directed towards certain 'goals' which may be conscious or sub-conscious.

Motives or needs of a person are the starting point in the motivation process. Motives are directed towards the achievement of certain goals which in turn determine the behaviour of individuals. This behaviour ultimately leads to goal directed activities such as preparing food and a goal activity such as eating food. In other words, unsatisfied needs result in tension within an individual and engage him in search for the way to relieve this tension. He will develop certain goals for himself and try to achieve them. If he is successful in his attempt, certain other needs will emerge which will lead to setting a new goal. But if he is unsuccessful he will engage himself in either constructive or defensive behaviour. This process keeps on working within an individual.

17.3 NATURE OF MOTIVATION

Motivation helps in inspiring and encouraging the people to work willingly.

1) **Motives are the energising forces within us:** These forces are invisible and it is very difficult to measure them, because all of us are different and the motives energising us at a point differ from time to time. All that is possible is to observe and measure the behaviour we choose and from this behaviour make a kind of backward causation statement to the possible motive. Observing someone's behaviour may indicate that a certain need is present in this person, motivating him onward.

2) **One motive may result in many different behaviours:** The desire for prestige may lead a person to run for political office, give money away, get additional educational training, steal, join, groups or may change his outward appearance. A person wanting acceptance will behave differently in a car pool, office secretarial pool, or swimming pool.

3) **The same behaviour may result from many different motives:** Behaviour may be caused by a number of different motives. For instance the motives underlying purchase of a car may be: to appear younger and attractive; to appear respectable; to gain acceptance from others; to maintain the acceptance already gained through a similar income level; to satisfy economic values and to reinforce company created status differentials. Thus it would be wrong for the manager of an organisation to lump all behaviour as coming from the same motive. People join unions, get married, attend class, and laugh at professor's jokes for many different reasons (motives). Thus a motive cannot be identified from any specific behaviour.

4) **Behaviour can be used as an estimate of an individual's motives:** It is possible to get repeated observations of one individual's behaviour and then make an estimate of the cause of that behaviour. For example, there is truth in the statement that some people always seem to feel insecure and thus behave continuously in a manner reflecting the insecurity of feeling. There are also people who behave in a way that radiates confidence. They are confident in many different social settings so that one finds a constant and

repeated behaviour from which probably estimate the motive of the person. Obviously, if a person is at a state of near starvation, most of his behaviour will be related to the need for food. Although it is dangerous to categorise people, it is also wrong to believe that individual behaviour, when looked at in a time perspective, cannot be used as an estimate for motivation.

5) **Motives may operate in harmony or in conflict:** Behaviour is frequently the result of the interplay of several motives. These motives may push a person in one direction or in a number of directions. For example, a girl may want to get high grades in school while also wanting to help her mother in the kitchen. An athlete may desire an outstanding performance and may also be sensitive to being shunned by his fellow teammates if he performs too well and receives too much of credit. Behaviour, therefore, is the result of many forces differing in direction and intent.

6) **Motives come and go:** It is very rare that a motive has the same energy potential over a long period of time. A young man who prefers to travel during vacation may give up the idea during the football season because the joy of travelling takes second place to the need to play footvall. The girl who is overly concerned about her hair and clothes during adolescence may turn her attention to other things once she grows up. Because humans are constantly growing, the motive at one point in time will not be as intense as the motive at another point in time.

7) **Motives interact with the environment:** The situation at a particular point in time may trigger or suppress the action of a motive. You probably have experienced situations where you did not realize the intensity of your hunger needs until your smelling senses picked up the odour of palatable food. Similarly, many of these sociological needs become stimulated when you are in a situation filled with the sociology factors. Thus needs that may be latent can be quickly stimulated by the environmental situation. We have now identified a number of generalisations that could be useful in understanding the concept of motivation. The topic of human motivation is very complex and is related to other fundamental ideas such as drives and needs so that it is difficult to put our thinking into a clear system of relationships.

17.4 PROCESS OF MOTIVATION

The basic elements of the process of motivation are (i) behaviour (ii) motives (iii) goals and (iv) some form of feedback as shown in figure 17.1

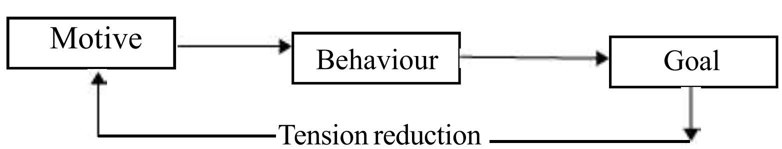

Figure 17.1: Process of Motivation

Behaviour: All behaviour is a series of activities. Behaviour is generally motivated by a desire to achieve a goal. At any moment individuals may indulge in multifarious activities like walking, talking, eating, and so on. They switch over from on activity to another activity swiftly. In order to predict and control behaviour managers must understand the motives of people.

Motives (Needs/drives/wants): Motives prompt people to action. They are the primary energisers of behavior. They are the 'ways' of behaviour and mainsprings of action. They are largely subjective and represent the mental feelings of human beings. They are cognitive variables. They cause behaviour in many ways. They arise continuously and determine the general direction of an individual's behaviour.

Goals: Motives are directed toward goals. Motives generally create state of disequilibrium, physiological or psychological imbalance, within the individuals. Attaining a goal will tend to restore physiological or psychological balance. Goals are the ends which provide satisfaction of human wants. They are outside an individual; they are hoped for incentives toward which needs are directed. One person may satisfy his need for power by kicking subordinates and another by becoming the president of a company. Thus, a need can be the satisfied by several alternate goals. The particular goals chosen by an individual depends on four factors; (i) the cultural norms and values that are instilled as one matures, (ii) one's inherited and biological capabilities, (iii) personal experience and learning influences and (iv) mobility in the physical and social environment.

The dilemma posed by a large number of needs can often be resolved by integrating wants where one activity may satisfy several needs. Researchers have found that many overweight people continue to eat excessively because they have fused the satisfaction of a number wants (Love, Security, Comfort) into the act of eating. Eating, in a way, releases the tension built by the numerous unsatisfied needs.

The process of motivation discussed above implies that individuals possess a host of needs, desires and expectations. All of these needs compete for their behaviour and ultimately the need with the maximum strength at a particular moment leads to activity. When a need is satisfied, it is no longer a motivator of behaviour.

17.5 ROLE OF MOTIVATION

The following factors contribute to the significance of the role of motivation:

1) Managers and organisational researchers cannot avoid a concern with the behaviour requirements of an organisation. Every organisation needs people (in addition to physical and financial resources) in order to function.

2) Motivation as a concept is pervasive and a highly complex activity that affects and is affected by a host of factors in the organisational milieu.

3) Organisational effectiveness becomes to some degree a question of management's ability to motivate its employees, to direct atleast a reasonable effort toward the goals of the organisation.

4) As technology increases in complexity, machines tend to become necessary, but insufficient vehicles of effective and efficient operations. In other words, it becomes necessary for an organisation to ensure that it has employees who are both capable of using and willing to use the advanced technology to achieve organisational goals.

5) Many organisations are now beginning to pay increasing attention to developing their employees as future resources (for talent bank) upon which they can draw as they grow and develop.

Check Your Progress A

1) Which of the following statements are True and which are False.

   i) Motives and needs are the 'whys' of behaviour.

   ii) Motives always operate in harmony and drive individuals in a single direction.

   iii) To control the behaviour of subordinates, managers must understand their motives,

   iv) Environment has nothing to do with human motive.

   v) Motives do not change in intensity over time.

2) Fill in the blanks.

   i) Motives are expressions of a person's: …………. and hence they are personal and ……………………..

   ii) …………………………….. can be used as an estimate of an individual's motives.

   iii) …………………… needs may be quickly stimulated by the environment.

   iv) Organisational effectiveness is to some degree a question of the management's ability to ……………. the employees.

17.6 THEORIES OF MOTIVATION

Theories of motivation generally aim at analysing the process of motivation and indicating how to motivate people. We shall discuss here three well known theories of motivation. These are McGeorge participation theory; Maslow's need priority theory and Herzberg's two factor theory.

17.6.1 McGregor's Participation Theory

Douglas McGregor's formulated two sets of assumptions about human beings based on the participation of workers. The first sets of assumptions are contained in Theory X and the second sets of assumptions are contained in 'Theory Y'. In the Theory X, McGregor proceeds with the assumption that the average human being has inherent dislike for work and will avoid it if he can. The managers, of such employees think that "most people must be coerced, contribute, directed, threatened with punishment to get them put forth adequate efforts towards the achievement of organisational objectives." Theory X presumes that people by nature:

1) Lack integrity.

2) Are fundamentally lazy and desire to work as little as possible.
3) Avoid responsibility.
4) Are not interested in achievement.
5) Are incapable of directing their own behaviour.
6) Are indifferent to organisational needs.
7) Prefer to be directed by others.
8) Avoid making decision whenever possible.
9) Are not very bright.

McGregor described Theory X as the **traditional theory** of what workers are like and what management must do to manage them. Workers have to be persuaded and pushed into performance. Workers can be made to work only through autocratic leadership. After describing Theory X, McGregor questioned if this view of human behaviour is correct. He propounded theory Y which, he felt better represents the human behaviour. Under theory Y it is assumed that people by nature:

1) Have integrity.
2) Work hard towards objectives to which they are committed.
3) Assume responsibility within their commitments.
4) Desire to achieve.
5) Are capable of directing their own behaviour.
6) Want their organisation to succeed.
7) Are not passive and submissive.
8) Will make decisions within their commitments.

In developing theory Y, McGregor made the following assumptions:

1) Engaging in physical and mental efforts – as natural as play or rest. The average human being does not inherently dislike work.
2) External control and the threat of punishment are not the only mean of directing efforts towards organisational objectives. Man will exercise **self-direction** and **self-control** in the service of objectives to which he is committed.
3) Commitment to objectives follows the rewards associated with their achievement. The most significant of such rewards namely **satisfaction of ego** and **self-actualisation needs**, can be the direct result of efforts toward organisational objectives.
4) The average human being learns, under proper conditions, not only to accept but to seek responsibility. Avoidance of responsibility, lack of ambition and emphasis on security are generally consequences of experience and not inherent human characteristics.

5) The capacity to exercise a relatively high degree of imagination, ingenuity, and creativity in the solution of organisational problems is widely, not narrowly, distributed in the population.

6) Under the conditions of modern industrial like the intellectual potentialities of the average human being are only partially utilised.

The assumptions of McGregor's theory Y suggest a new approach to management. It lays greater emphasis on cooperation between management and workers. The managers following this theory aim at getting maximum output with minimum degree of control. Generally, no conflict is visible between the organisational goals and individual goals. Thus, the efforts of employees which are in their best interest are also in the interest of the organisation. Theory Y has proved to be useful in such management practices as job enrichment, decentralisation and participative management. However these techniques are applicable in organisations where self-motivated, self-controlled mature and responsible people work. According to McGregor, researches in the behavioural sciences have shown that the assumptions of they Y are more valid than practices of theory X.

Appraisal: McGregor's contribution should be analysed in the proper perspective. All that he postulated and sought to dramatise through his theory X and theory Y is to outline the extremes to draw the fencing within which the organisational or enterprise man is seen to behave. No enterprise man would belong either to theory X or theory Y. He shares the traits of both, with emphasis shifting from one set of properties to the other with changing moods and impulses (needs and motives) and with the varying environment.

The chief merit of McGregor's formulation is that it helped to crystallise and set the right perspective to the findings of Elton Mayo, which had then puzzled management and productivity experts and set in motion a wave of research into the behaviour of the enterprise man. It (along with Hawthorne Studies) can be said to have been the starting point and mainspring that evoked wide and lasting interest in the area of motivation, leadership and techniques of manipulating behaviour of the human element of the enterprise.

One might get the impression that theory X is bad and theory Y is good. This is not true because the assumptions under these theories are attitudes or predispositions of managers towards people. They are not behaviour patterns. Thus, although the 'best' assumptions for a manager to have may be theory Y, it may not be advisable to behave consistently with these assumptions about human nature, but he may find it necessary to behave in a very directive manner (as if he had theory X assumptions) with some people in the short-run to help to be mature and self-motivated as per Y.

17.6.2 Maslow's Need Priority Theory

Maslow's theory is based on the needs of people. Maslow was of the view that the process of motivation begins with behaviour which at least in part, is directed towards the satisfaction of needs. He proposed that human needs can be arranged in a particular order from the lower to the higher as shown in figure 17.2.

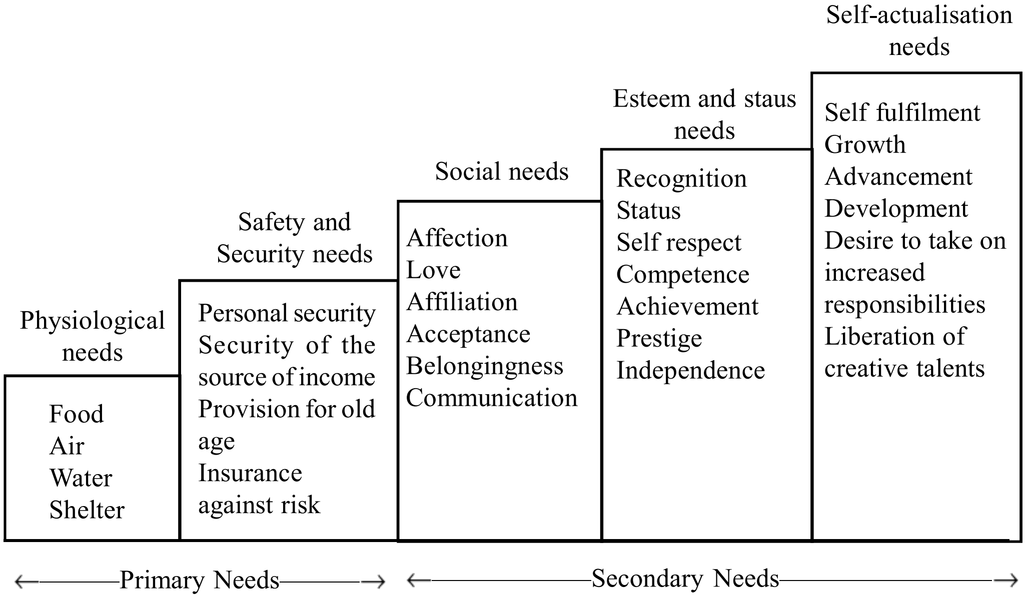

Figure 17.2: Maslow's Need Hierarchy

1) **Physiological needs:** The needs that are taken as the starting point of motivation theory are the physiological needs. These needs relate to the survival and maintenance of human life. These needs include such things as food, clothing, shelter, air, water and other necessities of life. These needs must be met at least partly before higher level needs emerge. They exert tremendous influence on behaviour. They are the most powerful of motivating stimuli. Therefore, we must satisfy most of them for survival.

2) **Safely and security needs:** After satisfying the physiological needs, people want the assurance of maintaining a given economic level. These needs include job security personal security, security of the income, provision for old age, insurance against risks, etc.

3) **Social needs:** Man is a social being. He is, therefore, interested in conversation, social interaction, exchange of feelings, companionship, recognition, belongingness, etc. Socialising is one of those reasons why many individuals (especially older people) go to work, and why people generally work better in small groups where they can develop affiliations that are important to them.

4) **Esteem and status needs:** These are concerned with awareness of self importance and recognition from others. Most people feel this need to be rated higher than other needs and seek recognition and respect on that account. Satisfaction of esteem needs produces feelings of self-confidence, prestige, power, and control. The fulfillment of esteem needs leads to self confidence strength and capability of being useful in the organisation. Whereas inability to fulfill these needs results in feelings of inferiority, weakness and helplessness.

5) **Self- Actualisation needs:** The final step under the need priority model is the need for self-actualisation also called self fulfilment or the need to fulfill what one's potentialities for continued self-development and for being creative in the broadest sense of that term. After his other needs are fulfilled, a man has the desire for personal achievement. He wants to do something which is challenging and since this challenge gives him enough dash and initiative to work, it is beneficial to him in particular and to the society in general. The sense of achievement gives him satisfaction.

Maslow felt that the needs have a definite sequence of domination. The second need does not dominate until the first is reasonably satisfied, and the third need does not dominate until the first two needs have been reasonably satisfied and so on. The other side of the need hierarchy is that man is never satisfied. If one need is satisfied another need arises. According to Maslow, if one's lower order needs (physiological and security needs) are not satisfied, he can be motivated only by satisfying these needs first and not by satisfying the higher order needs. Further, once a need or a certain order of needs is satisfied, it ceases to be a motivating factor.

The physiological and security needs are finite, but the needs of higher order are sufficiently infinite and are likely to be dominant in persons at higher levels in the organisation. Studies have also revealed that those needs which are thought to be most important like social needs, ego needs and self-realisation needs are also the best satisfiers.

Do needs follow a hierarchy

The need priority model may not apply at all times in all places. Surveys in continental European countries and Japan have shown that the model does not apply very well to their managers. The degree of satisfaction of needs does not vary according to the need priority model. For example, workers in Spain and Belgium felt that their esteem needs are better satisfied than their security and social needs. Apparently, cultural differences are an important cause of these differences. Thus, need hierarchy may not follow the sequence postulated by Maslow. Even if safety need is not satisfied, the ego or social need may emerge.

The proposition that one need is satisfied at one time is also of doubtful validity. The phenomenon of multiple motivation is of great practical importance in understanding the behaviour of man. Man's behaviour at any time is mostly guided by multiplicity of motives. However, one or two motives in any situation may be predominant while others may be of secondary importance. Moreover, at different levels of needs, the motivation will be different. Money can act as a motivator only for physiological and social needs, not for satisfying higher order needs. Employees are enthusiastically motivated by what they are seeking, more than by what they already have. They may react protectively to try to keep what they already have, but they move forward with enthusiasm only when they are seeking something else. In other words, man works for bread alone as long as it is not available.

There are always some people in whom, for instance, need for self-esteem seems to be more prominent than that of love. There are also creative people in whom the drive for creativeness seems to be more important. In certain people, the level of motivation may be permanently lower. For instance, a person who has experienced chronic unemployment may continue to be satisfied for the rest of his life if only he can get enough food. Another cause of reversal of need hierarchy is that when a need has been satisfied for a long time it may be under-evaluated.

17.6.3 Herzberg's Motivation Hygiene Theory

A significant development in motivation theory is based on the distinction between motivation and maintenance factors in job situation. On the basis of his research findings Herzberg drew a distinction between what he called 'motivators' and 'hygiene' factors.

Some job conditions operate primarily to dissatisfy employees when the conditions are absent, but their presence does not motivate employees in a strong way. Many of these factors are traditionally perceived by management as motivators, but these are really more potent as dissatisfiers. The potent dissatisfiers are called maintenance factors in job because they are necessary to maintain a reasonable level of satisfaction among the employees. They are also known as dissatisfiers or 'hygienic factors' because they support employees' mental health. Another set of job condition operates primarily to build strong motivation and high job satisfaction but their absence rarely proves strong dissatisfier. These conditions are 'Motivational Factors'. Herzberge's maintenance and motivational factors have been shown in the table given below.

Table: Herberzg's Maintenance and Motivational Factors

Need Structure
- Physiological or Primary Needs
- Social, Psychological, Ego, or Secondary Needs

Maintenance or Hygienic Factors

1) Company Policy and Administration
2) Technical Supervision
3) Inter-personal relations with Supervisor
4) Inter-personal relations with Peers
5) Inter-personal relations with Subordinates
6) Salary
7) Job Security
8) Personal life
9) Working Conditions
10 Status

Motivational Factors

1) Achievement
2) Recognition
3) Advancement
4) Work itself
5) Possibilities of growth
6) Responsibility

Hygienic factors include wages, fringe benefits, physical conditions and overall company policies and administration. The presence of these factors at a satisfactory level prevents job dissatisfaction, but they do not provide motivation to the employees. So they are not considered as motivational factors. Motivational factors on the other hand are essential for increasing the productivity of the employees. They are also known as satisfiers and include such factors as recognition, feeling of accomplishment and achievement, opportunity of advancement and potential for personal growth, responsibility and sense of job and individual importance, new experience and challenging work etc.

Herzberg further stated that managers have hitherto been very much concerned with hygienic factors. As a result, they have not been able to obtain the desired behaviour from employees. In order to increase the motivations of employees. It is necessary to pay attention to the satisfiers or motivational factors.

According to Herzberg today's motivators are tomorrow's hygiene because the latter stop influencing the behaviour of persons when they get them. When a person gets one thing, then something else will motivate him and the need which has been fulfilled will have only negative significance in determining his behaviour. It should also be noted that one's hygiene may be the motivator of another. For instance It is likely that workers in underdeveloped economies will designate some of the maintenance factors as motivators because their primary needs have not been fulfilled and they continue to be motivated by these factors.

17.6.4 Distinction between Herzberg's and Maslow's Theories

Both Herzberg and Maslow theories focus on motivational factors Maslow's motivation theory is based on the hierarchy of needs. According to him an unsatisfied need becomes a motivating factor for the individual and governs his behaviour in that direction. But Herzberg has developed a theory of motivation by differentiating between motivational and maintenance (or hygienic) factors. Maintenance factors avoid job dissatisfaction but do not provide motivation to workers. According to him lower order needs like physiological, safety and social needs act as maintenance factors.

Herzberg's theory has a limited applicability in the sense that it is more applicable to professional personnel, Maslow's theory on the other hand has universal applicability, it is applicable to all kinds of workers.

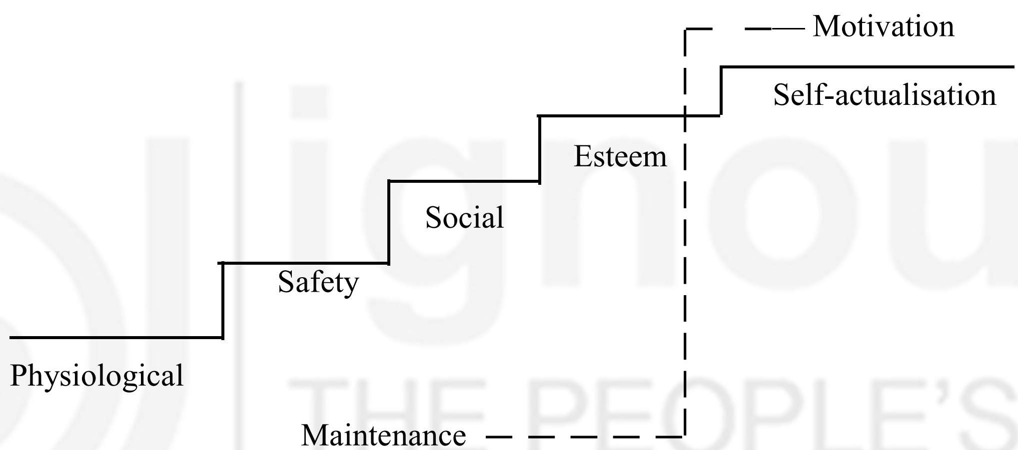

Figure 17.2: Relationship between Maslow's and Herzberg's Theories

17.6.5 Relationship between Maslow's and Herzberg's Theories

Though there are differences between the theories of Herzberg and Maslow still they are related to each other. Most of the maintenance factors of Herzberg come under comparatively lower order needs. Most of these needs remain satisfied and hence cease to be motivating. Maslow's physiological, security and social needs come under Herzberg's maintenance factors while self-actualisation comes under motivating factors. A portion of esteem needs like status becomes part of the maintenance factors and the remaining portion including advancement and recognition comes under motivational factors.

17.6.6 Job Enrichment

Herzberg attached greater importance to job enrichment in his two factor theory. Job enrichment implies enriching the content of job or the deliberate upgrading of responsibility, scope and challenge in work. Job enrichment is a motivational technique which emphasises the need for challenging and interesting work. It suggests that jobs be redesigned so that intrinsic satisfaction is derived from doing the job. In its best application, it leads to a vertically enhanced job by adding functions from other organisational levels so as to contain more variety, and challenge and offering autonomy and pride to the employees.

The term job enrichment should be distinguished from the term 'job enlargement'. Job enlargement attempts to make a job more varied by removing the dullness associated with performing repetitive operations. It involves a horizontal loading or expansion i.e. the addition of more tasks of the same nature. But in jobs enrichment, the attempt is to build into job a higher sense of challenge and importance of achievement. Job enrichment involves vertical loading. Additions in job enrichment require higher levels of skills and competence.

Some of the principles which make job enrichment effective are:

1) Give the workers the freedom of operation and responsibility.
2) Managers should have better understanding of what workers really want. They wish that their managers feel concerned about the welfare.
3) Workers should be consulted and given the chance to offer their suggestions.
4) Introduce new and more difficult tasks at each step, giving workers an opportunity to learn and specialise.
5) The workers should be given frequent feedback on their performance. Recognition and appreciation of their work induce them to learn more. It also eliminates possibilities of wide variations. This increases the efficiency of workers.

Advantages of job Enrichment

Following are the advantages of job enrichment:

i) It makes the work interesting
ii) It decreases the rates of absenteeism and labour turnover.
iii) It helps motivation through opportunities for growth and advancement.
iv) It makes for task reinforcement and increases the skill of workers.
v) Workers get higher job satisfaction.
vi) The enterprise gains through improvement of output both quantitatively and qualitatively and higher satisfaction of the workers.

Limitations of job Enrichment

Following are the limitations of job enrichment:

i) Technology may not permit the enrichment of all jobs. With specialised machinery, it may not be possible to make jobs very meaningful.
ii) Job enrichment has proved to be a costly process in certain cases as the expenditure involved is bigger than the gains in productivity.
iii) Jobs of highly skilled professional employees contain many challenging elements, but they are not necessarily that much efficient.
iv) It is difficult to say that all workers really want challenging jobs. Many of them even like to avoid responsibility. They seem to like above all job security and pay.
v) All those who prefer job enrichment may not have the requisite capability to meet the new challenges.

Check Your Progress B

1) Fill in the blanks.

   i) According to Theory X, workers can be made to work only through …………………… leadership.

   ii) Needs that are taken as the starting point of Maslow's motivation theory are the ……………… needs.

   iii) Lower order needs are ………………………… but the higher order needs are ………………

   iv) …………. factors also known as dissatisfiers are of negative importance in motivation.

   v) Job enrichment is a ……………. technique.

2) Match the following words/phrases in columns I and II by pairing the alphabets and number against each:

	Column I		Column II
i)	Hygienic factor	a)	Increased responsibility
ii)	Theory X	b)	Achievement
iii)	Theory Y	c)	Addition of similar tasks
iv)	Job enrichment	d)	Salary
v)	Real motivators	e)	Work is as natural as play
vi)	Job enlargement	f)	Dislike of work

17.7 TYPES OF MOTIVATION – FINANCIAL AND NON-FINANCIAL

Motivation may be classified on various bases:

1) Positive or negative
2) Extrinsic and intrinsic
3) Financial or non-financial

Positive motivation is the process of attempting to influence the employees' behaviour through recognition & appreciation of employees' efforts and contribution towards achievement of organisational goal. Examples of positive motivators are – taking interest in subordinates benefits, appreciation and credit for work done, delegating the authority and responsibility of subordinates etc. **Negative motivation** is based upon fear i.e. demotion, lay off etc. The fear of punishment affects the behaviour towards changes. Though punishment has resulted in controlling the misbehaviour and contributed towards positive performance but it may also lead to poor performance & lower productivity. The second classification relates to **extrinsic** and **intrinsic motivation**. Extrinsic motivators arise away from the job. They do not occur on the job. These factors include wages, fringe benefits, medical reimbursement, etc. Thus, they are generally associated with financial incentives. But, intrinsic motivators occur on the job and provide satisfaction during the performance of work itself. Intrinsic or internal motivators include recognition, status, authority, participation, etc.

Lastly motivators may be **financial** or **non-financial. Financial motivators** are those which are associated with money. They include wages and salaries, fringe benefits, bonus, retirement benefits, etc. **Non-financial motivators** are those which are not associated with monetary rewards. They include intangible incentives like **ego satisfaction, self-actualisation and responsibility.** Here we shall be confining our discussion only to financial and non-financial motivation/ incentives.

17.7.1 Financial Motivation/Incentives

Money plays an important role in motivation. Management generally makes use of financial incentives like wages and salaries, bonus, retirement benefits, insurance, medical reimbursement, etc. to motivate the workers. However, such incentives may not always prove to be motivating. In many cases, management may have to increase into the financial incentives to keep the workers with the organisation. This can be appreciated from the practice of making wages and salaries competitive between various enterprises so as to attract and maintain good work-force.

Money is a real motivating factor when the physiological and security needs of the workers have not been fully satisfied. Money plays a significant role in satisfying these needs. Therefore, management can use financial incentive for motivation. Money also helps in satisfying the social needs of employees to some extent because money is often recognised as a symbol of status, respect and power. Besides money is an important means of achieving a **'minimum standard of living'** although this 'minimum' has the tendency to go up as people become more affluent. But this should not lead one to conclude that money will always be a motivating factor to all people. To some people, importance of money may be reduced after a certain stage, and non-financial rewards may become more important. They are motivated by money only up to the stage they are struggling for satisfying their physiological and security needs.

Money provides for the satisfaction of physiological and safety needs only which have been called hygienic factors by Herzberg. **Hygienic factors** include wages and salaries and other fringe benefits. The presence of these factors at a satisfactory level prevents job dissatisfaction. They do not provide 'on a job satisfaction' to the employees and, therefore, cannot be considered as motivational factors. According to Herzberg, in order to motivate the employees, it is necessary to provide for the satisfaction of ego, social and self-actualisation needs. But these needs are present generally in case of employees in the higher positions, who get higher monetary rewards and are not motivated by increased monetary benefits. In case of employees at the operative levels, money certainly plays a significant role in motivating them because their survival and safety depends on it.

From the above discussion, it can be said that money is not the only motivator and it is not always a motivator. Management should therefore establish a motivational system which is capable of satisfying different kinds of human needs. On the job, satisfaction can be provided by helping the employees to develop themselves. Job enlargement, participative management, recognition, status symbols, and making the job challenging are some of the other non-financial incentives which also motivate employees.

17.7.2 Non-Financial Motivation/Incentives

When the physiological and security needs are satisfied with the help of money, it ceases to be a motivating force; that is why it is regarded as a maintenance factor. Indeed employees have other needs also. They want status and recognition in society; they want to satisfy their ego needs and they want to achieve something in their lives. In order to motivate the employees having these needs, management may use the following no-financial incentives:

1) **Competition:** If there is healthy competition among individual employees, groups of employees, it leads them to achieve their personal or group goals. Hence competition acts as a non-financial incentive.

2) **Praise or Appreciation of work done:** Recognition of satisfactory performance acts as a non-financial incentive since it satisfies one's ego needs. Sometimes appreciation of work done is more effective than any other incentive. However, this incentive should be used with great care because praising an incompetent employee creates resentment among competent employees.

3) **Knowledge of the results:** Knowledge of the results of work accomplished leads to employee satisfaction. A worker feels happy if he is informed about performance. He derives satisfaction when his superior appreciates the work he has done. In modern industry, the production workers have no contact with the consumers and so they cannot get the reaction of the consumers. However, they can be motivated to a greater extent if they are told the rating of their performance.

4) **Workers' participation in management:** Participation in management provides strong motivation to the employees. It gives them psychological satisfaction that their voice is heard. Participation in management provides for two-way communication and so imbibes a sense of importance.

5) **Suggestion system:** Suggestion system is an incentive which satisfies many needs of the employees. Many organisations which use the suggestion system make use of cash awards for useful suggestions. They sometimes publish the worker's name with his photograph in the company's magazine. This motivates the employees to be in search for something which may be of greater use to the organisation.

6) **Opportunity for growth:** Opportunity for growth is another kind of incentive. If the employees are provided opportunities for their advancement and growth and to develop their personality they feel very much satisfied and become more committed to organisation goals.

Check Your Progress C

1) Which of the following statements are True and which are False.

   i) Negative motivation influences behaviour through the threat of penalty.

   ii) Intrinsic motivation includes such factors as wages, fringe benefits, etc.

   iii) Employees participation in management acts as a non-financial incentive.

iv) Opportunity for growth is a financial incentive.

v) Money can be a motivator to an unlimited extent.

2) Fill in the blanks.

i) Money is a real motivating factor so long as .... and .... needs are not fully satisfied.

ii) Positive motivation is based on …………………….

iii) Hygienic factors satisfy the …………… needs.

iv) Competition among employees is a …………………… incentive.

v) Knowledge of the result of one's performance leads to ……………….

17.8 LET US SUM UP

Motivation may be defined as the complex of forces inspiring a person at work to intensify his willingness to use his maximum capabilities for the achievement of certain objectives. Motives or needs of a person are the starting point of the motivation process. Motives are energising, invisible forces. One motive may result in many different behaviours. Also the same behaviour may result from many different motives. Behaviour can be used as an estimate of an individual's motives. Motives can operate in harmony or in conflict. Motives change over time. Motives can also interact with the environment.

The basic elements of the process of motivation are: (i) behaviour, (ii) motives, (iii) goals, (iv) some form of feedback or reaction. Behaviour is generally motivated by the desire to achieve a goal. Motives are directed towards goals and prompt people to action.

McGregor formulated two sets of assumptions about human beings, which formed the basis of Theory X and Theory Y of motivation. He described Theory X as the traditional theory which required workers to be persuaded and pushed into performance on the assumption that the average human being dislikes work and would avoid it if he can. He propounded Theory Y based on the assumption that people by nature love work and can exercise self-direction and self-control in the service of objectives to which they are committed.

Maslow's need priority theory is based on needs of people which arise in sequence and hierarchical order from physiological needs through security needs, social needs, esteem needs and self-fulfillment needs. Herzberg's two-factor theory distinguishes between maintenance or hygienic factors and motivational factors, the former having only negative significance and the latter having positive effect on motivation. The absence of maintenance factors like wages, job security, physical conditions of work and such extrinsic elements cause dissatisfaction, but their presence does not provide motivation. On the other hand, motivational factors such as recognition, achievement, etc. are essential for motivating employees and these factors provide positive incentives.

Herzberg emphasised the importance of job enrichment as one of the motivational factors. It refers to enriching the job content or the deliberate upgrading of responsibility, scope and challenge in work. Job enrichment differs from job enlargement which involves horizontal loading, that is, addition of more tasks of the same nature.

Motivation may be classified on different bases e.g. positive and negative, extrinsic and intrinsic, financial and non-financial. Positive motivation is the process of attempting to influence the employees behaviour through the possibility of reward. Negative motivation is based on fear & threats i.e. demotion, lay off etc. Extrinsic motivators arise away from the job and are financial in nature. Intrinsic motivators are concerned with the state of self-actualisation and occur on the job.

Financial motivation refers to motivation induced by money or money's worth, like wages and salaries, bonus, medical benefits, etc. Non-financial motivation includes incentives like competition, praise, knowledge of results, participation in management, opportunity for growth etc.

17.9 KEY WORDS

Behaviour: Behaviour refers to the series of activities undertaken by an individual or a group with a view to achieving stated goals.

Esteem and status needs: They relate to self-confidence independence, achievement, competence, initiative, success, etc.

Extrinsic Motivation: Extrinsic motivation refers to the incentives which are external to the job, such as, salary, fringe benefits, etc.

Financial Incentives: Financial incentives are those which involve money or benefits in kind like wage, salary, retirement benefits, insurance, medical reimbursement etc.

Goals: Goals are the ends which provide satisfaction of human needs.

Intrinsic Motivation: It refers to incentives internal to the job and provides satisfaction during the performance of work itself.

Job Enrichment: It refers to the process whereby a job is enriched in terms of its contents, responsibility, scope, variety and challenge.

Motivation: Motivation refers to the process by which human needs direct and control the behaviour of a human being.

Motives: Motives are the primary energisers of behaviour which prompt people to action.

Motivators: Motivators are associated with positive feelings of employees about the job.

Negative Motivation: It refers to the process of influencing employees' behaviour through fear of losing the job or losing promotion.

Non-Financial Incentives: It includes incentives like status, recognition, challenge in work etc.

Physiological Needs: These needs relate to survival and maintenance of human life, such as, need for food, clothing, shelter, water, rest, etc.

Positive Motivation: It refers to the process of influencing employees' behaviour through the possibility of reward.

Safety and security Needs: These needs relate to job security, physical security, income security, provision for old age, etc.

Self-Actualisation or Self-Fulfilment: It refers to realizing one's potentiality for continued self-development and for being creative in the broadest sense of the word.

Social needs: These relate to need for social incentive, relatedness, companionship, belongingness, etc.

17.10 ANSWER TO CHECK YOUR PROGRESS

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

2) (i) needs internal (ii) behaviour (iii) latent (iv) goals (v) motivate

B) 1) (i) autocratic (ii) physiological (iii) finite, infinite

(iv) hygienic/maintenance (v) motivational

2) (i) –d (ii)-f) (iii) –d) (iv) –e) (v) -b) (vi) –c)

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

2) (i) physiological security (ii) rewards (iii) lower-order (iv) non-financial (v) satisfaction.

17.11 QUESTIONS FOR PRACTICE

1) Define motivation. Explain its importance to a modern enterprise.
2) What do you understand by the term 'motivation'? Point out the difference between positive and negative motivation.
3) Explain Herzberg's two-factor theory and differentiate it from Maslow's theory of Need Hierarchy.
4) Enumerate the assumptions of McGregor's Theory X and Theory Y. Which one is applicable in India?
5) What is meant by hierarchical nature of needs? Is the hierarchy rigid? Discuss with suitable examples.
6) "Money holds the key to work motivation in modern business organisations." Discuss.
7) "Non-financial incentives are as strong motivators as the financial ones" Critically examine this statement in the light of need-priority model and two-factor theory of motivation.

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

UNIT 18 LEADERSHIP

Structure

18.0 OBJECTIVES

After studying this Unit, you should be able to:

- explain the meaning of leadership
- describe the importance of managerial leadership
- state the theories and different styles of leadership
- outline the functions of leadership
- analyse the relation between motivation and leadership
- explain the meaning of leadership effectiveness and enumerate the qualities of an effective leader
- describe the meaning and significance of morale.

18.1 INTRODUCTION

In the previous Unit you have learnt about one of the important management functions viz., motivation. In this Unit, you will learn another management function, that is, leadership. As you know, management involves getting work done through the people. By virtue of their position, managers can issue orders and instructions to their subordinates to get work done. But it is also necessary to ensure that subordinates put in their maximum effort in performing their tasks. Hence, managers have to regulate and influence the subordinates' behaviour and conduct at work. It is through the leadership role of managers that employees may be induced to perform their duties properly and maintain harmony in group activities. A manager having formal authority can direct and guide his subordinates and command their obedience by virtue of his positional power. But as a leader, the manager can influence work behaviour by means of his leadership ability to get the cooperation of all members of the group.

18.2 WHAT IS LEADERSHIP?

Leadership may b defined **as a process of influencing group activities towards the achievement of certain goals.** Thus, the leader is a person in a group who is capable of influencing the group to word willingly. He guides and directs other people and provides purpose and direction to their efforts. The leader is a part of the group that he leads, but he is distinct from the rest of the group. As defined by George R. Terry "Leadership is the activity of influencing people to strive willingly for group objectives".

Leadership naturally implies the existence of a leader and followers as well as their mutual interaction. It involves inter-personal relation, which sustains the followers accepting the leader's guidance for accomplishment of specified goals.

Managers have to guide and lead their subordinates towards the achievement of group goals. Therefore, a manager can be more effective if he is a good leader. He does not depend only on his positional power or formal authority to secure group performance but exercises leadership influence for the purpose. As a leader he influences the conduct and behaviour of the members of the work team in the interest of the organisation as well as the individual subordinates and the group as a whole. But leadership and management are not the same thing. Management involves planning, organising, coordinating and controlling operations in achieving various organisational goals. Leadership is the process which influences the people and inspires them to willingly accomplish the organisational objectives. Thus, a manager is more than a leader. On the other hand, a leader need not necessarily be a manager. For instance, in an informal group, the leader may influence the conduct of his fellow members but he may not be a manager. His leadership position is due to the acceptance of his role by his followers. But, the mangers, acting as a leader, has powers delegated to him by his superiors. His leadership is an accompaniment of his position as a manager having an organised group of subordinates under his authority. Thus, managerial leadership has the following characteristics:

i) It is a continuous process whereby the manager influences, guides and directs the behaviours of subordinates.

ii) The manager-leader is able to influence his subordinates behaviour at work due to the quality of his own behaviour as leader.

iii) The purpose of managerial leadership is to get willing cooperation of the work group in the achievement of specified goals.

iv) The success of a manger as leader depends on the acceptance of his leadership by the subordinates.

v) Managerial leadership requires that while group goals are pursued, individual goals are also achieved.

18.3 IMPORTANCE OF MANAGERIAL LEADERSHIP

The importance of managerial leadership in an organisation arises from the basic nature of the managerial and leadership roles of managers. Combination of these roles invariably leads to not only effective task performance and fuller achievement of organisation goals but also human satisfaction alround. This is because management is based on the formal authority of managers. Whereas, being leaders of work groups enables managers to achieve results on the basis of inter-personal relations. The leader manager identifies himself with the work group. He acts as an intermediary between his subordinates and the top management. He takes personal interest in the development of his subordinates, helps them in overcoming individual problems through advice and counseling, creates appropriate work environment and builds up team spirit. As a result the leader manager is able to develop better team work. The subordinates willingly accept his advice, guidance and direction and are inspired as a group to accomplish the specific goals.

18.4 THEORIES OF LEADERSHIP

There are a number of theories which provide explanations regarding various aspects of the leadership phenomenon. Let us examine some of the theories.

Trait Theory: This is the earliest theory based on a distinction between the personal qualities or traits of successful leaders. The theory suggests a list of personality traits or characteristics which must be present in a person for his success as a leader. According to this theory, leaders must be physically strong and well-built, intelligent, honest and mentally mature. He must have initiative, self-confidence, ability to take decisions, and so on. Since all individuals did not have these qualities, only those who had them would be considered potential leaders. Following are the limitations of this theory:

i) The trait theory is not accepted as a valid theory.

ii) There is no universally agreed list of traits associated with successful leaders.

iii) It is difficult to measure the traits and, therefore it is not always possible to distinguish between leaders and followers.

Behavioural Theories: The behavioural theories of leadership are based on the belief that **leaders can be identified by reference to their behaviour in relation to the followers.** In other words, it is suggested that leadership can be described in terms of **what leaders do rather than what they are**. Behavioural theories have been presented mostly on the basis of research studies. According to the studies conducted in the States of Michigan, USA, leaders who treat their subordinates as human beings, are concerned about their well-being, and encourage and involve them in goal setting, are more effective. They are described as **'employee-centred'** leaders. On the other hand, leaders who are **'production-centred'** emphasise job performance in conformity with prescribed standards. He exercises close control over the employees as if they were tools of production. Such a leadership is associated with unsatisfactory work performance due to the low morale of employees.

Studies conducted in Ohio State University showed two dimension of leader's behaviour viz., **Initiating structure** and **Consideration**. Initiating structure refers to the leader's behaviour in delineating the relationship between himself and members of the work group and in endeavouring to establish well defined pattern of organisation, channels of communication and methods of procedure. Whereas, consideration refers to behaviour indicative of friendship, mutual trust, respect and warmth in the relationship between leader and the members of his staff.

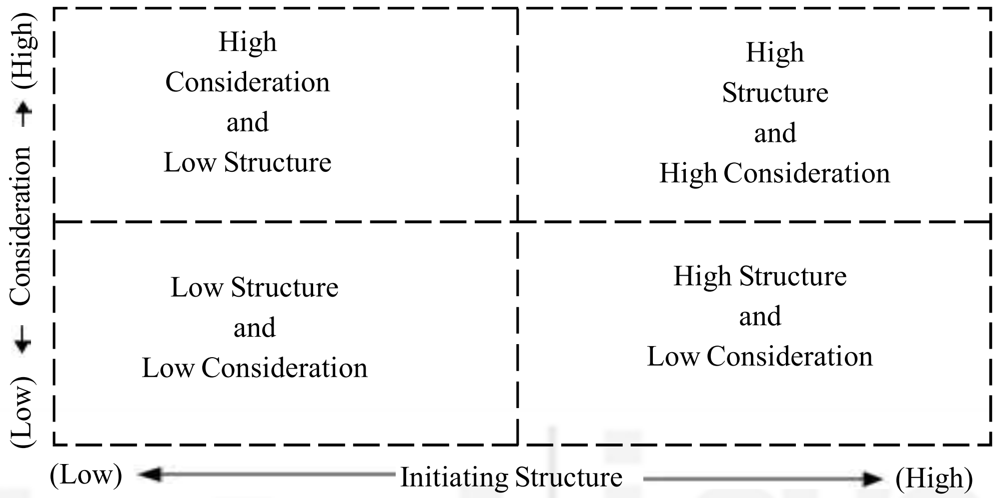

Figure 18.1: Combination of Initiating Structure and Consideration

Look at Figure 18.1 which shows that the behaviour of a leader may be described as any mix of both dimensions.

Situational Theories: In the situational theories of leadership the success of leadership depends upon the situation in which the leader operates.

According to leadership contingency model developed by Fred E. Fiedler, the leader's effectiveness depends upon three situational factors:

i) **Leader-followers relations,** that is the degree of follower's trust, confidence and respect for the leader.

ii) The extent to which the task performed by subordinates is routine or non-routine (known as **task structure**).

iii) The **position power** of the leader, that is, the power associated with the rank and position of the leader in the organisation. He defined favourableness of a situation as the degree to which the situation enables the leader to exert his influence over his group.

The most favourable situation for leaders to influence their group is one in which they are well liked by the members, the task is highly structured (i.e., routinised and predictable) and the leader has enormous power attached to his position. On the other hand, the most unfavourable situation for leaders is one in which they are disliked, the task is highly unstructured and he will have little position power.

Task Oriented	Relationship Oriented	Task Oriented
Very favourable leadership situation	Intermediate favourable leadership situation	Very unfavourable leadership situation

Figure 18.2: Appropriateness of leadership behaviour for various group situations

Look at Figure 18.2 which shows that task oriented leaders tend to perform best in group situations that are either very favourable or very unfavourable to the leader. On the other hand, relationship-oriented leaders tend to perform best in situations that are intermediate (medium) in favourableness.

Another situational theory is the **'Path-Goal Theory'**. According to this theory, leaders are effective due to their influence on followers' motivation, ability to perform, and their satisfaction. Subordinates are motivated by the leader to the extent he is able to influence their expectancies relating to the performance and attractiveness of the goal. Further, individuals are satisfied with their job if they believe that (a) performance of the job will lead to desirable outcomes and (b) with hard work they will be able to achieve the desirable outcomes.

18.5 LEADERHIP STYLES

The dominant behaviour pattern of a leader-manager in relation to his subordinates is known as leadership style. There are three basic styles of leadership as follows:

1) Autocratic or Authoritative Style
2) Democratic or Participative Style and
3) Laissez-faire or Free-rein Style.

Autocratic or Authoritative Style

An autocratic leader centralises power and decision-making in himself and exercises complete control over the subordinates. In this style subordinates are compelled to follow the orders of the leader under threat of penalties. They have no opportunity to take part in goal-setting, or take initiative of make suggestions. They are subject to close supervision and, thus have a tendency to avoid responsibility. The autocratic manager has little concern for the well-being of employees, who suffer from frustration and low morale. They do not have any sense of belonging to the organisation and try to work as little as possible.

Limitations: it should be clear from the above that there are several limitations of the autocratic style of leadership.

i) It results in low morale due to the inner dissatisfaction of employees.
ii) Efficiency of production goes down in the long run.
iii) It does not permit development of future managers from among capable subordinates.

Despite the above limitations, autocratic leadership can be successfully applied in the following situations:

i) When subordinates are incompetent and inexperienced.
ii) The leader prefers to be active and dominant in decision-making.
iii) The company endorses fear and punishment for disciplinary techniques.
iv) There is a little room for error in final accomplishment.
v) Under conditions of stress when great speed and efficiency are required.

Since the leader-manager takes all decisions in autocratic style, there is uniformity and consistency in decision-making.

Democratic or Participative Style

The democratic style is also known as participative style. In this style, decisions are taken by the leader in consultation with the subordinates and with their participation in the decision-making process. The participative leader encourages subordinates to make suggestions and take initiative in setting goals and implementing decisions. This enables subordinates to satisfy their social and ego needs, which in turn, lead to their commitment to the organisation goals and higher productivity. Frequent interaction between the manager and subordinates helps to build up mutual faith and confidence.

Several benefits can be derived from the participative style of leadership as listed below:

i) It helps subordinates to develop their potential abilities and assume greater responsibilities.

ii) It provides job satisfaction and improves the morale of employees.

iii) The group performance can be sustained at a high level due to the satisfied and cohesive nature of the group.

However, the democratic style cannot be regarded as the best style under all circumstances. Its limitations are as follows:

i) Decisions taken through consultation may cause delay and require compromises to meet different viewpoints.

ii) A few vocal individuals may dominate the decision-making process.

iii) No one individual may take the responsibility for implementing the decision taken by the group as a whole.

Despite the above limitations, democratic style is suitable in the following situations:

i) When subordinates are competent and experienced.

ii) The leader prefers participative decision-making process.

iii) Rewards and involvement are used as the primary means of motivation and control.

iv) The leader wishes to develop analytical and self-control abilities in his subordinates.

v) The organisation has clearly communicated its goals and the objectives to the subordinates.

Laissez Faire Leadership Style

Laissez faire leadership style is just the opposite of autocratic style. A manager, who adopts this style, completely gives up his leadership role. The subordinate group is allowed to make decisions and it is left to the members of the group to do as they like. The role of any leader is absent. The group members enjoy full freedom as regards goal-setting and acting on it. Hence, there is chaos and mismanagement of group goals. However, laissez faire leadership is found to be quite suitable where the subordinates are well-trained, competent and the leader -manager is able to fully delegate the powers of decision-making and action to the subordinates.

Laissez faire style is suitable in the following situations:

i) When leader is interested in delegating decision-making fully.

ii) Subordinates are well trained and highly knowledgeable.

iii) Organisation goals have been communicated well.

Despite a few suitability this style should be adopted rarely because it may lead to chaos and mismanagement.

Look at Figure 18.3 which shows diagrammatic representation of all these leadership styles:

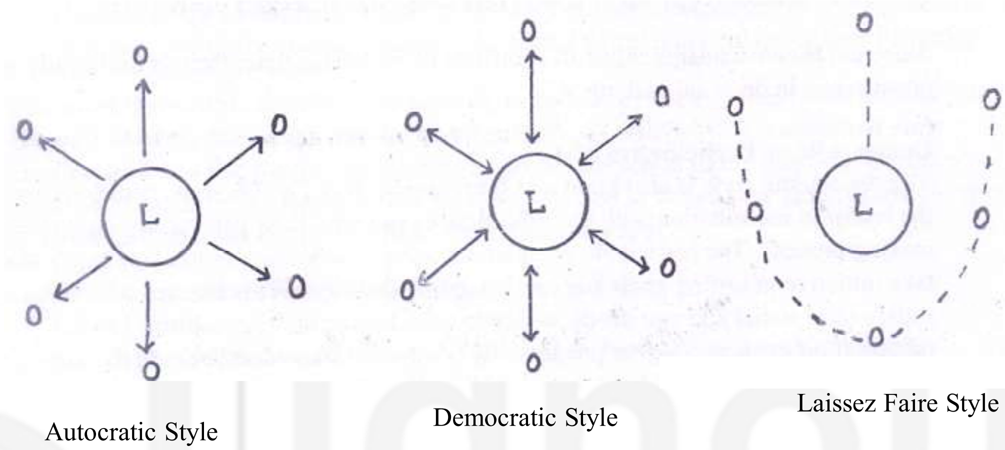

Figure 18.3: Diagramatic Representation of Leadership Style

Continuum of Leader Behaviour

Robert Tannenbaum and Warren Schmidt depicted a broad range of leadership styles on a continuum which moves from authoritarian or boss-centred leader behaviour at one end to democratic or subordinate-centred behaviour at the other end.

(Democratic) .... (Authoritarian)

Relationship Oriented .... Task Oriented

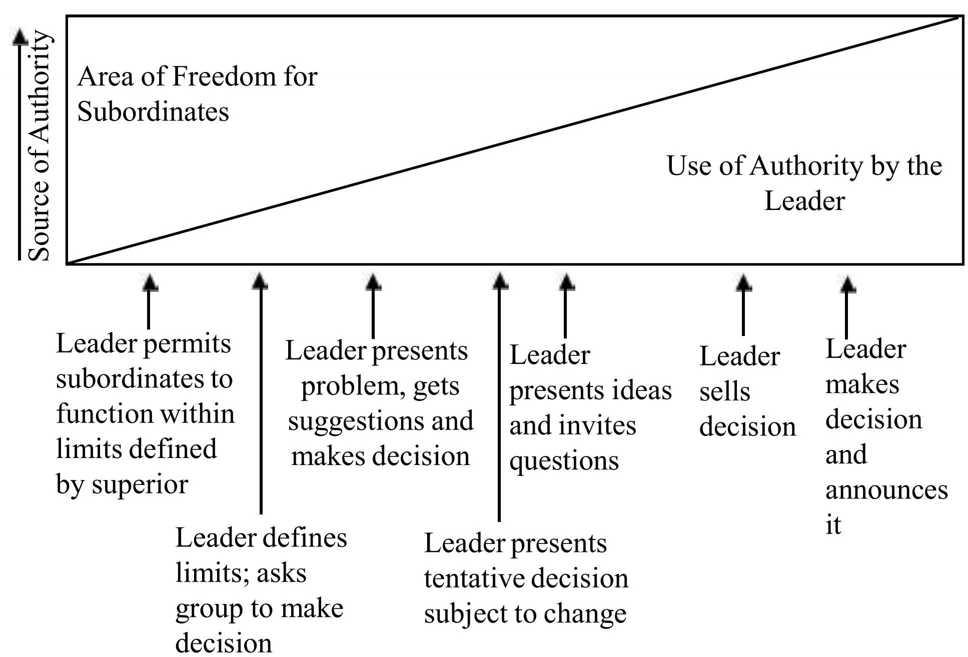

Figure 18.4: Continuum of Leader Behaviour

Look at Figure 18.4 which shows that leaders who are at the authoritarian end of the continuum tend to be task-oriented and use their power to influence their followers. He enjoys a high degree of control and delegate very little authority. On the other hand, leaders who are at the democratic side tend to be group oriented and provide their followers considerable freedom in their work.

Although the leader continuum approach provides a wide range of leader's behaviour. It identifies the number of behavioural alternatives available to a manager. Moreover, the success of the leadership style depends on the modification of the leader to the needs of the situation. Its major limitation is that it supports unidimensional thinking. It has been found that employees orientation and task-orientation are not opposite ends on a continuum.

Check Your Progress A

1) Which of the following statements are True and which are False.

   i) Leadership is not the same things as managership.

   ii) Leadership is a function of management.

   iii) Managerial Leadership involves pursuit of group goals, not individual goals.

   iv) Trait theory of leadership emphasises the behaviour of leaders.

   v) An autocratic leader-manager can be effective in the short-run, but not in the long-run

2) Fill in the blanks selecting appropriate words from those given within brackets.

   i) A leader manger invariably …………. his subordinates (commands / directs and guides/rewards).

   ii) Managerial leadership is a ……………… process (regular/continuous/ convenient).

   iii) A democratic leader takes decisions on the basis of ………………….. (his own judgement / group opinion / individual views).

   iv) Employee-centred leaders have maximum concern for ………………. (work / subordinates/ organisational goals).

   v) If the situation is highly favourable …………. leadership is most suitable (relations oriented / task oriented).

18.6 FUNCTIONS OF LEADERSHIP

A leadership functions of a managers are closely related with his managerial functions. But they are somewhat different as well as overlapping. Essentially, the leader as a manager has to set the group goal, make plans, motivate and inspire subordinates and supervise performance. But he has to perform several other functions as leader. The more important of these functions are given below:

1) **To develop team work:** One of the primary functions of the leader is to develop his work-group as a team. It is his responsibility to create a congenial work-environment keeping in view the subordinates competence, needs and potential abilities.

2) **To act as a representative of the work-group:** The leader of a work-group is expected to act as a link between the group and top management. When necessary, the leader has to communicate the problems and grievances of his subordinates to the top management.

3) **To act as a counseller of the people at work:** Where the subordinates face problems in connection with their performance at work, the leader has to guide and advise the subordinates concerned. The problems may be technical or emotional in nature.

4) **Time management:** The leader's functions include not only ensuring the quality and efficiency of work performed by the group, but also checking on the timeliness of completing different stages of work.

5) **Proper use of power:** While exercising power or authority in relation to his subordinates, the leader must be careful about using his power in different ways according to the situation. It may be necessary to use reward power, coercive power, or expert power, format or informal power, depending on what will stimulate positive response from the subordinates.

6) **Secure effectiveness of group-effort:** To get the maximum contribution towards the achievement of objectives the leader must provide for a reward system to improve the efficiency of capable workmen, delegate authority, and invite participation of employees in decision-making, ensure the availability of adequate resources, and communicate necessary information to the employees.

18.7 MOTIVATION AND LEADERSHIP

Effective leadership makes a positive impact on the motivation of members of a work group. This is due to the following reasons:

i) Leadership creates a congenial work environment and thus ensures job satisfaction.

ii) It enables group members to achieve individual goal as well as organisational goals.

iii) It provides for a proper system of rewards and incentives for capable employees, which includes both financial and non-financial incentives.

iv) The leader's concern for the well-being and development of subordinates promises self-fulfilment to every group member.

An effective leader-manager helps and supports his subordinates in the light of their individual values and expectations. This supportive relationship increases their motivation as it builds and maintains a sense of personal worth and importance of each individual.

18.8 LEADERSHIP EFFECTIVENESS

We have discussed above how different styles of leadership reflect the behaviour pattern of the leaders. The manager leader may be effective or ineffective depending upon the leadership style adopted by him. He may be **employee-centred** (i.e., relations-oriented) or **production centred** (i.e., task oriented). In other words, the style may reflect the leaders **concern for people** or **concern for production**. But in reality, the manager-leaders may combine his concern for people and concern for production with different degrees of emphasis on each. This idea was developed in the form of what is known as **'Managerial Grid'**, which is briefly outlined below.

Managerial Grid: The managerial grid refers to a diagrammatic representation of the possible combinations of concern for people and concern for production which may be reflected in the style of leadership. The concept of managerial grid was developed by Blake and Mouton in 1964.

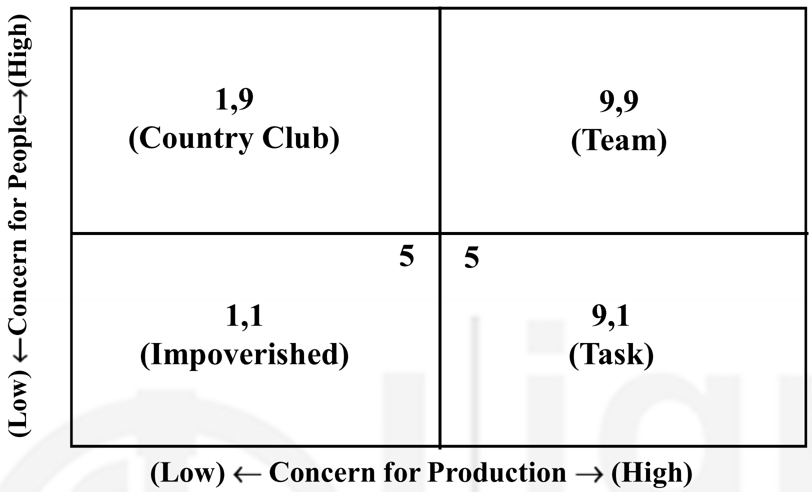

Figure 18.5: Diagramatic Representation of Managerial Grid

As shown in the diagram, there are nine degrees of concern each for people and production. Combining lower degrees and higher degrees of concern, five basis styles of leadership are distinguished as follows (No. 1 representing minimum concern, and No. 9 maximum concern):

- 1,1 style, where the manager has minimum concern for people as well as production, is known as **impoverished management**. This represents a casual attitude of the manager towards his job the organisation cannot be expected to survive.

- 9,1 style reflects the manager's highest concern for production but least concern for people. It is known as **task management**.

- 1,9 style in which the manager has the maximum concern for people and minimum concern for production is described, as **country club management**. It implies that the manager is inclined to keep people happy expecting that happiness will make them more efficient, which is not true for business enterprises.

- 5,5 style represents moderate concern for both people and production and therefore known as **middle of road management**. This style of leadership is preferred by many managers whose approach to management is that of "live and let live".

- 9,9 style is the best combination of concerns for people and production with maximum concern for both. In this case, the manager tries to integrate the objectives of the organisation with the objectives of the people employed. This style therefore represents **team management**. It may be suggested that the 9,9 management style is likely to be most effective.

Effective and Ineffective Styles

Effectiveness depends on the situational demands of a specific environment. When the style of a leader is appropriate to a given situation, it is termed effective. On the other hand, when the style is inappropriate to a given sitation it is termed ineffective. Look at Figure 18.6 which shown the effective dimension of leadership.

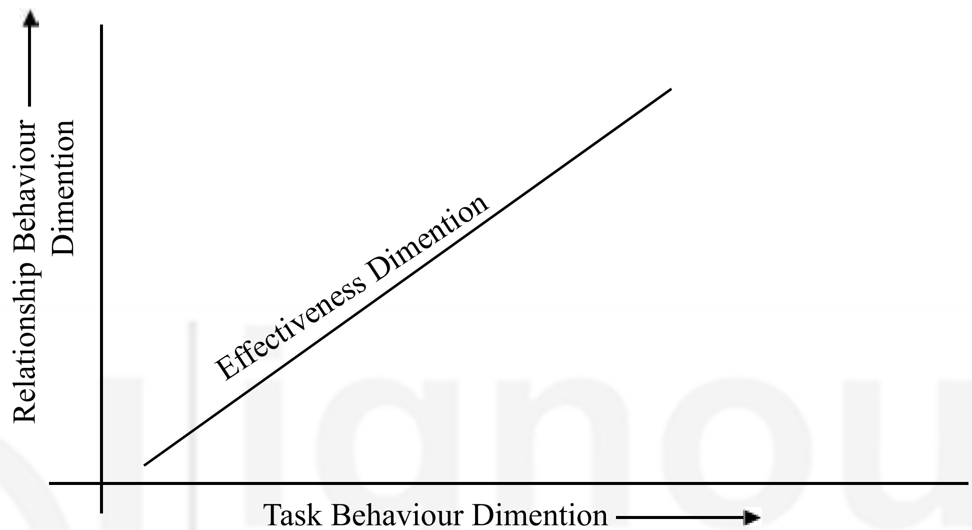

Figure 18.6: Diagramatic Representation of Effectiveness Dimension

The basic styles of leadership are further divided into eight styles according to their degrees of effectiveness i.e., as more effective and less effective styles. The following are regarded as **more effective styles.**

Executive: Used by a manger this style attaches maximum importance to work as well as the people. Such a manager is able to motivate people and utilise the team effectively. He sets high standards of performance and can accomplish the goals successfully.

Developer: The manager adopting this style attaches greatest importance to the people at work and has minimum concern for work. He devotes maximum attention to the development of individual subordinates and believes in their capability.

Benevolent autocrat: The manager whose attitude and style are those of a benevolent autocrat has high concern for work and low concern for people. But he is able to achieve the goals without causing any resentment among the subordinates.

Bureaucrat: With a bureaucratic style the manager is able to control the work-situation and achieve goals by means of rules and procedure. He has minimum concern for people and work as such.

The less effective (or **ineffective**) style are stated to be those which are not appropriate to the situation. These are as follows:

Compromiser: A manager who is equally concerned with people and work in a situation which requires emphasis on one of these, is a poor decision-maker due to pressures on both counts. Thus is ineffective manager leader.

Missionary: The missionary manager is one who aims at harmonious relations among people as an ideal and is little concerned with work, although the situation requires greater emphasis on work. He is unable to get results.

Autocrat: An autocratic manager is interested only in work and results thereof, whereas the situation requires relation-orientation. Such a manager lacks confidence in his subordinates and depends on high-handed management. So his leadership fails in the long-run.

18.8.1 Factors Influencing Leadership Effectiveness

Taking an overall view of the question of effectiveness of leaders, some writers have identified a number of factors that influence the leader and his effectiveness. These factors are:

1) The leader's own personality, past experience and expectations.
2) The expectations and behaviour of his supervisors.
3) The subordinates' characteristics, expectations and behaviour.
4) The requirements of tasks to be performed by subordinates.
5) Expectations and behaviour of fellow managers (peers).
6) Organisational culture (climate) and policies.

18.8.2 Qualities of an Effective Leader

A leader cannot be effective unless he possesses certain qualities of head and heart. Irrespective of the nature of the manager-leader's own responsibilities of the job and the styles adopted by him, a number of qualities are generally found to be possessed by the effective leader. The more important of these qualities are listed below:

1) **Mental and physical health:** To be able to bear the pulls and pressures of leadership, it is essential for the leader to have sound health both mental and physical. Along with a balanced temperament and optimistic outlook, he must possess stamina and sound health.

2) **Empathy:** A leader must have the capacity to appreciate others and look at things from his subordinates' angle. This attitude of the leader motivates his subordinates.

3) **Self-confidence:** Confidence about one's leadership ability makes it possible for a leader to analyse and face different situations and adopt a suitable style. Lack of self-confidence often prevents managers to adopt participative style and repose trust in his subordinates.

4) **Awareness of others' opinion about himself:** A leader having self-confidence should not ignore how others perceive him as a leader. He must be aware of his strength and weakness in relation to his subordinates.

5) **Objectives:** A leader who is effective does not get carried away by emotions. He is fair and objective in his dealings with subordinates.

6) **Knowledge and intelligence:** A leader to be effective must have knowledge of group behaviour, human nature, and activities involving technical and professional competence. He must have intelligent perception of human psychology and ability to think clearly and argue cogently on points of dispute.

7) **Decisiveness:** Decision-making is a necessary but difficult tasks for every leader. A leader often has to take initiative and exercise mature judgement while taking decisions. Besides, he has to have foresight, imagination and creative ideas for effective decision-making. Open mindness is yet another essential quality for that purpose.

8) **Ability to communicate:** The skill of effective communication of goals and procedure of work is extremely important in leadership. To achieve desired results and coordination of efforts in a group, oral communication is of great significance.

9) **Sense of purpose and responsibility:** A leader must have clarity of purpose and responsibility to be able to inspire his subordinates to achieve specific goals.

10) **Other qualities:** Enthusiasm, courage, sense of direction, judgement, tact, courtesy and integrity are also regarded as necessary qualities for a leader to be effective.

Check Your Progress B

1) Fill in the blanks.

   i) The primary function of the leader is to develop the work group as a ……………..

   ii) When subordinates at work face problems the leader must act as a …………………

   iii) Leadership enables group members to achieve …………… as well as ……………..

   iv) The leader-manager's effectiveness depends upon the …………. adopted by him.

   v) Maximum concern for people and minimum concern for work is known as ………………. management.

2) Which of the following statement are True and which are False.

   i) Team management refers to moderate concern of the manager for work and people.

   ii) A leader provides for a proper system of financial and non-financial incentives for subordinates.

   iii) The managerial grid represents combination of lower degrees of concern for people and concern for work.

   iv) Middle of the road management means a passive attitude on the part of manager leader.

v) The bureaucratic manager attaches maximum importance to work as well as to people.

3) Match the following expressions given in column (A) and (B) by reference to the alphabets and numbers against each.

	Column A		Column B
i)	Minimum Concern for people & work	a)	Executive
ii)	No Concern for people & work	b)	Benevolent autocrat
iii)	Maximum Concern for people & work	c)	Deserter
iv)	Maximum Concern for work and Minimum Concern for people	d)	Bureaucrat

18.9 MORALE

You have learnt different dimensions of leadership behavior. Effective leader tries his best to boost the morale of the employees which in turn motivate them to work willingly. Let us discuss about morale in detail.

18.9.1 Meaning and Significance of Morale

Morale is the state of mind or attitude of an individual or group towards the work and environment i.e. towards the superior, fellow members of the group and goal of the organisation as well as the task assigned. A favourable attitude is an indication of high morale, while an unfavourable attitude indicates low morale.

Morale is an important factor which contributes to the willingness of people to work, leads to their happiness and determines their productivity. It is regarded as a significant variable which determines the success of an organisation. With high morale, people work willingly and enthusiastically for the achievement of organisational goals. Further, high morale leads people to attach greater importance to group goals as compared with their personal goals. It also reduces absenteeism and labour turnover. On the other hand, low morale leads to inefficiency, waste, low productivity, unrest and indiscipline among employees.

18.9.2 Factors Determining Morale

Morale reflects a state of mind or attitude of people which result from the conditions under which they work in an organisation. The more important factors that influence morale are the following:

1) **Objectives of the organisation:** if the organisational goals are considered by the employees to be useful and important, morale generally tends to be high.

2) **Leadership:** The effectiveness of a leader in providing satisfactory work environment is another important factor in moral building. If leadership enables the subordinates to achieve their goals and aspirations, there is a positive impact on morale.

3) **Group members:** High morale also results from the nature and behaviour of co-workers in the group. If members of the work group are cooperative and there is mutual faith and understanding among them, morale is likely to be high.

4) **Job satisfaction:** The jobs assigned to employees are performed well if they derive personal satisfaction from the work they do are proud of it,. Satisfying jobs contribute towards high morale particularly when the employees thereby have opportunity of self development.

5) **Structure of organisation:** The organisation structure defines the lines of superior-subordinate relations. If the authority and responsibility are clearly defined and there is free and frank communication between the superior and the subordinates, the situation is highly conductive to morale building.

6) **Compensation:** Satisfactory levels of wages and salaries as well as a system of rewards and incentives for higher efficiency are basic requirements for employee satisfaction. Thus, the morale tends to be high when fair compensation and rewards are assured.

7) **Advancement and promotional opportunity:** An organisation in which capable employee has opportunities of advancement in their career through promotion is highly preferred by ambitious people. The scope of promotion to position of higher responsibility and remuneration is a positive factor that determines the morale of employees.

8) **Living conditions and health:** The living conditions of employees which contribute to the physical and mental health also affect morale indirectly. People who live under satisfactory conditions naturally have a better attitude in relation to their work.

9) **Working environment:** Conditions in the work place have of course a direct impact on morale. Provision for safety, health care, and welfare of employees help a great deal in building up their morale.

18.9.3 Leadership and Morale

There are different reasons which may explain the correlation between managerial leadership and morale of subordinates. Good leadership inspires confidence in the subordinates not only to work efficiently but to derive adequate satisfaction from their work. Morale is generally high where the leader recognises the needs and aspirations of employees and identifies himself with the work group. Democratic leadership style wins over the loyalty of subordinates due to their involvement and participation in decision-making. The leader-manager who is concerned about the well being and advancement of careers of subordinates, supports them when they need his support, and represents their interests to higher-level managers, may build up the morale of subordinates more significantly. Provision of a system of fair compensation and incentive scheme by the leader also contributes a great deal to employee satisfaction leading to high morale

Check Your Progress C

1) Which of the following statements are True and which are False.

   i) Morale is an attitude of mind which is reflected in willingness to work enthusiastically.

   ii) Living conditions of employees do not have any effect on their morale.

   iii) Manager leaders who are autocratic in their behaviour are able to build high morale.

iv) People with low morale are misfits in their work-group.

v) Leadership and morale are positively correlated.

2) Fill in the blanks:

i) Good health has a ……………….. effect on morale.

ii) Morale is …………….. when workers have a favourable attitude to their work.

iii) Working conditions affect morale ………………………

iv) Managerial leadership and morale are …………….. correlated.

v) Morale tends to be high if there is a system of ………… compensation.

18.10 LET US SUM UP

Leadership is a process of influencing group activities towards the achievement of certain goals. It is a continuous process whereby the manager influences, guides and directs the behaviour of subordinates to secure willing cooperation of the group. Combination of the managerial and leadership roles in the manager leads to not only effective task performance but also human satisfaction all round.

The trait theory of leadership suggests that the success of a leader depends mainly on his personality traits or characteristics. Whereas the behavioural theories of leadership are based on the belief that leaders can be identified by reference to their behaviour in relation to the followers.

In the situational theories of leadership the success of leadership is said to depend upon the situation in which the leader operates. The situational factors which influence leader's effectiveness include **leader-follower relations, the task structure** and the **position power of the leader.**

The dominant behaviour pattern of a leader-manager in relation to his subordinates is known as leadership style. There are three basic styles of leadership:

(1) Autocratic, (2) Laissez faire and (3) Democratic style.

An autocratic leader centralises power and decision-making in himself and exercises complete control over the subordinates. Hence it results in low morale, and decline of productivity in the long run.

In democratic style of leadership decisions are taken by the leader in consultation with members of the group and with their participation in the decision-making process. It helps subordinates to develop their potential abilities, provides job satisfaction and improves morale, in laissez faire style, subordinates are left to take the decisions and perform their work as they like. Hence there may be chaos and mismanagement under this leadership style.

The functions of a leader manager include: developing teamwork, representing the group and acting as a link with top management, advising and counselling subordinates, managing the time schedule of work performance, using power properly, and securing effectiveness of group effort.

Effective leadership makes a positive impact on the motivation of the members of the work group. The manager-leader may be effective or ineffective depending upon the leadership style adopted by him. The concept of managerial grid helps mangers to identify their own leadership style in terms of the degrees of concern for people and concern for work combined in the style.

More effective styles are said to be the following which reflect the manager's orientation: Executive, developer, Benevolent autocrat, and Bureaucrat, Less effective styles are those which are not appropriate to the situation e.g., Compromiser, Missionary, Autocrat, and Deserter.

An effective leader must possess certain qualities like physical and mental health, empathy, self-confidence, awareness of his strength and weaknesses, objectivity, knowledge and intelligence, decisiveness, ability to communicate, etc.

Morale is the state of mind or attitude of an individual or group towards the work and work environment. It is an important factor which contributes to the willingness of the people to work, leads to their happiness and determines their productivity. A favourable attitude is an indication of high morale, while an unfavourable attitude indicates low morale. High morale makes for the success of an organisation as people work willingly and enthusiastically for the achievement of organisational goals. Factors that influence the morale of employees are: Objectives of the organisation, leadership, behaviour of co-workers, job satisfaction, structure of the organisation, compensation, opportunity of career advancement, living conditions health, and working environment. There is a positive correlation between managerial leadership and morale of subordinates.

18.11 KEY WORDS

Leader: A person who is capable of influencing the group in its activities.

Leadership: The process of influencing group activities towards the achievement of certain goals.

Leadership Style: The dominant behaviour pattern of a leader-manager in relation to his subordinates.

Managerial Grid: Diagramatic representation of the possible combination of concern for people and concern for work which may be reflected in the style of leadership.

Morale: The state of mind or attitude of people towards their work and work environment.

18.12 ANSWERS TO CHECK YOUR PROGRESS

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

2) (i) directs and guides (ii) continuous, (iii) group opinion
(iv) subordinates (v) task oriented

B) 1) (i) team (ii) counsellor (iii) individual, organisational
(iv) leadership style (v) team

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

3) (i) and (d), (ii) and (c); (iii) and(a); (iv) and (b)

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

2) (I) Positive (ii) high (iii) directly (iv) positively (v) fair.

18.12 QUESTIONS FOR PRACTICE

1) What do you understand by leadership? How does it differ from managership?

2) Enumerate the principal characteristics of managerial leadership.

3) Define 'leadership style'. What are the main differences between autocratic, democratic and free rein leadership styles?

4) What are the two types of leader behaviour identified in research studies in the State of Michigan and Ohio in U.S.A? Explain briefly.

5) Explain in detail the concept of 'managerial grid' and its purpose.

6) Write explanatory notes on:

   a) Effective and Ineffective styles of leadership

   b) Functions of leadership

   c) Qualities of an effective leader

   d) Trait theory of leadership.

7) What is meant by morale? Outline the factors that influence the morale of employees in an organisation. What is the significance of leadership vis a vis morale?

> **Note:** These questions will help you to understand the Unit better. Try to write answers for them. But do not submit your answers to the university. They are for your practice only.