HARINI COACHING CENTRE

KOTAGIRI

PG TRB COMMERCE

STUDY MATERIAL

UNIT I AND II

Marketing Management

Unit I: Marketing - Fundamental Concepts and Approaches - Marketing Mix - Segmentation - Buyer behavior - Four P’s - Role of Middlemen - Arguments FOR and AGAINST - Pricing Policies and strategies.

Unit II: Advertising - Media - Copy - Effectiveness - Consumer rights and protection - Recent Trends in Advertising.

INTRODUCTION

The development of marketing is evolutionary rather than revolutionary. There is no single answer to the question of what is marketing. “Marketing is what a marketer does”. The evolution of marketing is as old as the Himalayas. It is one of the oldest professions of the world. The traditional objective of marketing had been to make the goods available at places where they are needed. This idea was later on changed by shifting the emphasis from “exchange” to “satisfaction of human wants”.

EVOLUTION OF MARKETING

1. BARTER SYSTEM: The goods are exchanged against goods, without any other medium of exchange, like money.

2. PRODUCTION ORIENTATION: This was a stage where producers, instead of being concerned with the consumer preference, concentrated on the mass production of goods for the purpose of profit. They cared very little about the customers.

3. SALES ORIENTATION: The stage witnessed major changes in all the spheres of economic life. The selling activity becomes the dominant factor, without any efforts for the satisfaction of the consumer needs.

4. MARKETING ORIENTATION: Customers’ importance was realized but only as a means of disposing of goods produced. Competition became more stiff. Aggressive advertising, personal selling, large scale sales promotion etc. are used as tools to boost sales.

5. CONSUMER ORIENTATION: Under this stage only such products are brought forward to the market which are capable of satisfying the tastes, preferences and expectations of the consumers – consumer satisfaction.

6. MANAGEMENT ORIENTATION: The marketing function assumes a managerial role to coordinate all interacting business activities with the objective of planning, promoting and distributing want-satisfying products and services to the present and potential customers.

MEANING OF MARKET

The word “Market” is derived from the Latin word “Marcatus” meaning merchandise, wares, traffic, trade or a place where business is conducted. The common usage of market means a place where goods are bought or sold. In its strict meaning market
need not necessarily mean a place of exchange. The following are the various definitions given by various authorities.

1. “Market includes both place and region in which buyers and sellers are in free competition with one another.” – *Pyle*

2. “The term market refers not to a place, but to a commodity or commodities and buyers and sellers who are in direct competition with one another.” - *Chapman*

**NEED FOR MARKETS**

1. For exchange (barter) of goods and services.
2. For adjustment of demand and supply by price mechanism.
3. For improvement of the quality of life of the society.
4. For introduction of new modes of life.
5. For higher production (development of markets encourage production).

**CLASSIFICATION OF MARKETS**

**I. ON THE BASIS OF GEOGRAPHICAL AREA**

1. **FAMILY MARKET:** When exchanges are confined within a family, or close members of the family, such a market can be called as family market.

2. **LOCAL MARKET:** When people, buyers and sellers, belong to a local area or areas, say a town or village, participate in market, it is called local market. The demands are limited. For example, perishable goods like fruits, fish, vegetables etc. But strictly speaking such markets are disappearing because of the efficient system of transportations and communications. Even then, in many villages such markets exist even today.

3. **NATIONAL MARKET:** For a certain type of commodities, a country may be regarded as a market, through the fast development of industrialization; it is called a national market. At the present stage, in India, the goods of one corner can reach another corner, because of the efficient systems of communications and transportation facilities. In the present decade almost all the products have national markets as the markets have widened to a great extent.

4. **WORLD MARKET:** World or international market comes up when buyers and sellers of goods evolve on world level i.e., involvement of buyers and sellers beyond the boundaries of a nation.

**II. ON THE BASIS OF COMMODITIES / GOODS**

**COMMODITY MARKET:** Produced goods or consumption goods are bought and sold. Commodity markets are sub-divided into:
1. PRODUCE EXCHANGE MARKET: This type of market is found only in developed industrial centres or cities. *One market deals in one commodity only.* Generally sellers and buyers of a particular commodity, set up such markets and run them regulated and controlled by certain rules. e.g., Wheat Exchange Market of Hapur, the Cotton Exchange Market of Bombay etc.

2. MANUFACTURED GOODS MARKET: Such type of market deals with manufacture goods e.g., Leather goods, machinery etc. The Leather Exchange Market at Kanpur, Piece Goods Exchange of Bombay are examples of such markets.

3. BULLION MARKET: This type of market deals with the purchase or sale of gold, silver etc. Bullion markets of Bombay, Calcutta, Kanpur etc., are examples of such markets.

**CAPITAL MARKET**

New or going concerns need finance at every stage. As such financial needs of concerns are met by capital markets. They are of three types.

1. MONEY MARKET: It is a type of market where money is borrowed or lent. This type of market helps or guides the public to invest their surplus fund in industrial concerns and helps people to take loans through banks. London is the world biggest money market.

2. FOREIGN EXCHANGE MARKET: It is an international market. This type of market helps the exporters and importers, in converting their currencies into foreign currencies and vice versa.

3. THE STOCK EXCHANGE MARKET: This is a market where shares, debentures, bonds etc., of companies are dealt with purchased or sold. It is also known as Security Market. Stock Exchanges of Mumbai, Calcutta, Madras etc., are examples for this type of market.

**III. ON THE BASIS OF ECONOMICS**

1. PERFECT MARKET: A market is said to be a perfect market, if it satisfies the following conditions:
   
   (i) Large number of buyers and seller are there.
   
   (ii) Prices should be uniform throughout the market.
   
   (iii) Buyers and sellers have a perfect knowledge of market.
   
   (iv) Goods can be moved from one place to another without restrictions.

   It should be remembered that such types of markets are rarely found.

2. IMPERFECT MARKET: A market is said to be imperfect when
   
   (i) Products are similar but not identical.
(ii) Prices are not uniform.
(iii) There is lack of communications.
(iv) There are restrictions on the movement of goods.

III. ON THE BASIS OF TRANSACTION

1. SPOT MARKET: In such a market goods are exchanged and the physical delivery of goods takes place immediately.

2. FUTURE MARKET: In such a market contracts are made over the price for future delivery. The dealing and settlement take place on different dates.

IV. ON THE BASIS OF REGULATION

1. REGULATED MARKET: These are types of markets which are organized, controlled and regulated by statutory measures. Example: Stock Exchanges of Mumbai, Chennai, Kolkata etc.

2. UNREGULATED MARKET: This is a free market. There is no control with regard to price, quality, commission etc. Demand and supply determine the price of goods.

V. ON THE BASIS OF TIME

1. VERY SHORT PERIOD MARKET: Markets which deal in perishable goods like, fruits, milk, vegetables etc. are for a very short period. There is no change in the supply of goods. Price is determined on the basis of demand.

2. SHORT PERIOD MARKET: In certain goods, supply is adjusted to meet the demand. The demand is greater than supply. Such markets are known as Short Period Market.

3. LONG PERIOD MARKET: This type of market deals in durable goods.

V. ON THE BASIS OF VOLUME OF BUSINESS

1. WHOLESALE MARKET: In wholesale market goods are supplied in bulk quantity to dealers.

2. RETAIL MARKET: In retail market goods are sold in small quantities directly to the users or consumers-consumer market. The consumer gets the goods for consumption and not for profit making.

VI. ON THE BASIS OF IMPORTANCE

1. PRIMARY MARKET: The Primary producers of farm produce sell their output or products through this type of markets to wholesalers or consumers. Such markets can be found in villages and mostly the products arrive from villages.

2. SECONDARY MARKET: The commodities arrive from other markets. The dealings are commonly between wholesalers or between wholesalers and retailers.
3. **TERMINAL MARKET:** The ultimate consumer gets the goods from such markets. Here the final disposal of goods takes place.

**KINDS OF GOODS**

Goods may also be called as product. They are tangible. They are

**A. CONSUMER’S GOODS**

_This type of goods are purchased by ultimate users or consumers for their personal use._ For example, food, biscuits, toys, clothes etc. are purchased by consumers to satisfy their non-business wants. These goods may be further classified as:

(I) **CONVENIENCE GOODS:** Consumers or purchasers get commodities such as bread, drug, perfumery, soap, sugar, tooth paste, newspapers, petrol, cold drinks, stationery items etc., at minimum effort and at low cost. They are often required by the consumers. These types of goods are available at places, where consumers need. The purchase of such goods cannot be postponed because they are daily necessities of life.

(II) **SHOPPING GOODS:** Before making final selection, the consumers make an enquiry as to the products’ comparative prices, durability, style etc., from different shops. Goods like jewelry, furniture, ready-made garments etc., are more costly than convenience goods. _Their need is also less when compared to the convenience goods._ Shopping goods are generally available from particular shops where similar but same type of goods are sold.

(III) **SPECIALY GOODS:** Certain products possess special attraction to the consumers. As such the consumer may wait or suffer inconveniences to get the desired goods. _This type of goods are of high value and manufactured by reputed firms._ For example, cars, refrigerators, fancy goods televisions, fans, scooters, photographic equipments, high grade shoes, stereo equipment, electrical appliances etc.

**B. INDUSTRIAL GOODS**

_Goods which are used for production or used in producing other products are industrial goods._ This type of goods are generally sold to manufacturers who in turn use them to make their own products. _The difference between the consumer products and industrial goods is based on their ultimate use._ If a product is brought by ultimate consumer, it is consumer goods. If a product is bought and used form making other products, it is an industrial product. The industrial goods can be further classified as:-

(I) **RAW MATERIALS:** Raw materials are the basic materials entering physically into the final products. For example, building stones, raw jute etc.

(II) **FABRICATED MATERIALS:** Materials of this category will enter physically into the final products, but some type of processing is already undergone. For example,
bricks, copper sheets, leather, yarn etc. As the processing is incomplete, further processing is required.

(III) COMPONENT PARTS: Such type of parts are already undergone some processing and more or less the parts can be called as final products. That is, the assembly of several component parts, makes the final products. The components are visible in the final products, such as batteries, tyres, speedometer, spark plugs, spare parts etc.

(IV) INSTALLATION: Machines, buildings, equipments etc., do not enter into final products and are durable for a long period. They are essential for production. For example, gas, power installation etc. They need heavy expenses for installation and sometimes decide the nature, scope and efficiency of an organization.

(V) ACCESSORIES: They are light machines or tools which are used for the operation of a business. This is not used for manufacturing a product. For example, hand-tools, cash-register in retail shop, type-writers, calculators, accounting machines etc.

SERVICES

Services are intangible activities which are offered for sale as such or in connection with sale of goods. For example, consultation, banking etc. Services may be two types.
(i) Personal: It comprises of education, communication, medical legal services etc.,
(ii) Business services: It comprises of advising, mercantile credits, collection agencies etc.

MARKETING MIX

Marketing mix is the policy adopted by the manufacture to get success in the field of marketing. Those days, when goods were matched with the market, have gone. The modern market concept emphasizes the importance of the consumer’s preference. All the marketing effort focuses attention around the consumer’s need. Marketing departments perform the operations and the market offering mix is the result.

According to Borden, “The marketing mix refers to the appointment of efforts, the combination, the designing and the integration of the elements of marketing into a programme or mix which on the basis of an appraisal of the market forces will best achieve an enterprise at a given time.”

According to Stanton, “Marketing mix is the term used to describe the combination of the four inputs which constitute the core of a company’s marketing system- the product, the price structure, the promotional activities and the distribution system.”
The term marketing mix is used to describe a combination of four elements - the product, price, physical distribution and promotion. These are popularly known as “Four Ps.”

1. PRODUCT: The product itself is the first element. Products must satisfy consumer needs. The management must, first decide the products to be produced, by knowing the needs of the consumers. The product mix combines the physical product, product services, brand and packages. The marketing authority has to decide the quality, type of goods or services which are offered for sale. A firm may offer a single product (manufacture) or several products (seller). Not only the production of right goods but also their shape, design, style, brand, package etc., are of importance. The marketing authority has to take a number of decisions as to product additions, product deletions, product modification, on the basis of marketing information.

2. PRICE: The second element to effect the volume of sales is the price. The marked or announced amount of money asked from a buyer is known as basic price-value placed on a product. Basic price alterations may be made by the manufacturer in order to attract the buyers. This may be in the form of discount, allowances etc. Apart from this, the terms of credit, liberal dealings will also boost sales.

3. PROMOTION: The product may be made known to the consumers. Firms must undertake promotion work-advertising, publicity, personal selling etc., which are the major activities. And thus the public may be informed of the products and be persuaded by the customers. Promotion is the persuasive communication about the products, by the manufacture to the public.

4. DISTRIBUTION (PLACE): Physical distribution is the delivery of products at the right time and at the right place. The distribution mix is the combination of decisions to marketing channels, storage facility, inventory control, location transportation warehousing etc.,

MARKET SEGMENTATION

Diversity is the basic characteristic of a market. The markets exhibit widely heterogeneous characteristics with widely differing and scattered consumer. The process of dividing a market into smaller homogeneous markets with similar characteristics is called market segmentation. The firm will focus only on those submarkets which can be served most effectively the basis of their evaluation of market requirements. This is called target marketing.
According to Philip Kotler, “Market segmentation is the sub-dividing of market into homogeneous sub-section of customers, where any sub-section may conceivably be selected as a market target to be reached with a distinct marketing mix.”

A market segment is a portion of a larger market in which the individuals, groups or organizations share one or more characteristics that cause them to have relatively similar product needs; whereas market segmentation is the process of dividing the total market into relatives distinct-homogeneous sub-groups of consumers with similar needs or characteristics that them to respond in similar ways to a particular marketing programme.

Market segmentation and the identification of target markets are an important element of each marketing strategy.

CRITERIA FOR MARKET SEGMENTATION

The market segmentation to be worthwhile six criteria, as shown below, must be satisfied.

1. **IDENTITY:** The marketing manager must have some means of identifying members of the segment, that is, some basis for classifying an individual as being or not being a member of the segment. There must be clear differences between segments. Members of such segments can be candidly identified by common characteristics which display similar behaviour.

2. **ACCESSIBILITY:** It must be possible to reach the different segments in regard to both promotion and distribution. In other words, organization must be able to focus its marketing efforts on the chosen segment. Segments must be accessible in two senses. First, firms must be able to make them aware of products or services. Secondly, they must get these products to them through needs to be refined.

3. **RESPONSIVENESS:** A clearly defined segment must react to changes in any of the elements of the marketing mix. For instance, if a particular segment is defined as being cost conscious, it should react negatively to price rises. It is does not, this is an indication that the segment needs to be refined.

4. **SIZE:** The segment must be reasonably large enough to be a profitable target. It depends upon the number of people in it and their purchasing power. The idea is that enough potential buyers must exist to cover the costs of production and marketing required in that segment. This is often called as substantiality.

5. **NATURE OF DEMAND:** It refers to the different quantities demanded by various segments. Segments Segmentation is required only if there are marked differentiation in items of demand.
6. MEASURABILITY: The purpose of segmentation is to measure the changing behaviour pattern of consumers. For example, the segment of a market for a car are determined by a number of considerations, such as economy, status, quality, safety, comforts etc.

BASES FOR CONSUMER MARKET SEGMENTATION

1. GEOGRAPHIC SEGMENTATION

In geographic segmentation, the whole market is divided into different geographical units. Generally, the market is divided into regions – northern, southern, western, eastern and so on. Each region consist states and districts. A national marketer may treat the whole nation as his market and divide it on the basis of region or zone for business operations. Moreover, a multinational company (MNC) may divide the global market on the basis of continental characteristics. For example, Coca-Cola may consider the entire Asia as its market but for further business operations, it may divide Asia into South Asia, Middle-east, Far-east Asia etc. Perhaps, each country may also be considered as a geographical segment.

2. DEMOGRAPHIC SEGMENTATION

In demographic segmentation, the market is subdivided into different parts on the basis of demographic variables – age, sex, family size, income, occupation, family life cycle, religion, nationality etc. Demographic variables have long been the most popular bases for distinguishing significant groupings in the market place. One reason is that consumer wants or usage rates are often highly associated with demographic variables; another is that demographic variables are easier to measure than most other types of variables.

3. PSYCHOGRAPHIC SEGMENTATION

Consumers are subdivided into different groups on the basis of personality, life style and values. These characteristics lead to psychographic segmentation. People exhibit different life-style and they express them through the products they use. Some social segments are very orthodox and tradition bound at home. But the same people look very modern and conspicuous when in the outside world. Marketers of cosmetics, textiles, soft-drinks, fast-food providers etc., must understand the lifestyle of the target market. Personality is another psychographic characteristic which is used to segment the market. Particularly, automobile manufactures-two wheelers and passenger cars- must consider different personality traits in dividing the market. Values are also used by marketers to segment a market. Value are beliefs which determine people’s product choices and desires.
4. SOCIO ECONOMIC CHARACTERISTICS

Income, occupation, education, religion and social classes are the important socio-economic data required for market segmentation. These are all components of socio-economic characteristics of a target population. Income and occupation characteristics are generally used in market segmentation for durable products such as automobiles, household appliances, electronic items, personal computer etc.,

5. BENEFIT SEGMENTATION

Buyers can be classified according to the benefits they seek. On a purchase of same product different customers look for different benefit because of which they buy products from different companies which satisfy their specific needs. Let us take the example of a car. The basic function of a car is transportation. But people prefer different cars because they seek different benefits.

(a) Quality: There are people for whom the quality is important; they buy Mercedes Benz Skoda Octavia
(b) Services: People buy things to avail some specific service; they buy Ambassador Bullet proof car.
(c) Economy: The price may be important deciding factor in case of any purchase; They buy Maruti 800.
(d) Speciality: People can be adventurous and sporty in purchase decision. They buy Ferari.

6. USER STATUS

The users of a product of service can be classified as heavy users, medium users and light users- heavy buyers, medium buyer and light buyers. Marketers of soft drinks, hot drinks etc. for example, many segment the market in terms of the above said criteria. A firm, generally, is interested in the heavy buyers or users. Sometimes, a firm may select light users as their target market with the intention of wooing and changing these customers into heavy users.

7. USAGE RATE

Markets can be segmented into various classes depending on usage rate. Considering the cosmetics usage, the different categories of usage rate are as follows.

(a) Light: These are the categories of the users who are very infrequent users. In case of cosmetics an average housewife who is not very fashion conscious is a light user of cosmetics.

(b) Medium: The fashion-conscious teenagers are the medium users of cosmetics, that is they use it frequently.
(c) **Heavy**: There are people for whom the cosmetics are the most important purchase and they are heavy users of it. Celebrities in entertainment world, the models etc. need cosmetics on a regular basis, as it is the most important part of their profession.

**8. LOYAL STATUS**

Consumers have varying degrees of loyalty to specific brands, stores and other entities. Buyers can be divided into four groups according to brand loyalty status.

(a) **Hard-core Loyals**: Consumers who buy one brand at all time.

(b) **Split or Safe Core Loyals**: Consumers who are loyals to two or three brands.

(c) **Shifting loyals**: Consumers who shift from one brand to another.

(d) **Switchers**: Consumers who show no loyalty to any brand. These are the people who will buy brand that is available in the market.

**9. ATTITUDE**

A market may be segmented by classifying people in it according to their enthusiasm for a product. Five attitude groups can be found in a market.

(a) **Enthusiastic**: These are people having tendency of impulsive purchase. They may not carry cash all the time but suddenly decide to buy something. They definitely need credit cards.

(b) **Positive**: They are serious but mobile people who need to buy suddenly at any time.

(c) **Indifferent**: There are some people who are technology averse with systematic purchasing pattern. They do not prove to be potential users of credit cards.

(d) **Negative**: People can be spend thrifty who fear of loosing money or misusing it. They would never go for a credit card.

(e) **Hostile**: People at times become very much irritated either by sales-people calling or meeting any time, giving false promise or by the service provided. For example, in case of credit cards, there are some hidden costs which are not clarified by the sales-person during selling.

**BENEFITS OF MARKET SEGMENTATION**

Benefits from segmentation are:

1. Segmentation helps in focusing strategies more sharply on target groups.
2. It helps the company to know demand pattern of each segment thus increases the sale volume of the products.
3. It helps the marketer to understand the needs, behaviors, habits, tastes and expectation of consumers of different segments. Thus marketing opportunities increases.
4. It is possible to satisfy a variety of customers with a limited product range by using different promotional activities.
5. Marketing can be more specialized when there is segmentation as the element of marketing mix.
6. Segmentation helps in adopting different policies, programmers and strategies for different markets based on rival’s policies, programmes and strategies.
7. New customers are attracted because of segmentation strategy and thus opportunities created for growth.
8. Customers are benefited as the products that serve customers interest and satisfy the needs and wants.
9. Segmentation supports the development of niche strategies.
10. It helps to achieve a better competitive position for existing brands.
11. Identify gaps in the market which represent new product opportunities.
12. It is possible to pay proper attention to a particular area.

THE PHILOSOPHIES OF MARKET SEGMENTATION

The marketer adopts several approaches to segmenting a market. The various approaches are as follows.

I. MASS MARKETING: Before the onset of the marketing age, there was widespread adoption of mass marketing, mass production, distribution and promotion. That is, offering the same product and applying the same marketing mix to all customers assuming that there is no significant difference among consumer in terms of their needs and wants. The company designs its marketing programmes to appeal to all buyers. This is undifferentiated marketing strategy. This type if marketing is well suited for fruits vegetables, drugs, chocolates, bakery items, stationery items etc.

II. PRODUCT VARIETY MARKETING: Once it is learnt that consumers would not accept standard products, the marketer might try to provide different sizes, colours, shapes, features, qualities, etc. to attract them.

III. TARGET MARKETING: The modern marketing concept starts with the definition or target markets. The target marketing has its root in the marketing age. The target marketing requires marketer to take three steps:

(a) Market Segmentation
4. MICRO MARKETING: The target marketing is being changed to micro marketing. Micro marketing occurs when target market is further bifurcated and the needs of the small customer groups are addressed on a local basis. Thus, even though target customer has been identified in the target marketing, some specific modern styles of features products are made available at selected places on local basis. It has four levels.

(a) Segment Marketing: A market segment consists of a large identifiable group within a market with similar wants, purchasing power, geographical location, buying attitudes or buying habits.

(b) Niche Marketing: A niche is a more narrowly defined group whose needs are not well served. It has the following characteristics:

(i) The customers in the niche should have distinct set of needs.
(ii) They will pay a premium to the firm that best satisfies their needs.
(iii) The niche is not likely to attract other competitors.
(iv) The niche gains certain economics through specialization.
(v) The niche has size, profit and growth potential.

(c) Local marketing: Target is leading to marketing programmes being tailored to the needs and wants of local customers.

(d) Individual Marketing: The ultimate level of segmentation leads to “one-to-marketing” or “customized marketing”. Mass customization is the ability to prepare on a mass basis individually designed products and communication to meet each customer’s requirements. The concept of service has broadened to include both breadth of product offerings and the ability to customize to meet specific needs.

5. CUSTOMISED MARKETING: The focus of the target marketing is further shifting from local basis to individual customer basis. With the advancement in manufacturing because of break through in information technology, for instance, use of computer-aided design and computer aided manufacturing; it has now become possible to manufacture a product as per the individual customer needs or of a buying organization. Tailors and drapers (cloth merchant), boutiques (ladies and children) beauty parlours etc. are customized products.

6. PERSONALISED MARKETING: Although in case of customized marketing, the requirements for a customer are met by a custom-made product, but still the customers might not be willing to retain his loyalty with the company because of competition. For instance,
one gets shirts made from a tailor as per personal fitting. Still, tailors find their customers shifting their loyalty to others. Heil, Parker and Stephens provide TEN RULES for building relationships with customers:

1. The average customer does not exist.
2. Make customer’s experience special. Give customer something to talk about.
3. If something goes wrong, fix it quickly.
5. Trust customer and customer will trust the company.
6. Customer’s time is as important as company’s.
7. Don’t take customer for granted.
8. The details are important to customer, as they should be to the company.
9. Employ people who are ready and willing to serve customer.
10. Customer cares to find out whether company is a responsible corporate citizen.

OBJECTIVE TYPE QUESTIONS

MARKETING MANAGEMENT

1. The three fold classification of consumer goods is developed by
   a) prof. M.T. Copeland  b) Stanton  c) peter F.Drucker  d) none of these

2. Which of the following goods have unique features?
   a) convenience goods  b) shopping goods  c) specialty foods  d) all of these

3. Market is an arena for potential exchanges who said?
   a) Williams Stanton  b) Philip kilter  c) clark and clark  d) Mitchell

4. Marketing is the creation and deliver of a standard of living to the society who said?
   a) William j. Stanton  b) Alderson  c) ducker  d) paul mazur

5. The eyes and ears of a business is
   a) marketing  b) management  c) production  d) economics

6. The king of the market is
   a) product  b) customer  c) agent  d) middleman

7. The heart of marketing is/are
   a) concentration  b) dispersion  c) equalization  d) all of these

8. All elements of business is geared towards customers satisfaction. the marketing concept related with this is
   a) production orientation  b) sales orientation  c) consumer orientation  d) none of these

9. The social marketing concept is otherwise called as
   a) human concept  b) ecological concept  c) both a) and b)  d) exchange concept
10. The primary function of a business is to create and maintain a satisfied customer who said?
   a) Peter F. Drucker  
   b) Stanton  
   c) Philip Kotler  
   d) Pyle

11. The process of building long-term trusting win-win relationship with customers, distributors, dealers and suppliers is relationship marketing who said?
   a) Peter Drucker  
   b) Philip Kotler  
   c) Pyle  
   d) None of these

12. A technique where a marketer plays a specialist role in a particular segment is called:
   a) Strategic marketing  
   b) Mass marketing  
   c) Niche marketing  
   d) Relationship marketing

13. Who among the following is related with environmental analysis?
   a) Pyle  
   b) Philip Kotler  
   c) Clark and Clark  
   d) Johnson and Scholes

14. Which of the following is an internal factor that affects marketing environment?
   a) Organizational policy  
   b) Demography  
   c) Technology  
   d) Demand

15. The diagram given below shows that a company is adopting
   a) Single segment concentration  
   b) Selective specialization  
   c) Product specialization  
   d) Full market coverage

16. The following diagram shows that a company is following
   a) Single segment concentration  
   b) Selective specialization  
   c) Market specialization  
   d) Full market coverage

17. The following diagram shows that a company is following
   a) Selective specialization  
   b) Market specialization  
   c) Product specialization  
   d) Single segment concentration

18. A marketer may follow
   a) Concentrated marketing strategy  
   b) Differentiated marketing strategy  
   c) Undifferentiated marketing  
   d) All of these

19. Under concentrated marketing strategy, the firm have
   a) Only one marketing mix  
   b) Only two marketing mix  
   c) More than two marketing mix  
   d) None of these

20. All the eggs in one basket is related to which of the marketing strategy?
   a) Undifferentiated marketing strategy  
   b) Differentiated marketing strategy  
   c) Concentrated marketing strategy  
   d) None of these

21. One marketing mix for several market segments is called as
   a) Undifferentiated marketing strategy  
   b) Differentiated marketing strategy  
   c) Concentrated marketing strategy  
   d) All of these

22. Different marketing mix for different market segments is called
   a) Undifferentiated marketing strategy  
   b) Differentiated marketing strategy  
   c) Concentrated marketing strategy  
   d) None of these
24. Which of the following is psychographic variable that affects demand for the product?
   a) personality  b) age and sex  c) family life cycle  d) culture

25. Which of the following is demographic variable that affects the demand for the product?
   a) personality  b) sex  c) lifestyle  d) perception

26. Who is regarded as a black box?
   a) managing director  b) board of director  c) customer  d) government

27. A person who suggests or thinks of the idea of buying the particular product is called as
   a) influencer  b) decider  c) initiator  d) buyer

28. The person who actually purchases is called as
   a) initiator  b) influencer  c) user  d) buyer

29. Sales forecasting can be made by
   a) sales force estimates  b) times series analysis  c) correlation analysis

30. The terms marketing nerve centre was used by
   a) Philip kilter  b) Stanton  c) peter f. ducker  d) Clark and Clark
Funds Flow Analysis

The technique of Funds Flow Analysis is widely used by the financial analysts, credit granting institutions and financial managers in performance of their jobs.

Meaning of funds flow statement

Meaning of funds

The term Funds has a variety of meanings. There are people who take it synonymous to cash and to them there is no difference between a Funds Flow Statement and a Cash Flow Statement. While other include marketable securities besides cash in the definition of the term funds. *The International Accounting Standard No. 7 on Statement of changes in Financial Position* also recognizes the absence of a single generally accepted definition of the term. According to the Standard, the term fund generally refers to *cash, to cash and cash equivalents or to working capital*. Of these, the last definition of the term is by far the most common definition of funds. *There are also two concepts of working capital*- gross concept and net concept. Gross working capital refers to *firms investment in current assets* while the term net working capital means *excess of current assets over current liabilities*. It is in the latter sense in which the term funds is generally used.

Current assets

*The term Current Assets* includes assets which are acquired with the intention of converting them into cash during the normal business operations of the company. However the best definition of the term *Current Assets has been given by Grady* in the following words:

“For accounting purpose the term Current Assets is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business”.

The Board categories of current Assets therefore are

(i) Cash including fixed deposits with banks,

(ii) Accounts receivable i.e trade debtors and bills receivable,

(iii) Inventory i.e stock of raw materials work in progress finished goods stores and spare parts,

(iv) Advances recoverable i.e the advances given to supplier of goods and services or deposit with government or other public authorities, customs port authorities advance income tax etc.,
(v) prepaid expenses cost of unexpired services e.g insurance premium paid in advance, etc.

It should be noted that short-term investments should be included in the definition of the term current assets, while loose tools should be excluded from the category of the current assets. Of course this is not strictly according to the requirements of the Companies Act regarding presentation of financial statement where investments even though held temporarily are to be shown separately from current assets while loose tools are to be shown under the category of current assets.

**Current Liabilities.**

The term Current liabilities is used principally to such obligations whose liquidation is reasonably expected to the use of assets classified as current assets in the same balance or the creation of other current liabilities or those respected to be satisfied within a relatively short period of time usually one year.

However this concept of current liabilities has now undergone a change. The more modern version designates current liabilities as *all obligations that will require within the coming year or the operating cycle.* Whichever is longer (i) the use of existing current assets or (ii) the creation of other current liabilities.

In other words, the mere fact that an amount is due within a year does not make it a current liability unless it is payable out of existing current liabilities. For example debentures due for redemption within a year of the balance sheet date will not be taken as a current liability if they are to be paid out of the proceeds of a fresh issue of shares/debentures or out of the proceeds realized on account of sale of debenture redemption fund investments.

The term current liabilities also includes amounts set a part or provided for any known liability of which the amount cannot be determined with substantial accuracy, e.g., provisions rather than liabilities.

The broad categories of current liabilities are:

(i) Accounts payable, e.g., bills payable and trade creditors.

(ii) Outstanding expenses, i.e., expenses for with services have been received by the business but for which the payment has not been made.

(iii) Bank overdrafts

(iv) Short-term loans, i.e., loans from banks, etc., which are payable within one year from the date of Balance Sheet.
(v) Advance payments received by the business for the services to be rendered or goods to be supplied in future.

(vi) Current maturities of long-term loans, i.e., long-term debts due within a year of the balance sheet date or instalments due within a year in respect of these loans, provided payable out of existing current assets or by creation of current liabilities. However, instalments of long-term loans due after a year should be taken as noncurrent liabilities.

**Provisions against current Assets:** Provisions against current assets, such as provision for doubtful debts, provision for loss of stock, provision for discount on debtors, etc., are treated as current liabilities, since they reduce the amount of current assets.

**Non-Current Assets:** *All assets other than current assets come within the category of non-current assets.* Such assets include goodwill, land, building, machinery, furniture, long-term investments, patent rights, trade marks debit balance of the profit and loss account, discount on issued of shares and debentures, preliminary expenses, etc.

**Non-current Liabilities:** *All liabilities other than current liabilities come within the category of non-current liabilities.* They include share capital long-term loans, debentures, share premium, credit balance in the Profit and Loss Account, revenue and capital reserves (e.g., general reserve, dividend equalization funds, debentures sinking fund, capital redemption reserve) etc.

**Meaning of Flow of Funds**

The term Flow means change and therefore the term Flow of Funds means change in Funds or Change in Working Capital. In other words **any increase or decrease in working capital means Flow of Funds. There will be said to be a flow of funds in case the working capital position of the company changes on account of any transactions.**

(1) There will be flow if a transaction involves:

(i) Current assets and fixed assets, i.e., purchase of building for cash;

(ii) Current assets and capital, e.g., issue of shares for cash;

(iii) Current assets and fixed liabilities, e.g., redemption of debentures in cash;

(iv) Current liabilities and fixed liabilities, e.g., creditors paid off in debentures

(v) Current liabilities and capital e.g., creditors paid off in shares;

(vi) Current liabilities and fixed assets, e.g., building transferred to creditors in satisfaction of their claim.

(2) There will be no flow if a transaction involves;

(i) Current assets and current liabilities, e.g., payment made to creditors;

(ii) Fixed assets and liabilities e.g., building purchased and payments made in debentures;
(iii) Fixed assets and capital e.g., building purchased and payments made in shares;

A fund flow statement is, therefore, a statement depicting change in working capital. It is also termed as a ‘Statement of Sources and Applications of Funds’, ‘Summary of Financial Operations Funds Generated and Expended’, ‘Where got and Where gone Statement’ and ‘Statement of Changes in Working capital’.

**Uses of funds flow statement**

Funds flow statements helps the financial analysts in having a more detailed analysis and understanding of changes in the distribution of resources between two balance sheet dates. In case such study is required regarding the future working capital position of the company, a projected funds flow statement can be prepared.

1. It explains the Financial Consequences of Business Operations
2. It answers intricate queries
3. It acts as an instrument for allocation of resources
4. It is a test as to effective or otherwise use of Working Capital

**FUNDS FLOW STATEMENT AND INCOME STATEMENT**

A Funds Flow Statement differs from an Income Statement (i.e., Profit & Loss Accounts) in several respects:

(i) A Funds Flow Statement deals with the financial resources required for running the business activities. It explains how were the funds obtained and how were they used, whereas an Income Statement discloses the results of the business activities, i.e., how much has been earned and how it has been spent.

(ii) A Funds Flow Statement matches the funds raised and funds applied during a particular period. The sources and applications of funds may be of capital as well as of revenue nature. For example, where shares are issued for cash, it becomes a source of funds while preparing a funds flow statement but it is not an item of income for an Income statement.

(iii) Sources of funds are many besides operations such as share capital, debentures, sale of fixed assets, etc. an Income Statement which discloses the results of operations cannot even accurately tell about the funds from operations alone because of non-fund items (such as depreciation writing off of fictitious assets, etc.) being included therein. Thus, both Income Statement and Funds Flow Statement have different functions to perform. Modern management needs both. One cannot be substituted for the other; rather they are complementary to each other.

**Preparation of funds flow statement**
In order to prepare a Funds Flow Statement, it is necessary to find out the sources and applications of funds.

**Sources of Funds**

The sources of funds can be both internal as well as external

1. Internal Sources

   **Funds from operations is the only internal source of funds.** However following adjustments will be required in the figured of Net Profit for finding out real funds from operations:

   **Add the following items as they do not result in outflow of funds:**

   (i) Depreciation on fixed assets.

   (ii) Preliminary expenses or goodwill etc., written off.

   (iii) Contribution to debenture redemption fund, transfer to general reserve etc., if they have been deducted before arriving at the figure of net profit.

   (iv) Provision for taxation and proposed dividend are usually taken as appropriations of profits only and not current liabilities for the purpose of Funds Flow Statement. Tax or dividends actually paid are taken as applications of funds. Similarly interim dividend paid is shown as an applications of funds. All these items will be added back to net profit, if already deducted to find funds from operations.

   (v) Loss on sale of fixed assets.

   **Deduct the following times as they do not increase funds:**

   (i) Profit on sale of fixed assets since the full sale proceeds are taken as a separate source of funds and inclusion here will result in duplication.

   (ii) Profit on revaluation of fixed assets

   (iii) Non operating incomes such as dividend received or accrued dividend, refund of income tax, rent received or accrued rent. These items increase funds but they are non-operating incomes. They will be shown under separate heads as sources of funds in the Funds Flow statement. In case the Profit and Loss Account shows Net Loss. This should be taken as items which decreases the funds.

2. External Sources

   These sources include:

   i. **Funds from Long-term Loans:** Long term loans such as debentures, borrowings from financial institutions will increase the working capital and, therefore, there will be flow of funds.
ii. **Sale of Fixed Assets**: Sale of land, buildings, long-term investments will result in generation of funds.

iii. **Funds from Increase in Share capital**: Issue of shares for cash or for any other current assets results in increase working capital and hence there will be a flow of funds.

**Applications of funds**

The uses to which funds are put are called applications of funds. Following are some of the purposes for which funds may be used:

1. Purchase of Fixed Assets
2. Purchase of fixed assets such as land, building, plant, machinery, long-term investments, etc., results in decrease of current asset without any decrease in current liabilities.
3. Payment of Dividends
   Payment of dividends results in decrease of a fixed liability and therefore, it affects funds.
4. Payment of Fixed Liabilities
   Payment of a long-term liability, such as redemption of debentures or redemption of redeemable preference shares results in reduction of working capital and hence it is as an application of funds.
5. Payment of Tax Liability
   Provision for taxation is generally taken as an application of profit and not as an application of funds. But if the tax has been paid, it will be as an application of funds.

**Technique for Preparing a funds Flow Statement**

A Funds Statement depicts change in working capital. It will therefore, be better to prepare first a Schedule of changes in Working Capital before preparing a Funds Flow Statement.

**Schedule of changes in Working capital**

The schedule of changes in working capital can be prepared by comparing the current assets and the current liabilities of two periods. It may be in the following form.

**SCHEDULE OF CHANGES IN WORKING CAPITAL**

<table>
<thead>
<tr>
<th>Items</th>
<th>as on</th>
<th>as on</th>
<th>( \frac{\text{changes}}{\text{Increase}(+) \text{ Decrease}(-)} )</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>( \ldots ) ( \ldots )</td>
</tr>
</tbody>
</table>

**Current Assets**

- Cash balance
- Bank balance
- Marketable securities
Accounts receivable
Stock in trade
Prepaid expenses

Current Liabilities
Bank overdraft
Outstanding expenses
Accounts payable

Net Increase/Decrease in working Capital

Rules for Preparing the Schedule
(i) Increase in a current asset, results in increase (+) in ‘working capital’
(ii) Decrease in a current asset, results in decrease (-) in ‘working capital’
(iii) Increase in a current liability, results in decrease (-) in ‘working capital’
(iv) Decrease in a current liability, results in increase (+) in ‘working capital’.

Funds Flow statement

While preparing a Funds Flow Statement, current assets and current liabilities are to be ignored. Attention is to be given to changes in Fixed Assets and Fixed Liabilities. The statement may be prepared in the following form.

Funds Flow Statement

Sources of Funds:
Issue of shares ……
Issue of debentures ……
Long-term borrowings ……
Sale of fixed assets ……
Operating profit ……

Total Sources ……

Applications of funds:
Redemption of redeemable preference shares ……
Redemption of debentures ……
Payment of other long-term loans ……
Purchase of fixed assets ……
Operating loss ……
Payment of dividends, tax, etc. ……

(Total sources-total uses) ……

The Funds Flow Statement can also be prepared in ‘T’ shape shown below:
Funds Flow Statement

<table>
<thead>
<tr>
<th>Sources of Funds:</th>
<th>Rs.</th>
<th>Applications of Funds:</th>
<th>Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue of Shares</td>
<td>...</td>
<td>Redemption of Redeemable</td>
<td>...</td>
</tr>
<tr>
<td>Issue of Debentures</td>
<td>...</td>
<td>Preference Shares</td>
<td>...</td>
</tr>
<tr>
<td>Long-term Borrowings</td>
<td>...</td>
<td>Redemption of Debentures</td>
<td>...</td>
</tr>
<tr>
<td>Sale of Fixed Assets</td>
<td>...</td>
<td>Payment of other long-term loans</td>
<td>...</td>
</tr>
<tr>
<td>Operating Profit*</td>
<td>...</td>
<td>Purchase of fixed assets</td>
<td>...</td>
</tr>
<tr>
<td>Decrease in Working capital*</td>
<td>...</td>
<td>Operating Loss*</td>
<td>...</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Payment of dividend, tax, etc.</td>
<td>...</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Increase in Working capital*</td>
<td>...</td>
</tr>
</tbody>
</table>

Only one figure will there.

The change in working capital disclosed by the schedule of changes in working capital will tally with the change disclosed by the fund flow statement.

Treatment of provision for taxation and proposed dividends

Provision of Taxation

While preparing a Funds flow Statement, there are two options available:

(i) Provision for tax may be taken as a *current liability*. In such a case when provision for tax is made the transaction involves Profit & Loss Appropriation Account which is a fixed liability and Provision for Tax Account which is a current liability. It will thus decrease the working capital because it will involve one current asset (i.e., Bank or Cash balance).

(ii) Provision for tax may be taken only as an *appropriation of profit*. It means there will be no change in working capital position when provision for tax is made since it will involve two fixed liabilities, i.e., Profit and Loss Appropriation Account and Provision for Tax Account. However, when tax is paid, it will be taken as application of funds, because it will then involve, provision for tax account which has been taken as a fixed liability and bank account which is a current asset.

Proposed Dividends

Whatever has been said about the provision for taxation is also applicable to proposed dividends. Proposed dividends can also be dealt with in two ways:

(i) Proposed dividends may be taken as a *current liability* since declaration of dividends by the shareholders is simply a formality. Once the dividends are declared in the general meeting they will have to be paid within 30 days of their declaration. In case proposed dividend is taken as a current liability, it will appear as one of the items decreasing working capital in the...
‘schedule of changes in working capital’. It will not be shown as an application of funds when dividends is paid later on.

(ii) Proposed dividends may simply be taken as an appropriation of profit. In such a case proposed dividend for the current year will be added back to current year’s profits in order to find out funds from operations if such amount of dividend has already been charged to profits. Payment of dividend will be shown as an ‘application of funds.’

Cash Flow Analysis

Cash flow analysis is another important technique of financial analysis. It involves preparation of Cash Flow Statement for identifying sources and applications of cash. Cash flow statement may be prepared on the basis of actual or estimated data.

Meaning of cash flow statement

A cash flow statement is a statement depicting change in cash position from one period to another. A Projected Cash Flow Statement or a Cash Budget will help the management in ascertaining how much cash will be available to meet obligations to trade creditors, to pay bank loans and to pay dividend to the shareholders. The term ‘Cash’ here stands for cash and bank balance. It has already been explained in the previous chapter that term funds in a narrower sense, is also used to denote cash. In such a case, the term funds will exclude from its purview all other current assets and current liabilities and the terms Funds flow statement and Cash Flow Statement will have synonymous meaning.

Preparation of cash flow statement

A cash Flow Statement can be prepared on the same pattern on which a Funds Statement is prepared. The change in the cash position one period to another is computed by taking into account Sources and Applications of Cash.

Sources of cash

Sources of cash be both internal as well as external:

Internal Sources

Cash from operations is the main internal source. The Net Profit shown by the Profit and Loss Account will have to be adjusted for non-cash items for finding out cash from operations. Some of these items are as follows;

(i) Depreciation. Depreciation does not result in outflow of cash of cash and therefore, net profit will have to be increased by the amount of depreciation

(ii) Amortization of intangible assets. Goodwill, preliminary expenses, etc., when written off against profits, reduce the net profits without affecting the cash balance. The amounts written off should therefore, be added back to profit to find out the cash from operations.
(iii) Loss on sale of fixed assets. It does not result in outflow of cash and, therefore, should be added back to profits.

(iv) Gains from sale of fixed assets. Since sale of fixed assets is taken as a separate source of cash, it should be deducted from net profits.

(v) Creation of reserves. If profit for the year has been arrived at after charging transfers to reserves, such transfers should be added back to profits. In case operations show a net loss such net loss after making adjustment for non cash items will be shown as an application of cash.

For the sake of convenience computation of cash from operations can he studied by taking two different situation:
1) When all transactions are cash transactions, and
2) When all transactions are not cash transactions.

**When all transaction are cash transactions**

The computation of cash from operations will be very simple in this case. The net profit as shown by the Profit and Loss Account will be taken as the amount of cash from operations.

\[ \text{Cash for operations} = \text{net Profit} \]

**When all transactions are not cash transactions**

The computation of cash from operations in such a situation can be done conveniently if it is done in two stages as

(i) Computation of funds (i.e., working capital) from operations as explained in preceding pages

(ii) Adjustments in the funds so calculated for changes in the current assets (excluding cash) and current liabilities.

\[ +\text{Debtors outstanding at the beginning of the accounting year.} \]

Cash from operations=Net Profit

\[ -\text{Debtors outstanding at the end of the accounting year.} \]

Or

\[ +\text{Decrease in Debtors} \]

Cash from operations= Net profit

\[ -\text{Increase in Debtors} \]

\[ +\text{increase in Creditors} \]

Cash from operations= Net profit
-Decrease in Creditors
+Decrease in Debtors
+Decrease in Stock
+Decrease in Prepaid expenses
+Decrease in Accrued Income
+Increase in Creditors
+Increase in Outstanding Expenses

Cash from operations = Net profit

-Increase in Debtors
-Decrease in Stock
-Decrease in Prepaid expenses
-Decrease in Accrued Income
-Increase in Creditors
-Increase in Outstanding Expenses

The above formula may be summarized in the form of following general rules:
Increase in Current Asset Decrease in Current Liability results in Decrease in Cash
AND
Decrease in Current Asset and Increase in Current Liability results in Increase in cash

External Sources
The external sources of cash are:
(i) Issue of new shares: In case shares have been issued for cash, the net cash received (i.e., after deducting expenses on issue of shares or discount on issue of shares) will be taken as a sources of cash.
(ii) Raising long-term loans: Long-term loans such as issue of debentures, loans from Industrial Financial Corporation, State Financial Corporations, I.D.B.I., etc., are sources of cash. They should be shown separately.
(iii) Purchase of plant and machinery on deferred payments: In case plant and machinery has been purchased on a deferred payment system, it should be shown as a separate source of cash to the extent of deferred credit. However the cost of machinery purchased will be shown as an application of cash.
(iv) Short term borrowings- cash credit from banks: Short term borrowings, etc., from banks increase cash available and they have to be shown separately under this head.
(v) **Sale of fixed assets investment, etc.** It results in generation of cash and therefore is a source of cash.

Decrease in various current assets and increase in various current liabilities (discussed earlier) may be taken as external sources of cash if they are not adjusted while computing cash from operations.

**Applications of Cash**

Applications of cash may take any of the following forms:

(i) **Purchase of fixed assets:** Cash may be utilised for additional fixed assets or renewals or replacement of existing fixed assets.

(ii) **Payment of long-term loans:** The payment of long-term loans such as loans from financial institutions or debentures results in decrease in cash. It is therefore, an application of cash.

(iii) **Decrease in deferred payment liabilities.** Payments for plant and machinery purchased on deferred payment basis has to be made as per the agreement. It is, therefore, an application of cash.

(iv) **Loss on account of operations.** Loss suffered on account of business operations will result in outflow of cash.

(v) **Payment of tax.** Payment of tax will result in decrease of cash and hence it is an application of cash.

(vi) **Payment of dividend.** This decreases the cash available for business and hence it is an application of cash.

(vii) **Decrease in unsecured loans, deposits, etc.** The decrease in these liabilities denotes that they have been paid off to that extent. It results, therefore, in outflow of cash.

Increase in various current assets or decrease in various current liabilities may be shown as applications of cash if changes in these items have not been adjusted while finding out cash from operations.

**Difference between cash flow analysis and funds flow analysis**

Following are the points of difference between a Cash Flow Analysis and a Funds Flow Analysis:

1. A Cash Flow Statement is concerned only with the **change in cash position** while a Funds Flow Analysis is concerned with **change in working capital position** between two balance sheet dates. Cash is only one of the constituents of working capital besides several other constituents such as inventories, accounts receivable prepaid expenses.
(2) A Cash Flow Statement is merely a *record of cash receipts and disbursements*. Of course, it is valuable in its own way but it fails to bring to light many important changes involving the disposition of resources. While studying the short-term solvency of a business one is interested not only in cash balance but also in the assets which are easily convertible into cash.

(3) Cash flow analysis is more useful to the management as a tool of financial analysis is short period as compared to funds flow analysis. It has rightly been said that shorter the period covered by the analysis, greater is the importance of cash flow analysis.

(4) *Cash is part of working capital* and therefore an improvement in cash position results in improvement in the funds position but the reserve is not true. In other words inflow of cash results in inflow of funds but inflow of funds may not necessarily result in inflow of cash. Thus a sound funds position does not necessarily mean a sound cash position but a sound cash position generally means a sound funds position.

(5) Another distinction between a cash flow analysis and a funds flow analysis can be made on the basis of the techniques their preparation. An increase in a current liability or decrease in a current asset results in decrease in working capital vice versa. While an increase in a current liability of decrease in a current asset (other than cash) will result in increase in cash and vice versa. Some people as stated earlier, use term funds in a very narrow sense of cash only. In such an event the two terms Funds and Cash will have synonymous meaning.

**Utility of cash flow analysis**

1. Help in efficient cash management
2. Help in internal financial management
3. Discloses the movements of cash
4. Discloses success or failure of cash planning

**Limitation of cash flow analysis**

Cash flow analysis is a useful tool of financial analysis. However it has its own limitations. These limitations are as under:

(1) Cash flow statement cannot be equated with the Income Statement. An Income Statement takes into account both cash as well as non cash items and therefore net cash flow does not necessarily mean net income of the business.

(2) The cash balance as disclosed by the cash flow statement may not represent the real liquid position of the business since it can be easily influenced by postponing purchases and other payments.

(3) Cash flow statement cannot replace the Income Statement or the Funds Flow Statement. Each of them has a separate function to perform.

**Accounting Standard-3 (revised) Cash Flow Statement**
AS-3 changes in Financial Position issued in 1981 was replaced by AS-3 Cash Flow Statement in April 1997.

The standard provides for the preparation of cash flow statement mandatory from 1 April 2001 in respect of the following enterprises.

1. Enterprise whose debt or equity securities are listed or going to be listed on a recognized stock exchange.

2. All other commercial, industrial and business reporting enterprises whose turnover for the accounting period exceed Rs. 50 crores.

According to AS-3 (Revised) Cash flow Statement should be presented a manner that it reports cash flow during the period classifying by operating, investing and financing activities.

1. **Cash flow from operating activities:** Cash flow from operating activities are primarily derived from pre-revenue producing activities of the enterprise. Examples of cash flow from operating activities are:

   (a) Cash receipts from the sale of goods and the rendering of services;
   (b) Cash receipts from royalties, fees, commission and other revenue;
   (c) Cash payments to suppliers for goods and services;
   (d) Cash payments to and on behalf of employees;
   (e) Cash receipts and cash payments of an insurance enterprise for premium and claims, annuities and other policy benefits;
   (f) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and
   (g) Cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

Cash from operating activities can be computed either by direct or indirect method. In case of direct method, the specific items of cash flow viz., cash from customers, cash from other operation income, payment to suppliers, other operating expenses are separately shown. While in case of indirect method, the net income from the business is taken and additions or deductions are made for non-cash expenses and for increase and decrease in operating current assets and current liabilities. It may be noted that increase in a current asset such as debtors, inventory, prepaid expenses results in decrease in cash and vice versa. Similarly, an increase in current liability viz., creditors, outstanding expenses results increase in cash and vice versa.
2. **Cash flows from investing activities:** These include activities on which expenditure has been incurred for resources intended to generate future income and cash flow. Examples of such activities are:

(a) Cash payments to acquire fixed assets (including intangibles). These payments include those relating to capital research and development costs and self-constructed fixed assets;
(b) Cash receipts from disposal of fixed assets (including intangibles);
(c) Cash payments to acquire shares, warrants or instruments of other enterprises and interests in ventures (other than payments for those instrument considered to be cash equivalents and those held for details or trading purposes).
(d) Cash receipts from disposal of shares, warrants or instruments of other enterprises and interests in ventures (other than payments for those instrument considered to be cash equivalents and those held for details or trading purposes).
(e) Cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
(f) Cash receipts from the repayment of advances and loan made to third parties (other than advances and loans of financial enterprise);
(g) Cash payments for future contracts, forward contracts, option contracts and swap contracts except when the contracts held for dealing or trading purposes, or the payments classified as financing activities; and
(h) Cash receipts from futures contracts, forward contracts option contracts and swap contracts expect when the contracts held for dealing or trading purposes, or the receipts classified as financing activities.

3. **Cash flow financing activities:** These include providers of funds (both capital and borrowings) to the enterprise. Examples of such activities are:

(a) Cash proceeds from issuing shares or other similar instruments’
(b) Cash proceeds from issuing debentures, loans, notes, bonds and other short or long-term borrowings; and
(c) Cash repayments of amounts borrowed.

**Marginal costing**

Elements of cost can broadly be put into two categories: Fixed Costs and Variable costs within a given period of time and range of activity in spite of fluctuations in production. The examples of Fixed Costs are rent insurance charges, management salaries, etc. on the other hand variable Costs are costs which vary in direct proportion to any change in the
volume of output. The costs of direct materials, direct wages etc., can be put into this
different elements of cost according to any of the following two techniques:
(i) Absorption costing and (ii) Marginal Costing

**Absorption costing**

Absorption Costing technique is also termed as *Traditional or Full cost Method*. According to this method, the cost of a product is determined after considering both fixed and Variable Costs. The variable Costs such as those of direct materials, direct labour, etc., are directly charged to the products while the fixed costs are apportioned on a suitable basis over different products manufactured during a period. Thus in case of Absorption Costing all costs are identified with the manufactured products. Under Absorption Costing each unit of product has to bear its total share of cost.

**Marginal costing**

Marginal costing is a technique where only the variable costs are considered while computing the cost of a product. The fixed costs are met against the total fund arising out the excess of selling price over total variable cost. This fund is known as contribution in marginal costing. According to the Chartered Institute of Management Accountants, London, marginal costing is a technique where only the variable costs are charged to cost units, the fixed costs attributable being written off in full against the contribution for that period.

**Difference between Absorption Costing and Marginal costing**

Under Absorption Costing full costs are charged to production, i.e., all fixed and variable costs are recovered from production while under Marginal Costing only Variable Costs are charged to production. Fixed costs are ignored. This is on the basis that for additional output only Variable Costs are incurred since Fixed Costs remain constant. There is, therefore, no reason to burden the additional output with the share of fixed overheads, otherwise it will give a wrong idea about the likely profit to be earned on additional sales. On account of recovery of only variable costs from production, the closing stock under marginal Costing is valued only at marginal cost. Thus Marginal Costing system differs from Absorption Costing system in two respects:
(i) Recovery of Overheads (ii) Valuation of Stocks.

**Profit planning**

The basic objective of running any business organization is to earn profits. Profits determine the financial position, liquidity and solvency of the company. They serve as a yardstick for judging the competence and efficiency of the management. Profit planning is therefore a fundamental function and is a vital part of the total budgeting process. The
management determines the profit goals and prepares budgets that will lead them to the realization of these goals. However, profit planning can be done only when management is aware about the various factors which affect profits. Some of the important factors affecting profits are as follows:

1. **Selling Price**

2. **Cost**

3. **Volume:** The term volume refers to the level of activity. This may be expressed in any of the following manner:
   (i) Sales capacity as a percentage of maximum sales;
   (ii) Value of sales;
   (iii) Quantity of sales;
   (iv) Production capacity as a percentage of maximum production;
   (v) Value of production;
   (vi) Quantity of production;
   (vii) Direct labour cost;
   (viii) Direct labour hours; and
   (ix) Machine hours.

The measure adopted for expressing the volume should be simple, consistent and well defined. It is common to express volume in terms of units or value.

4. **Product Mix:** In a multi-product company, the profit is also affected by the product mix, i.e., variation of product mix, may cause variation in profit also.

**Cost volume profit analysis**

Cost Volume Profit (CVP) Analysis is an important tool of profit planning. It provides information about the following matters:

1. The behavior of cost in relation to volume.
2. Volume of production or sales, where the business will break even.
3. Sensitivity of profits due to variation in output
4. Amount of profit for a projected sales volume.
5. Quantity of production and sales for a target profit level.

Cost-volume-profit analysis may therefore be defined as a managerial tool showing the relationship between various ingredients of profit planning, viz., costs both fixed and variable, selling price and volume of activity, etc. Such an analysis is useful to the Financial Manager in the following respects:

(i) It helps him in forecasting the profit fairly accurately,
(ii) It is helpful in setting up flexible budgets, since on the basis of this relationship it can ascertain the cost, sales and profits at different levels of activity.
(iii) It also assists him in performance evaluation for purposes of management control,
(iv) It helps in formulating price policy by projecting the effect which different price structures will have on cost and profits.

(v) It helps in determining the amount of overhead cost to be charged at various levels of operations since overhead rates are generally pre-determined on the basis of a selected volume of production.

**Break-even analysis**

Break-even analysis is a widely used technique to *study cost-volume profit relationship*. The narrower interpretation of the term break-even analysis refers to a system of determination of that level of activity where total cost equals total selling price. The broader interpretation refers to that system of analysis which determines probable profit at any level of activity. *It portrays the relationship between cost of production volume of production and the sales value.*

*It may be added here that CVP analysis is also popularly, although not very correctly, designated as Break-even Analysis.* The difference between the two terms is very narrow. CVP analysis includes the entire gamut of profit planning, while break-even analysis is one of the technique of break-even analysis is so popular for studying CVP Analysis that the two terms are used as synonymous terms. In order to understand the concept of break-even analysis, it will be useful to know about certain basic terms as given below:

1. **Contribution**

   This refers to the *excess of selling price over the variable cost*. It is also known as *gross margin*. The amount of profit (loss) can be ascertained by deducting the fixed cost from contribution. In other words, fixed cost plus profit is equivalent to contribution. It can be expressed by the following formula:-

   Contribution = Selling Price (-) Variable Cost

   Or

   =Fixed cost (+) Profit
   =Profit = Contribution – Fixed Cost

2. **Profit/Volume Ratio (P/V Ratio)**

   This term is important for studying the profitability of operations of a business. Profit volume ratio establishes a *relationship between the contribution and the sale value*. The ratio can be shown in the form of a percentage also. The formula can be expressed thus:

   \[ \frac{\text{P/V Ratio}}{\text{Sales}} = \frac{\text{Contribution}}{\text{Sales}} = \frac{\text{Sales}–\text{Variable Cost}}{\text{Sales}} \]

   Or \( C/S = \frac{S-V}{S} = \frac{\text{Variable Costs}}{\text{Sales}} \)
This ratio can also be called Contribution/Sales ratio. This ratio can also be known by comparing the change in contribution to change in sales or change in profit due to change in sales. Any increase in contribution would mean increase in profit only because fixed costs are assumed to be constant at all levels of production. Thus

\[
P/V \text{ Ratio} = \frac{\text{Change in Contribution}}{\text{Change in Sales}} \quad \text{Or} \quad \frac{\text{Change in Profit}}{\text{change in Sales}}
\]

This ratio would remain constant at different levels of production since variable costs as a proportion to sales remain constant at various levels.

**The following are the special features of P/V Ratio:**

(i) It helps the management in ascertaining the total amount of contribution for a given of sales.

(ii) It remains constant so long the selling price and the variable cost per unit remain constant or so long they fluctuate in the same proportion.

(iii) It remains unaffected by any change in the level of activity. In other words, P/V ratio for a product will remain the same whether the volume of activity is 1,000 units or 10,000 units.

(iv) The ratio also remains unaffected by any variation in the fixed cost since the latter are not at all considered while calculating the PV ratio.

In case of a multi-product organization, P/V ratio is of vital importance for the management to find out which product is more profitable. Management tries to increase the value of this ratio by reducing the variable costs or by increasing the selling price.

3. Break-even Point

The point which breaks the total cost and the selling price evenly to show the level of output or sales at which there shall be neither profit nor loss is regarded as break-even point. At this point, *the income of the business exactly equals its expenditure*. If production is enhanced beyond this level profit shall accrue to the business, and if it is decreased from this level loss shall be suffered by the business.

It will be proper here to understand different concepts regarding marginal cost and break-even point before proceeding further. This has been explained below:

Marginal Cost = Total Variable cost

Or = Total Cost–Fixed Cost

Or = Direct Material + Direct Labour + Direct Expenses (Variable )+ Variable Overheads

Contribution = Selling Price – Variable Cost
Profit = Contribution – Fixed Cost

Fixed Cost = Contribution – Profit

Profit / Volume Ratio (P/V Ratio) = \( \frac{\text{Contribution per unit}}{\text{Selling price per unit}} \)

Or \( \frac{\text{Total Contribution}}{\text{total sales}} \)

In case P/V ratio is to be expressed as a percentage of sales, the figure derived from the formulae as given above should be multiplied by 100.

Breakeven Point (of output) = \( \frac{\text{Fixed Cost}}{\text{Contribution per unit}} \)

Breakeven Point (of sales) = \( \frac{\text{Fixed Cost}}{\text{Contribution per unit}} \times \text{Selling Price per unit} \)

Or \( \frac{\text{Fixed Cost}}{\text{Total contribution}} \times \text{Total Sales} \)

Or \( \frac{\text{Fixed Cost}}{\text{P/V Ratio}} \)

At break-even point the desired profit is zero. In case the volume of output or sales is to be computed for a desired profit, the amount of desired profit should be added to fixed cost in the formulae given above. For example.

Units for a desired profit = \( \frac{\text{Fixed Cost} + \text{Desired Profit}}{\text{Contribution per unit}} \)

Sales for a desired profit = \( \frac{\text{Fixed cost} + \text{Desired Profit}}{\text{P/V Ratio}} \)

Cash Break-even Point

It is point where cash breaks even, i.e., the volume of sales where cash realizations on account of sales will be just sufficient to meet immediate cash liabilities. While calculating this point cash fixed costs (i.e., excluding fixed share of depreciation and deferred expenses) and cash contribution (i.e., after making adjustments for variable share of depreciation etc.,) are considered.

The point helps the management in determining the level of activity below which there are changes of insolvency on account of the firm’s inability to meet cash obligations unless alternative arrangements are made.

Composite Break-even Point

In case a concern is dealing in several products, a composite break-even point can be computed according to the following formula.

Composite Break-even Point (sales in Rs.) = \( \frac{\text{Total fixed cost}}{\text{Composite P/V Ratio}} \)

Or \( \frac{\text{Total fixed Cost} \times \text{total sales}}{\text{Total Contribution}} \)
Composite P/V Ratio = \( \frac{Total\ Contribution}{Total\ sales} \times 100 \)

**Cost Break-even Point**

It refers to a situation where the costs of operating two alternative plants is equal. The point enables the firm to identify which is the best to operate at or a given level of output assuming that sale price per unit is the same.

**4. Margin of safety**

The sales minus the sales at break-even point is known as the margin of safety. Thus the formula is

\[ M.S = T.S. - B.E.S \]

Margin of Safety = Total Sales – Break-even sales

Margin of safety can also be computed according to the following formula:

\[ \text{Margin of safety} = \frac{Net\ Profit}{P/V\ Ratio} \]

Margin of safety can also be expressed as a percentage of sales:

\[ = \frac{Margin\ of\ safety}{Total\ Sales} \times 100 \]

**5. Key factor**

Key factor is that factor which limits the volume of output or level of activities of an undertaking at a particular point of time or over a period. The extent of its influence must be assessed first so as to maximize the profits. Generally on the basis of contribution the decision regarding product mix is taken. It is not the maximization of total contribution that matters, but the contribution in terms of the key factor that is to be compared for relative profitability. Thus it is the limiting factor or the governing factor or principle budget factor. If sales cannot exceed a given quantity, sales is regarded as the key factor, if production capacity is limited, contribution per unit of raw material is in short supply, contribution has to be expressed in relation to per unit of raw material required. There may be labour hour is to be known. If machine capacity is a limitation, contribution per machine hour is to be considered for appropriate decision making. Thus, profitability can be measured by:

\[ = \frac{Contribution}{Key\ Factor} \]

**Break even chart**

The relationship between costs, sales and profits can be shown in the form, of a chart. Such a chart not only depicts the level of activity where there will be neither loss nor profit but also shows the profit or loss at various levels of activity. According to the Chartered Institute of Management Accountants, London, the break-even chart means a chart which
shows profit or loss at various levels of activity, the level at which neither profit nor loss at shown being termed the breakeven point. This may also take the form of a chart on which is plotted the relationship either of total cost of sales or of fixed costs to contribution. Thus, it is a graphical presentation of cost and revenue data.

Form of Break-even chart
A break-even chart can be presented in different forms as given below:

(i) Simple break-even chart: This is also known as traditional or orthodox break-even chart.

(ii) Contribution break-even chart

(iv) Analytical break-even chart: Analytical break-even chart is prepared to show different elements of cost and appropriations of profit.

(v) Cash break-even chart
The chart is prepared to shown the volume at which cash break even, i.e., the point at which the cash inflows will be just equal to the cash required to meet immediate cash liabilities. For the purposes of drawing this chart, the fixed costs are divided into two categories:

(i) fixed costs which do not require immediate cash outlay, e.g., deprecation, deferred expenses, and

(ii) fixed costs which require immediate cash outlay, rent, salaries, etc. while drawing the chart the cash fixed costs are plotted first parallel to the base line, variable costs (presuming all of them to be in terms of cash) are then plotted over them. The non-cash fixed costs are plotted in the last. The sales line is plotted as usual.

Angle of Incidence
Angle of Incidence is formed at the inter-section of total cost line and total sales line. As a matter of fact there are two angles of incidence:

(i) The angle formed at the right side of the break-even point.

(ii) The angle formed at the right left of the break-even point.

The angle formed at the right side of the break-even point indicates the profit area while that formed at the left side indicates the loss area. The size of the angle of incidence is indication of the quantum of profit or loss made by the firm at different output/sales levels. For example if the angle of incidence is narrow to the right side of the BEP, it indicates that the quantum of profits made by the firm is also low. Similarly, if it is narrow to the left side of the BEP, it indicates that the quantum of loss made by the firm is also low. In other words a narrow angle of incidence shows a slow rate of profit earning capacity while a wider angle of incidence shows a swift rate of profit earning capacity of the firm. A narrow angle also
indicates that the variable cost as proportion to sales is quite high and therefore very little has been left by way of contribution.

A study of angle of incidence, break-even point and margin of safety can help the management in having a better understanding about profitability, stability and incidence of fixed and variable costs on the performance of the firm. This can be understood by taking the following four different situations:

(i) High margin of safety, large angle of incidence and low break-even point,
(ii) High margin of safety, small angle of incidence and low break-even point,
(iii) Low margin of safety, large angle of incidence and low break-even point.

**Assumptions underlying CVP Analysis/Break-even Charts**

The following assumptions are common to both Break-even Charts and CVP Analysis

(i) Fixed costs remain constant at every level and they do not increase or decrease with change in output.
(ii) Variable cost fluctuates per unit of output. In other words, they vary in the same proportion in which the volume of output or sales varies.
(iii) All costs are capable of being bifurcated into fixed and variable elements.
(iv) Selling price remains constant even when the volume of production or sales changes.
(v) Cost and revenue depend only on volume and not on any other factor.
(vi) Production and sales figures are either identical or changes in the inventory at the beginning and at the end of the accounting period are not significant.
(vii) Either the sales mix is constant or only one product is manufactured.

**OBJECTIVE QUESTIONS**

**UNIT- III & IV**

**Management Accounting**

1. The basic function of accounting is to
   a) Attain non-economic goals   b) Record economic data
   c) Classify and record business transaction       d) All of these

2. Financial accounting records only
   a) Standard figures   b) Estimated figures   c) Actual figures       d) Imaginary figures

3. The branch of accounting which primarily deals with processing and presenting accounting data for internal use in a concern is
   a) Inflation accounting   b) Financial accounting
   c) Cost accounting       d) Management accounting

4. The term ‘management accounting’ was first used in
   a) 199   b) 1950   c) 1964       d) 1946

**http://www.trbtnpsc.com/2013/07/trb-questions-and-study-materials.html**
5. Management accounting is also known as
   a) Historical cost accounting   b) Financial Accounting
   c) Price level accounting   d) Management

6. The primary function of management accounting is to
   a) Assist tax authorities
   b) Assist the management in performing its functions effectively
   c) Interpret the financial data
   d) Record business transaction

7. Management accounting provides valuable service to management by performing
   a) Coordinating functions   b) Controlling functions
   c) Planning functions   d) All managerial functions

8. Management accounting is an offshoot of
   a) Financial accounting   b) Cost accounting
   c) Cost accounting and inflation accounting   d) Cost accounting and financial accounting

9. Management accounting is concerned with
   a) Recording of transactions   b) The problem of choice
   c) Causative relationship   d) Both b) and c)

10. Management accounting analyses accounting data with the help of
    a) Auditors   b) Statutory forms
    c) Tools and techniques   d) None of these

11. Management accounting is suitable for
    a) Large and industrial concerns   b) Co-operative societies
    c) Small business   d) Non-profit organization

12. Management accounting and cost accounting functions are
    a) Natural in effect   b) Complementary in nature
    c) Contradictory in nature   d) None of these

13. Financial statements provide a summary of
    a) Accounts   b) Assets
    c) Liabilities   d) None of these

14. Financial statements are
    a) Anticipate facts   b) Recorded facts
    c) Estimated facts   d) None of these

15. When financial statements for a number of years are reviewed and analyzed, the analysis is known as
    a) Vertical analysis   b) Internal analysis
    c) Horizontal analysis   d) None of these

16. When ratios are calculated from the financial statements of one year it is termed as
    a) Horizontal analysis   b) Vertical analysis
    c) Internal analysis   d) None of these

17. Horizontal analysis is also known as
    a) State analysis   b) Structural analysis
    c) Dynamic analysis   d) All of these

18. The short-term analysis of financial statements is mainly concerned with
    a) Stability of the concern   b) Earning potential of the concern
    c) Working capital analysis   d) None of these

19. The analysis by a banker for granting credit to a concern is an example of
    a) Critic analysis   b) External analysis
    c) Internal analysis   d) None of these

20. Trend analysis is significant for
    a) Forecasting and budgeting   b) Profit planning
    c) Capital rationing   d) Working capital management

21. Vertical analysis made on the basis of
22. Solvency ratio indicates
   a) Credit worthiness  b) Activity  c) Profitability  d) None of these

23. The safe level for proprietary ratio is
   a) 0.5  b) 2  c) 1  d) 3

24. Ratio analysis involves the process of
   a) Computation  b) Recording  c) Relationship between  d) None of these

25. A ratio is expressed in
   a) Weights  b) Rupees  c) Proportion  d) None of these

26. Market price per share divided by EPS is
   a) Earnings per share  b) Price earnings ratio  c) Book value per share  d) Return on equity

27. Debt-equity ratio is a
   a) Turnover ratio  b) Profitability ratio  c) Short-term solvency ratio  d) Long-term solvency ratio

28. The current assets to the current liabilities ratio is said to be satisfactory if it is
   a) 1:2  b) 2:1  c) 1:1  d) 3:2

29. Current ratio is sometimes referred to as
   a) The profitability ratio  b) The financial ratio  c) The solvency ratio  d) The working capital ratio

30. Collection of book debts
   a) Has no effect on current ratio  b) Has decreases in current ratio  c) Has increases in current ratio  d) None of these
Barriers and problems to entrepreneurship

The following are various barriers which Vasper has identified to the growth of entrepreneurs.

1. Lack of a viable concept
2. Lack of market knowledge
3. Lack of seed capital
4. Lack of business knowhow
5. Complacency – lack of motivation
6. Social stigma
7. Time pressures and distractions
8. Legal constraints and regulations
9. Monopoly and protectionism
10. Inhibitions due to patents

Socioeconomic origin of entrepreneurship

The following are socioeconomic factors which influence entrepreneurship.

1. Caste origins: It has often been suggested that certain religions and castes encourage the growth of entrepreneurial talent in the world.
2. Entry into Entrepreneurship: The time and age at which the entry is made into entrepreneurship are important factors. The Kamma community entered the field of entrepreneurship earliest of all other communities. It reveals the resourcefulness and enterprising quality of Kamma entrepreneurs. Kapu and Brahmin entrepreneurs entered into entrepreneurship at a younger age and Vysya entrepreneurs at an older age.
3. Family background: This factor includes size of family, type of family and economic status of family. Hadimani’s study revealed that Zamindar family helped to gain access to political power and exhibited higher level of entrepreneurship.
4. Religious background: Religion exercises a strong influence on attitudes towards materials gains relatively to efforts. Max Weber propounded the theory that the ‘protestant ethic’ among Christians fosters the right attitude for entrepreneurship.
5. Education and Technical Knowhow: Education, entrepreneurship and development are interrelated. Education is the best means of developing man’s resourcefulness which encompasses different dimensions of entrepreneurship.
6. Occupational Background: Generally employed people were more attracted towards entrepreneurship than those engaged in agriculture or business. A sizeable number of entrepreneurs were the unemployed youth prior to starting the industrial units.
7. Migratory Character: As much as four-fifths of the entrepreneurs were immigrants having come from different places within the State or from outside.
8. Type of Industry started: Nearly two thirds of the entrepreneurs started industrial units in engineering works. A little more than one tenth preferred to start units in non metallic products while 7.5 percent started units belonging to plastic works industry. A few other
entrepreneurs started units belonging to food products, aluminum products and other miscellaneous products.

9. **Type of ownership preferred**: More than one half of the units were partnership firms, nearly one third were sole trading concerns and about one tenth were private limited companies. Most of the entrepreneurs preferred partnership to avoid legal formalities involved in starting a company.

**Sharma investigated** the economic, social and geographic origins of the entrepreneurs who promoted 220 public limited non-government manufacturing companies during April, 1961 to March 31, 1963. The following are origins.

1. **Occupational origins**: An overwhelming majority (134 out of 198) of the individual entrepreneurs came from the mercantile background.

2. **Educational backgrounds**: About 30 percent of the entrepreneurs were graduates, 10 percent postgraduates. About 28 percent had professional qualifications in engineering and technology and about 11 percent in law. Rest had professional education in medicine, accounting and management.

3. **Social and geographic origins**: The traditionally trading castes of Banias-Hindu and Jain, Chettiars, etc., constituted 47% of all enterprising families and 49% of all promotions.

4. **Nature of enterprise**: Well established business houses and professionally qualified entrepreneurs have by and large preferred the modern sector (engineering, metals, chemicals and electrical).

**Environmental factors affecting entrepreneurship**

*A complex and varying combination of financial, institutional, cultural and personality factors determine the nature and degree of entrepreneurial activity at any time.*

The personal backgrounds of the entrepreneurs are determined mainly by the environment in which they are born and brought up and work. Some of the **environmental factors** which hinder entrepreneurial growth are given below:

1. Sudden changes in Government policy.
2. Sudden political upsurge.
3. Outbreak of war or regional conflicts, e.g. sons of the soil’ call.
4. Political instability or hostile Government attitude towards industry.
5. Excessive red tapism and corruption among Government agencies.
6. Ideological and social conflicts.
7. Unreliable supply of power, materials, finance, labour and other inputs.
10. Non co operative attitude of banks and financial institutions.

Generally the factor affecting entrepreneurship can be classified into two broad categories.

I. Economic Factors

The following are the various economic factor affecting entrepreneurial growth

1. Capital  
2. Labour  
3. Raw Material  
4. Market

II. Non-Economic Factors

The following various non-economic factor affecting entrepreneurial growth.

1. Social conditions  
2. Psychological Factors

Definitions of entrepreneurship

Entrepreneurship, like many other economic concepts, has long been debated. It has been used in various ways and in various senses. It is an elusive concept that may not be defined precisely. The word entrepreneurship has been derived from a French root which means to undertake. Today, people call it by various names, e.g. ‘adventurism’, ‘risk taking’ ‘thrill seeking’ ‘innovating’, etc.

According to Higgins, ‘Entrepreneurship is meant the function of seeking investment and production opportunity, organizing an enterprise to undertake a new production process, raising capital, hiring labour, arranging the supply of raw materials, finding site, introducing a new technique and commodities, discovering new sources of raw materials and selecting top managers of day-to-day operations of the enterprise’.

Richard Cantillon defined entrepreneur as agent who buys factor of production at certain prices in order to combine them into a product with a view to selling it at uncertain price in future.

Nature and characteristics (dimensions) of entrepreneurship

Entrepreneurship is a multi dimensional concept and it is necessary to consider many factors and perspectives. The various features of entrepreneurship are summarized below:

1. Innovation: According to Schumpeter, entrepreneurship is a creative activity. An entrepreneur is basically an innovator who introduces something new into the economy. Innovation involves problem solving and the entrepreneur is a problem solver.

2. A Function of High Achievement: McClelland identified two characteristics of entrepreneurship, namely ‘doing things in a new and better way’ and ‘decision making under uncertainty’. He stressed the need for achievement or achievement orientation as the most directly relevant factor for explaining economic behavior entrepreneurs. McClelland
explains the entrepreneurs interest in profits in terms of a need for a achievement. People with high achievement (N-Ach) are not influenced by money rewards as compared to people with low achievement. McClelland suggests that in order to raise the level of achievement motivation, parents should set high standards for their children.

3. Organisation building Function: According to Harbison entrepreneurship implies the skill to build an organization. Organisation building ability is the most critical skill required for industrial development. This skill means the ability to multiply oneself by effectively delegating responsibility to others. Unlike Schumpeter, Harbison’s entrepreneur is not an innovator but ‘an organization builder’ who harnesses the new ideas of different innovators to the rest of the organization.

4. A Function of Group Level Pattern: Accepting Schumpeter’s definition, Young suggests a casual sequence where ‘transformation codes’ are developed by the solidarity groups to improve their symbolic position in their larger structure and become entrepreneurs. Young conducted the Thematic Appreciation Test (TAT) on a group of entrepreneurs. The test revealed the tendency to describe the situation as a problem to be solved, an awareness of pragmatic effort required, confidence in their own ability to solve the problem and a tendency to take the viewpoint of each individual in turn and analyse the situation as he might see it before suggesting an outcome. Young’s theory is a theory of change based on society’s incorporation of reactive subgroup.

5. A Function of Managerial Skills and Leadership: According to Hoselitz, managerial skills and leadership are the most important facets of entrepreneurship. Financial skills are only of secondary importance. He maintains that a person who is to become an industrial entrepreneur must have more than the drive to earn profits and amass wealth. He must have the ability to lead and manage. He identifies three of business leadership, namely merchant money lenders, managers and entrepreneurs. The function of the first group is market oriented, that of the second is authority oriented while the third group has in addition to these a production orientation.

6. Gap Filling Function: Liebenstein identified two broad types of entrepreneurship. The routine entrepreneurship is associated with the managerial function of the business whereas the new entrepreneurship is innovative in nature. The most significant feature of entrepreneurship is gap filling. It is the job of the entrepreneur to fill the gap or make up the deficiencies which always exist in the knowledge about the production function. These gaps or deficiencies arise because all the inputs in the production function cannot be marketed.
7. A Function of Status Withdrawal: According to Hargen, creative innovation or change is the fundamental feature of economic growth. He describes an entrepreneur as a creative problem solver interested in things in the practical and technological realm. He feels a sense of increased pleasure when facing a problem and tolerates disorder without discomfort. Hargen has formulated a sequence of the formation of creative personality. Whenever there is any withdrawal of status respect, it would give rise to four different responses and create four different types of personality; viz:

(a) **Retreatist**: One who continues to work in the society but remains indifferent to his work and position.

(b) **Ritualist**: One who adopts a kind of defensive behavior and acts in the ways accepted and approved in his society but with no hopes of improving his position.

(c) **Reformist**: One who foments a rebellion and attempts to establish a new society.

(d) **Innovator**: A creative individual who is likely to be an entrepreneur. Hargen’s creative personality is characterized by Schumpeter’s innovation and McClland’s high need for achievement.

8. A Function of Social, Political and Economic Structure: In his theory of entrepreneurial supply, Kunkel argues that marginality does not generate entrepreneurship and there must be some additional factors at work. Entrepreneurs are not equally distributed in the population. Minorities (religious, ethnic, migrated, displaced elites) have provided most of the entrepreneurial talent. But all the minorities are not important sources of entrepreneurship. The supply of entrepreneurship depends upon four structures found in a society or community. These structures are: (i) Limitation Structure, (ii) Demand Structure, (iii) Opportunity Structure and (iv) Labour Structure.

(v) A Function of Religious Beliefs: Max Weber analysed religion and its impact on enterprising culture. According to him the ‘spirit of capitalism’ is a set of attitudes towards the acquisition of money and the activities involved in it. He also distinguished between the spirit of capitalization and adventurous spirit.

**Generally the entrepreneurs should have the following characteristics**


**A conceptual model of entrepreneurship**

There are several obstacles in defining entrepreneurship clearly. First, everyone has a personal opinion or understanding of entrepreneurship. Secondly, entrepreneurs are viewed as the new cultural heroes and are held in awe due to which critical examination of their...
characteristics is obscured. Thirdly, entrepreneurship is an abstraction, though entrepreneurs are tangible persons. Fourthly, well designed and controlled research studies on entrepreneurship are very few. Lastly, when it is assumed that entrepreneurship is something opposed to or divorced from management defining entrepreneurship becomes difficult:

Kao has developed a conceptual model of entrepreneurship. This model is presented in following figure.

The entrepreneurial personality

The entrepreneurial personality is a composite of the person, his skills, styles and motives. The entrepreneur is central to entrepreneurship because without the key individual who makes things happen, there can be no creative result in the world.

Vries identifies six main elements of entrepreneurial personality. They are as follows.
(a) Environmental turbulence, (b) Struggles around issues of authority with one’s parents, (c) A feeling of rejection, (d) Painful feelings of anger, hostility and guilt, (e) Identity confusion (identification with the person causing the hurt) and (f) Adopting the reactive mode to painful feelings (guilt, rebellion, impulsiveness).

Entrepreneurial style refers to social interactions, the interface between self and others.

The entrepreneurial task

The second leg of entrepreneurship is the role or task of an entrepreneur. The central task of the entrepreneur is to recognize and exploit opportunities. Opportunity may come from many sources. But entrepreneur must have the ability to perceive opportunities where others do not. The entrepreneur is both a ‘dreamer and a doer’.

The entrepreneurial environment

Entrepreneurship is to a great extent controlled by the environment. Entrepreneurial environment is made up of several elements economic, socio-cultural, political, legal and others. Availability of capital and human resources is very important.

The organisational context

The organizational context is the immediate setting in which creative and entrepreneurial work takes place. It includes the organization structure, and systems the definition of work roles, group culture, etc. These factors may facilitate or hinder creativity and entrepreneurship.
The Analytical Framework of Entrepreneurship

1. The Person: Personality, Skills, Experience, Motives, and Psychological preferences.

2. The Task: Perceiving opportunity, marshalling resources, providing leadership.

3. The Environment: Availability of resources, infrastructure, competitive pressures, social values, rules and regulations, state of technology, etc.

4. The Organisation: Structure, rules, policies, culture, human resource system, communication systems.

Views on Entrepreneurship

The following are views on entrepreneurship.

1. Schumpeter’s views on entrepreneurship

   Joseph Schumpeter has done pioneering work on entrepreneurship. According to him entrepreneurship is essentially a creative activity. It consists in doing such things as are generally not done in the ordinary course of business. An entrepreneur is one who innovates, i.e. carries out new combinations or enterprise. Entrepreneurs are especially motivated and talented class of people and key figures in development. They foresee the potentially profitable opportunity and try to exploit it. Innovations involve problem solving and the entrepreneur is a problem solver. An entrepreneur gets satisfaction from using his capabilities in attacking problems.

   Innovation may occur in the following forms:

   (i) The introduction of a new product with which consumers are not yet familiar or introduction of a new quality of an existing product.

   (ii) The introduction of a new method of production, that is not yet tested by experience in the branch of manufacture concerned, which need by no means be founded upon a discovery scientifically new and can also exist in a new way of handing a commodity commercially.

   (iii) The opening of a new market, that is a market into which the particular branch of manufacture of the country in question has not previously entered, whether or not this market has existed before.

   (iv) The conquest of a new source of supply of raw materials or semi-manufactured goods, irrespective of whether this source already exists or whether it has first to be created.

   (v) The carrying out of the new organization of any industry, like the creation of a monopoly position or the breaking up of a monopoly position.

2. Walker’s views on entrepreneurship

   Walker has considered an entrepreneur as an organizer and coordinator of the various factors of production. According to him the true entrepreneur is one who is endowed with
above average ability for organization and coordination. He is a pioneer and a captain of industry. However, in practice the entrepreneurs possess different degrees of organizational skills and coordinating capacity. The supply of true entrepreneurs is limited. The more competent entrepreneurs earn superior rewards in terms of profits.

3. Drucker’s views on entrepreneurship

According to Peter Drucker, an “entrepreneur is one who always searches for change, responds to it, and exploits it as an opportunity “ Entrepreneurs innovate and innovation is a specific instrument of entrepreneurship. It creates resource because there is no such things as a resource until the man finds a use for something and endows it with economic value.

Theories of entrepreneurial supply (origin of entrepreneurship)
The concept of entrepreneurship and its theory have been evolved over a period of more than two centuries. There are different opinions on the emergence of entrepreneurship. These opinions may be classified into three categories:

1. Economic Theory: According to economists entrepreneurship and economic growth will take place in those situations where particular economic conditions are most favourable. G.F Papanek and J.R. Harris are the main drive for the entrepreneurial activities. In some cases, it is not so evident, but the person’s inner drives have always been associated with economic gains.

2. Sociological Theory: Sociologists argue that entrepreneurship is most likely to emerge under a specific social culture. According to them social sanctions, cultural values and role expectations are responsible for the emergence of entrepreneurship.

3. Psychological Theory: According to the advocates of this theory, entrepreneurship is most likely to emerge when a society has sufficient supply of individuals possessing particular psychological characteristics. Schumpeter believes that entrepreneurs are primarily motivated by an atavistic will to power, will to found a private kingdom or will to conquer. Their main characteristics are

(a) An institutional capacity to see things in a which afterwards proves correct,
(b) Energy of will and mind to overcome fixed habits of thought; and
(c) The capacity to withstand social opposition.

Intrapreneurs

The entrepreneurs emerging from within the confines of the organization are called ‘intrapreneurs’ Innovation is the hallmark of entrepreneurship
The term “intrepreneur” was coined in America in the seventies. Several senior executive of big corporations in America left their jobs to start their own small business because the top bosses in these corporations were not receptive to innovative ideas. These executives turned entrepreneurs achieved phenomenal success in their new ventures. Some of them posed a threat to the corporations they left a few years ago. This type of entrepreneurs came to be known as intrapreneurs. Such corporate brain drain is a worldwide phenomenon and is not confined to the United States. Industrialists all over the world started devising ways and of stopping the flight of their brightest executives. Gifford Pinchot III wrote his famous book. ‘Entrepreneuring’ in 1985 and used the term ‘entrepreneurs’ to describe the persons who resigned from their well paid executive positions to launch their own ventures.

Pinchot suggested the creation of a system which will provide selected executives a status within the corporation similar to that of an entrepreneur in society. Such people are ‘intra-corporate entrepreneurs’ or ‘intrapreneurs’

The difference between the entrepreneur and intrapreneur

<table>
<thead>
<tr>
<th>Difference</th>
<th>Entrepreneur</th>
<th>Intrapreneur</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Dependency</td>
<td>An entrepreneur is independent in his operations.</td>
<td>But, an intrapreneur is dependent of the entrepreneur i.e, the owner.</td>
</tr>
<tr>
<td>2. Raising of funds</td>
<td>An entrepreneur himself raises funds required for the enterprise.</td>
<td>Funds are not raised by the intrapreneur</td>
</tr>
<tr>
<td>3. Operation</td>
<td>An entrepreneur operates from outside</td>
<td>On the contrary, an intrapreneur operates from within the organization.</td>
</tr>
<tr>
<td>4. Risk</td>
<td>Entrepreneur bears the risk involve in the business</td>
<td>An intrapreneur does not fully bear the risk involved in the business</td>
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Relationship between entrepreneur and entrepreneurship

<table>
<thead>
<tr>
<th>Entrepreneur</th>
<th>Entrepreneurship</th>
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<tbody>
<tr>
<td>Person</td>
<td>Process</td>
</tr>
<tr>
<td>Organiser</td>
<td>Organisation</td>
</tr>
<tr>
<td>Innovator</td>
<td>Innovation</td>
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<tr>
<td>Risk-bearer</td>
<td>Risk-bearing</td>
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<tr>
<td>Creator</td>
<td>Creation</td>
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<td>Visualiser</td>
<td>Vision</td>
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<tr>
<td>Leader</td>
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<td>Initiator</td>
<td>Initiation</td>
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Evolution of the concept of entrepreneur

The word entrepreneur first appeared in the French language and was applied to leaders of military expeditions in the sixteenth century. After 1700 it was applied to other types of adventures. Richard Cantillon, an Irishman living in France, was the first person to use the term entrepreneur to refer to economic activities. He defined an entrepreneur as a person who buys factor services at certain prices with a view to sell its product at uncertain prices in the future. He conceived of an entrepreneur as a ‘bearer of non insurable risk’.

The French economist J.B. Say defined an entrepreneur as the agent who unites all means of production and who finds in value of the products- the re-establishment of the entire capital he employs, and the value of the wages, and the rent which he pays as well as the profits belonging to himself. He may or may not supply capital.

F.H. Knight propounded the theory that entrepreneurs are a specialized group of persons who bear risks and deal with uncertainty. According to him, entrepreneur is the economic functionary who undertakes such responsibility which cannot be insured nor salaried. He also guarantees specified sums to others in return for assignments made to them.
Joseph Schumpeter regarded entrepreneur basically as an innovator who carries out new combinations to initiate and accelerate the process of economic development. Innovation may assume the following forms:

(i) Introduction of new goods, (ii) Introduction of new methods of production, (iii) opening of a new market, (iv) conquest of new source of raw materials or half manufactured goods; and (v) carrying of new organization of any industry.

John Kunkel considered entrepreneurship a function of social, political and economic structure. Max Weber treated entrepreneurship a function of religious beliefs. Classical economist never defined the term entrepreneur precisely.

Richard Cantillon was the first to introduce the term entrepreneur. He defined an entrepreneur as the agent who buys means of production at certain prices in order to combine them into a product that he is going to sell at prices that are uncertain at the moment at which he commits himself to his costs.

Entrepreneur …. individual or group

Whether entrepreneur is an individual or a group is a controversial issue. Most of the writers consider entrepreneur as an individual and not a group. In a recent study Casson defines an entrepreneur as someone who specializes in taking judgmental decisions about the coordination of scarce resources. Like many other theorists, Casson suggests that entrepreneur is a person, not a team or a committee, or an organization. Some writers, however, consider entrepreneur as a group. According to Cole entrepreneurship is the purposeful activity of an individual or a group of associated individuals, undertaken to initiate, maintain or aggrandize a profit oriented business unit for production or distribution of economic goods and services. The entrepreneur is in essence an institution which comprises all the people required to perform various functions. Such people not only introduce innovations but implement the necessary adjustments in production units when they expand on account of change in demand and its market conditions. These persons also foresee the opportunities inherent in a given situation and even make opportunities out of a given situation.

Relationship between Entrepreneur and enterprise

According to the classical economists, entrepreneur is one who provides the factor of production, namely ‘enterprise’. As the fourth factor it assembles and manages the other factors namely land, labour and capital. The essential features of an enterprise are as follows:

(i) An enterprise consists of people who work together primarily for the purpose of making and / or selling a product or service. Production for self consumption and non business
organisations, e.g., trade associations providing economically valuable services are not enterprise in spite of being important activities in an economy. An enterprise, whether public or private, large or small exists in order to produce a product or service that others consume and pay for it.

(ii) An enterprise utilises raw materials, machinery, energy, space and other inputs to produce and/or sell. It has to incur costs on the procurement of these inputs.

(iii) Every enterprise makes a comparison between its costs (inputs) and gains (outputs). Therefore, its management must have sufficient autonomy to take appropriate actions to maintain and improve the success of the enterprise.

(iv) An enterprise is a continuing entity. It is not an ad hoc effort to produce a single product but rather a recurring effort to produce a stream of products. Some firms may go out of business after a single transaction. But this is due to failure of management or unforeseen conditions and not a planned or desired outcome.

Relationship between entrepreneurs and managers

Very often entrepreneur and manager are used as interchangeable terms. For instance, Kao’s model of entrepreneurship does not treat the manager and the entrepreneur as distinct species within the business world. The main points of difference between the two may be described as follows:

1. Innovation: The entrepreneur does not live with the status quo. He works to change in accordance with his or her personal vision and values. He is more than an inventor.

2. Risk taking: An entrepreneur takes calculated risks. The manager is less tolerant of uncertainty.

3. Reward: An entrepreneur is motivated by profits while the manager is motivated externally imposed goals and rewards.

4. Skills: The roles of entrepreneur and manager demand different types of personal skills. An entrepreneur needs intuition, creative thinking and innovative ability among other skills. On other hand, a manager depends more on human relations and abilities.

5. Status: An entrepreneur is self-employed and he is his own boss. On the contrary, a manager is a salaried person and he is not independent of his employer, the entrepreneur.

6. Response to authority: One of the main features that distinguish managers from entrepreneurs is their ability to identify in a positive constructive way with authority figure using them as role models. This type of behavior is legally absent in entrepreneurs.

The difference between an entrepreneur and a manager
### Difference

<table>
<thead>
<tr>
<th></th>
<th>Entrepreneur</th>
<th>Manager</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. <strong>Motive</strong></td>
<td>The main motive of an entrepreneur is to start a venture by setting up an enterprise. He understands venture for his personal gratification.</td>
<td>But, the main motive of a manager is to render his service already set up by someone else.</td>
</tr>
<tr>
<td>2. <strong>Status</strong></td>
<td>An entrepreneur is the owner of the enterprise.</td>
<td>A manager is the servant in the enterprise owned by the entrepreneur.</td>
</tr>
<tr>
<td>3. <strong>Risk-bearing</strong></td>
<td>An entrepreneur being the owner of the enterprise assumes all the risks and uncertainty involved in running the enterprise.</td>
<td>A manager as a servant does not bear any risk involved in the enterprise.</td>
</tr>
<tr>
<td>4. <strong>Rewards</strong></td>
<td>The reward an entrepreneur gets for bearing the risks involved in the enterprise is profit which is highly uncertain.</td>
<td>A manager gets salary as reward for the services rendered by him in the enterprise. Salary of a manager is certain and fixed.</td>
</tr>
<tr>
<td>5. <strong>Innovation</strong></td>
<td>Entrepreneur himself thinks over what and how to produce goods to meet the changing demands of the customers. Hence, he acts as an innovator also called a’ change-agent’.</td>
<td>But, what a manager does is simply to execute the plans prepared by the entrepreneur. Thus, a manager simply translates the entrepreneur’s ideas into practice.</td>
</tr>
</tbody>
</table>

An entrepreneur need to possess qualities and qualification like high achievement motive, originality in thinking foresight, risk-bearing ability and so on.

On the contrary, a manager need to possess distinct qualification in terms of sound knowledge in management theory and practice.
6. Qualification

Qualities of a successful entrepreneur - Common Entrepreneurial Traits

Several research studies have been carried out to identify the traits of a true entrepreneur. McClelland points out in his book ‘Achieving Society’ that successful entrepreneurs are characterized by:

(a) An unusual creativeness; (b) A propensity of risk taking; and (c) A strong need for achievement.

The following are the various traits of entrepreneurs:

(i) Total commitment, determination and perseverance, (i) Drive to achieve and grow, (ii) Opportunity and goal orientation, (iii) Taking initiative and personal responsibility, (iv) Persistent problem-solving, (v) Realism and a sense of humour, (vi) Seeking and using feedback, (vii) Internal locus of control, (viii) Calculated risk taking and risk seeking, (ix) Low need for status and power and (x) Integrity and reliability.

Professor Tandon has described the following qualities of a true entrepreneur:

1. Capacity to assume risk
2. Technical knowledge and willingness to change
3. Ability to Marshall Resources
4. Ability of organization and administration

On the basis of the foregoing description, the qualities of a true entrepreneur may be classified as follows:


Types of entrepreneurs - Entrepreneurial Modes

In the initial stage of economic development, entrepreneurs tend to have less initiative and drive. As development proceeds, they become more innovating and enthusiastic.
Similarly, when entrepreneurs are shy and humble the environment is underdeveloped. In a study of American agriculture, Danhof has classified entrepreneurs in the following categories.

1. **Innovating entrepreneurs:** Innovating entrepreneurship is characterized by aggressive assemblage of information and the analysis of results derived from sound combination of factors. Persons of this type are generally aggressive in experimentation and cleverly put attractive possibilities into practice. Schumpeter’s entrepreneur was of this type.

2. **Adoptive or imitative entrepreneurs:** This kind of entrepreneurs are ready to adopt successful innovations created by innovative entrepreneurs. Instead of innovating the changes themselves, they just imitate the technology and techniques innovated by others. Such entrepreneurs are particularly important in under-developed countries because they contribute significantly to the development of such economies.

3. **Fabian Entrepreneurs:** Entrepreneurs of this type are very cautious and while practicing any change. They have neither the will to introduce new product nor the desire to adopt new methods innovated by the most enterprising. Such entrepreneurs are shy and lazy. Their dealings are determined by religion, tradition and past practices. They are not much interested in and they try to follow footsteps of their predecessors.

4. **Drone entrepreneurs:** Drone entrepreneurship is characterized by a refusal to adopt and use opportunities to make changes in production. Such entrepreneurs may even suffer losses but they do not make changes in production. They are laggards as they continue to operate in their traditional way of changes. When their product loses marketability and their operations is uneconomical they are pushed out of the market. They are conventional that they stick to conventional products and ideas.

Some more categories of entrepreneurs are given below:

(i) **Individual and institutional entrepreneurs:** In the small scale sector individual entrepreneurs are dominant. Small enterprises outnumber the large ones in every country. Such entrepreneurs have the advantages of flexibility, decision making and state patronage. But a single individual can establish, and control an organization up to a limit.

(ii) **Entrepreneurs by inheritance:** At times, people become entrepreneurs when they inherit the business. In India, there are a large number of family-controlled business houses. Firms in these houses are passed from one generation to another.

(iii) **Technologist entrepreneurs:** With the decline of the joint family business and the rise of scientific and technical institutions, technically qualified persons have entered the field of
business. These entrepreneurs may enter business to commercially exploit their inventions and discoveries. Their main asset is technical expertise.

(iv) Forced entrepreneurs: Many persons become entrepreneurs on account of the circumstances. The money lenders of yester years enter into business due to decline of money lending business with the growth of banking and Government legislation. Neo-rich Indians returning from abroad (NRIs) and educated unemployed seeking self employment may also be described as forced entrepreneurs.

On the basis of motive, entrepreneurs may be classified into three categories:
1. Managing entrepreneurs whose chief goal is security;
2. Innovating entrepreneurs who want excitement; and
3. Controlling entrepreneurs who above all desire power.

Following are some more types of entrepreneurs listed by some other behavioural scientists.

1. Solo operator: These are the entrepreneurs who essentially work alone and, if needed at all, employ a few employees. In the beginning most of the entrepreneurs start their enterprise like them.

2. Active partners: Active are those who start / carry on an enterprise as a joint venture. It is important that all of them actively participative in operation of the business.

3. Inventor: Such entrepreneurs with their competence and inventiveness invent new products. Their basic interest lies in research and innovative activities.

4. Challengers: These are the entrepreneurs who plunge into industry because of the challenges it presents. When one challenge seems to be met, they begin to look for new challenges.

5. Buyers: These are those entrepreneurs who do not like to bear much risk. Hence in order to reduce risk involved in setting up a new enterprise, they like to buy the ongoing one.

6. Lifetimers: These entrepreneurs take business as an integral part to their life. Usually, the family enterprise and business which mainly depend on exercise of personal skill fall in this type/category of entrepreneurs.

Women entrepreneurs

Women constitute around half of the total world population. So is in India. They, therefore, regarded as the better half of the society. Women entrepreneurs may be defined as a woman or group of women who initiate, organize and run a business enterprise. In terms of Schumpeterian concept of innovative entrepreneurs, women who innovate, initiate or adopt a business activity are called women entrepreneurs. In other words, an enterprise owned and
controlled by a woman having a minimum financial interest of 51% of the capital and giving
at least 51% of employment generated in the enterprise to women.

Functions of women women entrepreneurs

As an entrepreneur, a woman entrepreneur has also to perform all the functions
involved in establishing an enterprise. These include idea generation and screening,
determination of objectives, project preparation, product analysis, determination of forms of
business organization, completion of promotional activities, raising of funds, procuring men,
machine and materials and operation of business.

Frederick Harbison has enumerated the following five functions of a woman entrepreneur.

1. Exploration of the prospects of starting a new business enterprise.
2. Undertaking of risks and handling of economic uncertainties involved in business.
3. Introduction of innovations or imitations
4. Coordination, administration and control
5. Supervision and leadership

OBJECTIVE QUESTIONS

UNIT - 7 & 8
Entrepreneurial Development

1. The factor(s) which affect(s) entrepreneurship is
   a) Political ideology  b) Social ability  c) Need achievement  d) All of these

2. An entrepreneur
   a) Searches for change  b) Responds to the changes  c) Exploits the change as an opportunity  d) All of these

3. The process of extending the firm's domain of competence by exploiting new opportunities through
new combinations of its recasting resources is referred to as
   a) Franchising  b) Intrapreneuring  c) Both a) and b)  d) Invention

4. A situation in which there is a discontinuity between the individual's personal attributes and the role
which the individual holds in the society is referred to as
   a) Social marginality  b) Group marginality  c) culture marginality  d) None of these

5. A situation in which there is a discontinuity between the individual's personal attributes and the role
which the individual holds in the society is referred to as
   a) Behavior  b) Policies  c) Practices  d) All of these

6. The word entrepreneurship has been derived from__________ word.
   a) French  b) Latin  c) Italy  d) American

7. The French word entrepreneurship means
   a) To apply  b) To undertake  c) To involve  d) To participate
8. Entrepreneurship is a/an
   a) Art  b) Science  c) Both a) and b)  d) Technique

9. Who said that entrepreneurship is a creative activity?
   a) McClelland  b) Schumpeter  c) Higgins  d) Vasper

10. Entrepreneurship implies the skill to build an organization. This is the view of
    a) Schumpeter  b) Mc Clelland  c) Harbison  d) Drucker

11. An entrepreneur behaviour is type behaviour.
    a) A  b) B  c) C  d) D

12. The book “Achieving Society” is written by
    a) McClelland  b) Pyle  c) Schumpeter  d) Harbison

13. One who forments a rebellion and attempts to establish a new society is called
    a) Retreats  b) Ritualish  c) Reformist  d) Innovator

14. Innovation occurs in the following form
    a) The introduction of a new product with which consumers are yet familiar
    b) The introduction of a new method of production
    c) The opening of a new market
    d) Any of these

15. An entrepreneur is an organizer and coordinator of various factors of production”. This is the view of
    a) Schumpeter  b) A. Walker  c) Ruskin  d) Drucker

16. “An entrepreneur is one who always searches for change, responds to it, and exploits it as an opportunity”. This is the view of
    a) Drucker  b) Walker  c) Schumpeter  d) Pyle

17. Who wrote the book, “Innovation and Entrepreneurship Practice and Principal”?
    a) Peter Drucker  b) Economist  c) Socialist  d) Psychology

18. The book, “The theory of Economic Development” is written by
    a) Schumpeter  b) Randall  c) Vries  d) Walker

19. The “Intrapreneur” was coined in
    a) India  b) London  c) America  d) France

20. The book, “Intraprenering” was written by
    a) Giffor PinchohIII  b) Ruskin  c) Weter  d) Vries

21. The person who first used the term ‘entrepreneur’ was
    a) Richard Cantillon  b) C. Cochran  c) J.B. Say  d) F. Hoselitz

22. The trait of an entrepreneur is
    a) Drive to achieve and grow  b) Calculated risk taking and risk seeking
    c) Integrity and reliability  d) All of these

23. The entrepreneurs who are characterized by aggressive assemblage of information and the analysis of results derived from sound combination factors are called entrepreneurs.
    a) Innovating  b) Adoptive  c) Fabian  d) Drone

24. The entrepreneurs who are ready to adopt successful innovations created by innovative entrepreneurs are called as entrepreneurs.
    a) Innovative  b) Adoptive  c) Fabiran  d) Drone

25. The laggards are entrepreneurs
26. According to Schumpeter, the basic function of an entrepreneur is:
   a) To innovate    b) To start business    c) To risk    d) None of these

27. P.N. Sharma identified _______ motivating factors of entrepreneurs.
   a) 9    b) 10    c) 11    d) 12

28. Achievement motivation Theory was developed by:
   a) Karl Marx    b) McClelland    c) Maslow    d) Vroom

29. The Kakinada Experiment was conducted by:
   a) McClelland    b) Vroom    c) Durand    d) Walker

30. The trade fair authority of India (TFAI) was established in:

ORIGIN AND MEANING OF AUDIT

The term ‘Audit’ is derived from the Latin word audire, which literally means, “to hear”. In the olden days whenever the proprietor of a business enterprise would suspect a fraud, some independent persons were appointed to hear verbal explanations from those responsible for keeping the books of account, judge the facts, and therefore on the basis of their examination announce the results of the enterprise to the owner(s). This practice was known to have existed in the ancient Egyptian, Greek, and the Roman civilizations. The owners were chiefly interested in asserting whether all cash receipts and payments had been properly accounted for and checking the records for possible employee fraud. Put differently, initially, the aim of audit was to know whether any cash had been embezzled and if so, who embezzled it and what amount was involved. The scope of audit, therefore, as it exists today, cannot be confined to cash verification. The principal object of modern audit is to report on the financial position of a business undertaking as depicted by its balance sheet and the profit and loss account. Detection of errors and frauds is an incidental object of independent financial audit.

DEFINITION OF AUDIT

“An audit may be said to be such an examination of the books, accounts and vouchers of a business, as shall enable the auditor to satisfy himself whether the Balance sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business, and that the Profit and Loss account gives true and fair view of the profit or loss for the financial period, according to the vest of his information and the explanations given to him as shown by the books, and if not, in what respect he is not satisfied.” - Spicer and Pegler
"An audit is an examination of such records to establish their reliability and the reliability of statements drawn from them.” - A.W. Hanson

According to Auditing and Assurance Standard 1 (AAS1), ‘Basic Principles Governing an Audit’, issued by ICAI: “An audit is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.”

To conclude, auditing may be defined as “checking somebody else’s accounting and reporting thereon”.

ESSENTIAL CHARACTERISTIC OF AUDITING

1. Audit is an independent, scientific, intelligence and critical examination of the books of account or accounting records of a business.

2. Such examination enables the auditor to satisfy himself that the financial statements have been properly drawn up, and exhibit a true and fair view of the financial state of affairs of the business for the accounting period.

3. Detection of errors and frauds is an integral part of auditing.

4. The job of auditing is performed by an independent person or body of persons qualified for the job.

5. In order to report on the financial health of the business, the auditor has to go through vouchers and other related documentary evidence (both internal as well as external).

6. The auditor has to satisfy himself about the correctness, authenticity, and reliability of accounting information and submit his report accordingly.

COMPARISON BETWEEN AUDITING AND ACCOUNTING

Accounting: Accounting is the process of recording, classifying, and summarizing business transactions in monetary terms. Accounting aims at providing financial information for decision making. The person who performs this function is called accountant. His job includes following:

(a) Recording business transactions in monetary terms.

(b) Classifying and summarizing them.

(c) Preparing financial statements.

(d) Communicating the final information in a summary form to management and other users to make decision.

Auditing: “Auditing begins where accounting ends”. This implies that an auditor comes into the picture only when the accountant has done his job. While auditing accounting data,
the auditor has to determine whether the recorded information properly reflects the economic
events that occurred during the accounting period. Thus auditing is basically a review
function. An auditor examines the final product of the accounting system and, on the basis
of his examination and audit evidence, accumulated by him, expresses (through a formal
report) his impartial opinion- whether the accounting information is properly recorded and
fairly reflects the state of affairs of firm’s business. The main points of accounting and
auditing may be summarized below.

1. **Subject matter**: Accounting is concerned with collection, classification, and summarizing
of economic events in a logical manner for the purpose of providing financial information
for decision making. Auditing, on the other hand, is concerned with examination or review of
financial information so furnished.

2. **Object**: The main object of accounting is to know the trading results or state of affairs of a
business during the accounting period. Whereas the object of audit is to judge the correctness
and reliability of finance statements prepared by the internal staff of the business enterprise.

3. **Hierarchy**: Auditing begins where accounting ends. There can be no auditing without the
prior existence of accounting data.

4. **Nature**: Accounting is constructive in nature as it measures business events in terms of
profit and loss and communicates the financial condition of the business as depicted by
financial statements. Auditing on the other hand, is referred as analytical and critical aspect
of accounting since it reviews the measurements and communication of financial results
and condition of business.

5. **Expertise required**: An accountant may not be comfortable with audit techniques and
procedures, but an auditor must be well versed with the principles and techniques of
accounting. It is this expertise that distinguishes auditors from accountants.

6. **Process**: Accounting is a four-step process that involves collection and record,
classification, summarizing and communication of accounting information and results
thereof. Auditing, on the other hand, includes three principal steps, viz., preliminary
planning, performing the audit work, and reporting the findings. However, separation of these
steps in not always clear.

**OBJECTIVES OF AUDIT**

The objectives of an ‘Audit’ may broadly be categorized as:

I. Primary objectives
   
II. Secondary objectives

III. Specific objectives

**I. PRIMARY OBJECTIVE**
Expression of independent opinion on accounts: In auditing accounting data, the main concern is to determining whether recorded information properly reflects the economic events that occurred during the accounting period. The auditor of a joint stock company has to state in his audit report whether in his opinion the accounts disclose a “true and fair view” of the state of company’s affairs or not. In technical terms, this is called expression of expert opinion. Therefore, the primary objective of an independent financial audit is to determine whether the financial statements present a factual and impartial view of the financial position and working results of an enterprise.

II. SECONDARY OBJECTIVES

(A) Detection and prevention of errors and mistakes: The term ‘error’ in accounting refers to an unintentional misstatements of financial statements. Errors and mistakes are of various kinds, which are discussed now.

1. Clerical errors: These errors arise because of mistakes committed by the clerical staff in ordinary of accounting work. These are of five types:

   (i) **Errors of omission**: These occur on account of transactions not being recorded in the books of account either wholly or partially.

   (ii) **Errors of commission**: These consists of incorrect additions, wrong posting and entries.

   (iii) **Compensating errors**: These are the errors which counterbalance each other in such a manner that there remains no difference between the two sides of the trial balance.

   (iv) **Errors of duplication**: Errors of duplication arise when an entry in a book of original record has been made twice, or/and due to double posting of a journal entry in ledger accounts.

   (v) **Trial balance errors**: These may consist of casting errors in the trial balance, omission of a balance while extracting balance from the books of account, or entering an amount incorrectly or on the wrong side.

2. Errors of principle: Errors of principle are those which result from misapplication of or overlooking accounting principles. By and large, there are three types of errors generally considered to be errors of principle. These are

   (i) Incorrect allocation.

   (ii) Omission of outstanding assets and liabilities.

   (iii) Incorrect valuation of assets.

(B) Detection and prevention of frauds: The term ‘fraud’ may be defined as internal irregularities aimed at cheating or causing loss to another. Frauds are often committed by
two or more persons, acting in collusion with one another. The auditors responsibility for uncovering frauds deserves special mention. A fraud may take the following terms:

1. **Misappropriations and defalcations**

   (i) **Embezzlement of cash**: Embezzlement of cash refers to falsification or misappropriation of cash, which is very common especially in case of big business concern, as the proprietor has very little control over the receipts, and payments of cash. Cash may be misappropriated in a number of ways as follows:

   1. By omitting to enter receipts:
   2. By entering fictitious payments:
      - Under casting the receipt side of cashbook by entering fewer amounts than what has been actually received.
      - Overcasting the payment side of the cashbook by entering excess amount.

   (ii) **Misappropriation of goods**: Further, fraud may also be committed through misappropriation of goods.

2. **Misrepresentation of accounts**: Misrepresentation of accounts refers to Fraudulent Manipulation of Falsification of Accounts with a view to conceal the true picture and to reveal the distorted picture, the accounts of a firm may be falsified or manipulated by making false entries. It may take the following ways.

   (i) **Window dressing**: When accounts are prepared in such a manner that they seem to indicate a much better and sound financial position of the business enterprises, it is known as window dressing.

   (ii) **Secret reserves**: When accounts are prepared in such a manner that they seem to disclose worse financial position of the company than actual ones, it is known as ‘Secret Reserves’. Thus the real picture of the business is concealed and distorted picture is revealed. The main objectives behind showing less profit than actual one’s are

      - To avoid or reduce income tax liability
      - To buy bash shares form the open marker through reducing the prince of shares by paying less or no dividend.

      - To conceal the true position of company’s state of affairs from the competitors.

III. **SPECIFIC OBJECTIVES**

   The area of operation of audit is quite wide and such other areas like review of cost, operations, efficiency, management, and tax liability, etc. fall under the purview of audit. Accordingly, there would be specific objectives in respect of each type of such specified audit.
QUALIFICATION AND QUALITIES OF AN AUDITOR

An auditor must be professionally qualified, i.e., he must be a chartered accountant within the meaning of the Chartered Accountants Act, 1949 and should possess the certificate of practice. Apart from the statutory qualifications, an auditor should also possess certain other traits and qualities as mentioned below.

2. Knowledge of theory and practice of auditing and relevant laws.
3. Intelligence and tactfulness.
4. Responsible and prudent.
5. Familiarity with the latest developments/amendments affecting audit.
6. Integrity.
7. Objectivity, independency and transparency.
8. Vigilance.
9. Positive attitude and reliance upon client’s staff.
10. Diligence.
11. Confidentiality and loyalty.
12. Communication skills.

ADVANTAGES OF AUDIT

There are numerous advantageous of having accounting records audited, no matter whether there is hardly any legal requirements of audit. Audit is useful for every business organization. Some of the important advantages associated with auditing are given below:

1. Detection and prevention of errors and frauds become easier.
3. Acceptability by the authorities.
4. Professional advice available.
5. Speedy processing of loan.
8. Settlement of insurance claims.
9. Useful to compare the financial performance.
10. Keeps accounts department vigilance.
11. Identifies the weak areas.

LIMITATIONS OF AUDIT

(i) Auditor may not be in a position to uncover all sorts of manipulations. In others words, auditor may not trace out all types of errors, misappropriate or manipulations, especially those ingeniously perpetrated.

(ii) As per the Companies Act, responsible officer must give true and correct information to auditor who depends upon the information and explanation given by the company. If such officer intentionally does not give the true and correct information to the auditor, then the audit report will never show a true and fair view.

(iii) Influence of management is another major limitation of audit. Though, an independent auditor is appointed by the shareholders, he depends upon the management for his fees and obviously has a close working relationship with the latter. Every auditor suffers
from a pre-conceived notion that he has been appointed to safeguard the interest of management instead of to work as a financial police force to prevent the misuse of power and other financial irregularities.

**SCOPE OF AUDIT OR THE SUBJECT MATTER OF AUDIT**

Scope of audit refers to its subject matter. The scope of an audit is determined by the auditor, having regard to

(a) the terms of the engagement;
(b) the requirements of the relevant legislation; and
(c) the pronouncements of the Institute of Chartered Accountants of India.

**CLASSIFICATION OF AUDITS**

Auditing is a wide discipline. The entire process of auditing depends upon the kind of audit required in particular circumstances. Audit examination can broadly be classified on the following three bases:

I. Classification on the basis of the organizational structure
II. Classification based on timing and scope of audit procedures
III. Classification on the basis of specific objectives behind audit

I. **CLASSIFICATION BASED ON ORGANIZATIONAL STRUCTURE**

This type of classification is based on the organizational structure of business undertaking under audit. A business undertaking may be owned, managed and controlled by Government or private individuals, and may be operated in a corporate form or non-corporate form. The types of audits to be conducted for various organizations therefore should fall under the following categories.

(A) **STATUTORY AUDIT**

Where undertakings are formed under the statute or laws, audit for such undertakings is made compulsory under the statutes that govern them. Audit is compulsory under statute in the following cases:

1. Joint stock companies incorporated under the companies Act, 1956.
2. Cooperative societies registered under the Cooperative Societies Act.
3. Besides companies and cooperative societies, audit is a mandatory requirements in respect of the following institutions:
   (a) Public and charitable truths registered under the relevant Acts.
   (b) Banking companies governed by the Banking Companies (Regulation) Act, 1949.
   (c) Insurance companies government by the Insurance Act, 1938.
(d) Public sector undertakings (PSUs), local authorities, and government financial institutions established under special Act or law, if any.

(B) PRIVATE AUDIT

Private audit is one that is not mandatory under any statute or law. It is undertaken by the enterprises in view of the several benefits resulting from it. Various types of private audits are as follows.

1. **Audit of sole proprietorship:** Audit of accounts of sole proprietary is optional. Such type of business is owned, managed and controlled exclusively by an individual. He individually takes the decision whether to get the books of account audited or not. The auditor obtains clear instructions from the owner regarding the nature of work to be audited and its scope.

2. **Audit of partnership firm:** The Partnership Act, 1932 does not require a partnership firm to get their financial statements audited. Still many partnership firms provide for audit of their books of account.

3. **Audit of accounts of other entities:** There are some other institutions where financial statements are not required to be audited by an independent auditor under any statute or law, viz., clubs, libraries, hospitals, schools, colleges, other educational institutions and Hindu Undivided Family. For these entities audit of accounting data is not obligatory. They may, however, get their books of account audited so as to present a clear picture of state of affairs of the business transacted.

(C) GOVERNMENT AUDIT

The government offices, departments, undertakings registered as companies, are also subject to independent financial audit. Usually a statutory auditor, appointed by the Central Government on the advice of the Comptroller and Auditor General of India, audits the accounts of Government companies.

II. CLASSIFICATIONS BASED IN TIMING AND SCOPE OF AUDIT PROCEDURES

Under this classification, important types of audit are as follows.

(A) CONTINUOUS AUDIT

A continuous audit is one where the audit is required to examine the books of account of a business concern at regular intervals say weekly, fortnightly, and quarterly or as per the requirements of the management and quantum of work. He checks the books of account to date as far as possible. *It is also known as ‘running audit’.* In other words, a continuous audit is one, where the auditor or his staff attends and checks the accounting data...
regularly at appropriate intervals. *Continuous audit is followed in big organizations*, where business is extraordinarily large; numerous transactions of varied nature take place; and monthly or quarterly final accounts are required by the management for decision making throughout the year.

(B) INTERNAL AUDIT

Internal audit as the term implies is *an audit conducted within the organization by an internal auditor appointed by the management of an enterprise.* Normally, all large business organizations often set up an internal audit department to exercise an independent appraisal function within the organization. This department undertakes examination and evaluation of various accounting, financial and operating activities of the business enterprise. Internal audit aims at highlighting the weak areas in the organization besides assisting the management to discharge its responsibilities effectively. Internal auditor’s work assists the external auditor in fixing the extent of necessary tests. The internal auditor audits the accounts and other relevant records on daily, regularly or on periodical basis. The main advantages of interim audit are as follows:

1. It facilitates the final audit to be completed soon.
2. Auditors suggestions can be incorporated quickly.
3. Errors and frauds can be identified and rectified at an early and initial stage and their re-occurrence can be prevented.

(C) FINAL AUDIT OR PERIODICAL AUDIT

A final audit is one where the auditor undertakes the audit work only at the end of the financial year. In such a case, *the audit work commences after all the accounts are ready.* The auditor visits his client only once a year and completes the entire work in one go. The final audit is very useful in case of a small concern.

(D) BALANCE SHEET AUDIT

*Balance sheet Audit originated in the United States implies a critical review of Balance Sheet.* It is a procedure in which the figures, as stated in the balance sheet are taken as a base and their authenticity is verified from the records. Just opposite to normal audit procedures, the items appearing in the balance sheet and works back to the supporting evidence and related documents.

III. CLASSIFICATION OF AUDITS BASED ON SPECIFIC OBJECTIVES

(A) COST AUDIT

Cost audit as the expression implies is an audit of cost accounting record. It has been defined in various ways:
The charted Institute of Management Accountant of U.K. defines it as “the verification of cost accounts and a check on adherence to the cost accounting plan”.

According to Smith and Day “The term ‘cost audit’ means the detailed checking of the costing system, techniques and accounts to verify their correctness and to ensure adherence to the objectives of cost accountancy”.

The companies Act, 1956 introduced for the first time cost audit in India by inserting Section 233 B.

The main objective of the cost audit is to verify the accuracy of cost records under the above-mentioned section. It serves as an effective tool for cost control. Objective of cost audit is to know whether the cost statements are properly drawn up and whether they present a true and fair view of cost accounting system. A cost auditor has to submit his audit report to the Central Government

(B) SPECIAL AUDIT

According to Section 233-A of the Companies Act, 1956 the Central Government may at any time, by order direct that a special audit of a company’s accounts for such period or periods, as may be specified in the order, shall be conducted and may by the same or a different order appoint either a chartered accountant (whether or not such chartered accountant is a chartered accountant in practice within the meaning of the Chartered Accountants Act, 1949) or the company’s statutory auditor to conduct such special audit.

The Central Government may order a special audit of the company’s accounts in the following cases:

(a) If the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices.

(b) Where any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains.

(c) Where the financial position of any company is such as to endanger its solvency.

The Government may appoint the company’s auditor or any other chartered accountant to conduct the audit. The auditor so appointed shall have the same powers and duties as an auditor of the company. However such auditor shall submit his/ her report to the Central Government.

(C) MANAGEMENT AUDIT

Management audit refers to critical and analytical examination of the performance of different managerial functions in an organization. It involves a critical review of all aspects of the process of management. It analyses the effectiveness of policies, procedures and
operations of an enterprises. Management audit, in fact, is an appraisal of both policies and actions.

(D) OPERATIONAL AUDIT

The concept of operational audit is a contemporary development. It refers to a review of any part of an audit

(a) To assess the performance organization’s operating procedures and methods for the purpose of evaluating efficiency and effectiveness. At the completion of an operational audit, recommendations to management for improving operations are normally expected of the auditor. Operational audit is conducted with the following objectives:

(b) To improve the profitability of the business organization.
(c) To develop recommendations for improvement or further action.
(d) To achieve the other organizational objectives other than the profitability, i.e. , social, environmental , developing human resources and public interest.

Operational audit aims at improving the overall performance of a business enterprise by improving future business operations carried out by the management. To conduct such audit normally an-independent internal auditor is appointed.

(E) MARKETING AUDIT

Marketing audit, as is evident from the expression, refers to audit of marketing situation of a business undertaking. Such type of audit is conducted in order to evaluate and control marketing performance of a business. Marketing audit is very popular in the US and European countries.

(F) ENVIRONMENTAL AUDIT

Environmental audit, as the term indicates, is a process to examine the effects- good or bad- of the operations of an enterprise on the environment. The Confederation of British Industry has defined environmental auditing as the systematic examination of the interactions between any business operation and its surroundings. This includes all emissions to air, land and water; legal constrains; the effects on the neighboring community, landscape and ecology; the public’s perception of the operating company in the local area.

To put in simple words, an environmental audit is as assessment of the nature and extent of harm (or risk of harm). Environmental auditing originated in the United States in the 1970s as a way of checking whether a company was complying with a multitude of new environmental laws and regulations.

(G) SOCIAL AUDIT
Social auditing is a process that enables an organization to assess and demonstrate its social, economic, and environmental benefits and limitations. It is a way of measuring the extent to which an organization lives up to the shared values and objectives it has committed itself to. In simple words, **social audit attempts to assess the social performance of an enterprise**. Social auditing provides an assessment of the impact of an organization’s non-financial objectives through systematically and regularly monitoring its performance and the views of its stakeholders. **Social auditing requires the involvement of stakeholders**. This may include employees, clients, volunteers, fund providers, contractors, suppliers and logical residents interested in the organization. Stakeholders are defined as those persons or organizations who have an interest in, or who have invested resources in, the organization.

**I) HUMAN RESOURCE (HR) AUDIT**

A human resource audit reviews an organization’s policies, procedures, and practices concerning human resource. Its purpose is to examine the technical and practical dimensions of the HR function and to create a comprehensive system that adds value to the organization.

**Elements of HR audit**

A human resource audit generally includes the following elements:

1. Personnel policies
2. Personnel Files Review
3. Performance Appraisal
4. Evaluation process
5. Termination process
6. Unlawful Harassment Compliance
7. Hiring and Orientation Procedures
8. Benefits and Compensation Review
9. Employee Status and Classification
10. Job Descriptions

**J) ENERGY AUDIT**

The term energy audit implies a critical review of utility energy data for all fuels, including electricity, natural gas, fuel oil, and any other delivered fuels. It is commonly used to describe a broad spectrum of energy studies ranging from a quick walk-through of a facility to identify major problems areas to comprehensive analysis of the implications of alternative energy efficiency measures sufficient to satisfy the financial criteria of sophisticated investors.

**Types of Energy Audit**

(i) Preliminary audit  (ii) General Audit  (iii) Investment-grade audit

**AUDIT PLANNING**

Planning begins especially with an intended goal, an end result or targeted outcome. A plan is basically a device for the achievement of that goal. Planning is a two way function:
setting the right goals and selecting the right means to achieve those goals. Planning in audit operations too has been considered as an essential prerequisite so as to produce maximum out of minimum. Adequate audit planning enables an auditor to cover the different aspects of audit work including vouching, verification, valuation, expression of independent opinion on financial statements and submission of audit report in a systematic and methodical manner. Audit planning helps in enhancing the quality of audit work. It brings promptness and perfection in performance.

PRELIMINARY PREPARATIONS BY THE AUDITOR

Preparation before audit refers to preliminary arrangement made by the auditor with regard to auditing. An auditor must prepare him well before he actually conducts audit. Upon being appointed an auditor for the first time, the auditor will have to plan out the steps he would take before commencing the actual work. Before commencing a new audit, an auditor ought to undergo seven stages.

1. ‘Agreement’ with the client. 2. Ascertain the scope of audit work.
5. Information about the client’s staff. 6. Ascertain technical details.
7. Instructions to and information from client.

AUDIT PROGRAMME

An audit programme is nothing but a list of examination and verification steps to be applied set out in such a way that the interrelationship of one step to another is clearly shown and designed on the basis of an appraisal of the accounting records of the client. Before commencing audit, the auditor outlines the whole procedure of the audit from beginning till its completion, from the preliminary stage of the audit till the finalization of audit report and his signatures thereon. Audit programme is, therefore, an outline of procedures to be followed in order to arrive at an opinion concerning the financial statements of a business undertaking.

Audit programme is generally contained in the audit notebook and is invariably in black and white. AAS8 ‘Audit Planning’, issued by ICAI suggests that the auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan. One audit programme is prepared for a particular audit.

FEATURES OF AUDIT PROGRAMME

1. Audit programme is a set of procedures to be followed to support an opinion on the financial statements.
2. The audit programme is invariably in black and white.
3. It is the auditor’s plan of action.
4. It is a scheme according to which the audit work will be distributed among the
   audit itself.
5. It enables the auditor to delegate work to the audit staff as per their capabilities.
6. It enables the auditor to specify the work to be done and the manner in which it
   should be completed within the estimated time.
7. It determines the various audit techniques to be adopted and applied for conducting
   the audit in efficient and effective manner.

FACTORS TO BE CONSIDERED WHILE DEVELOPING AN AUDIT PROGRAMME

The audit programme must be developed with due care and skill. Particular attention
should be given to the following
1. Exact scope of the duties of an auditor,
2. Books of original entry and ledgers in use,
3. The system of bookkeeping employed, and its weakness (if any),
4. System of internal check and the extent of its reliability,
5. Special provision contained in the legal documents (Partnership Deed, Memorandum and Articles of Association etc.) affecting the duties of the auditor,
6. General nature and routine of the business,
The audit programme should not be very rigid; it must be capable of being reviewed
in view of changing circumstances.

OBJECTIVES OF AUDIT PROGRAMME
1. To integrate and coordinate the different parts of audit work,
2. To ensure the uniformity in the performance of audit work and to avoid duplication
   of work,
3. To have a fair allocation of audit job amongst audit staff,
4. To ensure the completion of audit work within a time frame,
5. To fix the responsibility of each member of the audit staff and
6. To provide a proof of completion of a particular audit work, the dates on which it
   was completed, who performed it and how was this done.

CONTENTS OF AUDIT PROGRAMME

It is somewhat difficult to mention all the items to be incorporated while drafting and
audit programme as it varies from company to company and depends on the type of audit
work to be carried out. A fresh audit programme is required for each audit. Generally
preparation for an audit programme needs the following information:
1. Name of the company.
2. Nature of operations of the company.
3. A review of the system of internal check.
4. Date of commencement of audit.
5. Tentative period of audit exercise.
6. Accounting system followed by the company for recording its financial transactions.
7. Preparation of the audit report.
8. Instructions or points of caution as mentioned by previous year’s auditors in his audit report.
9. Schedule of checking of various subsidiary books including journal proper.
10. Schedule of checking of ledger accounts including profit and loss account items and balance sheet items.

**ADVANTAGES OF AUDIT PROGRAMME**

Audit programme is one of the basic instruments to train the audit staff and can be used as guide for the performance of the audit job. It offers the following advantages.

1. Progress of the work can examined periodically.
2. The auditor can divide the work properly amongst the staff according to their qualifications and experience.
3. Uniformity in the performance of audit work is ensured.
4. It serves as a legal proof for the work done as initials of those who have performed a particular job are to be appended to it.
5. The responsibility for negligence can be fixed.
6. It is helpful in supervising the work of the staff.
7. It results in a proper audit routine. It not only saves time but also assures adherence to the principles of auditing and accountancy.

**AUDIT NOTEBOOK**

An audit notebook refers to a record of some important and meaningful information gathered or experienced prior to or during the course of audit. While conducting and audit, the auditor comes across certain points which require further clarification, explanation and investigation and he records the same in a diary maintained for the purpose known as the audit notebook. It contains significant audit observations. Objections, queries raised and replies received thereto, correspondence with the client, etc.

**CONTENTS OF AUDIT NOTEBOOK**

In an audit notebook, a permanent record is kept of the following:

1. **Audit Programme:** An audit programme is nothing but a list of examination and verification steps to be applied set out in such a way that the interrelationship of one step to
another is clearly shown and designed on the basis of an appraisal of the accounting records of the client.

2. Audit review notes: During the conduct of the audit, certain points do crop up which need further elucidation and discussion with the management. Therefore notes are taken during the conduct of work.

3. Audit queries: During the conduct of the audit, all those vouchers, which remain insufficiently vouched, are to be noted in the query list of the audit notebook. A complete record as to how they were cleared and those, which remained unclear and reported to management, is also maintained.

4. Important balances: A note of the important closing balances particularly in respective of cash and bank account should be noted so that after the work has been done alterations if any, in the closing balances may not be carried out

5. Extracts from documents: Extracts from Memorandum and Articles of Association, agreements, contracts, minutes of the proceedings of the directors of shareholders, etc. must be noted in the audit notebook for ready reference.

6. Accounting statistics: Statistics in respect of the pages of each book of original entry and the number of the vouchers must be noted in this section. This serves two purposes. Firstly, it is a check on the staff so that they may not indulge in wasting time. Secondly, it is intended to help the auditor for requesting for increase in the audit fee if the comparison of accounting statistics of the present year with the previous one reveals that the quantum of work has gone up.

Advantages of Usefulness of Audit Notebook

The main advantages of an audit notebook can be summarized as under:

1. It records all the significant information affecting the audit.
2. It ensures uniformity and assists in knowing the extent of work completed at a particular point of time.
3. It serves as a source of information about the audit work and the points, which deserves special attention.
4. It facilitates smooth conduct of audit.
5. It ensures that the audit programme has been followed sincerely, any deviation can be traced immediately and the reasons therefore can be investigated into.
6. Certain modification are also possible in audit programme in case audit staff faces certain practical difficulties in following the audit programme.
7. It helps the auditor in judging the efficiency of his staff.
8. It may also help the auditor to prove that he has not acted negligently. In future, if the auditor is charged with negligence, the audit notebook can be produced as an evidence to defend him and to show what actual work he has done in the course of audit.

**AUDIT WORKING PAPERS**

Audit working papers refers to all documents prepared or gathered by the auditor, relating primarily to set of accounts being audited and some basic information of continuing importance affecting the company or the audit. Working papers are the connecting link between the client’s records and the audited accounts. These include all the evidence gathered by the auditor indicating what work has been done by him and the procedure he has followed in verifying a particular asset or a liability. These would come to help of the auditor in future in case the client files a suit against the auditor’s negligence.

**Form and Contents of Working Papers**

Auditing and Assurance Standard 3 (AAS3), ‘Documentation’, offers the following guidelines in this regard:

1. Working papers should record the auditor’s planning, the nature, timing and extent of the auditing procedures performed, and the conclusions drawn from the evidence obtained.

2. Working papers should be sufficiently completed and detailed to enable an auditor to obtain an overall understanding of the audit. The extent of documentation is a matter of professional judgement since it is neither necessary nor practical for the auditor to document in his working papers every observation, consideration or conclusion made.

3. All significant matters, which require the exercise of judgment, with the auditors conclusion thereon, should be included in the working papers.

4. The form and content or working papers are affected by matters such as:
   (a) The nature of the engagement.
   (b) The form of the auditor’s report.
   (c) The nature and complexity of the client’s business
   (d) The nature and condition of the client’s records and degree of reliance on internal controls.
   (e) The need, in particular circumstances of direction supervision and review or work performed by assistants.

5. Working papers should be designed and properly organized to meet the circumstances and the auditor’s need for each individual audit.
6. To improve audit efficiency, the auditor normally plans with the client to utilize schedules, analyzes other working papers prepared by the client. In such circumstances, the auditor should satisfy himself that those working papers have been properly prepared.

CLASSIFICATION OF WORKING PAPERS

In the case of recurring audits, some working paper files may be classified as *permanent audit files as distinct from current audit files relating to the audit of a single period*. Thus, working papers may normally be divided between the following two files:

1. Current file, and
2. Permanent file

**1. Contents of current file:** *A current file contains information primarily relating to the set of accounts subject to audit during the current year.* Following are some of the examples of audit working papers to be placed in a current file.

   (a) Correspondence relating to acceptance of annual appointment.
   (b) Evidence of the planning process of the audit and audit programme.
   (c) A record of the study and evaluation of the accounting system and related internal control. This might be in the form of narrative descriptions, questionnaire or flowcharts, or combination thereof.
   (d) Analysis of transactions and balances.
   (e) A record of the nature, timing and extent of auditing procedures performed, and the result of such procedures.
   (f) Evidence that the work performed by assistants was supervised and reviewed.
   (g) An indication as to who performed the audit procedures and when they were performed.
   (h) Copies of communication with other auditors, experts and third parties.
   (i) Copies of letters or notes concerning audit matters communicated to or discussed with the client including the terms of the engagement and material weaknesses in internal control.
   (j) The working trial balance, bank reconciliation statement.
   (l) Conclusion reached by the auditor concerning related aspects of the audit, including how exceptional and unusual matters (if any) disclosed by the auditor’s procedures, were resolved or treated.
   (m) Copies of the financial information being reported on and the related audit reports.

Thus, a current file documents with all such information required for a single period audit.
Contents of a permanent file: A permanent audit file normally includes:

(a) Information concerning the legal and organizational structure of the entity such as memorandum and articles of association in case of a joint stock company and other appropriate regulations

(b) Extracts or copies or important legal documents, agreements and minutes

(c) Analysis of significant ratios and trends

(d) Notes regarding significant accounting policies

(e) A short description of the type of business carried on and the places of business.

Thus, a permanent file contains papers and information, which are of considerable use and important for the succeeding audits.

OWNERSHIP AND CUSTODY OF WORKING PAPERS

A query often arises as to who is the real owner of the audit working papers. Regarding this issue there has been a controversy as to whether they belong to the client or the auditor. The client claims that these papers belong to him. He justifies his claim on the plea that since the auditor is his agent, he has no right to retain these papers with him. Contrarily, the auditor argues that these papers are his property on the ground that he has collected the information for discharge of his duties. Also as a matter of professional conduct the auditor should handover these working papers to his successor. Another argument of the auditors to have claim over the working papers is that the working papers provide evidence of the audit work performed by them. These papers might come to their rescue in future should the client files a case against the auditors for negligence, etc.

*In Sockockinsky vs. Bright Graham and Co. (England,1938) case*, it was held that the working papers belonged to the auditor and were not the property of the client. The court gave judgment in favour of the auditors on the ground that auditors were independent contractors and not the agent of the clients. Again in Chantrey Martin and Co. vs. Martin (London, 1953) case, the court held the same view and further added that where the auditor acted as a mere agent to the client any correspondence between him (the auditor) and a third party (e.g., the Inland Revenue Authority concerning clients tax liabilities) belonged to the client.

*As per AAS3, ‘Documentation’, issued by the Institute of Chartered Accountants of Chartered Accountants of India, working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client. They should not, however, be a substitute for clients accounting records.*

1. Audit of joint stock companies is compulsory under the
   a) Institute of Chartered Accountants Act 1949       b) Companies Act 1956
   c) Partnership Act 1932                               d) None of these

2. Which of the following best describes the primary objective of an independent financial audit?
   a) Detection and prevention of frauds
   b) Detection and prevention of errors
   c) Both a) and b)
   d) Expression of independent opinion by the auditor about the truth and fairness of financial information examined by him

3. In a partnership firm the scope of audit and duties of auditor are determined by
   a) Partnership Act                                    b) Partnership Deed
   c) Agreement between partnership firm and the auditor
   d) None of these

4. “An auditor is a watchdog not a bloodhound” This was observed in
   a) London Oil Storage Company                         b) Kingston Cottons Mill Co. Ltd
   c) London and General Bank                            d) Delightful Cigarette Co.Ltd.

5. Transposition of figures is an error of
   a) Principle                                          b) Compensating of
   c) Omission                                           d) Commission

6. The wrong allocation of amount between capital and revenue expenditure is
   a) Error of Principle                                  b) Compensating error
   c) Error of Omission                                   d) Trial balance error

7. The Chartered Accountants Act was enacted in the year
   a) 1951                                                b) 1955
   c) 1959                                                d) 1949

8. “An auditor is not an insurer and all that he is required to do is to exercise with reasonable care and skill”
   a) Kingston Cotton Mills Co Ltd                       b) Allen Craig and Co.
   c) London and General Bank                            d) West minister Road Construction Co.

9. __________ audit means verification of items appearing in the position statement.
   a) Management                                        b) Balance sheet
   c) Profit & Loss                                     d) All of these

10. Special audit of the accounts of a company is directed by
    a) The shareholders of company                       b) The company Law Board
    c) The Comptroller and Auditor General of India
    d) The Central Government

11. When the audit is conducted at regular or irregular throughout the year, it is called
    a) Interim audit                                     b) Internal audit
    c) Continuous Audit                                 d) Statutory audit

12. Audit at the end of the year is known as
    a) Periodical audit                                 b) Standard Audit
    c) Efficiency audit                                 d) Operational audit

13. An audit which is conducted in between two annual audit is known as
    a) Periodical audit                                 b) Interim audit
    c) Occasional audit                                 d) Internal audit

14. Management audit can be best described as
    a) Examination of books and audit of accounts
    b) The periodic assessment of company’s activities
    c) Periodic assessment of company’s managerial planning, organizing, actuating and controlling 
       compared to norm of successful operation

d) Auditors assessment of financial statement

15. Consider the following stages, an auditor has to undergo before commencing a new audit
i) Ascertain the scope of audit work
ii) Knowledge about business of his client
iii) Agreement with the client
iv) Instruction to and information from client
What is the correct sequence of above stage?

a) (i), (ii), (iii), (iv)  
b) (i), (iii), (ii), (iv)  
c) (ii), (i), (iii), (iv)  
d) (iii), (i), (ii), (iv)

16. Which of the following is not recorded in audit notebook?
a) Audit Programme  
b) Accounting statistics  
c) Important balance  
d) Analysis of translations and balances

17. Which of the following is not a method of obtaining audit evidence?
a) Inspection  
b) Observation  
c) Accounting Statistics  
d) Compilation

18. Who is the custodian authority for audit working papers?
a) Shareholders  
b) Managing director  
c) Company secretary  
d) Auditor

19. A written plan containing the details regarding the conduct of a particular audit is called
a) Audit programme  
b) Audit memorandum  
c) Audit note book  
d) None of these

20. Current file and permanent file jointly known as
a) Audit note book  
b) Audit Programme  
c) Audit working papers  
d) Audit evidence

21. __________ is necessary for an effective, efficient and timely audit.
a) Audit planning  
b) Audit evidence  
c) Programme  
d) All of these

22. Audit techniques are concerned with
a) Examination of those evidence which have been traced by audit procedure  
b) Application of generally accepted accounting principles to accuracy and validity of management authorization to the accounts section employees.  
c) Method of conducting business affair and reporting is annual report  
d) All of these

23. Consider the following documents
i) Audit note book  
ii) Audit Programme  
iii) Audit report  
iv) Audit files
The correct sequence in which an auditor prepares these documents is
a) ii, i, iv, iii  
b) i, ii, iii, iv  
c) ii, i, iii, iv  
d) i, ii, iii, iv

24. Internal auditors are appointed by
a) The shareholders  
b) The management  
c) Board Directors  
d) Statutory auditor

25. Accounting control does not comprise
a) Internal check  
b) Statistical analysis  
c) Internal audit  
d) Budgetary Control

26. Internal audit facilitates
a) Internal check  
b) Internal control  
c) Final audit  
d) None of the above

27. Compliance of statutory requirements is the major concern of
a) Internal audit  
b) Internal Control  
c) Internal check  
d) External audit

28. An arrangement in which the accounting work of each individual is checked by other members is known as
a) Internal cheek  
b) Internal audit  
c) External audit  
d) Test checking

29. When the audit is conducted at regular irregular intervals throughout the year it is called as
a) Interim audit  
b) Internal  
c) Continuous audit  
d) Statutory audit
30. Internal control is
   a) A part of internal check          b) A part of internal audit
   c) Whole system of control employed by the management     d) None of these

31. What is the correct sequence of the following aspects in auditing?
   i) Special audit            ii) Internal audit            iii) Internal check          iv) Annual audit
   Select the correct answer using the codes given below.
   a) 1, 3, 2, 4          b) 3, 4, 1, 2          c) 3, 2, 4, 1          d) 1, 2, 3, 4

32. The most important objective of internal audit is
   a) Early detection of errors and frauds       b) To Facilitate final audit
   c) Early finalization of annual accounts     d) To ensure systematic accounting

33. Weakness letter is concerned with
   a) Internal audit       b) External audit       c) Internal control       d) Internal check

34. Vouching may be best described as
   a) Identification of the documentary evidence supporting the transactions
   b) Verification of the document supporting the transactions
   c) Authentication of the document supporting the transaction
   d) Verification of the accuracy and authenticity of the transaction

35. Which of the following is known as backbone of auditing?
   a) Verification of assets       b) Internal check       c) Vouching       d) Internal audit

36. In practice the job of vouching is done by
   a) Single person       b) Two persons       c) Book keeper and external auditor       d) Three persons

37. Verification of arithmetical accuracy of accounting entries and to ensure that ledger accounts are properly balanced is the main objective of
   a) Routine checking       b) Test checking       c) Vouching       d) Internal audit

38. __________ is documentary evidence produced in support of an entry made in the books of account.
   a) A voucher       b) Audit note book       c) Cash       d) Trial balance

39. At the time of vouching any cash receipt item an auditor to ensure
   a) Reliable system of internal check is in operation       b) Discount if any is allowed at uniform rate
   c) All the receipts noted in rough cashbook or diary or promptly and properly entered in the cash book
   d) All of the above

40. Vouching of cash transactions refers to
   a) Vouching of all cash receipts items       b) Vouching of cash payment items
   c) Vouching of both case receipts as well as cash payment items       d) Vouching of cash purchase and collection from debtors only.

41. Receipts from debtors who become bankrupt should be vouched with
   a) Dividend warrants       b) Correspondence exchanged between the official receiver and the client only
   c) Bad debts account       d) Cash book

42. Chances of fraud are maximum in case of
   a) Cash sales       b) Credit Sales       c) Credit purchase       d) All of these

43. Petty cash book is usually kept on
   a) Imprest system       b) Perfect system       b) Imperfect system       d) All of these
44. Lapping is
   a) A device used to detect the misuse of cash collected from debtors
   b) A malpractice under which a cashier makes private use of money for sometime
   c) A method of vouching the cash transaction
   d) None of the above

45. Sale ledger is also called
   a) Sales book
   b) Accounts receivable ledger
   c) Accounts payable ledger
   d) None of these

46. Forward contracts are entered into in connection with
   a) Purchase of goods
   b) Sale of goods
   c) Consignment of goods
   d) None of these

47. Purchase book records
   a) Credit purchases only
   b) Cash purchase only
   c) Both a) and b)
   d) None of the above

48. While vouching journal the auditors should ensure that
   a) Every journal entry has a narration
   b) The transaction has been authorized by some responsible officer
   c) The transaction is supported by documentary evidence
   d) All of the above

49. Forward purchases means
   a) Purchase made in the beginning of the financial year
   b) Purchases made at the end of the previous year
   c) Purchase to be made on a future date at a predetermined price
   d) None of the above

50. Memorandum book contains details of
   a) Outstanding assets only
   b) Outstanding liabilities only
   c) Both outstanding as well as outstanding liabilities
   d) Deferred revenue expenditure only
CLASSICAL THEORY OF INTERNATIONAL TRADE

INTERNAL AND INTERNATIONAL TRADE

Internal or domestic trade means trade within the geographical boundaries of a nation or a region. It is also known as intra-regional trade. International trade, on the other hand is trade among different countries or trade across the political boundaries. It is also known as foreign trade.

There are basic similarities to be found between internal or domestic and international trade. Both these trades are based upon division of labour and specialization. International trade becomes inevitable between the two countries on account of division of labour and specialization. International trade takes place between the two countries. International trade takes place because of the following reasons:

(i) Human wants are varied and unlimited and no single country possess the resources to satisfy all these wants. Hence, there is interdependence between the countries.

(ii) Factors endowments in different countries differ.

(iii) International trade is the result of territorial or geographical division of labour and specialisation in the countries.

(iv) Technological advancement of different countries.

(v) Labour and entrepreneurial skills differ in different countries.

(vi) Factors of production are highly immobile between countries.
Due to above reasons different countries specialise in different fields of productions. A country produces and sells those commodities in which it has more skill and efficiency and in return purchase those goods from other country which is more efficient in the production of that goods.

**NEED FOR A SEPARATE THEORY OF INTERNATIONAL TRADE**

Economists are divided on the question whether international trade should have a separate theory or not. A separate theory of international trade is justified on the ground of certain differences which are found between internal trade and international trade. The classical economists laid much emphasis on these difference between internal trade and international trade, and it was on the basis of these differences that they built up a case for a separate theory (known as the classical theory of comparative costs) to explain the emergence of international trade. The main differences between internal trade and international trade are as follows:

(i) **Difference in Jurisdiction**: Internal trade is the exchange of domestic output within the political boundaries of a country, while international trade is the trade between two or more countries.

(ii) **Comparative immobility of Labour and Capital**: The capital and labour between two countries are not so mobile as between two different parts of the same country. In other words, the labour and capital resources are more mobile within the country. It is on account of the greater mobility of labour and capital within the country that there is a tendency for the equalization of interest and wage rates. Consequently, there comes to be established an equality in the production costs of a commodity in different parts of the country. As said above, labour and capital are not as mobile between two countries as they are between two parts of the same country. Thus, due to the comparatively less mobility of labour and capital, the production costs of the same commodity becomes different in the two countries. It is on account of the differences in production costs that international trade takes place.

(iii) **Differences in Production Conditions**: Sometimes, the production conditions differ from country to country. This can be due to several causes. For example, one country can be more advanced than another country in science and technology. Thus, the production cost will be lower in the former country. Besides, the production costs of the same commodity can be different in two countries on account of the economic policies of the two Governments.
(iv) **Differences in Natural Resources and Geographical Conditions.** There can be differences in the natural resources and the geographical conditions of the two countries. One country can be endowed with greater and more abundant natural resources than another country. Thus, on account of these differences the production costs of the same commodity can be different in the two countries.

(v) **Restrictions on Imports and Exports:** Generally speaking, there is no restriction on the flow of trade between two parts of the same country. As against this, there is a multiplicity of restrictions on trade between two countries. Besides import and export duties, quota restrictions are also imposed by the Government on the import of various commodities.

(vi) **Differences in the Monetary System:** Since a country has one common currency, there are no difficulties in making payments in internal trade. But there are different currencies in different countries. As such, a number of foreign exchange difficulties arise in international trade.

(vii) **Difference in Political Units:** International trade occur between different political units, while internal trade occurs within the same political unit.

(viii) **Difference in Groups:** Internal trade takes place within a country among the same group whereas international trade takes place between differently cohered groups.

The modern economists like Bertil Ohlin and Haberler have regarded the internal and international trade as similar and have argued that there is no need for a separate theory of international trade. According to Ohlin, “International Trade is but a special case of inter-regional trade.” However, it is a well-established fact that there do exist certain basis differences between internal and international trade.

**THEORY OF COMPARATIVE COSTS**

The classical theory of international trade is also known as theory of comparative costs. The theory was first propounded by the well-known classical economist, David Ricardo. The theory was further developed and refined by John Stuart Mill, Cairnes and Bastable. The modern exponents of the theory are the American economist, F. W. Taussing, and the Germans economists, Gottfried Von Haberler.

If all the countries of the world had the same resources and were in the same stage of economic development, there would be no international trade because there would be no gain from such a trade. But if there are differences in natural, human and capital resources in different countries, international trade is bound to emerge in course of time. This is known as the theory (or law) of comparative advantage.

**Assumptions of the Classical theory**
We would do well to enumerate the various assumptions on which it is based. *Both Ricardo and Mill had developed the theory of comparative costs on certain important assumptions*; some of the assumptions were clearly stated, while others were only implicit in their analysis. The various assumptions of the theory are as follows:

(i) **Production costs meant only labour costs**, to be expressed in terms of so many units of labour. (Labour was assumed to be the only productive factors. Hence, costs were to be treated as labour costs.)

(ii) All labour was assumed to be homogeneous.

(iii) Production was assumed to take place under conditions of constant costs, i.e. changes in output were not supposed to affect the unit cost of production.

(iv) **The factors of production were perfectly mobile** within the country but totally immobile between countries.

(v) It is assumed that international trade takes place in goods only and that no capital movements take place between the countries concerned.

(vi) It is assumed that there are no transportation charges.

(vii) It is assumed that international trade is free from all barriers and restraints.

(viii) Only two countries and two commodities are to be considered at a time.

(ix) There are no disturbances from such sources and the trade cycle.

(x) **The two countries have common monetary standard and the quantity theory of money is valid.**

The movement of particular goods between two countries is determined by cost differences. Three types of cost differences may be distinguished:

(i) **Absolute Differences**, (ii) **Equal Differences**, and (iii) **Comparative Differences**.

(i) **Absolute Difference in costs**: Sometimes there develop absolute differences in production costs between two countries. A country may, for example, earn special profits in the production of a particular commodity on account of the existence of a natural monopoly. The production cost of that commodity is low on account of the natural monopoly enjoyed by the country in question. It becomes easier for that country to export that commodity to other countries. Likewise, some other countries of the world also enjoy natural monopoly in the production of certain commodities. Under these circumstances, there developed absolute differences in production costs in different countries.

(ii) **Equal Differences in Costs**: International trade can be profitable only when there are comparative differences in the two countries. On the contrary, if there are equal differences in production costs, international trade cannot take place. The reason is that there
is hardly any possibility of profit in international trade if there are equal differences in production costs between the two countries. Hence, international trade automatically comes to an end.

(iii) **Comparative Differences in Costs:** If there are comparative differences in production costs between two countries, international trade will inevitably take place between them. The reason is that these comparative differences in production costs will benefit both the countries.

**FACTORS INFLUENCING PROFIT ACCRUING FROM INTERNATIONAL TRADE**

The profit accruing from international trade depends, according to Prof. Taussig, on two factors: 1. Terms of Trade, and 2. Efficiency of labour producing Export Goods.

1. **Terms of Trade:** This refers to the rate at which the commodities produced in the two countries exchange with each other. The terms of trade keep on changing according to the intensity of demand of the products of the two countries. That country gains the most out of international trade, the foreign demand for whose products is the highest and whose demand for other countries products is comparatively low. That country gains the least out of international trade, whose demand for the products of other countries is the highest.

2. **Efficiency of Labour Producing Export Goods:** The second influence on the size of the profit arising out of international trade is the level of efficiency on the workers’ producing export goods. In reality the main reason for the differences in the level production costs of the two countries is the differences in the level of labour efficiency in those countries.

**CRITICISM OF THE COMPARATIVE COSTS THEORY**

The main criticisms leveled against this theory are as follows.

(i) **Assumption of Labour Costs:** The most fundamental criticism against the theory of comparative costs is that it had its roots in the labour cost theory of value. The classical economists sought to explain domestic exchanges of goods in terms of labour cost. From this, they proceeded to explain international exchanges of goods in terms of comparative labour costs. The theory is, thus, rooted in the labour cost theory of value. Now this theory was rejected even in the 19th Century as an explanation of relative values on several grounds. Firstly, labour is not homogeneous and that there are different types of grades of labour made use of in production. Secondly there are other factors besides labour which are involved in production, such as, land capital and enterprise. No homogeneous can be assumed even in
the case of these factors. It was on account of these difficulties that the labour cost theory of value was rejected as an explanation of relative values.

(ii) Assumption of Fixed Proportions: Based on the labour-cost theory of value, the theory of comparative costs requires the further assumption that the various factors of production are always combined in the same fixed proportions. Now this assumption of fixed factorial proportions is totally wrong and unrealistic. In the real world, there is a wide variation in the proportions in which the factors of production are combined with each other. With the assumption of constant factorial proportions, the theory of comparative costs becomes inapplicable to the real world.

(iii) Assumption of Constant Costs: Another criticism of the theory of comparative costs relates to its assumption of constant costs. According to the classicists the law of constant costs prevails in every industry so that additional units of the same commodity can be produced at constant labour cost per unit. But this assumption of constant costs is totally wrong and unrealistic.

(iv) Assumption of Internal Mobility and External Immobility: Another drawback of the classical theory of comparative costs is to be found in its basis assumption that, internally, factors of production are completely mobile but internationally, they are wholly immobile.

(v) Absence of Transport Costs: Still another criticism of the classical theory of international trade relates to its assumption that transport costs do not exist. This is manifestly a wrong and unrealistic assumption.

(vi) Unrealistic Theory: The theory of comparative costs is unrealistic in the sense that actual production in a country may not accord with the principle of comparative advantages.

(vii) Complete Specialization Impossible: The theory of comparative costs has been criticized on the ground that complete division of labour and specialization would not be possible even on the assumption of the classical economists.

(viii) Clumsiness of the Theory: Lastly the comparative cost theory has been castigated by Bertil Ohlin as unduly cumbersome and unreal. According to Ohlin, “The theory avoids the obvious and straightforward approach, taking instead a perversely indirect route”.

MODERN THEORY OF INTERNATIONAL TRADE

Bertil Ohlin, the well known Swedish economist, has attempted to extend this general equilibrium theory to the field of international trade. He has successfully extended
this theory (applicable to a single market) to deal with trade between different regions within a country or between different countries. In a forthright assertion, Bertil Ohlin pointed out that there was absolutely no need for developing a special theory of international trade. According to his much-quoted statement, “International trade is but a special case of inter local or interregional trade”. The type of analysis applicable to interregional trade may be extended without any substantial change to explain the phenomenon of international trade. As such the modern theory of international trade is often referred to as the Heckscher-Ohlin Theory in the same way as the classical theory of international trade is referred to as Ricardian Theory of International Trade.

**GENERAL EQUILIBRIUM THEORY OF VALUE**

As is well known, the price of a commodity is determined by the demand and supply of that commodity. The demand for a finished commodity depends upon

(i) consumers’ wants.
(ii) consumers’ income, which, in turn, depends upon conditions of ownership of the factors of production and upon the prices of these factors, and
(iii) the prices of all other commodities.

The cost of production of the commodity is also determined by the technique of production used by the firm in question. At the point of equilibrium, the demand for and the supply of the commodity will be equal to each other. Not only is that, the price of the commodity, at the point of equilibrium, equal to its cost of production. The cost of production of the commodity, as pointed out above, will comprise the prices of all those factors of production which are used in the manufactures of that commodity. The prices of factors of production are determined by the demand for and supply of these factors. The demand for factors depends upon the demand for the finished commodity, because these factors enter into the production of that commodity. The larger the demand for the finished product, larger will be the demand for all those factors which enter into the production of the finished product.

Likewise, the supply of factors of production depends upon the prices obtainable for their services. Thus, the various quantities involved in this situation, namely, the prices of finished goods, consumers’ incomes, the demand and supply of finished goods, and the demand and supply of factors of production are interdependent and interrelated.

This explanation of prices is referred to as the general equilibrium theory of value. The meaning of general equilibrium has been made clear by P.T. Ellsworth by citing an analogy.
ASSUMPTIONS MODERN THEORY OF INTERNATIONAL TRADE

Bertil Ohlin built up his theory of international trade on the basis of the following simplified assumptions:

(i) There are two regions only between which trade takes place.

(ii) The factors of production are perfectly mobile within the regions, but immobile between them.

(iii) There are no restrictions on the movement of goods between the two regions.

(iv) There are no transportation costs.

(v) Goods transactions alone are to be considered; export will then exactly then balance with imports.

(vi) There are no qualitative differences in the factors of production in the two regions

(vii) One country is labour-intensive whereas another country is capital-intensive.

(viii) Each region possesses a paper currency system which is insulated from external financial influences.

Bertil Ohlin points out the similarity with the individual specialization in production. Individual specialization is partly due to difference in personal ability and aptitudes. Individuals tend to specialize in different lines of economic activity according to their aptitudes.

Bertil Ohlin, thus, points out that variation in productive factor is a cause of interregional trade and specialization, just as differences in individuals. The variations in productive factors cause differences in prices in different countries and the price differences are the cause of interregional trade. In the words of P.T. Ellsworth, “The immediate cause of interregional trade in goods is to be found in price differences. In other words, interregional trade is a price phenomenon.”

The question now arises: Under what circumstances do relative commodity prices differ in different countries? Differences in relative commodity prices depend upon the demand for and the supply of a commodity in the two regions. The demand for a commodity depends upon (i) consumers’ wants, and (ii) consumer’s income which is determined by the conditions of ownership of the factor of production. The supply of a commodity depends upon (i) supply of productive factors, and (ii) the technical conditions of production. According to Ohlin, the technical conditions of production are virtually the same everywhere; hence, this factor can be safely kept out of our discussion. Consequently, differences in
relative commodity prices depend upon the two conditions [namely, (i) consumers’ wants, and (ii) consumers’ income], the demand and the supply of the productive factors.

Relative prices of all commodities will be the same in the two regions, if —

(i) The conditions determining the demand for goods are similar, i.e. if the consumers’ wants and consumers’ income are identical in the two regions,

(ii) The productive agents are available in both regions in the same proportions, and

(iii) Any differences in the supply of factors are balanced by an exactly compensating difference in demand conditions.

Bertil Ohlin’s main conclusion can, thus be summarized as follow:

(i) The immediate cause of interregional (or, international) trade is the differences in relative commodity prices in the two geographical regions or countries.

(ii) Differences in the relative commodity prices are due to the relative scarcities of productive factors in the two regions or countries.

REFINEMENTS OF THE THEORY

Bertil Ohlin, after explaining the basic cause of interregional (or, international) trade, sought to introduce certain refinements into his theory of international trade.

(i) He had discussed the basic cause of international trade with reference to two regions or two countries. But he claimed that his theory would also be applicable to more than two regions or two countries.

(ii) He introduced the economies of large-scale production into his discussion of the theory and claimed that these economies created an additional basis for interregional trade. Two regions may have identical factor endowments and yet they would specialize and trade in those goods whose purely domestic market is too small to permit large-scale production.

(iii) Bertil Ohlin had earlier built up this theory on the assumption that qualitative differences in the productive factors did not exist. Later, he discarded this assumption and took into account qualitative differences in the three factors of production.

(iv) The earlier version of Ohlin’s theory was based on the assumption that transport costs did not exist in international trade. He had assumed the non-existence of transport costs to simplify his analysis of international trade. Later, Ohlin discarded this assumption and introduced transport costs into his analysis.

(v) Bertil Ohlin discussed the obstacles to interregional mobility of factors and explained how factor movements could act as a substitute for movement of commodities.

COMPARISON OF THE MODERN THEORY WITH THE CLASSICAL THEORY OF INTERNATIONAL TRADE
The modern theory of international trade is better and more scientific than the classical theory of international trade, as is evident from what is given below.

(i) According to the classical economists, there was need for a separate and distinct theory of international trade, as international trade was marked by characteristics which were quite different from those of interregional or internal trade. Eli Heckscher and Bertil Ohlin, however, felt that there was no need for a separate theory of international trade, as international trade was not different from interregional trade. The difference between the two was one of the degrees, not of kind.

(ii) The classical theory explained the phenomenon of international trade in terms of the old, discredited labour theory of value. As such, the explanation of international trade was unsatisfactory. The modern (or. The H—O) theory explained the phenomenon of international trade in terms of the general theory of value which was much more satisfactory than the labour theory of value.

(iii) The classical theory attributes the differences in the comparative costs of producing the commodities in the two countries to difference in the productive efficiency of workers in the two countries. The modern theory, on the contrary, attributes the difference in comparative costs to the differences in factor endowments in the two countries. Differences in factor endowments lead to differences in factor prices, and relative differences in factor prices, providing thus the basis of international trade. According to the classical theory, international trade would come to an end if the differences in comparative costs disappear with the elimination of differences in productive efficiency with the free flow to the technical know-how across international frontiers. But, according to the modern theory, international trade would never come to an end because differences in factor endowments between two countries can never be eliminated completely.

(iv) The classical theory presents a one-factor (labour) model whereas the modern theory dilated upon a multifactor (labour and capital) model. To that extent, the modern theory is much broader and more comprehensive in scope.

(v) The classical theory never considered the factor price differentials; the modern theory, on the contrary, looked upon factor price differentials as the basis cause of commodity price differentials which provided the basis of international trade.

(vi) The classical theory is unrealistic whereas modern theory is realistic.

(vii) The classical theory stresses the quality differences of labour in two countries. Modern theory emphasizes the differences in factor endowments.
The Modern (H—O) Theorem, thus marks a considerable advance over the classical theory of international trade.

CRITICISMS OR SHORTCOMINGS OF THE MODERN THEORY.

Though the modern theorem (or, the factor-proportions theory) marks a considerable improvement over the classical comparative cost theory of international trade, it is not completely free criticism.

(i) Unrealistic Character: The modern theory is grossly unrealistic in character insofar as it is based on certain very oversimplified and unrealistic assumption, such as, perfect competitions, full employment of productive resources, absence of transport costs, similarity of production function in the two countries, absence of product differentiation, etc. These assumption, as pointed out above, are very unrealistic and even wrong.

(ii) It provides at best only a Partial Equilibrium Analysis, not a General Equilibrium System: In other words, the modern theory provides only a partial, not a full explanation of the phenomenon of international trade.

(iii) Leontief Paradox: The modern theory fails to explain what has come to be known as Leontief Paradox. According to the theory, relative factor prices in the two countries are determined exclusively by their relative factor endowments which, in plain words, mean that relative factor prices are determined by the supply of productive factors in the two countries.

(iv) Trade even with Identical Factor Endowments: According to the modern theory, trade between two countries takes place when there are differences in their factor endowments. In other words, if the factor endowments of the two countries are identical, there is no possibility of any trade taking place between them.

(v) Commodity Prices determine Factor Prices: The modern theory holds that international trade arises due to differences in relative commodity prices between the two countries, and the differences in relative commodity prices are attributed to differences in factor prices arising from differences in factor endowments in the two countries. In other words, the commodity prices, according to the theory, are determined by the factor prices in the two countries.

(vi) Products Differentiated: The modern theory assumes that the two products in the two countries are homogeneous or identical. This is rather an unrealistic assumption. The product in two countries may not be homogeneous.

(vii) Highly Static in Nature: The modern theory is based on certain assumptions which make it highly static in nature. Its static character makes it unsuitable to explain a dynamic situation. One such assumption relates to the factor endowments in the two countries. This
theory assumes that the factor endowments in two countries are fixed and unchanging in quantum. This is highly unreal assumption.

(viii) Production Functions not identical: Still another unrealistic assumption of the theory relates to production functions in the two countries. The theory assumes that the production functions of the same good are identical in the two countries. This assumption is not at all justified by the reality of the situation. How can the production function of the good be identical in the two countries?

(ix) Qualitative Differences in productive factors: The modern theory also assumes that there are no qualitative differences in the productive factors in the two countries. The theory assumes that the factors of production in the two countries are homogeneous in quality.

(x) Mobility of Productive factors: The modern theory assumes that the factors of production are perfectly immobile between countries. This assumption has been challenged by critics on the ground that there is no such thing as international immobility of the factors of production. Factors of production, it is pointed out, have never been immobile internationally.

(xi) Wijanholds is of the opinion that it is not the factor prices which determine costs, thus commodity prices as assumed by Ohlin, but it is commodity prices that determine the factor prices.

EFFECTS OF INTERNATIONAL TRADE

Following Bertil Ohlin we shall now discuss some important effect of international trade.

(i) Equality in Commodity Prices: An important effect of international trade is to bring about equality in the prices of internationally traded goods in all the regions of the world.

(ii) Equality of Factor Prices: Another effect of international trade is to bring about equality of factor price in all the regions of the world.

(iii) Advantages of International Specialization: International trade result in specialization (division of labour), efficient use of productive factors and maximization of real output.

(iv) Effect on the Volume and Nature of Demand: International trade influences the demand for commodities in two ways. Firstly, it increases the quantitative volume of demand by increasing the income of people in participating regions. Secondly it changes the natural demand by bringing the people in the participating countries.
(v) Modern Industrialization: International trade is the basic force which had promoted and sustained modern industrialization in the world.

GAINS FROM INTERNATIONAL TRADE AND TERMS OF TRADE

International trade confers a variety of gains and benefits on the participating countries. That is why, nations of the world are interested in the promotion of trade and commerce among themselves. The following gains accrue to the participating nations from international trade.

(i) Advantages of Territorial Division of labour: International trade enables a country to specialize in the production of those commodities in which it enjoys special advantages.

(ii) Increase in production: International trade leads to an increase in the world output of goods and services on account of the various advantages flowing from international specialization.

(iii) Equitable Distribution of Scarce Resources: There are certain scarce resources which are the exclusive monopoly of a single country or a group of countries.

(iv) Equality in Commodity and factor prices: International trade leads to an equalization of the prices of internationally traded goods and productive factors in all the regions of the world.

(v) Capital Utilisation: International trade leads to expansion of the size of market, thereby leading to more and more complex division of labour, improvement in quality and productivity.

(vi) Expansion of the size of market: International trade lead to an equalization of the prices of internationally traded goods and productive factors in all the regions of the world.

(vii) Promotes Competition: International trade promotes competition at every stage, economic alertness and efficiency in the country.

(viii) Promotes Consumption: International trade makes it possible to have increased consumption of more varieties of goods.

DETERMINANTS OF GAIN FROM INTERNATIONAL TRADE

The size of the gain from international trade is determined by a large variety of factors. Some important determinants of the size of gain are as follows:

(i) Terms of Trade: The term “Terms of Trade” refers to the rate at which the country’s exports exchange for imports. The terms of trade are determined by the relationship between the prices of exports and the prices of imports.
(ii) Elasticity of Demand: The gain from international trade also depends upon the elasticity of demand for the commodities in the two countries. International trade leads to an expansion in output in both the countries. Real income in both the countries also registers an increase.

(iii) Improvement in Productivity: An improvement in productivity in the two countries also increases the size of the gain arising out of international trade.

(iv) Difference in Cost Ratios: The size of the gain, it is pointed out, also depends upon the relationship between the ratio of the costs of production of the two commodities in the two countries.

(v) Stage of Development: The sharing of the gain out of international trade between the two countries is also governed by the stage of development in which a country finds itself.

MEASUREMENT OF GAIN FROM INTERNATIONAL TRADE

The classical economists adopted the following alternative criteria for measuring the gain arising out of international trade:

(i) Reduction in Production Costs (ii) Increase in Real Income (iii) Terms of Trade

TERMS OF TRADE

The term “Terms of Trade” refers to the rate at which a country’s exports exchange for its imports. Terms of trade are naturally governed by the prices of export and imports entering into international trade. They indicate the relationship between the prices of export and prices of imports of a country. The terms of trade are said to be favourable to a country when the prices of its exports are high relatively to the prices of its imports. In the same manner, the terms of trade are said to be unfavourable to a country when the prices of its imports are high relatively to the prices of its exports. There are several concepts of terms of trade. Following Gerald M. Meir, we can classify them as follows:

I. Those terms of trade which refer to the rate of exchange between goods:

   (A) Net Barter Terms of Trade.
   (B) Gross Barter Terms of Trade, and
   (C) Income Terms of Trade.

II. Those terms of trade which refer to the exchange between productive factors:

   (A) Single Factorial Terms of Trade, and
   (B) Double Factorial Terms of Trade.

III. Those terms of trade which express the gain arising from international trade in terms of utility.
NET BARTER TERMS OF TRADE:

This concept of the terms of trade was first introduced by the American economist, F.W Tausig. It is also referred to as “commodity terms of trade”. Net barter terms of trade refers to the ratio between the prices of exports and imports at a given period compared to an earlier period. Symbolically, the net barter terms of trade is expressed as follows:

\[ T_C = \frac{P_X}{P_M} \]

(Where, \( T_C \) = Net Barter Terms of Trade; \( P \) = Price Index; \( X \) = Export; \( M \) = Import)

GROSS BARTER TERMS OF TRADE

It was to get over the defects and drawbacks of the net barter terms of trade that F.W. Tausig devised the new concept of gross barter terms of trade. So this concept constitutes an improvement on the earlier concept of commodity terms of trade. Tausig suggested that instead of relating together the export and import prices, it would be better to relate together the physical quantities of export and imports of a country. Thus, the gross barter terms of trade represents the ratio of total physical quantity of importable to the total physical quantity of exportable. The higher is this ratio, the more favourable the gross barter terms of trade for the country concerned. Symbolically, the concept is expressed as follows:

\[ T_g = \frac{Q_m}{Q_x} \]

(Where, \( T_g \) = Gross Barter Terms of Trade; \( Q_m \) = Quantity of Imports; \( Q_x \) = Quantity of Exports.)

INCOME TERMS OF TRADE

This is not a new concept. It is only modified and refined version of the concept of net barter terms of trade. It was G.S. Dorrance who refined the net barter terms of trade concept to present the concept of income terms of trade. Income terms of trade may be defined as the index of the value of exports divided by the price index for imports. Symbolically, the concept may be expressed as follows

\[ T_g = \frac{P_x Q_x}{P_m} \]

(where, \( T_g \) = income terms of trade; \( P_x \) = prices of exports; \( Q_x \) = Quantity of exports; \( P_m \) = price of imports)

SINGLE FACTORAL AND DOUBLE FACTORAL TERMS OF TRADE
As pointed out above, the main defect of the commodity terms of trade was that it failed to take into account the changes taking place in the productivity or efficiency of the factors of production. To get over this defect, Jacob Viner devised the twin concepts of ‘single factorial and double terms of trade’. These concepts constitute a decided improvement on the older commodity terms of trade concept. The single factorial terms of trade refer to the ratio of the export-price index to the import-price index adjusted for changes in the efficiency or productivity of a country’s factors in the export industries. In Viner’s words, “If the commodity term of trade index was multiplied by the reciprocal of the export commodity technical coefficients index, the resultant index would provide a better guide to the terms of gain from trade than the commodity terms of trade index by itself.

\[ T_s = \frac{P_x}{P_m} F_x \]

(where \( T_s \) = Single factorial terms of trade; \( \frac{P_x}{P_m} \) = Commodity terms of trade; \( F_x \) = Index of productive efficiency in the export of industries.

The main drawback of the single factorial terms of trade is that it fails to take into account the potential domestic cost of production of imports. Hence, it provided only a partial view of the situation or the position of the country in the field of international trade.

Jacob Viner was quite conscious of this defect.

**DOUBLE FACTORAL TERMS OF TRADE**

This concept constitutes an improvement over the earlier concept of single factorial terms of trade. It takes into account the productivity of a country’s factors of production entering not only into the production of exportables, but also the productivity of the foreign factors of production entering into that country’s importables. That is why Viner has christened the concept as the ‘double factorial terms of trade’. Symbolically, this concept can be expressed as follows:

\[ T_d = \frac{P_x}{P_m} \frac{F_x}{F_m} \]

(where \( T_d \) = Double factorial terms of trade; \( \frac{P_x}{P_m} \) = Commodity terms of trade; \( F_x \) = Index of productive efficiency in export industries; \( F_m \) = Index of productive efficiency of foreign factors of production employed in foreign industries supply of goods to the country concerned)

**REAL COST TERMS OF TRADE**

The real cost terms of trade are arrived at by multiplying the single factorial terms of trade with the index of the amount of disutility incurred or suffered per unit of the productive
factors in the export sector of the country. Symbolically, the concept of real a cost term of trade is expressed as follows:

\[ T_r = \frac{P_x}{P_m} F_x R_x \]

(Where \( T_r \) - Real cost terms of trade; \( \frac{P_x}{P_m} \) = Commodity terms of trade; \( F_x \) = index of productive efficiency in export industries; \( R_x \) = Index of the amount of disutility incurred per unit of productive factors in the export sector.)

The concept of real cost terms of trade marks an improvement over the earlier concepts devised by Jacob Viner. It is a welfare-oriented concept. It attempts to measure the real economic gain or welfare accruing to a country out of international trade. But the main drawback of this concept is that it overlooks the real cost involved in the production of imports.

UTILITY TERMS OF TRADE

The utility terms of trade are arrived at by multiplying the real cost terms of trade with the index of the relative utility of imports as compared with the commodities that could have been produced for internal consumption with those productive factors which are at present devoted to the output of export goods. The concept of utility terms of trade is represented symbolically as follows:

\[ T_u = \frac{P_x}{P_m} F_x R_x U_m \]

(Where \( T_u \) - Utility terms of trade; \( \frac{P_x}{P_m} \) = Commodity terms of trade; \( F_x \) = index of productive efficiency in export industries; \( R_x \) = Index of the amount of disutility incurred per unit of productive factors in the export sector; \( U_m \) = Index of the relative utility of imports as compared with the commodities that could have been produced for internal consumption with those productive factors which are at present devoted to the production of export goods.

FACTORS INFLUENCING TERMS OF TRADE

The terms "Terms of Trade" is being used here in the sense of commodity terms of trade. The commodity terms of trade are determined by the relative elasticity of its import demand and export demand as compared with the relative elasticity of the import demand and export demand of the foreign country. These relative elasticity’s of demand and supply have been referred to as reciprocal demand by J.H. Mill. In other words, the terms of trade of a country are determined by the reciprocal demand. Basically, therefore, the terms of trade of a country are determined by four types of elasticites:

(i) Nature of Exports and Import.
(ii) Size of Population.
(iii) Tastes and Preferences of people.
(iv) Diversification of goods
(v) Government’s Tariff Policy.
(vi) Effect of the following on the country’s terms of trade:
Changes in any of the above elasticities will cause changes in the terms of trade of the
country concerned. Any of the following can cause changes in these elasticities
(i) Changes in the Demand for Imports and Exports.
(ii) Devaluation.
(iii) Tariff.
(iv) Economic Development.

BALANCE OF PAYMENTS

The balance of payments of a country is a systematic record of its monetary
transactions with other countries of the world during a given period (In a Year)

Charles P. Kinderberger defines balance of payments as “a Systematic record of all
economic transaction between the residents of the reporting country and the residents of
foreign countries during a given period of time”.

According to Bosodersten, “The balance of payments is merely a way of listing
receipts and payments in international transactions for a country.”

It is an important index which reflects the true economic position of a country in a
given period, whether the country is a creditor country or a debtor country, and whether its
currency is rising or falling in its external value. There are various types of monetary
transactions taking place amongst the countries of the world. Broadly speaking, we can
classify them under three heads: (1) The exports and imports of a country give rise to
monetary transactions with other countries. (2) The international lending and borrowing also
give rise to monetary transactions amongst the countries of the world. (3) The servicing of
foreign debts and their final repayments also result in international payments and receipts.
Thus, the balance of payments is an annual record of the international receipts and payments
of a country during a year. It is a summarized statement of all international receipts and
payments and indicates the real monetary position of the country concerned.

BALANCE OF TRADE AND BALANCE OF PAYMENTS

The balance of trade of a country shows its trade transactions with the rest of world
during the course of a year. It indicates the relationship between the value of exports and
the value of imports of the country in question. But the balance of trade takes into account
only visible exports and imports. The visible exports and imports are those which are actually recorded at the ports. The balance of trade of a country is, thus the relationship between the aggregate value of exports and the aggregate value of imports of goods during the course of a year. If the money value of exports is greater than the money value of imports, the balance of trade is said to be favourable to the country. On the contrary, if the money value of imports is greater than the money value of exports, the balance of trade is said to be unfavourable for the country.

However, it is not only the visible imports and exports which give rise to international payments and receipts. There can be several other items known as invisible items are those which are not recorded at the ports. These items are the services rendered by shipping insurance and banking companies, debt repayment and payment of interest, expenditure by tourists, payment of dividends on capital invested by foreigners, war indemnities, etc. The

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1. Who propounded the theory of comparative costs?
   a) Adam smith  b) David Ricardo  c) J.S. Mill  d) G.V. Haberler

2. The per unit cost of production of jute and cotton in country A is Rs. 8 and Rs. 16 respectively as against 7 and 6 respectively in country B. What type of cost differences is there?
   a) Absolute  b) Comparative  c) Equal  d) None of these

3. Under which type of cost differences International trade will not take place?
   a) Absolute  b) Comparative  c) Equal  d) All of these

4. Which of the following was an assumption of Ricardo’s comparative cost theory?
   a) Money cost differences  b) Influence of laws of returns  c) Influence of elasticity of demand  d) Labour cost of production

5. Bertie Ohlin’s theory of international trade
   a) Traditional theory of international trade  b) Opportunity cost analysis of international trade  c) Modern theory of international trade  d) Interregional theory of trade.

6. Modern theory of international trade is based on the assumption of
   a) Trade between many countries  b) Trade of goods and services  c) Labour-intensive production in all countries  d) Free trade

7. The immediate cause of international trade according to modern theory is
   a) Opportunity cost differences  b) Differences in relative commodity prices  c) Demand for the commodity  d) Conditions of supply of commodity

8. According to modern theory of international trade relative factor prices in two countries are determined by
   a) Comparative cost conditions  b) Productive efficiency of labour
9. Gains from international trade are determined by
a) Terms of trade  
b) Elasticity of demand  
c) Differences in cost ratios  
d) All the these

differences in factor endowments  

10. $T_c = \frac{P_x}{P_m}$ refers to
a) Net barter terms of trade  
b) Gross barter terms of trade  
c) Differences in cost ratios  
d) Factorial term of trade.

11. A country will have adverse terms of trade in case of
a) Inelastic demand for imports  
b) Inelastic foreign demand from exports  
c) Elasticity of supply of exports  
d) Elasticity of the supply of country’s imports

12. Which of the following is not a component of current account of balance of payments?
a) Merchandise  
b) Travel and transportation  
c) Transfers  
d) foreign investments.

13. Which of the following is debit item in balance of payments?
a) Import of goods  
b) Investment income from abroad  
c) Receipt of transfer payments  
d) Export of services

14. When the rate of growth in the economy of a country is higher as compared to other countries the import of this country will
a) Decrease  
b) Increase  
c) Remain stable  
d) None of these

15. Which of the following measures will be adopted to remove disequilibrium in the balance of payments?
a) Increase in exchange rate  
b) Devaluation  
c) Inflation  
d) Restrictions on exports

16. Which of the following arguments supports free trade?
a) Infant industries argument  
b) Employment argument  
c) Proper utilization of factors of production argument  
d) National self-stuffiness argument

17. Who was not a supporter of protection?
a) Alexander Hamilton  
b) David Ricardo  
c) Henry Carey  
d) Fredrick list

18. Which of the following is an adverse effect of production?
a) Obstacles in industrialization  
b) Import of unnecessary harmful goods  
c) Fall in industrial efficiency  
d) Check on monopolies

19. Which of the following is not a protectionist device?
a) Import quotas  
b) Export license  
c) Commodity agreement  
d) Exchanges control

20. Which is a non-economic argument for protection?
a) Infant industry argument  
b) Anti-dumping argument  
c) Defense argument  
d) Terms of trade

21. Protection encourages
a) Laissez-faire  
b) Competition  
c) Self-reliance  
d) Division of labour

22. Find out the correct statement.
a) The supply of foreign exchange being fixed in the foreign exchange market and increase in demand for foreign exchange will result into fall in exchange rate  
b) Demand for foreign exchange being fixed an increase in its supply will result into fall in exchange rate  
c) The demand for foreign exchange is relates to the volume of exports  
d) One import determine the supply of foreign exchange
23. Under gold standard if mint par is €1= $4.866 and the market value of pound becomes €1= $5 then it will be
   a) Gold import point for U.S
   b) Gold export point for Britain
   c) Gold export point for U.S
   d) Favorable market rate for dollar.

24. Which of the following statements is true in relation to purchasing power parity theory?
   a) Purchasing power parity is determined on the basis of gold prices in two countries
   b) It is applicable in case of convertible paper currency
   c) Purchasing power par is a moving par.
   d) Purchasing power par is a fixes par.

25. Equilibrium rate of exchange is one which
   a) Gives artificial gain from exports
   b) Makes the currency over- valued
   c) Increases foreign exchange reserves trade,
   d) Gives neither unfair gain nor loss in foreign trade,

26. Unstable exchange rates results into
   a) Internal economic instability
   b) Stimulates to international capital flows.
   c) Encouragement to capital formation
   d) Expansion of foreign trade.

27. Suppose present exchange rate is $1= Rs. 30 now if the price index in India goes up to 150 while it remains at 100 in the U.S ., the new exchange rate according to purchasing power parity theory would be
   a) $1= Rs. 40
   b) $1= Rs. 45
   c) $1= Rs 30
   d) $1= Rs. 32.50.

28. The act of simultaneous buying a currency in our market is called
   a) Speculation
   b) Spotting
   c) Forwarding
   d) Arbitrage

29. Exchange control does not include
   a) Fixation of exchange rate by the government
   b) Government’s control on foreign exchange market
   c) Determination of foreign trade policy
   d) Control on foreign exchange payments

30. Which of the following is not a method of exchange control?
   a) Intervention
   b) Blocked account
   c) Gold policy
   d) Rationing

31. Which of the following is not a unilateral method of exchange control?
   a) Rationing of foreign exchange
   b) Exchange paging
   c) Transfer moratoria
   d) Multiple exchange rate

32. Multiple exchange rate system aims at
   a) Increasing imports
   b) Reducing exports
   c) Maximizing outflow of capital
   d) Maximizing be foreign exchange earnings of the country

33. Which is the ill effect of exchange control?
   a) Contraction of international trade
   b) Economic nationalism
   c) Multi- lateral trade
   d) Disequilibrium in the country’s balance of payments

34. I.M.F. was established in
   a) 1945
   b) 1947
   c) 1951
   d) 1971

35. I.M.F quotas have been reviewed for how many times?
   a) 7
   b) 9
   c) 11
   d) 13

36. I.M.F. loans can be used for what purpose?
   a) Increasing the gold reserves of the central banks
   b) Projects for economic development
   c) To meet temporary deficits in balance of payments
37. I.M.F loans are known as
   a) Loans    b) Credits    c) Purchase    d) Assistance

38. Find out the correct statement.
   a) I.M.F. determines the exchange rates
   b) IMF determines the value of gold in international market
   c) IMF exercise surveillance on economic and financial policies of the countries
   d) IMF is a subsidiary of the World Bank

39. SDRs can be used as
   a) Securing foreign exchange from designated countries
   b) Transaction of foreign exchange under mutual agreements.
   c) Transactions with the general resources account of the I.M.F.
   d) All the above

40. Which of the following statements with regard to India’s membership of the I.M.F. is not correct?
   a) India’s quota is SDR 4,1582 million
   b) On the basis of quota India’s position is thirteenth
   c) India is a major debtor country of the I.M.F.
   d) India has repaid all loans from the I.M.F.

41. Which of the following institutions is called World Bank?
   a) IBRD    b) IMF    c) IDA    d) IFC

42. Which of the following institutions is not a constituent of World Bank group?
   a) IBRD    b) IDA    c) IFC    d) ABD

43. Which of the following institutions gives long-term concessional loans for less developed countries?
   a) IBRD    b) IDA    c) IFC    d) None of these

44. The loans given by which of the following institutions are called credits?
   a) world Bank    b) IDA    c) IFC    d) IMF

45. Make correct pairs.
   a) IMF    i) Investments in
   b) World Bank    ii) SDR
   c) Export trade    iii) Loans for development
   d) IFC    IV) Long – term concessional loans

46. The trade between regions within a country is termed as
   a) International trade    b) Inter regional trade    c) Export trade    d) Import trade

47. Ohlin calls inter regional trade as
   a) Inter-local trade    b) Internal trade    c) Domestic trade    d) None of these

48. The classical economists propounded a separate theory of international trade which is known as
   a) Theory of comparative costs    b) Theory of differential costs
   c) Theory of national costs    d) None of these

49. The theory of comparative costs was first formulated by
   a) Ricardo    b) John Stuart Mill    c) Bastille    d) None of these

50. Who among the following is associated with the theory of comparative cost?
   a) Carnes    b) Bastille    c) Stuart Mill    d) All of these