V Skills
Skills for a secure future

Certified Corporate Finance Analyst
Sample Material

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V-Skills
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1. GENERATIONAL FORMS OF BUSINESS

We shall recollect and look at certain basic things that you might have learnt earlier. This we shall do to be clear about the context in which we will be dealing with the subject 'Corporate Finance'. Business is the activity with the object of earning an income through profit. As you know, business activities can be production and sale of goods & services or purchase & sale of goods & services. Now you can group these activities into: Commerce, Industry and Service.

- ✓ Commerce involves the activities in the movement of goods and services from the producer to the consumer. It includes procurement, grading, storing, transporting commodities through the wholesalers, retailers etc.

- ✓ Industrial activities involve manufacture or some definite treatment of materials from which marketable commodities can be manufactured.

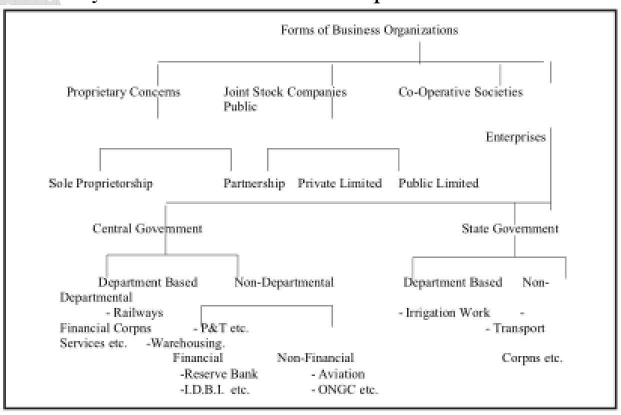
- ✓ 'Services' involve intangibles. It can be professional services like in case of doctors, lawyers etc. or it can be other services like transport etc.

1.1. Forms of Business Organization

Having understood the overall view of business activities, you need to relate these activities with how people organize these activities. It will lead to a better understanding if you relate the circumstances in your family business or with the other real life situations where you may be having at least minimum interactions.

A business unit may start as a sole proprietorship (one man ownership) and gradually expand into partnership firm and then into private limited company and into a big public limited company and finally into a giant business house having a number of subsidiary companies. A particular form of business adopted by a business unit at a particular point of time depends upon the various factors like tax advantages, capital requirements, owners' preferences etc.

You may try to visualize each organizational form of business & relate to the business unit known to you, as I explain them one by one. First the overall picture:



1.2. Proprietary Concerns

You might have heard people talking about business of a person or a person being a partner in a business. When a business owned by a person or co-owned by few persons we may call it as Proprietary concerns. Full ownership & control of the business under this category remains with one or few individuals. The business or firm's name does not have any legal status or existence.

Sole Proprietorship

This form of business is fully owned by one person and this single person runs the show, may be with the help of family members or relatives or may be employing one or more persons to assist.

Any person who is competent to enter into contract can start a sole proprietary concern. As per law a person, who has attained the age of majority, of sound mind and who is not disqualified (for a period) by insolvency law or any other law, can enter into a contract.

The sole proprietor is entitled for all the profits and shall also bear all the risks and losses.

Advantages

- ✓ Easy formation with formal license only
- ✓ Freedom available to the sole proprietor to take action enables quick decisions and prompts action. There is no need to consult anyone.
- ✓ Personal contacts with customers & employees
- ✓ Business secrecy can be maintained and hereditary business is enabled
- ✓ There is direct relationship between the economical & efficient effort and rewards. Hence costs are also controlled effectively.
- ✓ Since the business is conducted alone or with a tight family structure, there is no necessity for formal organizational structure and hence absolute flexibility is there.
- ✓ Business Tax procedures are relatively simple with all income from business getting reported in the owner's individual tax return. The owner can take maximum benefits of tax concessions given for individuals

Disadvantages

- ✓ The capital structure (capital and borrowings) of the business is limited to personal wealth and credit standing of the proprietor
- ✓ Limited managerial and technical skills
- ✓ The owner is responsible for all the debts and the liability is unlimited dipping into personal assets like house property, vehicles, furniture, appliances etc
- ✓ Since the business is dependent upon the health & wealth and life of the owner, there is no continuity
- ✓ This form of business is suitable where personal skills & contacts are important.

Partnership

A Partnership is an association of two or more persons (maximum of 10 in case of banking and 20 in case of other businesses) for carrying out a business as co-owners for a profit. In India, Partnerships are governed by the provisions of The Indian Partnership Act, 1932 which defines partnership as "the relation between two or more persons who have agreed to share profits of a business, carried on by all or any of them acting for all." The term business includes all trades, occupation and professions.

The owners of a partnership business are individually called partners and collectively called as firm. The name of the business is called 'firm name' which has no legal status though it might accumulate reputation or build image resulting in goodwill.

Usually a partnership is formed to combine capital, labour and varied specialized skills and abilities through an agreement or deed called partnership agreement or deed which might set out various terms including sharing of profit.

Partners can be sued individually and jointly in respect of the business and the liability is unlimited. So each partner is a principal for the outside world and each partner is an agent to other partners.

Advantages

- ✓ Communication across the network is cheap and fast.
- ✓ Increased Capital Raising Power and Managerial & Technical expertise compared to sole proprietorship.
- ✓ Easy formation compared to joint stock companies & easy dissolution as agreed by all the partners or 14 days notice to other partners in case of partnership at will.
- ✓ Business Secrecy can be maintained since there is no requirement by law for publication of final accounts

Disadvantages

- ✓ Partnership has a less capital raising power and Managerial or Technical expertise as compared to joint stock companies.
- ✓ Unlimited liability renders the partnership unsuitable to take up large scale operations.
- ✓ Absence of separate legal status for the business and continuity
- ✓ The partnership is not transferable unless all the partners agree for the same

In Europe and America, there is a system of Limited Partner-ship wherein two types of partners – General and Limited / Special Partners - will be there. The liability of the Limited / Special Partners are limited to the extent of their investment only whereas the liability of General partners is unlimited whose personal assets are also liable for the actions of the business.

1.3. Joint Stock Companies

If you are wondering how to have limited liability, let me tell you that the answer is Joint Stock Companies.

A company is an artificial person (an association of minimum 7 natural persons) created by incorporation under law, having common seal and perpetual succession. Once it is created by law, a company gets separate identity and it can enter into legal contracts under its common seal. An incorporated company enjoys perpetual (continuous) life until the law itself winds up the company in accordance with law.

The capital is raised in the form of shares and called share capital. Share means a portion of capital raised by issue of shares. The liability is limited to the amount invested in shares. The shares are generally transferable except under certain circumstances when the transfer may be restricted. In view of limited liability and transferability of shares, large number of persons may come forward to invest, enabling rising of enormous capital. Since a company is an artificial person, operating powers get vested with the elected board of directors and gets delegated mainly to the managing director and the company secretary. In this way most of the shareholders are kept away from the day-to-day operations of the organization. Ultimately, functional experts are employed to manage and carry out the activities. This results in experts doing the respective job and performance gets enhanced.

Advantages

- ✓ Huge capital mobilization
- ✓ Facility of Transfer of ownership through transfer of shares
- ✓ Wide distribution of risk of loss with large membership and limited liability
- ✓ Comparatively lower tax liability

Disadvantages

- ✓ Excessive legal requirements at all stages from the time of formation.
- ✓ In practice fraudulent management and concentration of economic power & wealth are found
- ✓ Slow Decision making
- ✓ Double Taxation – once on the profit of the company and another in the hands of the share holder

If you further want to know how to have limited liability and still have advantages of partnership firm, the answer is in the form of Private Limited Companies.

Private Limited Companies

A private limited company like partnership should have minimum of 2 members and ceiling of 50 members is there unlike no ceiling in public limited company.

In case of private limited companies, there is no public issue of shares and the transfer of shares is restricted. The name of the company will include the words 'private limited'.

This form of business organization enjoys the benefits of lower corporate tax, limited liability and continuity.

1.4. Market Value and Stock Prices versus Book Value

Share capital of a joint stock corporation is raised by issue of shares which have a face value. Section 2 (46) of Indian Companies Act, 1956, defines share as "share in the share capital of the companies and includes stock, except when a distinction between stock and share is expressed or implied."

When shares have been fully paid-up they may, if so authorized by the articles, be turned into stock by the company in general meeting (Section 94 (i) C). Stock is merely a name for the aggregate ownership. This is the most convenient method of representing ownership and makes the transfer of ownership easier.

The price at which a share is bought and sold in the stock market is called the Market Price which may be higher or lower than the face value of the share. Whereas Book Value of share is the value arrived at by dividing the Owners' Equity (Share Capital + Reserves & Surplus) by Number of shares.

1.5. Co- Operative Organizations

You are aware of the importance of co-operation and team spirit in every sphere of life. One form of business organization which truly practices co-operative efforts is Co-operative organizations.

The Co-operative organizations are formed on the basis of equality for the promotion and furtherance of common economic interest.

The International Labour Organization had defined a Co-operative organization as "an association of persons who have voluntarily jointed together to achieve a common economic end through the formation of a democratically controlled organization, making equal contributions to the capital required and accepting a fair share of risks and benefits of the undertaking".

Service, Co-operative joint action and Self-help are the essence of a co-operative organization. Co-operative Societies must have at least ten members and must be registered under Co-operative Societies Act'. Examples of Co-operative
Organizations are Credit Co-operative societies, Consumers' Co-operative organizations, Producers' Co-operative organizations

Advantages

- ✓ This is a democratic and secular form of business organization. Poor and Persons of limited means can improve their economic conditions
- ✓ Co-operative organizations remove the evils of monopoly and concentration of wealth and power
- ✓ The liability can be limited and separate legal status may be enjoyed.
- ✓ Privileges and exemptions in the form of tax concessions, lower stamp duty etc., are accorded to this form of business organizations.

Disadvantages

- ✓ Co-operative organizations can not raise capital for large scale operations

- ✓ Since the very basis is democratic way of managing, business secrecy can not be maintained.

1.6. Public Enterprises

Public enterprises aim at public service in the public utility areas. They are expected to stabilize the supplies of essentials. The strategic and basic industries are taken care by Government only. Public sectors are there in the industrial line to have rapid and balanced economic development.

I am sure that you would be able to imagine the evils, if only non-governmental organizations, whose aim is only profit maximization, are there.

Public Enterprises are managed in the following ways:

- ✓ Government Department
- ✓ Public Corporation
- ✓ Government owned Joint Stock Company
- ✓ Mixed-ownership Corporations

Government Department – A separate department in the government manages this form of organization which normally caters to the public utility. Examples of this type of organizations are Post and Telegraph, Broadcasting, Railways and Defense industries etc. The minister in-charge of the particular department controls the enterprise. This form is adopted where secrecy and strict control are needed in the areas like defense and strategic industries.

Public Corporation – A public corporation is an artificial legal person created by a special Act which sets out the powers and functions. Public Corporations have financial independence and clear jurisdiction over a specific area, industry or commercial activity. A chosen Governing board manages the affairs of the organization. It enjoys the internal autonomy with no interference from government. Not only its formation is elaborate, any amendment also to be done by amending the Special Act and hence rigid. Public corporations are presently found in insurance, finance, industry, mining, transport, trade etc.

Government owned Joint Stock Company – The entire capital or 51 per cent or more of the share capital is owned by the Central and/or State Government. The concerned ministry performs the functions of shareholders and exercises control over the operations of the company. All or majority of the directors are nominated by the Government. One or few shares are in the name of the officials to take care of legal needs. This form of organization is more autonomous than Public Corporation

Mixed ownership corporations – This is a form of partnership between public sector and private sector enterprises. These are in the form of Joint Sector / Venture. It is a partnership among domestic partner, government and public. Additionally there may be one more player in the form of foreign collaboration. This enables to bring together capital, technology and skill from abroad, private sector and government. Hindustan Machine Tools is an example of Joint Sector.

Let us now compare various forms of organizations in respect of aspects of our interest:

1.7. Comparison among Different Forms of Organisations

Proprietory Concerns	Joint Stock Companies	Co-Operative Societies	Public Undertakings
Role of Capital			
Limited to personal capacity	Vast	Secondary Role	No equity interest of shareholders
Ownership & Control			
Proprietor or Partners	Shareholders	Members / Shareholders	Government
Transfer of Ownership			
Consent of all owners required	Shares are freely transferable in case of Public Ltd. Co.; restricted in case of Pvt. Ltd. Companies	Membership can be withdrawn	Transferable in case of joint stock company form
Management			
Limited managerial ability	Expert Management; ownership separated from management	Democratic management with the rule `one member one vote'	By Government or Governing body