

STUDIES IN INDIAN ECONOMICS

EDITED BY

C. N. VAKIL

UNIVERSITY PROFESSOR OF ECONOMICS, BOMBAY

No. 9

STUDIES IN INDIAN ECONOMICS

A series of volumes dealing with the Economic history and problems of Modern India.

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C. N. VAKIL

UNIVERSITY PROFESSOR OF ECONOMICS, BOMBAY

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**ORGANISATION AND FINANCE
OF
INDUSTRIES IN INDIA**

BY
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AND
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EDITOR'S PREFACE

The question of the industrial development of this country has been in the forefront since the policy of discriminating protection was adopted. Rapid changes in industrial activities have occurred in the leading countries of the world which affect us directly or indirectly. In spite of differences of views regarding the exact method which may be adopted for bringing about the growth of industries in this country, the fact that such a growth should be brought about is accepted on all hands. The growth of industries in other countries has led to many problems both of policy and organisation, and the economic history of these countries is full of lessons from which those like us who come later in the field may profit. It is in the fitness of things therefore, that a systematic study of the different aspects of this problem be made with a view to form correct ideas for the ordered growth of industries, and the removal of difficulties and obstacles as far as possible.

Some effort in this direction has been made in this series. In a former volume entitled 'The Growth of Trade and Industry in Modern India,' an introductory survey of facts relating to the principal industries in the country was made. This prepared the way for the consideration of the question of industrial policy which was discussed in another volume namely, 'Industrial policy of India with special reference to Customs Tariff.' It was indicated in the Preface to the latter volume that the forward industrial policy, which was advocated therein, would not by itself be sufficient to develop industries in the country. It was necessary along with such a policy to solve problems relating to the organisation and finance of industries. These problems have attracted great attention in recent times partly in the form of investigations by the Banking Committees, and partly in the form of legislation, which has brought about important changes in the Companies Act.

The present volume aims at the discussion of questions relating to the organisation and finance of industries. The authors have

approached the question in an unbiassed manner, and have not hesitated to point out defects and suggest radical remedies. The impression is easily formed that while we insistently ask the State to help by adopting a forward industrial policy, we should at the same time be prepared to put our house in order by removing all those weaknesses and deficiencies which have crept into our industrial organisation. Some of these can be removed only by enlightened public opinion and by improved methods on behalf of those who are in charge of industries. It is to be expected that in view of the general awakening in the country for economic progress, greater interest will be taken in problems of this nature, which otherwise become the concern of the few.

The present work in its original form was done in the form of theses for the M. A. degree of this University by Messrs. D. R. Samant and M. A. Mulky during the years 1930-33. The material of these two theses was subsequently co-ordinated for the purpose of this volume. While this was being done Dr. P. S. Lokanathan's book on 'Industrial Organisation in India,' was published in 1935. Though the general object of Dr. Lokanathan is similar, his approach and emphasis on different aspects of the problems are different. He is more concerned with the organisation of industries and less with their financial problems. He devotes considerable space to the managing agency system, to describe which, he draws largely on the experience of certain European houses working mainly in Calcutta. The object of the present volume is wider, because while it gives due consideration to the problems of the managing agency system, it considers other equally important allied problems both of finance and organisation. It also discusses the position of small industries which does not find place in Dr. Lokanathan's work. These observations are made not with a view to criticise Dr. Lokanathan's work, but to point out the differences in the treatment of the two volumes, and the fact that the material part of the work was done before Dr. Lokanathan's volume was published.

The co-ordination of the work of Messrs. Samant and Mulky, and its revision for the press was unfortunately delayed because of the absence from India of Mr. Mulky. Mr. Samant had therefore, to undertake the greater amount of responsibility in this connection. So far as the actual division of work between the two authors is

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concerned it may be mentioned that chapters I–V, VII and VIII are written by Mr. Samant and chapters VI, IX, X and XI by Mr. Mulky. Advantage has however, been taken of this delay in incorporating in the book an appendix giving a survey of important changes in the Companies Act, which affect the organisation and finance of industries in India. Mr. Samant is responsible for the appendix.

It may be added that academic workers writing on subjects of practical importance have naturally to depend on the co-operation of the men of affairs not only for information but also for that outlook which is born of experience. Though efforts were made to obtain such co-operation in writing this work, they were not always successful. It is to be expected that those in trade and industry take a broader view of things, and do not discourage such efforts, because the systematic study of their daily work, is bound to be beneficial to all concerned.

C. N. Vakil.

*School of Economics & Sociology,
University of Bombay,
15th January 1937.*

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CHAPTER I

THE GROWTH OF INDUSTRIAL ENTERPRISE

INDUSTRIAL ENTERPRISE BEFORE AND AFTER THE INTRODUCTION OF MACHINERY

The processes of production and distribution which existed in the days previous to the introduction of large-scale production did not necessitate much enterprise on the part of the agents rendering these services. Production in those days was carried on on a small scale, mostly to order. In the field of distribution, no doubt, there existed a mercantile class; but the merchants of those days were catering for a limited market and consequently their business did not involve great risk. These conditions have changed since the introduction of machinery and the consequent changes in the scale of production. The market for such production naturally became widened; and the wider the market the more uncertain are its conditions. It is a risky thing to produce for an uncertain and an indefinite market. Thus the risk in production increased along with the scale of production.

This risk increased in another direction also. As the scale of production increased the amount of capital required to carry out such production also naturally increased. Such large amounts of capital could not be supplied by a single individual or even by a small group of individuals. The necessity of funds in amounts which were beyond the capacity of a few individuals brought with it certain forms of organisation which made it easy to raise funds from a large number of individuals. As it was impossible for such large number of individuals to manage the concerns financed by them, the actual management had to be left to a chosen few. To hand over one's own funds to the management of others involves risks and hence necessitates a greater enterprise on the part of the suppliers of such funds, than on the part of the capitalists who manage their own concerns. Of all the forms of business organisation which were

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introduced in order to facilitate the supply of funds from a large number of investors, the most common and popular is the public joint-stock company or corporation with limited liability.¹ This form is followed so extensively in the field of industries, even in our country, that the consideration of its progress gives a fair idea of her industrial development.

SOME CHARACTERISTICS OF INDIAN ENTERPRISE

The joint-stock organisation was first introduced in India during the early fifties of the last century. The first company was started by some Scotch businessmen to conduct a jute mill. Indian businessmen too, were not slow in adopting this new form of organisation to their own business. Soon after this, cotton mill companies were started in Bombay by Indian businessmen. It must be admitted here that the introduction of cotton industry was more or less in imitation of the jute industry. Both of them were textile industries, and besides in the case of cotton the raw material and the market already existed in India. The risks undertaken by the promoters of these industries thus were not great. They were not treading unknown and uncertain paths. A great deal more of enterprise would be necessary to start industries for which a ready and extensive market did not exist at hand and which also involved competition with foreign manufacturers. We still lack in industrial enterprise of this nature.

As a result of this weak point, Indian businessmen restricted themselves, till recently, mostly to cotton industry. The other industries, therefore, passed into the hands of the foreigners. The industries other than cotton, such as jute, tea, coal, oil, etc., were started and developed by British enterprise and capital. The general tendency of British enterprise was to start and

¹ Mr. G. D. H. Cole describes the importance of this form of business organisation in the following terms. "The modern capitalist age is the age of joint-stock enterprise, and its outstanding achievements in economic organisation is the joint-stock company. Wherever capitalism appears and develops, the joint-stock system develops with it. There are differences in the company laws of the various capitalist States, and some of these differences are important. But everywhere the essential institutions, by whatever names they may be called and however they may differ in secondary characteristics, are fundamentally the same. The joint-stock company, or corporation, is as central and representative an institution of the capitalist world as the craft or merchant guild was of the medieval economic system." "Studies in Capital and Investment" Edited by G. D. H. Cole, p. 58.

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develop such industries as were not likely to compete with British manufactures. We therefore, find that the foreigners restricted their activities to such industries as jute, tea, coal, oil, etc. Indian coal being of inferior quality did not affect the market of British coal. Leaving aside this limited field of manufacturing activities, the English as well as the Indian businessmen were mainly engaged in commerce. They did the business of importing foreign manufactures and exporting raw produce from India. Industries as such, therefore, made a slow progress during the last century.

INDUSTRIAL POSITION IN PRE-WAR DAYS

In 1901 there were in all 1400 companies with a paid-up capital of Rs. 37 crores. The average paid-up capital of these companies amounted to slightly over 2.5 lakhs per head. The size of the concerns floated in those days was thus small. Out of these 37 crores, 12 crores were invested in cotton mill companies, and 2 crores in industries subsidiary to the cotton industry, such as ginning and pressing factories. Thus nearly 40 per cent. of the total capital investment was taken up by the cotton manufacturing industry. Jute, tea and coal among themselves employed 6 crores. These three industries of course had grown to far greater dimensions than indicated by this figure of capital investment. A large number of companies engaged in them were floated and financed in England and therefore their capital accounts are not included in the above figure. Indians so far had no hand in these industries, whose development was wholly due to foreign enterprise and capital. Besides this, European enterprise had developed the oil industry of Burma. But Indian enterprise made no progress beyond the cotton textile industry up to the beginning of this century.

Some new industries, the most important being the iron and steel and cement, were introduced during the pre-war years. The iron industry had made a great progress in India in early history. Long before the Christian era, and that for many centuries, India was an important iron manufacturing country. Even as late as the end of the eighteenth century, India used to meet her own requirements of the metal and even used to export though on

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a diminishing scale.¹ The art of iron making was however steadily progressing in Europe, and iron and steel took their place among the manufactured goods which India began by degrees to import. This increasing import of machine-made cheap material caused the complete disappearance of the old iron industry of India. The fact that ample supplies of the raw material necessary for this industry existed in India gave an impetus to foreign enterprise to revive the old industry on new lines. Attempts in this direction were started as long ago as 1830, though they did not meet with any visible success until the end of the last century when the Bengal Iron Company under the management of Martin & Co. of Calcutta started the manufacture of pig iron on systematic lines. But the world no longer uses pig iron to any great extent in its unrefined form. In order to satisfy modern requirements, far the greater part of it must be converted into steel. Attempts were made on a small scale to manufacture steel but this did not meet with success. The first concern to manufacture steel on a large scale was the Tata Iron and Steel Company started in 1907.

The manufacture of Portland cement in India was commenced in Madras in 1904. But it was not until the year 1912 that a real impetus was given to the industry, and by 1914 three factories were established, which, collectively catered approximately for one half of the annual Indian demand.

The third industry that was growing in dimensions during this period was that of supplying electricity for power and light. But electricity in those days was generated on a small scale at different places each with a steam station of required dimensions. Hydraulic works for this purpose were first started at Mysore with State enterprise. The development of this industry like that of the steel industry² was left to the enterprise and business acumen of the Tatas.

Leaving aside the beginning of these industries, the old industries on the whole showed a good progress during the pre-war years of this century. The total paid-up capital of joint-stock companies registered in India rose from 36 crores in 1901, to 76

¹ See for instance the article contributed by Sir N. B. Sakiatwala to the Industrial Supplement issued by the 'Times of India' in 1933.

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crores in 1913. Thus the total new investment in joint-stock companies in these thirteen years was more than that of the preceding forty years. The progress shown by the above figures was mainly due to the expansion of the old industries such as cotton, jute, coal, tea and oil. Banking business had also made some progress in those years. These six branches of business employed nearly 30 crores out of the total addition of 40 crores. This shows that industrial enterprise was almost inactive outside the old industries. Even in these, all, except cotton, owed their existence to foreign enterprise.

While reading these figures one important point must be remembered that they do not represent a complete picture of Indian industrial progress. From the very beginning a very large part is played by foreign capital and enterprise in the industrial progress of India. Besides the companies which are registered in India, though financed and managed by foreigners, there is a large number of companies registered outside India but working in India. In 1913, for instance, there were 579 such companies with paid-up capital of £200 millions or Rs. 300 crores. The average paid-up capital of these companies comes to Rs. 50 lakhs per head while that of the Indian companies, i.e. companies registered in India, comes to only 3 lakhs per head. The industrial enterprise in India was thus still limited to small ventures only.

WAR AND POST-WAR BOOM PERIOD

During the war period Indian industries underwent a great expansion. On the one hand they were freed for a time from foreign competition, and on the other, the demand for their products had largely increased owing to war activities. As a result of this expansion the total paid-up capital of Indian registered joint-stock companies rose from 76 crores in 1914 to nearly 100 crores in 1918.

In 1918 the war ended and there came the boom period which brought with it feverish industrial activity. Industrial enterprise was never so active in India as in those days. The period 1919 to 1928 is the most interesting decade in the history of industrial enterprise in India. During the first three years, 1919, 1920 and 1921, on an average 900 companies were registered every year.

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On the whole 7,000 new companies were registered during these ten years. Unfortunately the industrial activity of these years was without proper foresight and without sound bases. As a result of this the years of phenomenal activity proved to be the years of phenomenal failures. There were 3,000 companies working in 1919 and 7,000 new companies were started during the following ten years. But in 1928 there were only 6,000 companies working. Thus about 4,000 companies went off the register during these ten years. The total loss of capital on these wound up concerns amounted to about 64 crores.

The industrial activity of the boom years show that industrial enterprise in the sense of willingness to invest in industries has made a great progress in recent years. On the other hand the large number of failures show that this enterprise lacked proper guidance. And the investors had to pay during such short period to the tune of 64 crores as a penalty for this unguided industrial activity.

PRESENT POSITION

According to the latest statistics published by the Government of India, the total paid-up capital of all sorts of Indian companies in 1932 amounted to Rs. 270 crores. Out of this Rs. 29 crores were taken up by financial companies such as banks, insurance companies, etc. Nearly one-fourth of the aggregate paid-up capital was invested in mills and presses, chiefly for working cotton, jute, wool and silk. The transit and transport companies accounted for a paid-up capital of about Rs. 22 crores, and the plantation industry for nearly 16 crores. The rest, amounting to about 96 crores, was taken up by trading, public service, construction and minor manufacturing concerns.

The important part played by foreign capital in our economic organisation will be clear from the following facts. The companies incorporated outside India but working in India, of which returns were available, numbered 906 in 1932, and their capital investments including paid-up capital and debentures amounted to nearly £882 millions, which according to the present rate of exchange amounts to nearly Rs. 1200 crores. This is a large figure as compared with the capital investments of Indian con-

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cerns. The capital resources of an average foreign concern amount to Rs. 130 lakhs per head. The foreign concerns are engaged in all sorts of business; there are railway companies, tramway companies, tea companies, jute companies, insurance companies, navigation companies, banks etc. These banking, insurance and navigation concerns, of course, work in other countries also. In addition to these concerns which are started and financed in foreign countries, a very large proportion of the capital of companies started in India has come from the pockets of foreigners. It is thus clear that quite an insignificant part is played by indigenous enterprise and capital in the industrial activity of this country.

SHORTCOMINGS OF INDIAN ENTERPRISE

This brief survey of industrial progress shows that India has failed to keep pace with the economic progress of the world. She showed lack of enterprise when other countries like Germany and Japan, the economic conditions of which were in no way better than hers, were making rapid progress. During this period India remained satisfied by merely exporting her raw produce and importing foreign manufactures. The complete indifference on the part of the State and lack of enterprise and ignorance on the part of the people, made India a large market to purchase raw materials from and to sell manufactured goods in. Now when we are trying to develop industrial enterprise, we find that owing to keen foreign competition we cannot make use of our enterprise with success. In those cases where protection is available by design or accident, Indian enterprise now readily comes forward to take advantage of it. The recent growth of the cement, match and sugar industry amply testifies to this. To-day not the lack of enterprise but the lack of opportunities or openings seems to be the main cause of our industrial backwardness. Whenever any opportunity of profitable investment of capital is presented it is not lost owing to lack of enterprise. On the other hand we find that difficulties are created by over-investment.

The indigenous industrial enterprise still evinces one shortcoming, viz. lack of ingenuity and foresight. With the exception of the Tatas, Indian industrialists have not taken to any notable

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extent, to industries beyond the cotton, and we might say, the sugar which, of course, is of quite recent growth. But the circumstances were so favourable for the growth of the latter industry that it implies no ingenuity or enterprise of any great extent. With ample raw material, wide home market and restricted foreign competition owing to high import duties, it is no wonder that the industry developed. In normal course this industry will shortly be over-financed, and again there will be a halt, which may continue till similarly favourable circumstances are created for investment in some other industry. The real industrial ingenuity lies in creating new wants and supplying them, and the real industrial ability lies in facing fair competition. We cannot claim credit in either of these spheres. Our industrial ✓enterprise is mostly of imitative nature. If a certain industry is found to be profitable, we go on investing in it to such an extent that at last it becomes over-financed and unprofitable. In the hurry of imitation, we completely disregard even geographical factors like the distance between the source of raw material and the place of manufacture or the place of manufacture and the expected market. The blind imitation of old undertakings goes to such an extent that many times the same location is chosen for new factories. The disadvantages that the cotton mills in Bombay suffer as compared with the up-country mills are due to this defect. The difficulties in which the cement industry had once found itself were also due to the same defect. When it was found that certain cement factories were making good profits some new factories were started in close proximity to the former ones.¹ The promoters of new factories did not realise that the adjacent factories must operate in the same markets. This led to devastating price-cutting which involved the industry in heavy losses. Cement, being a heavy article, becomes very expensive to carry to distant markets, and consequently the price becomes uneconomic and prohibitive to the consumers.

Before starting a new enterprise, it is quite essential to consider the effect of the quantity and variety of the proposed product on the expected market. If the proposed addition of the particular variety of the product is likely to glut the existing market

¹ Cf. The article on Cement Industry in the Industrial Supplement issued by the Times of India in 1933.

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the promoters of new enterprises must either change the variety or explore the possibilities of extending the market for the same variety. An extension of the existing market may seem impossible to some but how this can be achieved may be seen from the example of the cement industry. Mention has already been made of how this industry was once suffering from the evils of over-production. In order to free the industry from the evils of over-production, the cement manufacturers came in close co-operation and formed the Indian Cement Manufacturers' Association. The removal of internal strife, made possible an active concentration upon measures to increase the demand, and following American and European practice a Bureau was established in 1927 which is known as the Concrete Association of India. During its short existence this Association came to be known throughout the length and breadth of India as the source and origin of the latest information available on the uses of cement for any one who desires it. The objects of this Bureau are to assist by educative and other means, all users and prospective users of cement. The services of this Bureau have the desired effect, viz. increasing the demand for cement.

NECESSITY OF INDUSTRIAL COMBINATION

The days when we could manufacture for ready markets free from competition have long been past. We must either replace the present suppliers or create demands and markets for our manufactures. In order to oust the present suppliers we must be more efficient than they are; we must be able to produce the goods at lower costs and sell them at lower rates. It is a well-known theory of industrial organisation that the cost of production decreases as the scale of production increases. Production in India is carried on on much smaller scale than in other countries. The average capital of a joint-stock company in India comes to only four lakhs. With such small and independent units of production it is difficult to compete with other countries with their countrywide organisations. They have organised their manufactures and sales on such wide scales that they are able to reduce the overhead charges to a minimum. This tendency to

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combine is not restricted to political boundaries; international cartels have been growing in importance and number especially since 1926. These combinations are often able to dictate their own terms to the world-market. If we wish to replace such competitors we must try to increase our efficiency and decrease our costs.

One of the ways of achieving this, and the most important one, is to widen the dimensions of business units by organising cartels on the lines of our competitors. There is a time-honoured complaint against such combinations, that they tend to become monopolists and try to regulate prices at the cost of the consumers. But this argument has been proved to be false by the recent growth of industrial combinations. The aim of the modern combinations is not to regulate prices but to reduce costs. A newly developing country like ours being faced with keen competition on all sides cannot have regulation of prices as the aim of industrial combinations. This can only be possible under a high protective policy, but as our Government is following the policy of discriminating protection and is aiming mainly at keeping industries alive, we need not fear that industrial combinations will mean an unnecessary burden upon the consumers. They will only help us to keep pace with our competitors. A really efficient industrial combination is able to achieve a greater economy in many directions.¹ Industrial combinations will prove of special advantage in India so far as they will be in a better position to influence the Government as regards tariffs, store-purchases, etc.

This short survey of our industrial progress shows that the part played in it by indigenous capital and enterprise is very meagre. The industrial activity of this country, meagre as it is,

¹ Dr. Hermann Levy gives the following long list of the economics of industrial combinations. "This, (i.e. economy) especially applies," he says, "to a better and steadier supply of material, unification of buying departments and staffs, bulk instead of detail purchase, greater opportunity for comparison and selection, cheaper credit and better discounts, standardisation of products standardisation of materials, specialisation of product improvement in plant, use of by-products, equalised distribution of work, quality, transport economics, unification of selling departments and staffs, extension of export trade, collective advertising, lower costs of distribution, fewer middlemen, interchange of data and experiences, standardisation and interchange of costings, collection and dissemination of trade statistics, promotion of scientific and technical research, concerted promotion of problems, which may be affected by the economic policy of the State, etc., etc."

is mainly in the hands of the foreigners being initiated, managed and financed by them.¹ One important point to be borne in mind in this connection is that the industrial backwardness of this country is not an index of available capital resources or enterprise. All the commissions and committees that have investigated the problem of capital resources of this country have come to the conclusion that the country is potentially rich in this respect.² And this is verified on different occasions. During the ten years, for instance, from 1913-14 to 1923-24, the period of financial activity, the Government rupee loans increased from 145 to 358 crores, and the paid-up capital of joint-stock companies from 80 to 254 crores, a net increase of 387 crores.³ Similarly the ease and cheapness with which the Government and semi-Government bodies are able to borrow, and also the abnormally low rate of interest prevailing at present indicate plethora of capital resources. Industrial enterprise too is not now so very lacking as it once was. This is well evinced by the industrial activity of the post-war boom period which, misguided though it was, clearly shows that industrial enterprise in the sense of readiness to invest in industrial schemes is not lacking in India. Even to-day an enterprise promoted by well-known businessmen scarcely finds it difficult to raise the necessary capital. The fact is that willingness to invest in industrial enterprise is not now absent as in former days; only the investors must feel that the enterprise is a sound one. They have, of course, their own ways of estimating the risks. But this means that if we can reduce the risks in industrial investments and make the investors convinced of this the supply of capital to industries will largely increase. If we wish a speedy industrial progress we must try to create such conditions that it will be possible to put the available resources to the greatest use.

¹ "Nevertheless, a not inconsiderable amount of capital invested in Indian Industries is still non-Indian. The result is that the control and management in the case of some of the important industries are even now in the hands of non-Indian firms." Central Banking Enquiry Committee Report Vol. I part I para 332.

² See the reports of the Industrial Commission (1918), the External Capital Committee (1925). The Central Banking Committee, and also our chapter on the Capital Market.

³ Cf. The External Capital Committee Report (1925) para 8.

CHAPTER II

SOME PROBLEMS OF ORGANISATION

IMPORTANCE OF JOINT-STOCK ORGANISATION FOR INDIA

There are three main forms of business organisation classified according to the way in which the ownership of the enterprise is held: (1) The individual owning his own business and managing it himself; (2) a group of owners working together under some form of partnership agreement; and (3) the impersonal owner the company or corporation standing between the business and the individuals who have various kinds and degrees of claims upon the business. The last being the most complicated and the most important of the three will be considered first.

The company form of organisation is employed by all big industrial establishments, and if we wish a speedy promotion of industries in India we must try to encourage and popularise it. It is the only form of organisation that will enable us to raise the enormous amounts of capital necessary for present day industrial establishments out of our small savings scattered throughout the vast country. Besides, most of our wealth is due to agricultural or non-industrial activities. A very small portion of our total wealth is due to industries of the modern type. Capital resources and business ability to organise industries on modern lines, therefore, cannot be found together in India, and hence the necessity of a contrivance to make, what capital resources we possess, available to those who possess business ability. This can be achieved only through joint-stock organisation. It will enable us to increase the efficiency of our small capital resources by passing them over to the control of those who can put them to the best use.

PROMOTION OF INDUSTRIAL SCHEMES

A large number of individuals invest in a joint-stock company. It is obviously impossible for all of them to come together and

find out an industrial proposition in which to invest their money. They will come forward to invest when a properly planned out scheme of an undertaking is placed before them. The first step in starting a joint-stock company is, therefore, to find out an opening for profitable investment of capital. The next step is to outline a scheme to exploit that opportunity and to make an estimate of funds necessary to materialise the scheme. This is called promoting a concern, and those who do this are called the promoters. A scheme can succeed only if it is well conceived and well promoted i.e. organised and established as a going concern.

The importance of the part played by the promoter in the success of a scheme is not usually realised. The success of an enterprise in a great measure depends upon the efficiency and ability of the promoters. It is the promoter who first of all sees the chance of making a gain and then starts to organise the factors that will enable him to realise the gain. It is he who arranges for the finances and organisation of the proposed enterprise.

The function of promotion involves three stages:—(1) The discovery of the proposition including its investigation; (2) the assembling of the proposition; and (3) the financing of the scheme.

The efficient promotion of any industrial enterprise requires services of three different classes of experts: economic experts, engineering experts and financial experts. The advice of economic experts is required with regard to points such as availability of raw material and the possible cost of it, conditions of market and competition, labour situation, the economic or optimum size of the proposed establishment etc. The next step is to estimate the costs of equipment, and for this engineering advice is necessary. The makes and types of machinery and materials, the economical methods and types of construction etc., cannot be decided upon without the aid of an engineer. When after all these considerations the capital estimates to launch and work the proposed enterprise are prepared, the banker comes in with his advice as to the methods of raising the required funds. The good or bad promotion of any concern depends upon the efficiency and co-operation of these three services, viz. economic, engineering, and financial.

The promoters themselves are required to spend large amounts

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from their own pockets before they are able to place before the public a properly planned out scheme. Expenditure is required first of all to undertake a proper investigation of the potentialities of an enterprise. Funds are also required to take advantage of expert services which the promoters lack. All these expenses cannot be undertaken by a single individual. And even if they can be undertaken it is risky to do so, because if the scheme does not materialise all the expenditure on it will mean a total loss.

THE PROCESS OF PROMOTION FOLLOWED IN OTHER COUNTRIES

It will not be improper to give a short description of the promotion process usually followed by other industrial countries, especially in view of the fact that this topic has not received the attention that it really deserves. The first step in promotion viz. to find out a possibility of starting a profitable enterprise is usually carried out by a small capitalist of business-like bent of mind. He spends energy and money and investigates the possibility of development. If he finds that the project outruns his means he passes on the result of his investigations to a banker or a big capitalist. This banker or capitalist takes in two or three other bankers or capitalists and forms a syndicate and develops the proposition. After this the original promoter passes out with sufficient remuneration for his efforts either in the form of cash or a part in the concern. The syndicate manager then arranges for a thorough examination of the proposition. The examination is carried out on the following lines:—

- (1) The possibility of getting raw material, its distance and price.
- (2) The freight charges to and from the factory.
- (3) The likely markets for the products.
- (4) The possible market that the products will command.
- (5) The possible cost of production per unit.
- (6) The conditions of competition.
- (7) The methods of economical operation.
- (8) The probable changes in demand.
- (9) The labour situation of the region.

After the concern is properly organized and launched the promoters disappear from the field with adequate remuneration, and the concern continues to exist independently as a legal entity.

PROMOTION ACTIVITIES AS CARRIED ON IN INDIA

In India the promotion business is carried on on very unsatisfactory lines. There are no experts or specialised promoters as we find in some other countries. The promotion business in this country is undertaken by business firms, which are, as a rule, already engaged in trade or management of some other business concerns. These firms are called the managing agency firms, as they are the sole agents to look after the entire management of the concerns under them. And when they promote any new concern, they establish themselves as the managing agents of those concerns. The qualities that are required for the trader or the manager of a concern are quite different from those that are required for a successful promoter. Besides, these firms never restrict themselves to a particular line of business. An agency firm managing a bank or an insurance company comes forward to promote and manage a sugar mill or a cotton mill. A firm restricting itself to a particular line of business can be said to possess special qualifications to promote a concern in the same line. But when one single firm undertakes to promote and manage diverse types of concerns, its work in all the different fields cannot be efficient.

A promoter of a business concern obviously cannot be expected to render personally all types of services required in promotion business. He therefore, should and must take outside help on all such points on which he cannot have a definite say. We saw above how this is done in other countries. There are two reasons why the promotion of industrial concerns in India is deprived of the advantage of expert advice. First there is generally a want of such agencies which can render expert advice in this respect. Secondly, our businessmen are generally unwilling to take advantage of such advice even when it is available.

Whenever an agency firm promotes a new concern, it does so with the intention of establishing itself as its managing agents, and in the agency agreement it claims for itself some special

privileges for rendering the promotion services. The promoters thus are unwilling to give the credit of rendering the promotion services to any one outside themselves. It is perhaps feared that the other parties who may be asked to help in promoting the concern might claim something in proportion to what the agency firm is claiming. Even supposing such a situation does not arise, and the outside experts remain satisfied with an adequate fee only, another difficulty may arise. For, if this practice is followed, the shareholders may legitimately question the undue privileges obtained by the Managing Agent—Promoter, who would also have to be then satisfied with some fees instead of permanent control.

It must also be added that specialised services necessary for promotion business are not available in India. For instance, specialised engineering or technical advice on different industries is not always available in this country. At the same time, bankers hesitate to help in the promotion of new ventures. As a matter of fact no banker in India is in a position to render such services. Banking business in India is carried on on such narrow lines that bankers, as a rule, do not possess industrial information useful for new ventures. If we wish an all sided industrial development of the country, we must encourage the use of the services of suitable experts in different branches of the work.

In the last chapter we have remarked that the size of an average industrial concern in India is comparatively small. One important reason for this can be found in the promotion process followed in this country. The promoters in India do not sever their connection with the promoted concern as soon as it is properly launched. They try to make their connections permanent with special privileges due to the promotion services. This makes it necessary that a concern should be promoted by a single individual or a single firm. A syndicate cannot be formed for promotion purposes as it cannot remain permanently linked to the promoted concern. If some parties of the syndicate are to sever their connections as soon as the concern is launched it will mean disproportionate remuneration to the co-operating parties, and therefore this method is not adopted. The promotion of large schemes which is a costly affair and cannot be undertaken by a single individual or a single firm, is therefore, very difficult in

India. A big firm like that of the Tatas can undertake big schemes, but there are very few such firms, and fewer still possess the enterprise necessary for such undertakings.

Schemes floated even by such big firms often suffer from defects in investigation and financial planning.¹ Funds raised in the hope of launching and working a scheme are found to be exhausted long before even the construction work is completed.² A very large proportion of the boom time failures were due to faulty financial planning usually resulting in insufficiency of funds.³ This defect was not due to the over-activity of those days. It existed long before that; as a matter of fact it is there since the introduction of joint-stock organisation in this country. Complaints about ill-drawn schemes and faulty financial plans were heard from many a witness before the Industrial Commission of 1916. Similar complaints were reiterated by witnesses before the recent Banking Inquiry Committees, Central as well as Provincial.⁴ Obviously whatever is already spent on such schemes is mere waste. If the want of additional funds be not very great, then it is met by the managing agents by issuing debentures which in many cases are held by themselves. As a result of such transactions the borrowing concern usually passes totally into the hands of the creditors, who not infrequently are the managing agents. Even if it is able to lead an independent existence, it leads only a sickly one, being over-burdened with heavy fixed charges from the very beginning. Under any circumstance, the shareholders either lose their investments or do not earn the dividends that were promised.

In order to avoid such losses, it is necessary that there should be some efficient agency to certify the validity of estimates supplied by the organisers to the future shareholders. Unsuccessful attempts entail great indirect social loss over and above the actual direct loss. Such failures increase the shyness of investors

¹ See for instance the evidence of Mr. A. D. Shroff before the Central Banking Enquiry Committee.

² See for instance the history of the C. P. Portland Cement Company.

³ Cf. A booklet entitled "Company Failures and their causes," by N. J. Shah, B. Com., F. S. S. A.

⁴ See for instance C. P. Provincial Banking Enquiry Report, Vol. I. Bengal Provincial Banking Enquiry Committee, Vol. I. Central Banking Enquiry Committee Report, Vol. II.

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as regards industrial investments and consequently increase the supply price of capital to industry. This increases the cost of production, which either means an unnecessary sacrifice on the part of the consumers, or the absence of industrial progress.

INVESTORS IN JOINT-STOCK COMPANIES

After a company is promoted in the legal and business sense the next step in its life is to raise the necessary funds. For this an appeal is made to the public in the form of a prospectus containing detailed estimates about the cost of production, prospects of profits, etc. Those who believe in the accuracy of these statements come forward to invest in that enterprise.

There are three types of investors:—(a) The safety-first type, to whom security of income and capital are essential; (b) the long-run speculative investor, who wishes for income as well as capital appreciation; (c) the short-term speculator, who endeavours to make quick profits. Those who belong to the first category do not usually invest in ordinary shares. They are, at the most prepared to invest in preferred shares. From the point of view of industrial investment, the last two types are important; the second being more important than the third. The third type consists more of speculators than of investors. The majority of industrial investors in India belong to this class. They wish to derive profit out of the increased value of the shares and not out of the increased productivity of the concern. The investor as well as the speculator both look forward to capital appreciation. But their methods of achieving this are quite different; the former wishes to bring about appreciation through increased productivity, while the latter through speculative activities. The much complained of scramble for high dividends is due to the predominance of this speculative tendency among our shareholders. They always press for high dividends even though it be at the cost of the future good of the concern. Such high dividends bring about a rise, though temporary, in the price of the shares, and this is what they want. They keep themselves concerned only with the figure of dividends and never care to know the conditions under which those dividends are declared. This tendency, besides being harmful to the ultimate interests of the concern,

gives undesirable freedom to the management as the shareholders do not take any interest in the internal management.

This speculative tendency is stronger among the Bombay shareholders than among the Calcutta shareholders. This is perhaps due to the commercial instinct of the people of Bombay. They look upon shares as articles of trade and not as articles of permanent investment. Frequent trading in shares keeps their prices fluctuating which frightens away bona fide investors from industrial investments. Besides, a large volume of credit is kept engaged in their speculative activities which otherwise would have been available for industrial purposes.

INFLUENCE OF BIG NAMES

From the point of view of a single concern it is a matter of indifference whether the funds come from speculators or from investors, though it is important from the point of view of the society as a whole. What is of importance for an individual enterprise is the supply of sufficient funds. This supply depends upon the way in which the prospective investors view the scheme placed before them. There is a common complaint against the investors in India that they are led more by names than by the actual contents of the prospectus of the new concern. They are prepared, it seems, to entrust their savings to certain persons however unsound their propositions may be. This prejudice in favour of big names is not so strong when the proposal is about an industry which has already succeeded in convincing the public of its profitability. If any company can command both these favoured attributes, its shares are sure to be over subscribed in a short time.

Really speaking we cannot blame our investing public for this attitude. An investor in the shares of a company exposes his capital to two sorts of risks, personal and industrial. And obviously when he cannot know anything about the industrial risks, he wishes to protect himself at least against personal risks. Being generally ignorant of business affairs, and therefore unable to decide for themselves the business prospects of any proposal placed before them, the outside investors prefer to be led by others, whom they consider to be shrewd enough in such matters.

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Such people do not come forward to invest in the shares of a new company unless they are quoted on the stock exchanges. The quotations on the exchange are taken to be the real value of the shares as they are the result of the opinion of leading businessmen.

There is one more reason why the stock exchange quotations are awaited. Investors wish to know the names of purchasers of the shares. Especially, if they find that the organisers have invested a good deal in the scheme, they take courage thinking that the organisers would not have invested if the scheme were not a sound one. The organisers and their friends, who are aware of this fact, usually subscribe in large amounts just to create confidence in the minds of the prospective purchasers. Later on when the demand increases, they slowly unload their holdings, usually with great profit.¹ Sometimes more objectionable methods are followed. For instance, the original purchasers enter the market to purchase the shares which are already in their possession. This sends up the prices, and the outside investors who are not aware of the dodge are deceived by the artificially raised prices. They think the high prices are due to the high value of the securities and thus fall a prey to the shrewd manoeuvring of the inside group. Under these circumstances some intermediate agencies commanding the confidence of the public, are essential to investigate the claims of a proposal and to present that claim to the public supported by its guarantee.

The investing public of India show ignorance not only at the time of making the purchases but even afterwards. They are usually too ignorant to protect their interests even after they purchase the shares of a company. The majority of our shareholders do not possess any intimate knowledge of the working of the company in which they have invested. This lack of knowledge is not due so much to indifference on the part of the shareholders, but to their ignorance of the intricate problems that arise regarding the finances of a joint-stock company.

¹ See the next chapter on the Managing Agency System, the Managing Agents and Supply of Share Capital.

DIRECTORS OF JOINT-STOCK COMPANIES

After a concern is promoted and financed the next question is about its management. Really speaking those who finance are the owners, and as such they should manage the concern. But the number of the owners of a joint-stock company runs into hundreds and they cannot all take part in the management. What is usually done, therefore, is that the actual management is handed over to a few chosen from among themselves. These persons are called the directors.

Even the directors cannot and do not look to all the details of management. The real function of the board of directors is to select the right officials, to outline policies and to pass well informed judgments from time to time as to the efficiency and honesty of the management. Leaving aside the details of management, the directors wield such powers that they are for all outward purposes the real controllers of the concerns. When the joint-stock form of organisation first came into existence the directors were often the proprietors of the concerns. Even when the group of proprietors out-numbered the directors, the latter were a sort of confidential representatives of the former. But these conditions have undergone a vast change in recent times. To-day we find that in most cases, the stake and the interest of the directors are much less than those of many other shareholders, and still the rights and powers of the directors are the same as before. The possession of proprietary powers without a corresponding stake leads often to undesirable results. Usually, it so happens that in every board there are some members who have either a great stake in the concerns or wish to build up a reputation for themselves. Such persons usually take an interest in the management, others only take their fees. It may be argued that though some of the members of the board do not seem to be taking an active interest in the daily work, still their presence proves of great use at some critical moments, if they are experts in some branch. But usually even this hope is rendered futile, because seats on the board of directors are offered to persons who have made a name in politics or other spheres, and who, as a matter of fact, cannot be expected to be of any use in matters of business.

DIRECTORS AND MANAGING AGENTS

In reply to complaints about the merits and efficiency of the directors, it is argued that they are elected by the shareholders themselves, and therefore, the latter have no grounds to grumble. The directors are said to be the representatives of the shareholders by whose consent they hold their position. If the latter, therefore, suspect anything wrong with their representatives, they can remove them and elect new ones. All this sounds well in theory. In practice, the election of directors has become a mere farce. Directors are supposed to be elected by shareholders but the fact is quite different. In practice, the vacancies on the board are filled mostly by co-option. The shareholders being scattered and disorganised scarcely dispute the nominations. As a result of this, a director, once appointed considers himself entitled to the office for life, unless he chooses to retire.

As a matter of fact, the management of a company does not like a strong board of directors. And the stronger the management, the greater is their dislike for active directors. The worst example of this can be found in India, where the management of a company is completely in the hands of the managing agents who always attempt to make the board of directors as ineffective¹ as possible. The directors of Indian companies, whether under Indian or English managing agency firms, hardly take an active interest in the concerns. It is the sad experience of able directors that if they are active they have to go out soon.

There are various methods of making the directors as ineffective as possible. It must be remembered that it is the agents who nominate the directors in the beginning and also propose their names at annual elections. The votes of independent shareholders prove ineffective even in such forward countries like England, where the shareholders are far more instructed than what they

¹“As to that, my impression is speaking broadly, that the majority of Directors, whether they are Directors of Banks or Directors of Mills, hardly take much interest in the concerns. If they are a bit active then they go. I am told the same thing about the jute mills in Calcutta, that you should not interfere with the agents; if you do you go. They told me that about the English managed concerns; and here it is the same thing more or less. It all depends upon the position of the Directors..... But still the Agents are all powerful and they have a large number of shares which enable them to get rid of them.” Evidence of J. A. Wadia before the Tariff Board, Cotton Textile Enquiry of 1926-27.

are in India. It is thus no wonder that agents in India are able to carry out their wishes in this connection. Even while making nominations, the agents generally take care to nominate such persons as will be completely under their influence. The usual practice in this respect is to nominate relatives, friends or such other persons who are directly or indirectly under their obligations. If any of these devices be impossible care is taken to nominate such persons who know very little about business matters, and who being ignorant of their duties take care not to meddle in the affairs of the company. A non-interfering board of directors may be created also by another method. One agency firm chooses as directors of the concerns under their management, the members of another agency firm and vice versa. Thus obligations and counter-obligations are created; the whole system resulting in the creation of a sort of class interest. The system of partial retirement of the board of directors is also made use of to avoid any undesirable elements being predominant. If in any election the management find that they are defeated by the shareholders, they become more careful to have their own men elected at the time of subsequent elections. This they can do by securing more proxies or if necessary even by purchasing more shares. The most objectionable method followed by the managing agents of bringing in their own men as directors, is by paying even for the qualification shares of such directors.¹ It can easily be imagined what interest the directors will be taking in the concerns, in which they are not prepared to purchase even the qualification shares.

As the directors are mere puppets in the hands of the managing agents, the latter do not care to consult them even on important matters. Affairs involving lakhs of rupees are transacted without the knowledge of the directors. It is not an unusual phenomenon to find that the directors are called only once in a year to sign the balance sheet when it is ready.² If directors are to be totally neglected they naturally desire that they should be relieved of the responsibility incumbent on them. And this is

¹ Cf. Evidence before the Indian Tariff Board during Cotton Textile Enquiry of 1926-27.

² See the evidence of Mr. J. V. Desai: Indian Tariff Board Cotton Textile Enquiry Report Vol. IV. 1927.

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accomplished by providing in the Articles of Association that a director shall not be responsible unless for his personal wilful misconduct. This practice of relieving the directors of almost all the responsibilities helps to get influential persons as directors, as they are not required to do anything nor to bear any responsibility. It is necessary that any such attempt to relieve directors of their proper responsibility should be made illegal.

In reply to the complaint about inactivity of directors it is said that the remuneration that directors get for doing their duty is small. For such a small remuneration, it is added, they cannot be expected to take an active interest in their work. As a matter of fact, the position of the director of a company is looked upon as a sort of public service, and not as a business proposition. Directorships are often accepted to oblige the organizers or management of a company. The company Directorship in India has been reduced to a sinecure. The big names included in the list of directors are there more to grace the company than to direct it. The remuneration that the directors get, therefore, though it appears to be low at first sight, is really speaking too high compared with the work done by them.

As directors are relieved of most of their duties, it is possible for an individual to be a director of a large number of companies at the same time. As the underlying motive in choosing directors is not their usefulness in business matters, but their usefulness in bringing prestige to the company, it is usually found that a certain number of important persons, either in the business circle or in the political circle, are found on the boards of a large number of companies. Some of the famous businessmen in Bombay for instance, are found to be the directors of dozens of companies. It is quite impossible for any man, however competent, to do justice to his work when he is to serve on so many boards. A person who is supposed to be an able businessman is requested to serve on so many boards that he is rendered useless to all of them. This tendency to include names of big persons in the directorate of companies provide a good source of income in the aggregate to such persons without corresponding responsibility or work.

REMUNERATION TO DIRECTORS

It is true that the fees that the directors get at present are not adequate to inspire them to take active interest in the business, and therefore if we wish to have efficient services from them we must see that they get adequate remuneration for their work. One important factor in making the directors take a personal interest in the working of a company is to make them interested in its profits. When joint-stock organization was first introduced in England, the directors of a company were usually its principal shareholders. They were thus directly interested in the working of the company. What they were getting as directors, thus, was not the only remuneration that prompted them to discharge their duties efficiently. We, who are in the habit of imitating British practice, have, in this matter imitated the form without the underlying conditions which even in England have been disappearing. In other countries, notably in Continental Europe, it is the custom to distribute among the directors at the end of each year, a fixed percentage of the net profits; thus each director, even though he may not be a shareholder, has a direct and personal interest in building up the profits. He is less likely to wink at incompetence or to avoid criticism that would be for the good of the concern. He realises that he must himself pay a portion of the penalty in the form of reduced reward.

If we want the directors to be active and devoted to the well-being of the concerns, we too should introduce this practice of distributing a certain percentage of profits among them. It will of course be very costly to introduce this practice with the present size of our boards. But if we look more to efficiency of services and less to the grandeur of the list, we can reduce the present size of our boards without any loss of efficiency.

DIRECTORS AND TECHNICAL KNOWLEDGE

The usefulness of a board does not depend upon its size but upon the services that the members render. A board of directors to be really useful must be able to pass opinion even on technical matters. It is necessary that every board should have at least one technically trained person. It is notorious that the boards of our

companies lack in this matter. Leaving aside new industries, the dearth of technically trained persons is found even among the directors of cotton mill companies, though this industry claims an existence of more than three quarters of a century. A recent investigation in the cotton mill industry of Bombay City shows that out of the total number of 175 directors managing 64 concerns, only eleven had received technical training. Out of 64 companies only 20 had the advantage of having technically trained directors.¹ It is sufficient if every board has at least one member who has received technical training. But it is necessary that the rest of the members should be well versed in business matters. In India it is believed that business ability is an inborn quality where training is of no use. But it is now a well established fact that there is a science of business administration, comparable in many ways with any other field of applied science. The problems of business are becoming increasingly complex, and if a businessman wishes to solve them successfully he must bring to his aid the accumulated knowledge and experience of other countries. If he wishes to form an accurate judgment on any problem he must have all the necessary facts before him. These facts are not matters of personal experience but matters of record. A successful businessman must have received training in problems of finance, organisation and administration. The directors of companies must be trained in business matters on these lines. It is no use appointing as directors persons who have achieved eminence in professions such as medicine and law.

COUNCIL OF EXECUTIVES

Besides the board of directors there should be a Council of Executives. This council should comprise of the managing director, a member of the board of directors who possesses technical knowledge, and the heads of important departments. This council should discuss and formulate all the details of the working of the company. They might discuss other important points also, but their decisions on such points should be subject to the consent of the board of directors. The discussions of this body will prove of great use to the board in coming to a decision on any point.

¹ Cf. "Bombay Industries: Cotton Mill Industry," by S. M. Rutnagar, pp. 49-51.

It will prove of great help if the board invite the opinion of the council on certain matters. It is suggested by some that a board of supervisors should be established over and above the board of directors. But this will unnecessarily increase the overhead costs.

SHAREHOLDERS AND THE RIGHT OF VOTING

Whatever the composition of the board of directors, one thing is clear that the board must be under the control of the shareholders, who really bear all the risks. The extent of the control of the shareholders on the directors will depend upon the extent to which the shareholders are able to make their voting right effective in the election of the directors. Usually it so happens that the management of a company desires to have as much free field for themselves as possible. They do not like interference from the shareholders. The managing agents therefore always try to carry the elections in a way favourable to them, and this they are able to do with their own votes and with the proxies secured from some outside shareholders. Other shareholders are scattered and disorganised, and scarcely do they exert their voting rights. The management group thus, is able to carry the day with proportionately small number of votes.¹ The present system of one vote for each share is specially favourable for this, as it renders the manipulations very easy by limiting the amount of capital necessary to hold the control.

This difficulty of a small group of shareholders becoming predominant in the management is felt in other countries also. Different methods of voting rights are, therefore, tried in order to remove the difficulty arising out of one vote for one share. Businessmen in the United States of America, for example, found it difficult to interest small subscribers owing to this system of voting rights. In order to remove the complaint of the small shareholders a new system has been introduced, of giving one

¹ "In the first place the owner of a large concentrated block of shares usually finds himself confronted not by a united body of other shareholders capable of common action, but by a number of scattered individuals who are not unlikely to attempt to interfere in a concerted way with the operation of the company. In practice a 30 p. c. holding may be quite enough to ensure absolute control if the remainder of the shares are sufficiently widely diffused in the hands of other investors." *Studies in Capital Investment*, edited by G. D. H. Cole, p. 35.

vote for each share up to a certain number of shares and then one vote for a group of shares beyond that number, with a maximum number of votes for each shareholder. Thus a shareholder may have ten votes for the first ten shares, thereafter one vote for every ten shares until a maximum of hundred votes is reached, no shareholder having more than a hundred votes. One defect in this system is that its aim can be frustrated by transferring shares to other names. This is the principal argument made against this system in England. To prevent such attempts legislation has been passed in the United States of America making any attempts to defeat the provision of the rule illegal.

THE CUMULATIVE VOTING SYSTEM

Another system of voting followed in order to avoid the disadvantages arising out of one vote for each share is that of cumulative voting. Under our present system of voting a shareholder is entitled to cast a number of votes equal to the number of shares he holds for one candidate for each seat on the board of directors. Under this system persons commanding 51 per cent. of the total number of votes exercised can elect all the candidates that they want. The remaining 49 per cent. of the voters remain totally unrepresented. Under the cumulative system each shareholder has as many votes as is equal to the number of voting shares he owns multiplied by the number of directors to be elected. These votes he may accumulate for one candidate or may distribute among the candidates for election in any way he likes. In this way the minority interests can elect the men whom they want, and can at least keep themselves in touch with the affairs, and voice their opinion on the board. This voting system has been prescribed by statute in some of the states of the U. S. A. In those states in which no such provision is made by law, it is included in the certificate of incorporation.

For successful working of the cumulative voting system, it is necessary that the shareholders should be well organised and should have a unity of opinion among themselves. The shareholders in no country, much less in India, are ever well organised. Under such circumstances, even with cumulative voting it will be difficult for outside shareholders to secure effective represen-

tation on the board. The inside group being well-knit will always command a dominating position. The limited voting system possesses better advantages than this. Under this system the inside group whatever their holding, will be in possession of a limited number of votes. On the other hand the outside shareholders, i.e. those who are not connected with the management, will possess relatively a far greater number of votes, as the shares among them will be scattered in small lots. Besides, the limitations on exercisable votes will dissuade the management group from holding any considerable part of the capital. The outside group of the shareholders thus will be much more powerful than the inside group. For successful working of this system, there must be strict regulations against any attempts to frustrate the aim of this system by transferring shares to others. Whatever the voting system one regulation is quite imperative: everybody who is connected with the management of a company must be strictly forbidden to secure proxies from other voters.

AUDITORS—THEIR DUTIES AND ELECTION

There is one more way in which the shareholders can keep an eye on the affairs of the company. It is through the auditors. Like directors, auditors also are representatives of the shareholders. Under diffused ownership auditors are expected to work as a check upon the management in the interest of the owners. The auditors are there to inspect the financial working of the concern and to report it to its owners. The importance of auditors in the finances of a company is not properly realised in India. One reason for this is that the duties and functions of auditors are not properly understood. The auditors, really speaking, are not to confine themselves to verifying the arithmetical accuracy of the balance sheets; they must enquire into substantial accuracy. They do not discharge their duties by simply putting the shareholders in the way of obtaining information, but they must state their conclusions in unmistakable terms, calling attention of the shareholders to matters of importance which it would be in their interest to know. They must also elucidate in the report any item in the balance sheet as published, which might, in their opinion,

mislead an average person as to the true position of the company's affairs.

It is obvious that if the auditors are to carry out their duties satisfactorily they must have all the necessary facts before them. There must not be anything in the financial matters which is not the concern of the auditors. They must have a full account of all the assets if they are to value them properly. It is a general complaint against our auditors that they do not go into the details, and do not even check the accounts properly. The management of our companies, as a matter of fact, do not allow the auditors to check and value the stock. How auditing is made sometimes a mere farce can best be seen from the fact that in Ahmedabad the audit of about twenty mills was carried out by one auditor who had a staff of two clerks only.¹ In fact, auditing in India is considered to be a formal thing which must be done only because the Law says so. Our companies, therefore, try to minimise the auditing expenses as much as possible. This results in keeping away efficient auditors' firms, and therefore the audit of even large companies is carried out by ordinary firms with an incompetent staff. For a proper valuation of the assets the auditors must have an access to all kinds of stock held by the company. The stock must be checked and valued by them. A general complaint in this respect is that our companies do not allow the auditors to check and value the stock.²

One great defect about the auditing system as followed in India is that the auditors are appointed and their remuneration and tenure settled by the management themselves. In Law, this is to be done by the shareholders, but in practice everything is done by the managing agents. The auditors are there to examine and criticise the action of the management. It, therefore, does not stand to reason that they should be appointed by the managing agents themselves. How can we expect them to be impartial and just in their findings about those on whose sweet will their remuneration and tenure depend? And all this, in the interest of those who will not prove of any benefit to them. Because, though the auditors are legally to be elected by the shareholders, in practice

¹ Cf. Indian Tariff Board, Cotton Textile Report, 1927. Vol. I.

² Ibid.

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the votes of the shareholders have no effect. The managing agents usually have complete control over the appointment, removal, etc., of the auditors, and as a result of this, we find that often the auditors are either relatives or friends of the agents.¹

If we want efficient services from the auditors we must bring them under the complete control of the shareholders. The managing agents as well as the directors must be debarred from securing proxies or even voting at the time of electing auditors. This will ensure that unfavourable criticism by the auditors against the management will not affect their position.

¹ Cf. The Indian Tariff Board, Cotton Textile Enquiry Report, 1927 Vol. I, p. 147.

CHAPTER III

THE MANAGING AGENCY SYSTEM

THE ORIGIN OF THE SYSTEM

In the foregoing pages we have made frequent references to managing agents and the managing agency system. In this country the affairs of joint-stock companies, especially of the industrial ones, are not entrusted to persons directly employed by the companies but to large firms already at work. Such firms are called the managing agents and they take in their hands all the financial, managerial and commercial functions of their client concerns; they control the finances, appoint higher officials and carry out the necessary purchases and sales. This peculiar feature of joint-stock organisation is found only in India. It is interesting to note that the joint-stock company organisation was introduced here with the managing agency system as its fixed and permanent feature. As a result of this the number of joint-stock companies managed without managing agents is so small, that they can very well be taken as exceptions proving the general rule. This system has become such an important feature of Indian business organisation, that no study of industrial organisation and finance is complete without a detailed study of it.

Though the managing agency system is peculiar to India still it does not mean that it is an indigenous feature of business organisation. It is the outcome of British trade relations with this country and is due more to its geographical conditions than to economic ones. The origin of this system can be traced back to the year 1793 when the trading monopoly of the East India Company was curtailed. The privilege granted to the private traders brought into existence small trading houses at Calcutta. These houses increased in number and size after 1813 when the trading monopoly of the Company was totally abolished. Though the first trading company i.e. the East India Company, was a joint-stock company, its successors carried on business as individuals, in partnership or by means of private companies. These houses

worked as agents to foreign firms in importing British goods and exporting Indian goods. And that is why they came to be called agency houses. Over and above their commercial activities they also carried on financial activities. These agency houses were first started by men employed in the civil and military services who thought themselves better adapted for commercial pursuits. They also received as deposits the savings of their friends, and lent the same to others or employed them themselves for purposes of commerce. They made their profits in the usual course of trade, and by the difference of interest in lending and in borrowing money, and by commission.¹ These houses were not dissolved on the retirement of their partners; the retiring partners were succeeded by others. The successors enjoyed all the advantages of established credit and financial resources of the houses without themselves contributing anything at the time of their joining. This last feature makes clear why these houses became hereditary concerns. These business houses carried on three different types of business: they worked as importing and exporting agents, as independent traders, and also as bankers in so far as they used to accept deposits and make advances to others.

These houses slowly came to play a more and more important part in the organized industries of India. This side of their business got a stimulus owing to certain external causes. When the British capitalists found that they could invest their money profitably in Indian industries they began to start companies for this purpose. But though there were opportunities for profitable investment of capital in India, there was one difficulty in exploiting these opportunities. For successful conduct of these business concerns it was necessary that they should be under continuous supervision of able businessmen. During those days it was difficult to find among the relatively small number of foreign businessmen available in India, directors especially managing directors, who could do this. The agency houses removed this difficulty. They took over the management of such industries into their hands. These houses henceforward came to be known as managing agency firms. As the shareholders and also the boards of

¹ Cf. Report of the Commons Committee on the Affairs of the East India Company 1832, Vol. III, part I.

directors of these concerns were thousands of miles away, their management passed into the hands of these managing agents. These agents being the managerial heads on the spot, all the affairs as regards the supply of labour, supply of technical men and the arrangements as regards the supply of raw materials and machinery and sale of manufactured goods were left to their control. Besides, they had to arrange even about the finances of such concerns. They found it especially easy and beneficial to render the last service owing to their banking business, which they had not given up in spite of their increasing activities in other directions. What they now did was that instead of lending their funds to others, they used them in financing the concerns under their management.

MANAGING AGENTS TAKE TO PROMOTION

The next stage in the evolution of the managing agency system was reached when the agency houses began to play the part of promoters themselves. Instead of being the managers of concerns floated independently in England, these firms began to float concerns on their own responsibility. They became the self-appointed managing agents of the companies which they had themselves promoted. This was advantageous to the shareholders also, most of whom were Englishmen either in India or in England. The presence of the managing agency firms removed the difficulty of finding managing heads like managing directors. It must be mentioned here that the services rendered by the managing agents were not purely of the managerial type. In those days banking facilities were not sufficiently available in this country. And the deficiencies of banking facilities were made up by the agency houses who had sufficient capital resources. This is how the managing agents came to play the roll of financiers. Another roll played by these houses was that of sale and purchase agents. We have seen that these agency houses were mainly trading concerns; and as such they could easily arrange about the purchase of machinery etc. or the sale of manufactures.

As the business of these agency firms increased, their size also increased, and they began to have their branches in different commercial and industrial centres. The partners attended to the

affairs of the firm at different branches in turn; while some were taking their turn of duty in India others attended to the affairs of the firms in London or elsewhere. The arrangement to do work in India by turn enabled the partners to overcome climatic disadvantages of this country.

The managing agency system thus developed as a device facilitating the foreigners to carry on industrial business in this country. It helped to overcome the difficulties created by the distance between the place of origin of an industrial proposition and the place of its actual operations. But it did not remain restricted only to concerns promoted in a foreign country. These houses were the only business firms of the modern type working in India, and therefore when they realised the advantages of being the managing agents of joint-stock concerns, they appointed themselves as managing agents of concerns promoted and registered in India by them. As the advantages of being managing agents were tempting, every firm or businessman whosoever promoted a concern became its self appointed managing agent. No promoters naturally desired to lose the profits to be derived by being the managing agents of the promoted concerns. Thus, the system which came into existence as a device to manage the concerns floated outside India, became perpetuated and universal owing to the advantages that it offered to the promoting class.

Though the managing agency system first came into existence with regard to the concerns promoted by foreigners, our own businessmen did not lag behind in copying it. The first joint-stock company started by Indian businessmen to work a cotton mill company was of this type.¹ It is doubtful whether this was due to mere imitation of the foreign businessmen or was due to the realization of the possibilities of making profits by becoming managing agents. Whatever the motives of those who introduced this system with regard to concerns started and financed by Indians, the fact remains that it became as universal among Indian concerns, as in the case of European concerns. Slowly the geographical factors which had given rise to this system were lost sight of and the material advantages to the

¹ Cf. *Bombay Industries: Mill Industry* by S. M. Rtnagar, p. 9.

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promoters by establishing themselves as managing agents became the dominating factors.

ORGANISATION OF THE AGENCY HOUSES

In the beginning these agency houses were one-man shows. As the volume of the business of these houses increased they came to be formed of more than one person. And later, we find that these agency firms are organised under all forms of business organisation such as, (1) individual proprietorship, (2) private partnership, (3) private limited companies, and (4) public limited companies. Of these the second and the third are the most popular; and most of the important agency houses are organised under either of these two forms. Very few firms are organised as public limited companies, as this form is inconvenient to carry on the business of a managing agency firm.

Whatever the form under which the agency firm is organised the services that these firms render are similar in all cases. In the beginning there was some difference between the role played by a European and an Indian firm of managing agents, towards the concerns under its management. The latter then used to hold a large proportion of the share capital of the client concern, while the former merely managed concerns financed by others. But this point of difference has slowly disappeared except in the case of Ahmedabad agency firms. As the European firms began to promote concerns themselves they used to invest in the concerns promoted by them. On the other hand as the investment habit took root among the Indian public, the Indian firms were required to invest less and less in the client concerns. The usual functions of the managing agents are to look to the general management of the concern, including purchase of machinery, appointment of staff, purchase of raw materials, sale of manufactured goods etc. and to arrange for the necessary working capital.

THE AGENCY AGREEMENT

The principal promoters or organisers appoint themselves as managing agents of the proposed concern by one of the Articles of Association. The period of the agreement varies from 20 to 30 years to permanency. The ways of remuneration also differ in

different cases. The main source of remuneration usually is commission on production or sales or profits. Besides the commission from one of these sources, they get commission for purchase of machinery and raw materials, for arranging sales, for providing capital, permanent as well as working, and for such other similar services. The very term of managing agents signifies that they are agents and not employees. They, therefore, can charge a commission for any and every service they render. They can sell their agency rights to anyone they like or pass them on to their successors.

THE AGENCY SYSTEM AS FOLLOWED IN AHMEDABAD

The managing agency system as followed in Ahmedabad is somewhat different from the systems followed in the other two centres, viz., Calcutta and Bombay. Here the managing agency is made into a limited concern with a nominal capital, say of Rs. 500/- divided into 500 shares of Re. 1/- each. The condition of purchasing the shares of the agency is that the purchaser must supply a certain amount of share capital of the company and a certain amount of short time deposits. These agency shares are purchased by a small group of businessmen usually not exceeding three or four. These original subscribers later on sell their shares in the company to the general public though they retain their deposits in it, and continue to participate in the agency commission. The original subscribers thus render more or less the services of underwriters so far as the share capital is concerned, though the underwriting commission becomes a permanent charge upon the finances of the company, in the form of exorbitant agency commissions. It is of course true that though these agents sell off the shares they do not withdraw all the financial help from the client concern. If the concern is able to establish reputation as a sound one it attracts deposits independently, whereupon the agents can withdraw their funds, if they so desire. Under such circumstances the agents cease to render any financial help out of their own pockets. But all the same they continue to draw the agency commission, a large part of which, was considered in the beginning as a remuneration for the financial help given by them.

The agency commission in such cases, therefore, becomes an unnecessary burden to the extent to which it was paid for financial accommodation received from the agents.

MANAGING AGENTS AND SUPPLY OF SHARE CAPITAL

The managing agency system, as described above, originated as a device to provide supervision over concerns organised and owned by outsiders. Owing to the peculiar nature of the money market then existing in India the function of supervision included the responsibility of supplying working capital. With the increased initiative on the part of the managing agents, their responsibility regarding the finances of the client concerns also increased. They undertook to supply not only the working capital but also the fixed capital. But their responsibility as regards the supply of the latter type of finance has diminished a great deal recently, owing to the increased boldness on the part of investors in India. But to arrange for the supply of working capital has remained to this day as important a function of the managing agents as it was some three quarters of a century before. In spite of all the changes that the Indian money market has undergone during this period, the managing agents still continue to arrange for the supply of the working capital. And this is considered to be the main justification for the existence of the agency system.

In the beginning, the Indian managing agency firms used to participate to a great extent in the supply of share capital. The European agency firms were not required to play the part of investors in the shares of the client concerns. If they did so, it was due to free choice on their part. There was no difficulty as regards the supply of block capital in the case of companies under European agency firms. Investors in such firms were mostly Europeans, who, unlike Indians were well acquainted with business organisation and finance. The shares of such concerns, therefore, were easily subscribed. The Indian managing agency firms were faced with some difficulty in this matter. They could not get the shares of the client companies subscribed by the public. The agents themselves thus had to take up a large proportion of the shares of the concerns floated by them. But this condition has slowly undergone a great change. The Indian public

has now become well acquainted with industrial investments, and readily comes forward to invest in any sound scheme floated by reputed businessmen. With this change the share of the managing agents in the finances of the client concerns has proportionately decreased. If we leave aside such concerns which are public only in name but are actually financed, out of choice, by only a small group of financiers, we find that normally the holdings of the managing agents amount to 10 to 15 per cent. of the total share capital of the client concerns. Whatever the holdings of the agents, one thing should be borne in mind that they hold the shares not because they cannot dispose them of to the public but because they choose to do so for certain other reasons, for instance, to control the voting power.

Even to-day we find the managing agents subscribing a large proportion of the shares of a newly launched concern. But now the reasons are quite different from what they were half a century ago, when the public did not readily come forward to purchase the shares of such concerns. Nowadays we usually find that 60 to 70 per cent. of the shares for public allotment are subscribed to by the agents and their friends. And then on the ground of having themselves subscribed and got subscribed by others a large proportion of the shares, they demand some special considerations in the agency commission. Even when they do not demand any direct remuneration for this, they try to justify their exorbitant commission for other services on this ground. Thus the subscription commission proves a permanent drag upon the finances of the company. This small group of original subscribers do not hold their shares permanently. At the opportune time such shares are unloaded on the market and are purchased by the general public. These new comers are the real sufferers as it is at their cost that the agents get their commission. The initial subscribers also get a commission of 2 to 5 per cent. of the nominal value, for subscribing or agreeing to subscribe. Besides, there is the chance of selling off the shares at a premium. On the other hand there are very remote chances of sustaining losses. The agents being always in the field of finance can affect the prices of the shares by their own operations. Even when all the shares are disposed of, the agents never lose an opportunity to remind the shareholders of their obligation in taking the initial risks and making the

company start. The managing agents thus initially subscribe a large proportion of shares, not because the investing public is not willing to subscribe, but because they themselves are not willing to allow it to subscribe. They allot the shares to themselves and their friends, with the intention of selling them to the public at inflated prices.¹ Not quite infrequently, the prices are artificially raised, and when ultimately they assume their real value they leave an acute depressing effect upon the investing public. Under such circumstances, the agents cannot claim any credit for initial subscription of the shares.

MANAGING AGENTS AND THE SUPPLY OF WORKING CAPITAL

(a) Agents' Own Money.

That the managing agents nowadays are not required to take up any considerable part of the share capital is admitted without much argument. As regards the working capital, it is maintained that the managing agents play an important part. Their services in this field are considered to be the main justification for the continuance of the agency system. When this system was first introduced it was meant to provide day to day supervision as well as finance. The business houses which first undertook this sort of work were carrying on banking business also, and therefore, the provision of day to day finance to the client concerns became a profitable business for them. The Indian business houses which imitated the European ones also undertook the responsibility of providing the short term finance to the client concerns. The absence of industrial banking was perhaps responsible for this sort of financial arrangements. The wonder is that this arrangement has continued, at least in form, to this day especially with regard to the Indian agency firms.

The Indian business firms which accepted the managing

¹ "The managing agents take advantage of a rise of prices to boom their shares and unload them at top level, leaving the public to hold the baby. In this they not only play with loaded dice, but they discourage the bonafide investors and give to industrial investments a bad name." Central Banking Enquiry Committee Report, Vol. I, part II, p. 331.

agencies of joint-stock companies were not engaged in banking business like their European *confreres*. But these firms were composed of wealthy families which possessed great financial resources of their own. Slowly these firms also began to receive deposits which they utilized in their expanding business. Under the financial conditions existing at that time, companies started independently would have found it difficult to get the necessary working capital. Banking facilities were almost non-existent, and the joint-stock organisation had not created sufficient confidence in the minds of the depositors to attract their deposits. In those days agency firms—either European or Indian—thus provided the short term finance from their own purses or from the deposits attracted on their own credit. With the growth of commercial banking, a third method of financing came into existence. The managing agents began to finance the client concerns by borrowing from the banks on their own security. This last method of financing has become quite common with regard to the European agency firms. The Indian agency firms outside Bombay scarcely take advantage of it, and even the Bombay firms resort to it only as a last recourse.

The ability of the managing agents to finance from their own resources is obviously limited by the size of their purses. Owing to the increased demand for funds on the part of the client concerns, this method of financing has lost its former place in the field of short time finance. The increase in demand is due to several causes. The size of individual concerns has become enlarged. Besides, the number of concerns under each firm has increased. An additional cause is the dwindling of the resources of individual agency firms. Whatever the cause, it must be admitted that the change is on the whole for good.

Usually the managing agents make much of their financial aid to the client concerns. If we go deeper into the problem we find that the agents do not deserve the credit they claim for this. In the first place they do not run much risk in doing so. The concerns to which they lend are under their complete control, and therefore they know all the details of their financial position. Besides, they charge a sufficiently high rate of interest which is usually higher than what they would have got, or what others get, by investing in shares with all the risks incidental to such

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investments.¹ The risks of the agents are far less than those of the shareholders, because in case of loss the former can take hold of the assets which belong to the latter.

Sometimes no doubt, the agents incur losses from such financing activities. But such situations mostly arise only when they finance unsound concerns. Such losses, therefore, do not signify anything like a sacrifice for client concerns, but only lack of business ability. It is in the interest of the financiers and also of the society as a whole, that such financing should be stopped at the earliest opportunity. It is a noteworthy point that agents may be tempted to keep an unsound concern going by making such advances. In the first place they get a fairly good return for their advances, and besides, which is more important, they get money by way of different kinds of commissions. And all this is done at the cost of shareholders, who do not get any dividends for their investments.

The most important ground on which the managing agents claim credit is that they meet the financial needs of a concern in difficult times. Our faulty system of industrial finance renders industrial concerns helpless when they are confronted by temporary financial difficulties. Under such circumstances, if the managing agents do not come forward with their advances, it will be rather difficult for such concerns to tide over an adverse period. But in doing this, there is no sacrifice of which so much is made by the agents. If the agents help a concern to tide over an adverse period, they do so in the hope that the benefits of the managing agency will continue to accrue to themselves and to their successors from generation to generation. On the other hand, we might say that the agents get too much for their simple business-like gesture. It is not merely the continuance of agency with which the agents are satisfied, but they also try to be rewarded in many different ways. For instance, it is not unusual to find a permanent enhancement of the rate of agency commission which means a permanent burden upon the shareholders in return for a temporary help, in addition to the interest charged for the

¹ Leaving aside the boom period, even the cotton industry, which was one of the prosperous industries of India, was not giving 6 or 6½ per cent. dividends. See the evidence of the Ahmedabad Millowners' Association: Indian Tariff Board, Cotton Textile Enquiry Report, 1927.

same. Sometimes the agents turn their loans into debentures with the result that the concerns consequently pass into their hands and the shareholders lose all their capital.¹ It is thus clear that the agents made advances in a perfect business-like manner there is not the least ground to raise such advances to the high pedestal of sacrifice deserving extra rewards. In a few cases the agents no doubt might have lost their money. But this does not mean sacrifice or philanthropy but wrong judgment and lack of business foresight.

(b) *Public Deposits.*

Equally important is the practice of financing the client concerns out of the deposits received by the agents on their own personal credit. This deposit money is advanced to the client concerns with a sufficient margin in the rate of interest for the receiving agents. The extent of this margin differs in different cases. In some cases the concerns are charged two per cent. more than the rate at which the deposits are received. In some cases the charge is two per cent. more than the highest Bank Rate prevailing in that year. Sometimes the funds are advanced without any reference to the receiving rate or the Bank Rate. In such cases the rate of interest is determined by the need of the borrowing concern. The agents argue that whatever the current rate, these funds would not at all have been available to the concerns but for them. But this is not true. If the agents cease to be intermediaries between the depositors and the concerns, the funds, in all possibility, will be deposited directly with the concerns, as is done in many cases even to-day, or with the banks. In either case they will be available to the industry, and perhaps even at a lower rate owing to the elimination of the intermediary. Such a change will prove beneficial in more than one way. When funds are deposited with the agents, the volume of deposits is limited by the financial position and reputation of the agents. The supply of finance in this way has no relation to the actual needs and financial position of the concerns. Under a direct deposit system, which would have been the practice in the absence of the agents, there would have existed some co-ordination between the volume of deposits and

¹ See for instance the Central Banking Enquiry Committee Report, Part I, para 352.

the financial position and the needs of the concerns. The concerns at least would have been in a position to say no, when they did not want such deposits. Under the present situation the agent, being himself interested in such deposits, is likely to over-finance a concern by the same. Not only this, but there are instances when the reserves of companies were lent to agents at very low rates of interest, and the financial needs of such concerns were met by deposits at high rates of interest.¹ Under the present situation the deposits are withdrawn whenever the depositors think that the financial position of the agents has weakened. Many sound concerns have thus to suffer financial distress for no fault of their own. Such a situation will not arise if the deposits are made directly to the concerns.

There is another variety of this deposit finance which though not very important from the point of view of volume, still deserves consideration. Sometimes the funds of one concern are deposited with another concern under the same managing agency. This system of inter-depositing funds presents many opportunities for fraudulent manipulations on the part of the agents. The funds of a good concern are many times lent to a losing concern. This is to the advantage of the agents who can thereby keep the sources of their income going. Sometimes the agents derive a double benefit by such lending. They get the funds of one concern lent to them at a low rate of interest, and then they lend them to another concern at a higher rate. Thus the agents stand to gain in the very process of lending. This interlending is carried on not only with the actual funds possessed by a concern, but also by borrowing on the credit of a good concern, and then making the same available to a bad concern.²

Such financial mismanagement will be very difficult in the absence of the present agency system. In the first place, instances of separate concerns being under the complete control of a single management will be very rare. Even though there might be interlocking of directorates, still each concern will have its separate managerial and financial head, working as a managing director

¹ Cf. For instance the cases of Whittle and Saraspur groups of companies. The Tariff Board, Cotton Textile Enquiry Report, 1927 Vol. IV, pp. 397-98.

² See for example the evidence contained in Vol. IV, the Indian Tariff Board, Cotton Textile Enquiry 1927.

or manager, who will work as a check upon the conduct of the directorates.

(c) *Bank Advances.*

One more way in which managing agents arrange the finances of the client concerns is through advances from the banks. These bank advances to industrial concerns are secured in two different ways. In some cases the agents merely guarantee that the over-drafts granted are secured by stock. In other cases the agents themselves stand guarantee for the advances made by the banks. The former method is followed in Calcutta;¹ while the latter is followed in Bombay. Formerly the practice of making advances on the personal security of the agents was common throughout India. One of the important grounds on which the agency system is supported to-day is this peculiar method of getting finance. It is believed that we cannot replace the managing agency system unless the present banking organisation is changed.² But the practice followed in Calcutta shows that even the present banking organisation permits an alternative method. The sort of guarantee which is necessary in Calcutta viz. that the over-drafts are covered by stocks can be given by the managing director or the board of directors. There seems to be no reason why what is practicable in Calcutta should not be so in Bombay. The difference between the methods at these two centres seems to be due to either of the following two reasons: (1) it may perhaps be due to the oft-complained racial prejudice on the part of the bankers; or (2) it may be due to the silent consent and indirect encouragement on the part of the agents, as they are directly or indirectly benefited by it. Whatever the underlying causes, the effect is that the concerns have got to pay greater costs and suffer greater inconvenience owing to the round about method of financing.

¹ Cf. Report of the Indian Central Banking Enquiry Committee. Vol. I, Part I, p. 276.

² "It is wellknown that banks at present are unwilling to advance money on the security of assets of a limited concern, unless the same is backed by the personal security of the agents themselves. And no practical banker at present would be prepared to make a departure from this practice, it is no use hoping for an alternative system, unless the whole organisation of commercial and banking credit in India is changed." Evidence of Sir Purshothamdas Thakurdas. Indian Tariff Board Cotton Textile Enquiry Report, 1927. Vol. IV, p. 4.

There is one common feature of all the three methods of securing short-term finance so far discussed. The supply of finance under any of them is limited by the financial position of the agents without any reference to the actual needs of the companies concerned. This defect can be removed only by bringing about a direct contact between the concerns and the sources of the supply of funds. But this cannot come about so long as the present agency system continues.

REMUNERATION OF THE MANAGING AGENTS

The Managing Agents are agents and not employees, and, therefore, they can charge a commission for any and every service that they render to the concern under their management. There is no general fixed rule or rate according to which the agents charge their commission. As a matter of fact they try to make money out of every financial, commercial or manufacturing activity of the client concern. The principal source of the agent's remuneration is either, (1) commission on production, (2) commission on sale, or (3) commission on profits.

COMMISSION ON PRODUCTION

The commission on production is calculated on the total output of a concern by fixing a certain rate of commission on a certain unit of production, for instance, 3 pies per lb. of yarn produced by a certain cotton mill company. The rate of commission of course differs in each individual case. This system of remuneration was followed, wherever possible, in the beginning of the agency system. Even to-day it is common outside Bombay.

Of the three methods of charging commission, this is the most defective from the economic point of view. When commission is paid on a quantitative basis, the agents become interested in the turnover only, and not in efficient and profitable management. Not only this, but the agents also become quite unmindful about the quality of the produce. As their remuneration depends upon quantity and not on quality, the improvement in quality is ignored. The agents become careless even about the disposal of the produce, as their remuneration is not affected by the sales. They need not care to study the market conditions, because they are

not interested in the profitable marketing of the goods. Thus, whether the output is produced at high or low cost, whether it is marketable or not, and even when marketed whether it brings profit or loss, become matters of indifference from the point of view of the managing agents.

COMMISSION ON SALES

Under the second system, the commission is charged as a certain percentage of the sale proceeds. For example, in Ahmedabad, where this system is very popular, usually 3 per cent. of the sale proceeds is charged as commission. This system was first introduced by the Ahmedabad mill agents. The Ahmedabad mills were engaged in weaving cloth of superior quality; and hence the agents found that by introducing this new system, which was also likely to create a favourable impression upon the minds of the shareholders, they stood to gain more than by charging commission on the basis of production, according to the then prevalent rate of three pies per lb. Besides, as the price of cloth was rising, the commission on the basis of sales proved more profitable than commission on the basis of production.

This system is better than the first in two respects; the agents have an impetus to look after the quality of the produce and its marketing. But though the agents cannot neglect the marketing of the produce still there is no great incentive to sell it at the best prices, because their remuneration is not much affected thereby. For example, suppose in a given case the agent's commission is fixed at 3 per cent. on sales; it will make very little difference to him whether a certain quantity of goods is sold at Rs. 100/- or Rs. 105/-. But this affects the shareholders in a different way. Usually the annual sales of a normal-sized mill amount to nearly 25 lakhs, which is also the figure of capital investments in such a mill. If we, therefore, suppose that in the above instance a selling price of Rs. 100/- is sufficient to meet the costs that of Rs. 105/- will mean a net 5 per cent. return to the shareholders. This shows that in ignoring the profit of a few annas for himself the agent may deprive the shareholders of a reasonable dividend. The incentive to secure the best prices, therefore, is not great under this system, which like the former one offers no impetus

even to efficient management. The agents become interested in increasing the production at high or low cost and disposing of it. This system also gives an opportunity for the less scrupulous agents to charge their commission twice. For example, in a hurry to dispose of the stock more than necessary consignments are sent to sale agent, on the condition that whatever is not disposed of in a certain period should be returned. As soon as the consignments are sent to the sale agents, commission is charged on their value. In due course the unsold portion comes back, and the commission is charged again when that is disposed of later on. ¹

Though the system of charging commission on sales is, in some respects, better than the system of charging commission on production, still the former is more expensive than the latter. This will not be visible in any one year as there is the possibility of some of the production being not sold. But if we take a number of years in which the production is usually disposed of the high costs will be clear. ² The bad effects of both these systems are magnified in times of depression. In the first place, the commission proves to be a heavy charge upon the industry and entails a great loss to the shareholders. Secondly, as the agents are not interested in profits, they keep up the rate of production and add to the bad effects of depression by causing over-production. To this the agents reply that they lessen the burden in times of depression by suspending, in part or whole, their commission. ³ But this is an exception rather than the rule. And in so far as they do it, it brings credit not to the system as a whole, but to those few individuals who practise it.

Sometimes the agents do not bind themselves to anyone of these systems but leave the method of ascertaining the commission undecided. This means that they will charge the commission

¹ See for instance the evidence before the Indian Tariff Board during the Cotton Textile Enquiry of 1927.

² "Calculations we have made show that, over a series of years, the system of commission on sales is the most expensive of the three." Indian Tariff Board Cotton Textile Enquiry Report, 1927. Vol. I, p. 87.

³ Q:—"Does not your system of remuneration on sales mean that at the time of depression you are getting far larger commission than the Bombay Mills.

A:—"No; because in Ahmedabad the desire for maintaining one's reputation is so keen that no sooner there is a depression or the mill has not made profits, then they leave off half or even the full commission." Evidence of Ahmedabad Millowners' Association. Indian Tariff Board, Cotton Textile Enquiry, 1927. Report Vol. II

according to the system that gives them the largest amount of commission. For example, if in any particular year a large portion of production remains unsold, or prices happen to be very low, the commission will be charged on the basis of production.¹ This sort of option to the agent proves more injurious than either of the systems followed permanently, because, if the agents are not quite scrupulous, there exists the possibility of some portion of the stock being subjected to double commission: once on the basis of production, and later, on the basis of sales.

COMMISSION ON PROFITS

The third system of taking commission is to charge it on profits. As in the other cases, there is no one fixed rate of charging commission on profits. Usually the rate varies from 10 per cent. to 15 per cent.; 10 per cent. and 12½ per cent. being rather popular. Though the agents have no fixed rate of charging commission, still they have a fixed definition of the word, "Profits". The term "Profits" or "Net Profits" in the agency parlance, means whatever is left after deducting the payments to the employees and interest on the short-time loans from the gross returns. No deduction is made for income-tax, interest on debentures, expenditure for repairs, depreciation charges or insurance payments. The use of the words, "Profits" and "Net Profits," is thus quite deceptive.

This system of calculating the managing agents' commission on profits is popular only in Bombay. At other centres including Calcutta either of the other two methods is usually followed.² The majority of jute-mills charge commission on sale proceeds, so also almost all the tea companies.³ It was the late Mr. Jamshedji Tata who originated the system of charging commission on pro-

¹ The following lines which are quoted from an agency agreement will give an idea of such latitudinarian commission clause. "The company shall pay every month 3 per cent. commission on sales of yarn, or three pies per pound avoirdupois on the sale at the option of the Agents, and commission of 3 per cent. on the proceeds of cloth sold or commission of three pies per pound avoirdupois at the option of the Agents."

² "The system of paying commission on profits is found popular only in case of Bombay. In Ahmedabad the commission is charged on the basis of production or sales. The Calcutta agency firms too are reverting to the method of charging commission on production." Evidence of Sir Purshottamdas Thakurdas: Tariff Board; Cotton Textile Enquiry Report 1927 Vol. 4, p. 21.

³ Cf. Indian Tariff Board Cotton Textile Enquiry Report 1927 Vol. 3 page 323.

fits. To him it looked quite iniquitous to give away large sums of money to men who were not qualified for the work. The other managing agents of course were quite opposed to this move and Mr. Tata had to face a bitter opposition from them while introducing this new system of commission.¹ Even in Bombay this system is not universally followed. In the cotton industry alone there were in 1927 twelve mills that were paying commission on the basis of production.²

Of all the three systems of charging commission, that on profits is relatively the most preferable. It is expected to furnish the greatest stimulus to efficient working. As commission on profit is charged after deducting the working expenses and interest charges on short time loans, the agents are expected to reduce these charges to the minimum without affecting the volume of production. To this extent, therefore, this system is conducive to efficiency. When profits are made the basis of commission, the agents cannot be indifferent to prices. Still the stimulus to secure the best prices is not very great because of the faulty method of calculating profits, as explained above.

There is one more defect in this system of calculating the commission. The agents who always enjoy unlimited financial powers can burden the concern with debenture liabilities with advantage to themselves. It is obvious that with increased resources production can be increased which will result in higher remuneration to the agents, especially as interest on debentures does not affect them. The shareholders of course suffer owing to the increased liability. In this connection, a question may be asked that if the agents profit by raising funds by issuing debentures, why do they not finance working capital in this way? There seem to be two reasons why the agents do not do so. First, their profits under the present system are far greater than the profits that they stand to derive by issuing debentures for working capital. Secondly, the present method keeps the client concerns dependent upon them to a greater extent.

¹ "The agents in general were bitterly opposed to his (Mr. Tata's) attitude, for they could always count upon their gains, even if a balance sheet were disastrous to the shareholders. To Jamshedji Tata the quarter anna paid to these men as a commission on every pound of yarn and cloth, whether the mill was worked at a profit or at a loss appeared a pernicious system." *Life of Mr. Jamshedji Tata*: By. F. R. Harris, p. 51.

² Indian Tariff Board: Cotton Textile Enquiry Report 1927 Vol. 3

THE MINIMUM COMMISSION CLAUSE

In the agency agreements there is usually a provision for minimum commission. This practice seems to be more popular in Bombay than in Calcutta. The minimum commission varies according to the size of the concern, in some cases it being as high as Rs. 1,20,000 a year.¹ In one agency agreement it was found that while the nominal capital of the concern was Rs. 15,00,000 the minimum commission was Rs. 50,000 a year.²

In some agency agreements it is provided that the agents should get their full commission, when the shareholders get a dividend of 5 per cent. or 6 per cent. This outwardly satisfactory provision is most undesirable from the point of view of sound finance. In order to obtain their commission, the agents have the temptation to declare the required dividends even by manipulations and by the neglect of provision for depreciation and reserve funds.

A GENERAL REVIEW OF THE THREE SYSTEMS

It will not be out of place to take a summary review of the three systems together. One important point to be remembered about these systems is that though they are different in names, they are materially not much different from each other. Whatever difference there exists, is the difference of degree and not of quality. The commission of managing agents under any of the three systems is a charge upon production and capital. The agents therefore, become interested, in a greater or less degree according to the nature of their remuneration, in the increase of production only. The aim of any industrial enterprise is not mere increase of production, but increase of production in such a way that it will yield the highest profits. The industrial organisation which aims at increase of production without proper attention to profits, is founded on a wrong basis and cannot hope to prosper. When the organisers of industries become interested in the volume of production only, the industries are sure to suffer from over-production and over-investment. The industrial heads under such conditions are apt to show lack of enterprise and reluctance to

¹ Cf. The Agency Agreement of the E. D. Sassoon United Mills Company Ltd.

² Cf. The Agency Agreement of the Swadeshi Lakshmi Mills.

embark on new ventures, especially as they do not stand to lose by such an attitude. This is one of the important causes why we find over-investment and over-production in certain beaten tracks. In so far as the agents' commission proves to be a charge upon capital the effects are still worse. The industrial organisation which maintains itself upon capital instead of profits is self-destructive. A large portion of the annual supply of resources, such as human energy and savings will be spent in replacements, instead of additions. And as a consequence, industrial progress if any, will be very slow.

HEAD OFFICE ALLOWANCE

In addition to the commission, the client concerns in most cases make a regular payment to the managing agent as "allowance for Head Office expenses." When a company is managed by managing agents its head office means the office of the agents. This office, wherever it exists, is maintained to look after all the business activities of the agents, and is quite a private affair of theirs. The expenses of this cannot be charged to this or that concern, but properly speaking, must be defrayed by the agents from their own earnings. This should be so, especially as the payment of this allowance does not relieve the concerns from meeting the expenses of maintaining an office of its own, where all the matters regarding its finances and management are discharged.¹ Besides, as all the business activities of the agents are concentrated in their office, it is difficult to divide properly the expenses among the client concerns. Not only this, but there is nothing to prevent the agents from charging all the expenses to each of the client concerns separately. As a matter of fact the item of head office expenses is a sort of safety valve which the agents can make use of as necessity arises. Supposing a concern does not show good profits in a certain year, they can make a gesture of generosity and relinquish a part of their commission with one hand, and make up the loss by increasing the head office allowance with the other. This allowance often prove an exorbitant charge amounting sometimes to as high a figure as 4 to 5

¹ "We have known of instances where the office allowance is regarded as an additional remuneration for the managing agents, while all expenses in connection with the head office are debited to the company." Indian Tariff Board Cotton Textile Report, 1933.

lakhs per annum. One noteworthy feature about this allowance is that it does not necessarily vary according to the size of the concern. In some agency agreements no definite amount is stated, but it is provided that the company should pay all the office expenses over and above the stipulated commission. Such a provision is especially advantageous to the agents as they can lower or raise the figure according to the needs of the time. The office allowance thus, is nothing but an addition to the agents' commission under a different name, and an extra burden upon the industry.¹

The Ahmedabad mill agents do not charge anything to the client concerns for their "head office" expenses. They charge their commission on the sales or production basis and not on profit, which is more fluctuating than either of the former two. Their source of income thus is steady, and that is why perhaps they do not feel the necessity of having another string to their bow, as in the case of the managing agents in Bombay.

SOME MINOR SOURCES OF AGENTS' REMUNERATION

The commission on the basis of profits, sales or production and the "head office allowance" are not the only sources of income to the managing agents. It is an invariable feature of the managing agency agreements, that the managing agent is entitled to work for and to contract with the company in respect of various services such as purchase of materials, the sale of finished goods, the insurance of buildings, plant and stock etc. For all such "extra" services, the agent is entitled to receive such additional payment as may be arranged between him and the directors. Not unusually we find that the agents are entitled to charge commission on the cost of machinery and plant. It is needless to discuss how such payments remove from their minds all stimulus for economy. This commission clause in many cases is extended to all sorts of purchases. For example, it is not uncommon to find a provision like "a commission of 2½ per cent. on all purchases made for the company" in the agreements.

¹ Cf. "There being no charge on account of the managing agency commission, the head office charges (as we call them) are also low". My impressions of Japan, by Sir Lallubhai Samaldas, p. 69.

Most of the managing agents also work as sale agents of their client concerns, and for this they get an extra commission. This process of sale proves too costly from the point of view of the concern. The sale costs can be vastly reduced if each concern maintains its own selling organisation. The difference between these two systems of arranging sales can be realised if we take the example of a cotton mill. The sale commission of a cotton mill with 1000 looms amounts to something like Rs. 60,000 to Rs. 70,000 per annum. But a mill with 1500 looms which maintains its selling organisation can defray the selling expenses by nearly Rs. 1,500 per month.¹ To such arguments the agents' stock reply is that they are responsible for the payments by the customers, but it is questionable whether the risks of non-payment are so very great as to justify the difference between the expenses of the two methods. The agents of their own accord cannot be expected to encourage direct selling system, as thereby they stand to lose an important source of income.

Over and above these direct sources of remuneration there are many indirect ways in which the agents make money. As we have said in the beginning of this chapter, the agency firms are engaged in different types of businesses. For example, they are agents of insurance companies, dealers in machinery, brokers for raw materials such as cotton, jute, and so on. They, therefore try to make money in all possible capacities. And there are no grounds to complain so long as this is done honestly. But, unfortunately, the agents are found to take undue advantage of their position as supreme managerial heads of the client concerns. For example, as insurance agents they are found to insure the property of the client concerns for a sum greater than its actual worth, as it increases their insurance commission.² The client concerns thus are burdened with unnecessarily heavy insurance charges.

As dealers in machinery and such other goods too, the agents are found to make profits at the cost of the client concerns. In

¹ The Indian Tariff Board Cotton Textile Enquiry Report, 1927, Vol. II, p. 179.

² "I find that some mills seem to insure for a good deal more than the value of the block and stores held by them. One mill, for example, the total value of which is 47 lakhs, insured for 74 lakhs." Remarkd by a member of the Tariff Board in their enquiry of the Cotton Textiles in 1927.

regard to supply of such goods, the agents are found not to be particular about their quality and price. Not only this but they also make the concerns purchase a larger stock than necessary, as they stand to gain by it. Whenever the managing agents change, every new agent tries to make profit by selling machinery and other stock to the new concern. As the makes of the machinery in which the different agents deal differ, in many cases it so happens that the new purchases do not fit properly with the former equipment. But such considerations never deter the agent from making the sales to the concerns of those makes in which he happens to deal at that time.¹ That the interests of the agents dominate the interests of the client concerns in the purchases made on behalf of the latter can be seen even in the case of the Calcutta concerns. There too we find that new machinery is added when the existing equipment cannot be profitably employed for full time; and often extensions are undertaken on the plea of improvement though the probable results do not justify the expenditure involved on them.²

The agents in many cases also work as brokers for various products. For example, the agents of cotton mills also work as cotton brokers, and naturally they supply cotton to their client concerns. The usual commission for cotton supply is 1 to 2 per cent. in Bombay. At the rate of even one per cent. the commission amounts to more than Rs. 3,000 per month for the normal consumption of a mill.³ When the agents themselves do not work as brokers they engage such other brokers in whom they are interested.⁴ The brokerage charges can be annihilated if the necessary

¹ Cf. "Many of the Bombay Mills having frequently changed hands, and belonged to managing agents, who were also representatives of textile machinists, some are museums of all kinds of machinery from different machinists, as every time a mill was taken over the new mill agent was anxious to get some of the machinery into the mill which was made by a firm of textile machinists that he happened to represent at that time." *The Cotton Industry of India* by Mr. Arno Pearse, p. 60.

² Vide for example Mr. Narayandas Bajoria's booklet entitled "A Note on the Amendment of the Indian Companies Act, 1913-1914."

³ *The Indian Tariff Board Cotton Textile Enquiry Report, 1927, Vol. IV, p. 176.*

⁴ The universality of this practice will be clear from the following remarks about the Calcutta Agency Houses. "Even in the matter of buying raw materials for the mills and selling finished products etc. only such brokers are employed as are in some way or other related to the members of the firms of Managing Agents by race, colour or friendship or flattery and many concessions are given to them even in the matters of prices." "A Note on the Amendment of the Indian Companies Act, 1913-14" by Mr. N. Bajoria.

purchases and sales are undertaken directly by the concerns without the middlemanship of brokers.

There is one more way in which the agents can make money at the expense of the client concerns. Some of the agents deal in futures in order to purchase raw materials for their client concerns. So long as the agents think that they can make profits by dealing in this way the transactions are kept on their own names, and profits are credited to themselves. But whenever the agents sustain any loss, the transactions are transferred to the company's account and the company is debited with the loss. There is one more disadvantage in this process of purchase. The concerns can never get the materials at the lowest prices. So long as there is the possibility of the prices going higher the agents keep the transactions to their own accounts and transfer them to the concerns when prices rise.

TENURE OF AGENCY AGREEMENTS

One of the main complaints against the managing agency system is that once a certain agency firm obtains control of a company it becomes almost impossible to remove it. The agency agreement which is entered into at the time of incorporation of the company usually provides for a tenure of about 40 years in Bombay, and 20 in Calcutta, while it is permanent in the case of Ahmedabad. The Articles of Association are usually so framed that even at the expiry of the fixed period it becomes impossible to remove them from office, and as a result a fresh term has always to be sanctioned.

The period of the agency contract, the agents argue, does not matter much. According to them the shareholders, always enjoy powers necessary to remove the managing agents if they wish to do so. For instance, if the agents commit any frauds, redress can be had from the courts of law, and if they are incompetent the shareholders can remove them. The apparent cogency of the argument vanishes if we go deeper into the problem. Everyone who possesses any knowledge of business organisation and finance will admit that a concern can be ruined without committing a fraud that may come within the purview of law. It is, therefore wrong to suppose that so long as no redress is sought from the court of law, everything is going on allright.

If an agent is not fraudulent but incompetent, the agents argue, he can be removed by the shareholders by passing a resolution to that effect. Legally this is true, but in practice, so many difficulties are created in the way of accomplishing this by different provisions in the Articles, that the removal of the agents becomes impossible. In the first place, such an extraordinary resolution must be passed by a certain large majority. For instance, in Calcutta, it is invariably provided that there must be a three-fourths majority for passing such a resolution; this limit is still higher in Bombay, being four-fifths, and sometimes even five-sixths.¹ In many cases it is further provided that a specified minimum, usually three-fourths, of the total number of votes must be cast at such meetings. For a proper realisation of the significance of these provisions, we must remember one underlying factor that the agents can and do hold shares and use the votes in their own favour. They never fail to provide for sufficient opportunities to adjust their own position to changing circumstances. By one of the Articles, it is generally provided that one full year's notice must be given to the agents, whenever a resolution about their removal is to be moved. The agents thus get full time to arrange for a sufficient number of votes in their favour. If by any chance, which is very rare, the agents are not successful in defeating the opponents at this stage they get one more opportunity to accomplish this. Because it is usually laid down in the Articles, that such a resolution to be valid must be confirmed by another passed at a meeting to be convened six months after the previous meeting.² Thus they get a pretty long interval to make up the deficiency felt at the previous occasion. The agents usually are wealthy persons, and therefore they can at any time enter the security market and purchase the shares at tempting prices. The loss that is likely to be sustained in this way is more than compensated for by retaining the agency.

AGENTS TO BE COMPENSATED ON REMOVAL

The agents, if by an extraordinary feat on the part of the shareholders, happen to be defeated on both the occasions, are to

¹ Cf. The Indian Tariff Board Cotton Textile Enquiry Report, 1933.

² See for instance Appendix "A" to the "Note on the Amendment of Indian Companies Act 1913-14" By Mr. N. Bajoria.

be compensated for leaving their office. They are to receive such compensation even when they are requested and consent to resign, owing to their own inability to manage the concern or deliberate mismanagement thereof. The compensation to be paid on such occasions is generally ten or twelve times the average annual income of the agent from the client concern for the previous five years. It seems the agents look upon the agency rights as their permanent family possession. If we take into consideration all the different sources of income from a client concern, we can easily imagine the enormous amount that will have to be paid as compensation to the agents when they are required to relinquish their agency rights. They are to be compensated for, even when a concern is wound up and ceases to function. On one such occasion the agents took 20 lakhs as compensation on the winding up of the company.¹ To remove the agents at such high costs means to bring about the financial ruin of the concern.

Though there are so many difficulties in the way of a client concern, if it wishes to remove the agents, the latter, on the other hand, can leave the concerns any time they like, without any obligations. The agents can sell off the agency rights any time and to any body they like just as we sell our private possessions to others. The concern on its part must accept the purchasers as managing agents on the same terms on which the former ones were working. However disadvantageous such a transfer might be to the shareholders, they are rendered helpless by the Articles and the Agency Agreement.

MANAGING AGENTS THE VIRTUAL OWNERS

The general attitude and also the virtual position of the managing agents regarding their client concerns is best illustrated by the fact that the managing agents of the cotton mills in Bombay, and also in Ahmedabad, have named their associations as "Millowners' Association." It is interesting to note that in Bombay we find two separate organisations with conflicting interests called the Millowners' Association and the Shareholders' Association, when as a matter of fact the shareholders are the

¹ Cf. Representation of Bombay Shareholders' Association to the Tariff Board Cotton Textile Enquiry (1932).

real owners. "This is applicable not only to cotton industry but to all industries, and therefore, the Shareholders' Association whose object is "to promote, protect and safeguard the interests of the shareholders," consists of shareholders of all sorts of companies.

EFFECT OF AGENCY SYSTEM ON INDUSTRIAL INVESTMENTS

If we consider the different ways in which the managing agents make money out of the management of a client concern we can easily realise that they absorb too large a share of the profits. The natural consequence of this situation has been to make industrial investment as a whole less attractive to the investors. The agency system thus tends not to increase but to check the flow of capital in industry. The present system of industrial organisation holds out great temptations for those lucky few who can establish themselves in the privileged position of managing agents; for the rest there is no incentive to invest in industries. No financial measures, therefore, can bring about further development, which presupposes a sufficient supply of capital, so long as we do not improve this faulty organisation. The supply of capital to industries can be increased only by making the returns to the investors commensurate with the risks they undertake. Industrial prosperity can be achieved only when the returns from industry become distributed proportionately to the risks and costs undertaken by the different parties. At present the distribution of income from industries is unequal, and the party against whom the injustice is made is reluctant to invest in industries. The latter party being disproportionately larger than the former we cannot expect industrial investment to make any satisfactory progress so long as the present conditions continue.

HEREDITARY CHARACTER OF THE SYSTEM

The agency system is not only a costly process of management but is also an inefficient one. The main qualification—or rather the only qualification of the managing agent is his possession of funds. But the history of the development of industrial organisation has shown us that the possession of wealth is not necessarily accompanied by qualities of efficient management.

Besides, the period of the tenure of the agency and the difficulties in the way of changing the managing agents involve all the defects of a hereditary system. Because a certain person possesses the funds and abilities necessary to work as a managing agent of a concern, we cannot guarantee that his sons and grandsons will also possess those qualifications. But whether they possess them or not the agency rights will pass on to them automatically and if they prove inefficient the shareholders will have quietly to suffer the ruin of their enterprise and the loss of their wealth. It is really a pity that the real owners of the property should not possess the ordinary rights of maintaining it in order and putting it to the best possible use.

When the agency system originated there were very few able businessmen who could conduct the affairs of large scale manufacturing concerns. Business ability and knowledge in those days was restricted to a limited number of families, and the members of such families alone could get the necessary training to conduct such business. In those days, therefore, there was no ground to complain if the management of the concerns became permanent in one of the well-known families. On the other hand it was a source of satisfaction and security that the affairs of a certain concern were going to remain permanently in the hands of a particular well-known family. The managing agents too in those days had great financial stake in the client concerns and naturally they desired that the concern should be a permanent source of income to their family. As the client concerns were dependent upon the resources of the agents it was considered to be a satisfactory feature that a particular wealthy family was always going to be at the back of the concern.

But these conditions have undergone a vast change. Business ability and knowledge no more are restricted to certain families. Owing to spread of education and industrial development, business knowledge and experience have become widespread and many able businessmen are found outside the agency houses. Business talent has not remained the monopoly of particular families. Not only this but business knowledge and administrative ability become more crystallized outside the wealthy families owing to the varied experience of such people. But by making the agents hereditary administrative heads we deprive the industries

of the advantages of outside business talents. The hereditary feature which once was a desirable thing has now become a source of weakness as it does not allow infusion of fresh blood and energy into industrial organization and thus deprives it of better talents and superior ability. The dependence of industrial concerns on the finances of the managing agents also has decreased a good deal and can still further be decreased without any loss if things are managed on proper lines. It is therefore necessary that the present organization should be changed so as to make possible to take advantage of business ability and talent separated from wealth. The European agency firms in this respect are superior to the Indian ones. They take the advantage of the knowledge and experience of outside persons by making them partners. Even in the case of these firms the founders or the principal partners continue to be represented on them from generation to generation, but they try to increase their efficiency by taking up one or two able members of the managerial staff of different concerns, who bring with them a fund of business experience and technical knowledge and also some capital. Such persons, of course, continue to be members only so long as they are able to render active service. In this way a permanent flow of fresh energy and experience is made possible. Indian firms too should adopt such changes in their organization. It cannot be said too often that our industrial organization should be such that it will put to the greatest use whatever human and material resources we possess. Every intelligent and able person must have free field to rise to industrial leadership if he desires and deserves that position.

RESPECTIVE POSITION AND POWERS OF DIRECTORS AND AGENTS

The supporters of the agency system flatly deny the possibility that the managing agents by themselves can do any harm to the client concerns. Because, they contend, that there are directors who represent the shareholders and supervise in their interest the actions of the agents. But how far the directors represent the shareholders can very well be imagined from the following observations of no less an authority than the Indian Tariff Board.

"It is not a sufficient answer," they observe, "to the criticism that the shareholders have a right to appoint directors. Allowing for the number of directors appointed by the agents and of special debenture directors and also for the fact that only a limited number of vacancies occur every year, the extent to which the shareholders can actually exercise this right is restricted particularly in view of the short period generally allowed for nominations to vacancies in the Directorate."¹ It is thus wrong to suppose that the board of directors represent the shareholders. Even when under exceptional circumstances the board happens to represent the shareholders, they realise to their dismay that they are rendered powerless by the Articles of Association.

The Articles of Association and the Agency Agreement are so framed that all important powers become vested in the hands of the agents and the directors are prohibited from interfering in the same. As a result of such provisions, the directors who legally are the superior authority, being the representatives of the proprietors, find themselves possessing powers far less than those of the agents, thus creating an anomalous situation in which the servants dominate the master. The agents as a matter of fact look upon the directors as a necessary evil; they are to be there because the Company Law requires that there should be directors in the case of a joint-stock company.² Consequently, the directors are not empowered to do anything beyond the minimum required by the Law to be done by the board of directors. The directors thus neither represent the shareholders in the proper sense of the term, nor do they possess any power to protect their (the shareholders') interests. The managing agent consequently is the most powerful party in the management of a joint-stock company possessing full powers to make or mar its prospects. The shareholders cannot exercise any check over the actions of the agent, nor is it possible for them to conduct their concern more efficiently, even when they feel confident of doing so by bringing about a

¹ Cf. Report of Indian Tariff Board Cotton Textile Enquiry, 1933.

² "The Law has compelled limited companies to have Directors. Therefore the law has to be complied with. In any case, the law says that if you do not do certain things we shall hold you responsible, and that is one reason why the Directors are there." Evidence of Sir. C. N. Wadia. The Indian Tariff Board Cotton Textile Enquiry Report, 1927. Vol. II. p. 321.

change in the management. The managing agency system thus, besides being too costly is apt to degenerate into irretrievable inefficiency. In these days of keen competition no industry can be expected even to exist, not to talk of prospering, if it is not conducted in the most efficient way possible.

FOREIGNERS AS MANAGING AGENTS

The managing agency system has another great disadvantage under our present economic condition. This system makes it possible for the agents to become all powerful as regards the management of the client concerns; and naturally when the agents happen to be foreigners, the management passes wholly and permanently into the hands of the foreigners. These foreign agents, possessing all powers to make appointments, appoint men of their own nationality to all superior posts, thus excluding Indians from having any real knowledge about the management or technique of the industry. When the foreign businessmen retire, and they retire early owing to unfavourable climatic conditions of this country, they take away with them all the business experience and industrial knowledge that they had acquired here.¹ We thus neither get the opportunity to acquire the experience and knowledge ourselves nor can we derive full advantage of these things from those who possess them. So long as the agency system continues in its present form, it will be quite easy for the foreign managing agents to exclude us from having real knowledge about the technique or management of the industries in their hands.² It is not a source of satisfaction that we can supply

¹ A warning in this respect was long ago given by Sir Alfred Chatterton. In his book "The Industrial Evolution of India" he had observed: "Much outcry has been made regarding the drain of India's wealth, but the drain of experience which is constantly going on has almost entirely escaped the attention of your political leaders. There is much industrial enterprise in India but it is mainly in the hands of the foreigners, and year by year these men retire from the country, taking with them not only some of the wealth they have helped to create, but all the experience they have been able to gain. If we wish to see India restored to industrial prominence you must be prepared to entrust your capital to your own countrymen. Only in this way can you gradually accumulate in this country that fund of industrial experience which, must exist if you are to successfully compete against manufacturers in other parts of the world." Page 206

² "Nevertheless, a not inconsiderable amount of capital invested in Indian industries is still non-Indian. The result is that the control and management in the case of some of the important industries are even now in the hands of non-India firms. The predominance of non-Indian management in some of the important industries has detracted from the value of Indian participation in industrial enterprise. Generally speaking the managing

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the capital. Our goal should be not only to finance, but also to manage our own industries.

The agency system by rendering the management permanent and beyond the control of the shareholders yields a double advantage to foreigners. The foreign investors can be sure that whether they are in a majority or a minority, the management will always be in the hands of their own nationals if it is so in the beginning. So also the agents can be sure that whatever the nationality of the shareholders their position is secure. This system thus offers opportunities and temptations to foreign capitalists to exploit our industrial possibilities. The Government of India have provided that the industries to be protected must have a certain percentage of Indian capital, and a certain proportion of Indian directors. As regards the directors we have seen how they are rendered powerless by the managing agents. Under these circumstances even though the whole board happen to be composed of Indians, we cannot say that the management is in Indian hands, so long as the managing agents are not Indians.

The advantages that a country derives from industrialisation cannot be measured only in terms of dividends. Even from the material point of view, the wealth created by an industrial concern is distributed in many forms other than dividends to shareholders. It is distributed, for instance, as wages of the labourers, salaries of the superior staff, payments to managing and directing authorities, and profits of other concerns supplying different services and materials such as transport, insurance, machinery etc. So by allowing the foreigners to possess all the powers of the managing agents, we allow them to patronize their own nationals, even at the cost of our countrymen. Besides such material advantages, industrial development produces certain moral and intellectual advantages to the people. But so long as we continue to carry out the orders of others, and not obtain the power to give the orders, we cannot hope to reap any great intellectual advantages from the industrial development of our country of whatever extent it may be. As long as the managing agency

agents have not given any scope to Indians to hold such positions in the companies they manage as might have a comprehensive idea both in regard to the technique of production and management of the business."

The Central Banking Enquiry Committee Report, Vol. 1, Part 1, para 332.

system continues, it will be possible for foreigners to hold the strings of our industries in their hands even when they do not supply the capital. In the absence of the agency system, it will be possible for us to be the masters of the situation at least to that extent to which we supply the capital.

THE PART PLAYED BY THE AGENCY SYSTEM IN THE PAST

So far we discussed the origin, evolution, and the working of the managing agency system as we find it to-day. However faulty and imperfect the system is found to be to-day, it cannot be denied that it has played an important and useful part in the industrial development of this country. While speaking about the system we must not fail to distinguish between managing agents and the managing agency system; generally in our hurry to praise or condemn the one or the other we fail to distinguish between these two. An organisation is a contrivance to use the different human and material factors in the promotion of the well-being of the society. The success of any organisation, therefore, depends upon the extent to which it puts these different factors to the best use. The efficiency or otherwise of agency system also, therefore, depends upon the extent to which it is able to bring about the industrial development of the country. Considered from this point of view, it must be admitted that this system has helped the industrial progress a good deal in the beginning.

The foregoing discussion must have shown that the origin of the managing agency system was due not to the avarice of the agents, but to the peculiar economic and social conditions then existing. Industrial organisation of the type of joint-stock companies was newly introduced in India, and therefore, businessmen able to conduct such large organisations were very few either in the European or the Indian community. And most of such men were engaged in commerce. It was therefore, natural that traders should also become manufacturers. We have seen how the difficulty to get able managing directors originated the managing agency system in regard to European concerns. So also it was difficult in the case of Indian concerns to find able persons to

manage them outside the trading community. As a matter of fact industrial enterprise and ability were almost absent outside the merchant class, and therefore, naturally the traders became the promoters and managers of industrial undertakings.¹ The traders too were limited in number and that is why a single firm came to manage a number of concerns. In order to facilitate this the administrative work had to be subdivided. The managing agents undertook the responsibility of supplying finance and rendering general supervision. All the details of management were left to managers and other officers of the companies. This was a sort of specialization of the administrative functions. Technical knowledge could be hired but business ability and enterprise could not. The managing agency system through subdivision and specialization of the managerial duties put to the greatest use the business ability and enterprise available at that time. When a businessman undertakes all the duties of a managing director it is not ordinarily possible for him to manage more than one concern at a time.

The trading activities of the managing agents were also useful in those days. Every manufacturing concern is required to undertake certain commercial activities for carrying on the necessary purchases and to dispose of the manufactures. And, therefore, when the knowledge of commercial practices on modern lines was limited the association of trading houses was of special benefit. If it were not for the managing agency system which helped to concentrate the trading and manufacturing activities in the same hands the industrial concerns would have found it difficult and costly to arrange for the necessary sales and purchases.

The greatest services of the managing agents lay in the field of finance. We have already explained how the supply of working capital was one of the most important functions of the early European agency business. The responsibility of the Indian agency houses was still greater as they were required to supply not only the working but even the block capital. If the managing agency system had not made it possible for the wealthy merchants to supervise the concerns financed by them, the supply of capital to

¹ "Until about 1888, the Agents were almost exclusively drawn from the merchant classes and were ignorant of the machinery and processes of manufacture." Bombay Industries: the Mill Industry by Mr. S. M. Rutnagar, page 50.

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industries would certainly have been far less than it was. As industrial enterprise outside the merchant class was almost non-existent, the industrial progress would have been very slow without their capital, enterprise and supervision.¹ The managing agency system, therefore, in those days made available to industries not only the personal services of able businessmen but even their wealth.

One important point to be remembered about the managing agency system is that it was not the outcome of any design but had evolved as an adjustment of joint-stock organization to the social and economic conditions then existing, and therefore naturally was suited to those conditions. There was one weak point of this system, it gave too much power to the managing agents who slowly began to use it more and more for their own benefit. There was no harm in this so long as the managing agents were the only, or the principal investors. But as the investment habit went on spreading the stake of the managing agents in the concerns decreased. The advantages of the system were relative, arising out of the conditions then existing. Those conditions have naturally undergone a considerable change, but the managing agency system has failed to adapt itself to the changes. This special feature of joint-stock organization was found to be of great advantage by the organizers of joint-stock companies, who retained it without any changes corresponding to the changes in the surrounding circumstances. As the social and economic conditions have undergone a considerable change since the origin of the system, it has now become antiquated and uneconomic. It must, therefore, be changed a good deal or given up altogether; it cannot be retained in its present form without serious economic losses.

¹ "It must be remembered that if it had not been for the enterprise of the Managing Agents, the textile industry of India would not at present exist. It was their enterprise and their money that brought the industry into being at a time when grave doubts were entertained as to cotton spinning and manufacturing could be carried on in India in competition with the industrially advanced countries of the West and when capital was notoriously shy."

Evidence of the Bombay Millowners' Association, The Tariff Board, Cotton Textile Report 1927, Vol. 2, Page 135.

CAN THE SYSTEM BE ABOLISHED?

In spite of the grave defects pointed out by us, the managing agency system is considered to be essential under the existing economic conditions of the country. The Federation of Indian Chambers of Commerce and Industry, for instance, in the recent memorandum submitted to the Government of India have expressed the view that they regard the system as indispensable.¹ They, like many others, are afraid that without this system sufficient funds will not be available to industrial enterprises. It is therefore, better in their opinion to permit the formation of more companies on the present lines than to restrict the industrial development by putting an end to that system. Such fears about the diminution of the supply of capital for industrial purposes are, to say the least, baseless.

The part played by the agents in the supply of capital to industries is of three main types: They supply funds out of their own pockets, they borrow on their own personal credit and they help to raise funds from the public by their good name and status. Now, let us see what will be the effect of the abolition of the agency system on each of these three ways of securing capital. No one, we believe, will suggest that in the absence of the agency system the funds of these persons will be locked up in chests. They are sure to be invested in one way or another, i.e. either in Government paper, or in the form of bank deposits, or in industrial paper. With so much industrial development, it is not possible that these gentlemen might invest their money in Government paper yielding low returns. Those who aspire to be the managing agents of industrial concerns have a definite predilection for industrial investments and can therefore never be satisfied with the low yield of Government paper. The other way open to invest their funds will be to deposit them with banks. But if the banks cannot utilize their deposits profitably, they will reduce the rate of interest. The bank deposits too, thus will cease to have any temptations. If the banks can offer tempting rates of interest, it means that they are able to utilise their deposits in a profitable

¹ Cf. The Memorandum submitted by the Federation of Indian Chambers of Commerce and Industry to the Government of India on the proposed reforms of the Company Law.

way. This means that the funds are available for industries in one way or another, because without industries there will be only a few avenues for banks to use the funds at their disposal with advantage. The next question is about the funds which the agents make available to the client concerns on their own personal guarantee, viz. the deposits kept with them and the loans from banks. As regards the depositors they have now grown bold enough to deposit their money direct with the concerns. They have already begun to do this and the practice is gaining strength day by day. We can therefore confidently say that if the agents refuse to accept deposits they will directly go to the concerns. We need not also suppose that banks will stop making any advances to the industrial concerns, if they cannot do so on the personal security of the management. If at present we find them unwilling to do so, it is only because they can avail themselves of greater security, and everybody likes to advance money on as great a security as possible. The bankers have already begun to make advances in certain cases without the personal guarantee of the agents,¹ and there is no reason why they should not make this practice universal. The funds which are at present available to the industries on the personal securities of the agents will therefore continue to be so even in the absence of the agency system. There might occur some diminution for some time in the funds supplied by the agents out of their own pockets. But this will be more than made up even during the short transitory period by an enhancement in the supply of funds from the general public. Owing to different acts of commission and omission on the part of the agents, the agency system has gone into such disrepute, that if any new company is organised without managing agents, the fact is given a wide publicity by the organisers with the air of business honesty. And the public too, are attracted more towards a concern without agents than towards one with agents. This shows that though in the absence of the agency system there might occur some shortage in the funds available from the agents it will be easily made up by the increased public subscription.

Now the question remains about the investors who are attracted by the names of the managing agents. If at present we find that

¹ See *supra* Managing Agents and Supply of Working Capital: (c) Bank Advances.

concerns floated by a certain agency firm can raise the required capital more easily than concerns floated by a certain other agency firm, it is because that particular agency firm is composed of certain noted businessmen in whose ability the public have confidence, and this has nothing to do with the agency system as such. Such men will find it still more easy to raise funds for a concern of which they are not managing agents, but only managers or managing directors. Industrial enterprises started without managing agents, few though they are, amply show that the absence of the agents far from impeding capital collection, only helps it. What the public concern themselves about is the soundness of the scheme and the ability of the managing authority. If they can have the advantage of the services of able businessmen without the agency contract, they are so much more pleased. It may be argued that in the absence of the agency system the services of able businessmen will not be available. There do not seem to be any grounds for such fears. The other countries which pay definitely less than we do in this country to the managing and directing authorities, have not suffered from lack of business ability, nor have we, in spite of our lavish payments, been able to show any great achievements in this field. By encouraging the agency system, we have allowed a disproportionately large part of the industrial profits to go into the pockets of the agents in one way or another. If we do away with the agents and divert their undue gains to the shareholders, the legitimate owners, the supply of funds to industries will automatically increase.

UNIVERSALITY OF THE SYSTEM

Another argument forwarded in favour of the agency system is that if it were possible to start companies without managing agents that system would not have been followed so universally. Those who favour this argument seem to be quite ignorant of human nature. The businessmen who come forward to organise an industrial enterprise are out not to do a philanthropic turn to society but to earn money. And if so, why should they not avail themselves of the opportunity to secure the greatest return for their physical and monetary services, especially when they can do

so quite honourably? Those who do not do this will be called not wise but fools in business parlance.

SOME SUGGESTIONS FOR REFORM

Most of those who wish to free our industrial enterprise from the yoke of the agency system concentrate their attention on the period of the agency contract only. They think that things will be all right if the agency contract is made valid only for a short period, say ten years or so. Some go a bit further and suggest that even during this period, the contract should hold good only if the original contracting party or parties are in a position to render active service to the concern. Mr. Manu Subedar, for instance, in his Minority Report of the Central Banking Enquiry Committee observes, "A provision which demands the contract for management being limited to a certain number of years and being good during that period, only if a specified individual is able to offer his personal services will not work hardship on most industrial concerns, that are managed by capable partners of managing agency firms. But a provision of this kind will eliminate, wherever it exists, the additional risk to industry arising from the death or the financial weakness of the active managers." By the by, we are at a loss to understand how any provision on these lines will eliminate the risks arising from the financial weakness of the active managers. Perhaps it is hoped that as the contracts are for short period, the financial weakness of the agents will not be felt so much. But it does not take a long time for a concern to be ruined owing to the financial bankruptcy of the agents. It must be remembered that our industrial concerns are always under-capitalized, and therefore, they are to a great extent dependent upon short-time finance which under the present system is secured either directly from the agents or on the credit and guarantee of theirs. If under such circumstances, the agent goes bankrupt all these sources will immediately be dried up and the concerns will be financially starved. This will continue to happen so long as the agents are able to benefit by keeping the concerns financially dependent upon themselves.

Those who press for the shortening of the period of the agency

¹ The Central Banking Enquiry Committee Report, Vol. I, pt. II, p. 332.

contract making it terminable after a given date, or on the happening of a certain event, should bear in mind that even to-day there are so many contracts which are only for fifteen or twenty years, or in some cases even for ten years. But this does not mean that at the expiry of such periods the agents leave the concerns or if they do not leave they enjoy the confidence of the shareholders. Nothing of the sort. As a matter of fact once the agents get in, it becomes almost impossible to remove them.¹ We have already seen how the different provisions in the agency contract render the shareholders helpless in regard to the removal of the agents and are required to grant a fresh lease every time. In this way, whether the contract is for five years or for fifty, the agents become permanent and cannot be got rid of unless they themselves resign. This makes it clear that not only the period of contract but many other aspects of the contract also need a change; and unless we change the nature of the contract, a mere change in the period will prove of no benefit.

The period of contract and the removability of the agents are not the only points that demand reform. Those who concentrate their attention only on these points ignore other defects. It is equally important that our industrial concerns should be relieved of the financial burdens that the system entails. But it is not possible to deal exhaustively and specifically with all such details in Law. An agency contract is after all a private affair concerning the contracting parties. If we, therefore, wish to bring about salutary changes in the agency contract we must first of all try to reform the process of settling the contract. We have already seen how the agency contract is settled before the shareholders come in. This must be forbidden. No contract of this sort should be deemed valid unless it is sanctioned by the shareholders in the Statutory Meeting. The party interested, that is the proposed managing agents should be debarred from voting on such occasions. Then it is necessary that any payments for the work of promoting and organising services should not be a charge on the income of the proposed enterprise. It should be laid down that all such payments should be a charge on the initial capital expendi-

¹ "Managing agents have contracts with provision not only for long period but for their perpetual renewal, and often the managing agents could not be got rid of, except when they resign." The Central Banking Enquiry Committee Report Vol. I, part II, p. 331.

ture. The managing agents, or for that purpose any other party, should be strictly forbidden from demanding in consideration of such services any agency rights or commission, or compensation at the time of severing their connections with the concern, beyond the payment made at the start. Just as at the time of settlement of the contract, so also on all such occasions, when the agents happen to be interested in the decision, they should be debarred from voting. This in no way will be an injustice to the agents as their interests as shareholders will be well protected along with those of the other shareholders.

The managing agents not infrequently try to tie down the client concerns perpetually to themselves, by bringing them under large financial obligations. The Ahmedabad agents, for instance, finance half of the fixed capital in the form of short-term deposits either from their own pockets or borrowed on their own credit. Now if an occasion arises to remove the managing agents of such a concern they would naturally demand back their money. In order to remove such a contingency, and also from the point of view of sound finance, it is necessary that companies should not be allowed to start work with an insufficient share capital. Some provision, therefore, on the lines of Sec. 39 of the English Companies Act, 1929, should be made in our Company Law, whereby a company will not be permitted to allot its shares unless it obtains the minimum subscription amounting to a figure sufficient to provide for the purchase price of property, preliminary expenses, working capital, etc. These suggestions of course indicate the general line of reforms and do not claim to be exhaustive.

CHAPTER IV

FORMS OF CAPITAL ISSUE

INTRODUCTORY

The capital required for a modern large scale industrial concern cannot be supplied by one or two individuals; it has got to be raised from a large number of persons. The development of the corporate form of business organisation has made it possible to raise funds from a large number of people. The number of the shareholders of some of the big industrial corporations of to-day runs into hundreds of thousands.¹ The corporate form of industrial organisation has recently developed to such a stage that it has made it possible to raise funds not only from a large number of people but also from people of different temperaments. The whole problem of industrial finance has recently been developed on such scientific lines that now it has become possible to raise funds for industrial purposes from the greatest risk-taking person to the most cautious one, by issuing securities bearing different degrees of risks. The supply of capital to industries has also increased along with the development of the methods of raising it, as it has become possible to attract funds from all sorts of people. The supply of capital to industries in this country also will depend upon the extent to which we use these methods in securing it. So, before considering the problem of the actual supply of capital to industries, we shall consider the different important methods of securing the supply, and the extent to which those methods are being practised in this country, and their effects.

¹ How large is the number of shareholders of modern companies can be seen from the following number of shareholders of some of the big American corporations in the beginning of 1928. The American Telephone and Telegraph Company, 423,580; The Pennsylvania Railroad, 153,294; The United States Steel Corporation, 175,000; The Southern California Edison Company, 116,037. The average number of stockholders in 17 leading corporations quoted on the New York Stock Exchange come to 90,432, Applied Business Finance. By Edmond E. Lincoln, p. 251.

THE OWNERSHIP SECURITIES

The securities by which long time capital is raised for a company can broadly be divided into two classes, the one representing ownership and the other representing creditorship. The securities under each of these two broad groups can be divided into numerous classes and sub-classes. A new concern as a rule should not raise capital by issuing such securities which would entail fixed charges upon its income, because however conservative the management or however stable the industry, it is always more or less a sort of speculation. It is, therefore, unwise to burden a business with interest charges, before its earning capacity attains a stable position. It is also unsafe for the creditors to lend to a concern before its earning capacity is known; because the assets of an industrial concern are practically valueless if earnings cannot be realised. A new concern, therefore, should start its business by issuing securities which do not entail fixed charges but create ownership interests.

The securities which represent owners' rights can broadly be divided into two classes, stocks and shares. The stock is differentiated from shares by the fact that it can be divided and transferred in odd and varying amounts. The shares, on the other hand, are expressed in definite amounts and are not divisible. In practice, however, stock is usually bought and sold in round amounts, very small or odd amounts being avoided whenever possible. There is also some difference in the method of transfer of these securities. The shares are usually bearer securities, i.e. the transfer of their ownership is complete by the mere transfer of physical possession. But no dealings in stock are complete unless they are registered. The transfer of stock is thus more difficult than the transfer of shares.

The stock is an uncommon form of industrial paper in India. But it possesses some special advantages for the conditions found in this country. It will, in the first place, work as a check on the speculative tendencies of our investors by creating difficulties in the way of speculation. As no deal in stock is complete unless it is registered, any transfer of stock becomes more difficult and expensive than the transfer of shares. Besides, as the stock is not divided into exact fixed amounts it proves an inconvenient instru-

ment for speculation. Another advantage in the use of stock is that the purchase or sale can exactly be adjusted to one's pockets. The stock is disadvantageous in so far as the investments in it are not as liquid as in shares.

The stocks as well as shares are divided into the following three main sub-classes, ordinary, preference and deferred. The simplest form of organising capital is by issuing ordinary shares. All the holders of such shares participate in the profits of the company in proportion to the amount of capital that they own. They also possess the right to manage the company's affairs, through the exercise of the voting privilege.

THE DENOMINATION OF THE ORDINARY SHARES

One important problem about this class of shares is their denomination. One general rule about the denomination of shares is that it should be fixed at a figure which will appeal to the type of buyers who are to be approached. If we look to the denomination of the shares issued by Indian companies, we find that the general tendency in Calcutta is towards shares of small denominations while in Bombay it is towards shares of large denominations. While in Calcutta a ten-rupee share seems to be more popular, in Bombay a hundred-rupee share is more common. Many large companies in cotton mill and other industries have issued shares of more than Rs. 100/- each, such as of Rs. 500/- or 1,000/- each. Recent tendencies in Bombay no doubt are towards issuing shares of smaller denominations. The difference in denomination between the Calcutta and Bombay shares seems to be due to the peculiarity under which companies were started at both these places in the beginning. In Bombay the capital was subscribed by a few wealthy persons and hence the denomination of the shares was kept high. In Calcutta the companies were started by Europeans, and the capital was subscribed by a large number of Europeans in small lots. Another difference between Calcutta and Bombay was that the European businessmen of Calcutta had greater experience in joint-stock organisation than the Bombay businessmen, and therefore, they knew the advantages of small denominational shares.

If the general economic condition is taken into consideration

the shares of small denominations seem to be better fitted to India. The large denominational shares are more suitable for speculation. This may even be one of the reasons why we find shares of large denominations more popular in India. Considering the risks of industrial investments, shares of denominations higher than Rs. 100/- or even of Rs. 100/-, are not suited to middle class investors. Thus, it is obvious that the larger the denomination, the restricted becomes the field of drawing capital for industries. Besides, shares of large denominations deprive the society of one of the important advantages of joint-stock organisation, namely, the utilisation of small savings. Another great disadvantage in large denominational shares is that when assessable shares are issued, the instalments naturally become larger and the difficulty of paying them increases.

But this does not mean that the smaller the denomination the greater the advantage. The small denomination is advantageous only up to a certain limit. Denominations beyond that limit are disadvantageous, and should be discouraged. For instance, because ten-rupee shares are more advantageous than hundred-rupee shares, it does not mean that one rupee shares are of more advantage than ten-rupee shares. The smallness too when it goes beyond a certain limit is liable to be more harmful than beneficial.

The small denominational share is a recent development in corporation finance; its popularity dates since the early post-war years.¹ In favour of such too small denominational shares it is argued that they afford to the poor man a chance of participating in the prosperity of the company which issues them, by using his humble savings for the industrial development of the country. Those advantages will no doubt be reaped when the shares are issued honestly with the purpose of achieving them. But scarcely do we find such honest purpose to exist in the issue of very small denominational shares. Shares of very small denominations are usually issued by the organizers of speculative and unsound enterprises, and are sold to poor and ignorant investors. Such shares are usually vended from house to house among the lower class people who easily fall a prey to the bright description of the future of the enterprise given by the vendors. In these days when

¹ Cf. *Theory and Practice of Finance*. By W. C. Brooks, p. 252.

the wealth of a man is counted in paper, it gives a sort of gratification to the poor to find that he too owns shares in industrial concerns and is not in a different class from the big industrialists. During the boom period some enterprises were started with shares of one rupee or two rupees each, and the sayings of many poor people were wasted in such schemes. When the shares are not of too small denominations they have to be sold to higher class people, who can form their own opinions about the soundness and prospects of the schemes placed before them, and hence the possibility of corruption and swindling is less in such cases. The joint-stock organization no doubt widens the field of raising capital for industrial purposes, but at the same time it offers greater opportunities to the organizers of industrial schemes to swindle the money belonging to others. And hence while attempting to raise capital from as wide a field as possible we must also try to put a brake upon the swindling activities of the unscrupulous organizers. The best way of securing protection in such matters is the vigilance on the part of the investors; but where they are not able to protect themselves the law must come forward to do that work. If we can make the issue of even very small denominational shares fool-proof and knave-proof that is so far so good but so long as that is not achieved it is better that the poor and ignorant should be protected from wasting their savings on unsound and speculative schemes, by keeping such investments outside their easy reach. Considering all these points it seems better that shares of denominations smaller than Rs. 10/- each should be prohibited under present circumstances.

PREFERENCE SHARES

The next important type of securities used to raise initial capital is the preference shares. There are two main classes of preference shares, namely, cumulative and non-cumulative. In the case of the former class the preference dividend if not paid in any one year or for a term of years must be paid up in full before the ordinary holders share in the profits. But when the preference is not cumulative it extends only to each year or sometimes each half year of the company's working. Sometimes, specially in the case of speculative business, the preference shareholders are entitled to

get more than the stipulated rate, if the ordinary shareholders get a certain rate of dividend. These are called the participating preference shares. But this type is not a popular one. The most popular type of preference shares, especially in India, is that of cumulative preference shares.

The preference share is designed to meet the want of the cautious investor who prefers a comparatively low, but certain yield on his savings to taking the risks involved in the ordinary shares. The income on ordinary shares necessarily fluctuates with the good and bad days of the enterprise; but so long as the fluctuations are not too wide the preference shares are safe. But the certainty of return on the preference shares is only comparative. When a misfortune overcomes a company it may wipe out the claims even of the cumulative preference shareholders. Supposing the arrears extend to exorbitant dimensions and the preference shareholders claim their arrears they run the risk of ruining the concern altogether and thus far from realising their arrears, stand to lose even their capital. Leaving out such extreme cases, the cumulative preference shares usually bear far less risks than the ordinary shares. The non-cumulative preference shares are issued very rarely and they are not as safe as the cumulative ones.¹ One great defect of the non-cumulative feature is that the management is tempted to re-invest the profits in the business, and in this way to increase the dividends of the ordinary shareholders at the cost of the preference shareholders who receive only the fixed percentage. The preferred stock-holders' dividends, thus, for the intervening period is absolutely lost so far as they are concerned.

PREFERENCE SHARES AND VOTING RIGHTS

The situation that we find in India in this respect is somewhat peculiar and deserves some attention. In the first place non-cumulative preference shares are very rare in this country. In 1929, for example, out of 147 cases of preferred shares only six were of non-cumulative nature. Secondly they enjoy voting rights

¹ "If investors were wise there would be no sale for non-cumulative stock, for there is no legal way for the holder of such stock to prevent the directors postponing dividends until the common stock-holders can share equally or even receive more than do the holders of the preferred stock."

Business Finance. By William Lough, p. 72.

similar to those of the ordinary shares. This practice of giving equal voting rights to ordinary and preferred shares possesses some special advantages from the point of view of the management especially under the managing agency system. Because the managing agents thereby can adjust their investments in such a way that they can keep the control in their hands without undertaking any great risks. They can thereby also change their holdings of ordinary and preferred shares according to the prospects of profits on each of them, without affecting their control over the company. If the agents, for example, think that the returns on ordinary shares are likely to dwindle, they can slowly reduce their holding of ordinary shares with an equal increase in the holding of preferred shares, without affecting their control over the concern. As preference shares enjoy voting rights similar to the ordinary shares, the managing agents are tempted to issue a comparatively large number of preference shares and to hold them whenever it is advantageous to do so. The Tata Iron and Steel Company, for example, has raised 74 per cent. of the share capital by issuing preference shares.¹ So also in the case of the E. D. Sassoon United Mills, when this company was started preference shares of the face value of Rs. 2 crores were issued to the vendors Messrs. E. D. Sassoon & Co. who were also the managing agents of the company. When the managing agents become interested in the preference shares they become careless about the interests of the ordinary shareholders. This has a bad effect upon the efficiency of the management as the high or low returns on the ordinary shares do not affect them. Really speaking there is no reason why the cumulative preference shareholders should have any voting rights. Their interests are not likely to suffer even though they do not possess the privilege of votes. The ordinary shareholders cannot get anything unless the cumulative preference shareholders get their dividends. The latter thus need not possess any voting rights at all. At the most they should be given the right to vote on matters in which their

¹ "I am to draw pointed attention to the fact that the arrangement of capital whereby 74 per cent. of the share capital consist of cumulative preference shares and whereby more than 90 per cent. of these cumulative preference shares bear the high rate of 7½ per cent., cannot be regarded as satisfactory." From a letter from the Secretary to the Government of India, Commerce Department, to the Tata Iron and Steel Co. Indian Tariff Board Steel Enquiry, 1926. Vol. II, p. 335.

interests conflict with those of the ordinary shareholders. If the preference shareholders are deprived of the voting privileges the ordinary shareholders are likely to be benefited in two different ways. In some respects it will work as a check upon the tendency to water the stock, by reducing the temptation to issue more than necessary preference shares, as such shares will not carry with them power to control the concern. The management obviously will hold ordinary shares with the intention of possessing control, and this will make them more interested in the fate of ordinary shares which will have a salutary effect upon their attitude towards the finances of the concern.

But it must be mentioned here that if we are going to deprive the preference shareholders of voting rights they must be given a better legal protection than what they enjoy at present. In the U. S. A., for example, where the preference shares do not enjoy the voting privilege, such protection is given on the following lines. Strict provision is made for the maintenance of the company's property in first class condition by proper depreciation allowances, and insurances against losses from fire and such other contingencies. Such provision is necessary, otherwise the preference shareholders will get only the stipulated rate of return while the assets are likely to be dissipated in giving unwarranted dividends to the ordinary shareholders. Along with the provision for keeping the assets in good condition, there must be restrictions against selling the assets or changing the character of the business. Further, protection must be given in the form of prohibition to issue new preferred stock or other obligations taking precedence over the previous issue. In the U. S. A., for example, it is commonly provided that no additional preferred stock shall be issued without the favourable votes of three-fourths of the holders of preferred stock already issued and outstanding.

THE DENOMINATION OF PREFERENCE SHARES

The denomination of preference shares is as a rule higher than that of the ordinary shares. As a matter of fact the greater the security the lower must be the denomination of the paper. Because paper of greater security is always sought by poorer investors, and, in order to bring it within their reach it must be of smaller

denomination. But we find quite the reverse situation in India. Here we find that the greater the security the higher the denomination of the paper. One result of this is that the money of the small investors, who care more for security than for income, is not available for industrial purposes. All such savings are held in cash or at best are invested in Government paper. If we wish to make use of all such small savings for industrial purposes, we must see that industrial paper with greater security is issued in small denominations. It is therefore advisable that our companies should bring down the denomination of the preference shares to at least Rs. 25/-.

REDEEMABLE PREFERENCE SHARES

One important feature of preference shares, namely, callability or redeemability, is not found in India. This feature has recently become very common in America. It is provided in the preferred stock covenants that the stock will be redeemed at a certain rate which is always 10 or 25 per cent. above its par value. In many cases no definite time limit is set for such retirement. Some of the reasons for issuing redeemable preference shares are as follows. This feature is generally present in the case of concerns with a comparatively short period of life. In such cases it becomes necessary that the preference shareholders should feel confident that besides the annual return they will get back their principal. The redeemable preferred stock is also issued while a company is new and its credit not well established. Later on common stock is usually substituted for preferred as the former gives greater flexibility to the financial programme. Sometimes owing to low credit of the new concern or owing to the market conditions then prevalent, preferred shares have got to be issued at a comparatively high rate of return. When conditions change, these high rate securities can be substituted with low rate ones. Callable preferred stock is also issued by a new concern in order to secure working capital or to meet some other temporary expenses, the intention being to redeem such issue later on with the reserves created out of the profits. The redeemable issue in such cases serves a double purpose as it helps to raise capital without losing control of the original management, on the one hand, and without

incurring fixed obligation on the other. When the concern becomes well seasoned the redeemable issue is replaced also by bonds at lower rate.

Such redeemable preference shares will prove of great benefit in India. Whenever the original share capital becomes exhausted in the construction stage, which, as we shall see further, is a common occurrence in this country, this type of security will prove a convenient way to secure working capital. This device will remove the necessity of depending upon borrowed funds with all the uncertainty and high costs that they imply, and will provide sufficient capital without incurring the burden of fixed charges in the beginning or without making the charge permanent.

DEFERRED OR FOUNDERS' SHARES

Next to the ordinary and preferred shares, we have the deferred or founders' shares. These shares participate in the profits usually after the ordinary shareholders get a certain percentage of dividends, and are generally taken up by the original promoters and vendors. In India these shares naturally pass into the hands of the managing agents. Mr. Hartley Withers calls these shares an ingenious device of keeping a very substantial share in the profits for its holders, and also at the same time preserving an air of great modesty and moderation.¹ The deferred shares as compared with ordinary shares represent a small amount of capital, and therefore when the concern is running profitably the deferred shareholders derive profits quite out of proportion to their holding. In some countries these shares are called management shares and are given to the managing director, the manager and other chief officials. In India we do not find such a system. Here these shares are taken up by the managing agents and the directors. It will certainly prove of great advantage if we issue such shares to the chief officials of the company, who will thus receive an extra incentive for efficient work. When the deferred shares are held by the managing agents and the directors they are likely to be inconsiderate in declaring profits in order to secure and justify dividends on deferred shares. This of course is detrimental to the interests of the ordinary shareholders.

¹ Cf. *Stocks and Shares*: by Mr. Hartley Withers.

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The deferred shares are usually issued in consideration of promoting or organising services; and because the payment is made in terms of deferred shares it is made lavishly. The holders of deferred shares thus benefit far in excess of the services they render to the company.

The deferred shares are used by our company organizers as a device of keeping control over the company with a relatively small stake. This is accomplished by issuing deferred shares of very small denominations as compared with the ordinary shares and by giving both the types equal voting rights. The Tata Construction Company, for example, had issued 50,000 deferred shares of Rs. 10/- each, and 75,000 ordinary shares of Rs. 100/- each. In this case it is obvious that the management, if they hold the deferred shares, will be able, with a stake of 5 lakhs, to control the destiny of the ordinary shareholders who have invested Rs. 75,00,000. The condition becomes worse in India where the interests of the management are not always the same as those of the ordinary shareholders.

NO-PAR STOCK

There is one more variety of stock called no-par stock, which has recently become popular in America but is not found in India. The no-par stock, as the name suggests, is stock without a par value. The share of no-par stock is an integral part of the net worth of the company; its value is not stamped on it as in the case of a share of par-value stock but depends upon the value of the issuing company. Under this variety a stock certificate for a certain number of shares merely indicates that the owner is entitled to a certain portion of the unencumbered assets of the business, without any statement of the money value of each share. What is usually done in such cases is that the directors divide the total capital or assets of the company into a certain number of shares, each share representing a proportionate part of the total assets.

The no-par stock possesses certain special advantages the most important of which is that it provides for greater flexibility in financing, because it becomes possible for a company to sell its shares at different prices according to the general financial and

business conditions of the time. There being no fixed price or face value to the shares, their actual price does not attract any public attention. There is, in fact nothing like selling at a discount or at a premium. From the point of view of the stockholder himself it is significant that when no-par stock is issued, he is free from liability to assessment that sometimes confronts the holder of par value stock which has not been fully paid. The elimination of a fictitious par value will safeguard innocent investors, who are frequently persuaded by speculators to buy stock selling at a nominal price on the assurance that it is worth much more than they are paying for it. Under such circumstances, it becomes easy for a swindler to convince his victim that a rare bargain is being offered and that the shares will soon be brought to par. The no-par stock is likely to result in an indirect benefit under Indian conditions; as the no-par shares cannot be of the assessable nature, the organisers will be required to raise sufficient capital in the very beginning. In America no-par preference shares are also issued but they are not popular.

It must be stated here that the no-par stock is in no way knave-proof or fool-proof. In the hands of unscrupulous management it is even more harmful than the par-value stock. The success and advantages of this variety of stock depend upon the existence of intelligent and educated investing class. The no-par stock gives great scope to manipulation of accounts and hence the investors must be able to exact sufficient and accurate data on the financial affairs of the concerns and to understand the same. Where the investors are not able to safeguard their own interests, the law must prevent the innocent from being abused by means of technical accounting loopholes. It is better therefore that no-par stock should not be introduced unless such checks exist upon the activities of the management.

CREDITORSHIP SECURITIES

Long-time capital is also raised by issuing creditorship securities. Unlike ownership securities the creditorship securities have not got many varieties. There are two main classes of creditors' instruments, (1) bonds, and (2) debentures. The former is secured by a mortgage on specific property or by the deposit of other

securities as collateral, in the hands of lawfully appointed trustees. The debentures, on the other hand, depend for their security only upon the general credit of the issuing company, though they are ordinarily backed by many protective and restrictive covenants and provisions. While the mortgage or collateral trust bonds are common in the U. S. A., the debentures are common in England and India.

Whatever the class of instruments, the process of issuing them is almost the same. There is in the first place the elaborate document which is usually in the form of a triple agreement between the company, the holders of the securities and the representatives of the latter. The last party are the trustees who serve as a kind of intermediary between the company and its scattered and unknown bond-holders. Then there are the separate bonds issued under the agreement. They are distributed among the investors as the individual and separate evidences of debt. Each is signed in the name of the company with the certificate by the trustee and the bond is covered by the agreement. The agreement specifies in great detail the obligations of the company, the duties of the trustees and all the rights and privileges of the bond-holder. As the creditorship securities are issued secured against the assets of the borrowing concern, the repayment of the principal invested in them becomes secured, because on default the assets can be attached. Of course, the degree of security will differ in individual cases according to the nature of the assets and the conditions of the mortgage.

INCLUSION OF DEBENTURES IN THE INITIAL FINANCIAL PLAN

It is a time-honoured practice, no doubt based on sufficient wisdom, that a new concern should issue only ownership securities. Recently this policy has undergone some change and the financial plans of new concerns are found to include creditorship securities also. But this practice cannot be recommended in each and every case. It will prove beneficial only under certain conditions, and even then it must be used very cautiously. The most important rule in this respect is that the creditorship securities should be issued only when the future earnings of the company are expected

to be liberal and reasonably steady. The company must not also belong to that class of industry the constructive stage in which spreads over a long period. In such cases, if the earnings are expected to be steady, creditorship securities may be issued for securing working capital after the construction stage is over. When large sums have got to be raised and it becomes difficult to do so by issuing ownership securities only, resort may be taken to creditorship securities to a limited extent.

The practice of supplementing the initial share capital by debenture capital is likely to yield certain benefits, under present conditions, if followed cautiously and in strict conformity with the principles of sound finance. Thereby it will be easier to raise sufficient funds as it will be possible to tap conservative people who desire a fixed income without much risk. Besides, the fear that if too many ownership securities are issued the rate of return on them may fall down, will also be removed as the return on the debentures will be fixed leaving the rest for being shared by the owners.¹ If sufficient funds are raised in this way the difficulties that arise owing to dependence upon uncertain sources of capital like private depositors and commercial banks will be removed. The debentures will also prove more economical as the rate of interest on them will certainly be lower than the rate of interest on the short-time borrowings, which moreover rises according to the intensity of the needs of the borrowing concern. The debenture issue thus will make the supply of capital certain and cheap. But it must be remembered that the advantages of debenture issue in the beginning are not universal but depend upon the merits of individual cases, and therefore, must be practised cautiously and after full consideration of the income yielding possibilities of the enterprise.

DEBENTURES NOT POPULAR IN INDIA

Despite their advantages, debentures do not seem to be as common in India as elsewhere. The calculations about the capital of the companies quoted on the Calcutta Stock Exchange show that only 8 per cent. of the capital was raised by issuing debentures.

¹ See chapter on Initial Capital.

tures.¹ This percentage will be even lower in the case of Bombay where debentures are said to be less popular. In England 20 per cent. of the capital is raised by issuing debentures.² The same percentage is found with regard to the manufacturing concerns in America, where it goes even as high as 50 to 60 in the case of public utility companies.³

Various reasons are forwarded for the relative unpopularity of this type of industrial paper. The speculative tendency, for instance, of the Indian investors, who prefer a paper which gives a prospect of capital appreciation, is said to be an important reason of the unpopularity of the creditorship securities.⁴ But in contradiction to this it is maintained by others, that there is at all times a large class of investors who prefer the security offered by sound debentures to the possibility of capital appreciation.⁵ The latter view seems to be more in keeping with the circumstances than the former. It is true, that a great proportion of the present investors in industrial securities are influenced by their speculative prospects. But this does not mean that there is no demand for non-speculative securities. Considering the general shyness of Indian capital it seems more probable that there should be a greater demand for debentures with all the security that they imply, than for shares. And the existing conditions of the security market do indicate that to be the state. What actually happens is that debentures are readily purchased by Indian princes or big landlords and merchants who hold them as permanent investments.⁶ Thus a market is never being created in debentures which makes it difficult and inconvenient for people with moderate means to invest in such paper. A certain amount of investment securities, varying according to the general economic conditions, is absorbed by the public and unless that amount is exceeded

¹ Cf. Central Banking Enquiry Committee Report, Vol. I, Part, I, pp. 641—42.

² Cf. Report of the Committee on Industry and Trade; Factors of Industrial and Commercial Efficiency, 1927 pp. 458-9.

³ Applied Business Finance, By E. E. Lincoln, p. 205.

⁴ Cf. Evidence of Mr. (now Sir) K. M. Macdonald, Managing Governor, the Imperial Bank of India; The Central Banking Enquiry Committee Report, Vol. II.

⁵ Cf. Evidence of Calcutta Stock Exchange Association. The Central Banking Enquiry Committee Report, Vol. II, p. 682.

⁶ See the evidence of Mr. A. D. Shroff before the Central Banking Enquiry Committee, Report, Vol. III.

they will not be available on the market for normal transactions. The creditorship securities thus do not seem to have gone beyond the absorption stage; there is, therefore, still a great potential market for them. A great customer of the creditorship securities is the insurance companies but this customer is still untapped. Either owing to lack of confidence in the stability of the industrial enterprises or owing to the inconvenience created by lack of market, our insurance companies are not found to invest in debentures, but in them there is a great potential customer.

The relative unimportance of debenture capital in our industrial finance is in many respects due to the industrial concerns themselves. From the point of view of the enterprises debentures have certain disadvantages. Being secured against the assets they affect the credit of the issuing concern in the money market. The result is that the banks which supply short-term finance to such concerns curtail their advances. It is feared by the bank that it can have no tangible assets, as they have already been mortgaged.

Whenever debentures are issued they are issued in such large denominations that they are beyond the reach of the investors with moderate means. Out of the 70 debenture issues quoted on the Calcutta Stock Exchange, in 1929, only one had a denomination of less than Rs. 100/-; fifty-six were of the denominations of Rs. 500/- or more, and twenty-seven were in denominations of Rs. 1000/- or more. Formerly, in the U. S. A. too, the bonds were uniformly of 1000 dollars each. But during the last few years, the denomination has come down to fifty dollars.¹ A low denomination gives a double advantage to the investors with moderate means. Because they can not only invest their money in paper with greater security but can also reduce their risks further by diversifying their investments. If the debentures are to be made popular they must be issued in small denominations.

WANT OF EFFICIENT TRUSTEE SERVICES

There are, no doubt, certain risks in having low denominational debentures under the present circumstances. The ease with which the debentures can be marketed is likely to lead to too lavish an issue. The debenture holders run two types

¹ See "Applied Business Finance," by E. E. Lincoln, p. 126.

of risks. Either the debentures may be issued without being secured by sufficient assets or the assets may be dissipated by too lavish dividends or otherwise. It is not possible for the scattered and uninstructed investors to guard themselves against such financial intricacies. The harm done by an unsound issue of debentures is more serious than that done by the issue of speculative stock. The investors in common stock invest with the consciousness that they are investing in speculative paper. The creditor securities, on the other hand, are taken to be sound investments, and are purchased confidently by the investors. If anything, therefore, goes wrong with such securities, the investors are likely to sustain a great loss.

In order to avoid such losses and to protect the small investors, it is necessary that there should be some good agencies doing the work of trustees. To have efficient and honest services from these trustees it is necessary that they should be interested in the success of the issues offered under their trusteeship. In India the trustee business is done by certain influential businessmen or managing agency firms. But as the debentures are purchased by big capitalists in large lots, the presence of the trustees has become unimportant, the holders themselves being in a position to protect their interests. If we wish to interest a large number of investors in debenture issues, we must have efficient and honest trustees to protect the interests of these scattered investors. The agency best suited to do this work is the investment bank as we find it in the U. S. A.¹ One important reason for the recent popularity of the small denominational bonds in that country seems to be the rapid development of investment banking during the past few years. The establishment of investment banks will help a good deal to popularise debentures in our country too. But until such financial institutions are established, the present banks will do the work of debenture trustees with profit to themselves and also without any undue risks. They will in this way give a sound lead to the industrial concerns and also will be able to dispose of the issue easily among their depositors who will readily purchase it being confident that the bank will protect their interests.

¹ See the Chapter on "Capital Market".

CHAPTER V

INITIAL CAPITAL

ESTIMATES OF CAPITAL REQUIREMENTS

Every industrial concern requires capital for three different purposes: the expenses of organisation, the costs of fixed and permanent assets, and the expenses of working the concern. In other words, the capital raised should be sufficient to launch and operate the proposed enterprise efficiently and economically. The first question that confronts the organisers regarding the capital requirements of the proposed scheme is how to estimate them. The amount of capital required for inaugurating a scheme, of course depends upon its size. The organizers first of all must, therefore, decide upon the size of the proposed enterprise. Evidently the most economical size is that which will permit production at the lowest per-unit cost. Perfect technical knowledge is essential for a correct decision in this respect. Once the size is decided upon the financial estimates become comparatively an easy matter. The correctness of the estimates regarding the size and costs depends upon the efficiency of the promotion services. In a country like India where promotion services, as we have already seen, are deficient, the estimates are sure to lack in correctness. As a matter of fact our industrialists do not generally base their estimates on scientific calculations. Wherever possible they take as the model some other concern, which they think is making good profit and imitate it in size and equipment. They do not consider whether a concern differing from the model is likely to yield greater profits. Where no such model can be had, the size is fixed upon in an arbitrary manner, without proper consideration of costs or profits.

For a proper estimate of the costs, perfect technical knowledge is quite essential. If the organisers, therefore, are not able to secure expert technical assistance their estimates are likely to be wrong. And as a rule they are wrong. One peculiar feature to be remembered in this respect is that our businessmen err on the

side of insufficiency. Cases in which the capital raised is more than necessary are rare. This is the result of two conflicting ideas that influence the organisers. On the one hand, they wish to raise as little share capital as they think is absolutely necessary for the scheme about which they have only a vague conception in their minds; on the other hand, they wish to have a big project without any consideration of the available resources. All the while, they completely forget the fact that both these things, the capital resources and the size of the concern, are interdependent.

The initial financial plans of Indian concerns, as a rule, do not include working costs, or working capital as it is commonly called. The share capital raised in the beginning is just enough to meet the construction costs. It seems to be the general belief that once the construction stage is over the working expenses can be secured in one way or another. The neglect of working capital is a short sighted policy.¹ The financial plan of every new concern must include a liberal provision for working it. If later on it is found that the provision for current expenditure is in excess of the requirements, the excess can easily be transferred from the current expenditure item to that of fixed and permanent assets.

THE PROCESS OF STARTING A NEW CONCERN

To have a proper idea of the finances of a new concern we must pay attention to the process of starting it. In India, as we have already said, there are no professional business promoters. Industrial ideas in India are picked up and developed by the existing business firms, or sometimes by persons not actually engaged in business but possessing business inclination and talent. Big concerns are almost invariably promoted by the business firms, while smaller ones are promoted by people engaged in other walks of life but endowed with special business inclination. Whatever the position of the promoters, their relations with the promoted concern are invariably of the same nature, as they establish themselves as the latter's managing agents.

¹ "So appealing is the glamour of size that the mistake is much more frequent of making too elaborate provisions for fixed permanent assets than over-estimating requirements for current expenditure. Yet many are the situations in which, if economy is necessary it might more advantageously be exercised in respect of fixed tangible propertybut not without incurring grave risks can there be economy in provision for current expenditure." Principles of Corporation Finance, By Harold L. Reed, pp. 62-63.

Once an industrial proposition has been taken in hand, the next step is to "assemble" the different factors necessary for developing the idea into a workable business scheme. Certain rights, patents or properties have got to be secured before the idea can be placed before the public. All this implies a good deal of expenditure of time and money, and therefore can be undertaken only by wealthy business firms or individuals. Sometimes one or more of the promoters are in possession of some of the necessary factors. When the scheme materialises payments have got to be made to the holders of the different factors and also to the promoters for their efforts and expenditure.

PAYMENTS TO THE VENDORS AND PROMOTERS

The payments to the vendors, for the assets acquired from them, and to the promoters for their services, are made partly in cash and partly in shares. Such payments must also be included in the total capital issue in addition to the three items already discussed. Whenever payments are made in shares, they are made rather lavishly which results in increasing the capitalization¹ figure without corresponding benefits. In other countries, the vendors and promoters usually sever their active connections with the whole affair as soon as a company is formed to work the idea. The new company, therefore, usually assumes a careful attitude towards the payments to be made to the retiring parties. In India, the promoters, who are not infrequently also the vendors of different assets, continue their connections with the enterprise as its chief managers by establishing themselves its managing agents or directors. The Tata Publicity Corporation had in the beginning six out of eight directors who were interested as vendors to the new company. The Tata Power Company had to pay as investigating charges Rs. 7½ lakhs to the Tata Sons, Ltd., who were its managing agents, and three of the recipients of that amount were on the Board of Directors of that Company. The Belapur Company was started to take over the Property of the Belapur Syndicate in liquidation. The former company had seven

¹ "The total par value of all the securities outstanding at any given time is usually referred to as the 'Capitalization' of an enterprise."

Business Finance by W. H. Lough, p. 172.

directors in the beginning and out of them four were interested as vendors of the property of the Belapur Syndicate. The Andhra Valley Power Supply Company was started to acquire and work from the Tata Hydro-Electric Power Supply Company the concession for generating electrical power in Andhra Valley. For transferring this right the Andhra Valley Power Supply Co. had to pay to the Tata Hydro-Electric Power Supply Co. Rs. 5 lakhs in cash and besides Rs. 50,000 or such larger sum as may be represented by 15 per cent. upon the remainder of the profits. The new company had fourteen directors in the beginning out of whom ten were the directors of the vendor company. This new company was promoted by a Syndicate, all the members of which, who were to receive promotion fees, were also directors of the new company.¹

It is obvious that under these circumstances, the charges for the services or assets are sure to be exaggerated. When the personal interest of the directors and the interest of the company conflict, it is natural that the former should predominate the latter. For an exact valuation, the value must be settled by all the interested parties or by an independent disinterested party. Under the existing circumstances, we find that the values are fixed by a single interested party, the party which is to receive the payments. Our Company Law too, does not provide for an independent scrutiny of the payments made to the promoters and vendors. In other countries, legal protection is granted to the investors against such over-valuations.

In France, for example, it is provided by Law that the value of the assets acquired by a public limited company and the consideration for any profits granted to the promoters should both be examined by a committee of scrutinisers appointed by the shareholders. The findings of this committee must be presented to and approved of by the shareholders themselves.² The regulations imposed in Germany are still stricter. There, when shares are issued for property instead of cash, elaborate measures are to be taken to insure that the property was actually worth as much as the par-value of the shares issued in exchange for it. Whenever, for

¹ Cf. The prospectuses and Agency Agreements of the respective companies.

² Cf. The English Capital Market: By F. Lavington, pp. 215-216.

instance, a director also happens to be an organiser of the company, interested in property acquired in exchange for stock, special outside auditors must investigate and report on the transaction. In Germany every corporation must have two boards of directors, a supervising board and a managing board. The same person cannot be a member of both these boards at the same time. At the time of making an application for registration the reports of both these boards—the supervising board and the managing board—the organisers, and of the outside auditors when required, in regard to the terms and considerations for which all the shares or stock are issued and the names of the stockholders must be filed. When stock is issued for property, the organisers have to include in this sworn written statement, the basis for the valuation put upon such property. Thus ordinarily three, and in case a director is also an organiser, four, independent investigations must be made and reported upon, under oath to establish the parity between the value of the property acquired by the company, and the stock issued for such property.¹ As a result of these elaborate precautions the danger that a German company would begin business with nominal capitalization exceeding its bonafide assets is reduced almost to vanishing point.

The protection afforded in the U. S. A. is rather indirect, and therefore, not as effective as in the case of the other two countries. Here the law intervenes only when anything goes wrong with the concern. If a corporation, for instance, gets into difficulty and a receiver is appointed owing to mismanagement, and if he finds that stock was issued fraudulently, he can recover out of the difference between the par value of the stock and what the court considers the fair value of the property, such amounts as are necessary to meet the claims of the creditors.² When a corporation is considered not to have received full value for the stock issued as fully paid to the vendors, the fully paid stock is considered as assessable stock and those who have received it are considered liable for the difference between its true value and par value. If in the meanwhile, any of the delinquents become in-

¹ Cf. "The Trust and Corporation Problems," by Henry R. Seager and Charles A. Gullick J. R., pp. 578-79.

² Cf. Corporation Finance: By E. S. Mead, p. 122.

solvent, the solvent ones are compelled to take over the shares of the insolvent ones.

Some protection on these lines, or even stricter than in either of these three cases is essential in this country. If the sellers of the property have full freedom to dictate prices, it is but natural that they (the prices) should soar high. Whenever stock is issued to persons in excess of the benefits received from them, the capital of the concern is said to have been watered. The capital becomes watered even when the payments are made not in terms of stock but in cash if it be in excess of the value of the assets received. Such stock watering has many disadvantages. As the outstanding share capital exceeds the value of the assets the percentage of return on the shares becomes low. In such cases the real losers are those who buy the shares with hard cash; the returns they get on their investments prove to be less than what might be termed a fair rate of return. The vendors on the other hand derive sufficient, or even more than sufficient return, for the assets passed over to the company by them. There are two other disadvantages from the point of view of the concern itself. First, as discussed above, it means a waste of the resources in so far as the payments exceed the benefits received. Secondly, the capitalization of a concern is always limited by its profit earning capacity, and therefore, the more we spend on such payments the less is left for other purposes. As a result of this the concern soon finds itself in financial difficulties. This is also one of the reasons of the common complaint about insufficient share capital of our industrial concerns.

MISCALCULATIONS ABOUT CAPITAL

After an industrial idea is worked out on systematic lines, and the payments to be made to secure the preliminary tangible and intangible assets as well as the services of different parties are settled, the next stage in the life of an enterprise is to calculate the capital requirements and to devise the ways to secure the same. We have already discussed the different items that comprise the total capital requirements of an enterprise. Financial ease, to a great extent depends upon a correct estimate of all the different financial needs.

When we turn to examine the financial condition of our com-

panies we find that miscalculation about capital requirements is a common malady from which they suffer. The phenomenal company failures which took place after the War Boom was over were due mainly to this defect.¹ But one need not think that the concerns floated under the feverish boom activity only suffered from financial miscalculations. This defect existed long before; many a witness, for example, before the Indian Industrial Commission had complained of it.² As a matter of fact, the complaint about insufficient capital supply has been there, ever since the beginning of the modern industrial system in India. The worst of it is that the same situation has continued to this day without any improvement in it, and the evidence before the recent Banking Enquiry Committees bears ample testimony to this.³

At the beginning of this chapter we have said that the share capital must be sufficient to provide for (1) the organising expenses incurred in the beginning, (2) the assets necessary to make the project complete and to bring it to working condition, and (3) the necessary working capital. But our companies, far from making any provision for the last mentioned item, find the funds insufficient even to make the project a complete entity. The history of almost every industrial enterprise, worth the name, will prove this. To choose a few random recent instances we may refer to the following cases. The C. P. Portland Cement Company was started in 1919 with an authorised capital of one crore, with Messrs. Burns & Co. of Calcutta as managing agents. Out of one crore, 60 lakhs were issued for public subscription. As it was the boom period and the company was promoted by a reputed agency firm, the capital issued was easily subscribed; not only this but the shares were soon at a premium of 40 to 80 per cent. The capital raised in this way was exhausted in no time and the directors were required to raise more funds by issuing the remain-

¹ "Many an otherwise promising concern had to close their doors because either from the very commencement sufficient capital was not provided for, or funds were not forthcoming when they were urgently needed." *Company Failures and their Causes*; a Booklet published by Mr. N. J. Shah.

² See for example, the Report of the Indian Industrial Commission, Evidence Vols.

³ Cf. Report of the C. P. Provincial Bank. Enq.: Com. Vol. I, Ch. IX. Report of the Bengal Provincial Bank. Enq.: Com. Vol. I. Ch. IX. Report of the Central Bank. Enq.: Com. Vol. II. Especially the evidences of the Andhra Bank, Ltd.; Mr. B. Ramchandra Rao, and Mr. A. D. Shroff.

ing shares of 40 lakhs. But by this time the boom was over, and owing to the financial difficulties the credit of the concern reached a low ebb. As a result of both these events the late issue could not be disposed of at all. In the meanwhile, the managing agency of this concern was taken over by Messrs. Mathuradas Gokuldas of Bombay who raised a debenture loan for Rs. 40 lakhs. This sum was also exhausted, and then the agents raised another 20 lakhs by a second debenture loan. The company wanted to erect three units of machinery and up to this period they were working for all the three units, but after spending the 120 lakhs, the three units were only half finished. And the agents made an appeal for a further sum of 15 lakhs in order to finish only two units. Five lakhs were necessary to complete the two units and ten lakhs as working capital.¹ This company afterwards passed into the hands of the debenture holders, who were the members of the agency firm.² Financial straits resulting from insufficient share capital had to be faced by the Tata Power Company also. This Company was registered in 1919 with an authorised capital of 9 crores, out of which only 4.5 crores were issued. Afterwards it was found that the funds raised were not sufficient even to complete the construction. The company later on took a debenture loan to the extent of 2 crores from the Tata Hydro-Electric Company and brought the construction to working condition.³ Similarly the Andhra Valley Power Supply Company also had to undergo the unfortunate experience of shortage of capital. A time had reached when this company would have been obliged to close down but for the friendly assistance of one of the Bombay Banks on the personal guarantee of the Managing Agents.⁴ The last two concerns were floated by a firm of no less repute than the Tata Sons, Ltd. These three instances will show how defects arise in capitalization even with regard to companies floated by the most reputed industrialists. Obviously conditions must be worse with regard to the companies floated by less able businessmen.

¹ Cf. *The Capital*, May 3, 1923.

² Indian Tariff Board: Cement Industry Report, Evidence Vol. p. 63.

³ Evidence of Mr. A. D. Shroff: Central Banking Enquiry Committee Report, Vol. II.

⁴ *Ibid.*

The difficulties arising from insufficient share capital are in no way peculiar to Bombay. Industrial establishments in other provinces like Madras¹ and Bengal are labouring under the same difficulties. In Bengal all sorts of industrial establishments whether jute, coal, tea, rice or oil mills are suffering from insufficient share capital. The Bengal National Chamber of Commerce observe, "The realisation from their share floatations do not enable them to meet all the capital requirements and their dependence on outside finance is no less marked than in the case of similar establishments owned by individual proprietors."² The Chamber while speaking about the tea industry say, "Concerns which are faced with such a plight have to go into liquidation though there may have the prospects of yielding crops in a couple of years."

The financial difficulties in which a new concern finds itself involved can be traced to two different causes, the ignorance on the part of the promoters as regards the amount of capital required, or difficulty in raising the required amount. With regard to the first three important cases quoted above, viz., C. P. Portland Cement Company, the Tata Power Company and the Andhra Valley Power Supply Company, we cannot say that their financial predicament was due to any difficulty of raising more initial capital. If the directors of the first concern had issued shares of Rs. 120 lakhs instead of Rs. 60 lakhs, in the very beginning, they would not have found it difficult to market them. So also anyone who has studied the psychology of the Indian investors will admit that companies floated by the Tatas need not be afraid of lack of subscribers. It is a matter of common knowledge that shares of companies floated by firms of the standing and repute of that of the Tatas are almost invariably over-subscribed. Naturally the real cause of the financial difficulties of such concerns lies in miscalculation on the part of the promoters.³

¹ Cf. The evidence of Mr. B. Ramchandra Rao, and also of the Secretary, the Andhra Bank; The Central Banking Enquiry Committee Report, Vol. II.

² Cf. Evidence of the Bengal National Chambers of Commerce: The Central Banking Enquiry Report. Vol. II.

³ "If an enquiry is made into the causes that sent most of the Companies floated during the period referred to (i. e. the post-war boom period) to a premature grave, it will be found that in a majority of instances, before launching ambitious schemes, no preliminary investigations as to the capital requirements was ever made." *Company Failures and their Causes.* By N. J. Shah.

GENERAL ATTITUDE OF THE INVESTORS

The lack of confidence shown by the investors in the organizers of industrial enterprises also proves in some cases to be a great difficulty in the way of raising sufficient capital. If a scheme wants a good response from the investors, it must satisfy two conditions, (1) it must be intended to work in that line of industry which is already showing good returns, and (2) it must be launched or supported by reputed businessmen. It is a long standing complaint against Indian investors that they are not led by the intrinsic merits of a scheme but by the names of the promoters and directors. This was a common complaint made by the witnesses before the Indian Industrial Commission. And the complaint is true even to this day. The Bihar and Orissa Banking Enquiry Committee, for example, observe, "We do not subscribe to the view that a good proposition always commands capital. On the other hand we believe that it is the name rather than the proposition which attracts capital. The investing public entrust their savings to certain persons however unsound their propositions may be."¹ This is true not only about Bihar and Orissa but about the whole of India.

We cannot entirely blame the investors for the lack of confidence shown by them in new schemes. It is clear that the demand for capital to float new undertakings must rest entirely on the prospective earning power and cannot be supported by an offer of security. The prospective investor must be able to estimate the earning power of the new venture, and he must also be able to form opinion about the integrity of the management. This requires intimate and expert knowledge which we cannot expect our investors to possess. As a result of this the supply of capital is regulated, as an economist puts it, "not by the proper risks of the venture but by the distorted image of those risks resulting from imperfect knowledge of the capitalist."² The ignorant investing public in some cases magnify their estimation of risks and hold back capital from useful enterprises, or in some cases diminish the same and so waste their resources on unsound and even

¹ Report of the Bihar and Orissa Provincial Banking Enquiry Committee. Vol. I p. 103.

² The English Capital Market : By F. Lavington, p. 109.

fraudulent schemes. Thus the actual supply of capital bears no relation to the intrinsic merits of the proposed scheme. The financial difficulties of our industrial concerns, therefore, are not so much due to the commonly alleged shyness of Indian capital but to the lack of proper guidance to the investors.

DISPARITY BETWEEN AUTHORISED AND PAID-UP CAPITAL

There are certain other minor commissions and omissions on the part of the organizers, who thereby drag an industrial concern into financial difficulties in the early part of its existence. The vast difference between the authorised and paid-up capital, which is a common feature of our companies, for instance, does more harm than is apparent. The practice of keeping the authorised capital higher than the paid-up capital is followed in imitation of the English practice. In England only a part of the par value of the stock is usually called, the remaining uncalled portion being used as a sort of reserve. The underlying idea of the practice is that some margin should be left for increasing the business at short notice. The uncalled portion is, therefore, meant to be called up whenever further demands for capital arise. This reserve is created in two different ways: sometimes only a part of the whole capitalised amount is issued for subscription and the rest is held as reserve; sometimes the whole of the capitalised amount is issued but only a small percentage of the face value of each share is called up. Not quite infrequently both the methods are used. This practice, though it has proved beneficial in England, is followed here to a great disadvantage. It is often forgotten that the success of this arrangement depends upon the knowledge of the investing public of business methods and possibilities, and also on their possessing sufficient liquid resources. In India, unfortunately, both these conditions are lacking, and that is why the practice proves disadvantageous, and not beneficial. In a large number of cases of insufficient capital resources it will be found that the difficulty was mainly due to having issued too small a portion of authorised capital. Whenever a concern finds the original subscription insufficient and asks for more funds, the public think that something is wrong with the enterprise, and

simply refuse to subscribe to the later issue. This was what happened in the case of the C. P. Portland Cement Company. Under these circumstances it is advisable to issue as large a portion as possible in the beginning. In the first wave of enthusiasm it is possible that a much larger number of shares may be sold.

The creation of reserve is not the only motive that underlies the disparity between the authorised and the issued capital. By keeping the authorised capital at a high figure it is intended to create an impressive outlook on the minds of the ignorant investors. But even from this point of view, the trick has lost all its force being used too often. The investors have now come to realise that a high nominal capital signifies nothing. As a result of this, far from deceiving the investors, the organisers themselves are deceived. By a high figure of authorised capital an unconscious impression is created on the minds of the organisers, that if the raised funds prove insufficient they can raise more by issuing the unissued portion. But when the actual need arises, they, to their great dismay, find that the source is quite useless.

ISSUE OF ASSESSABLE STOCK

The stock sold by a company, is of two sorts, assessable or fully paid, according as the payment is partial or full. When assessable stock is issued the purchasers are required to pay only a part of the face value of the shares in the beginning with promises to pay the rest in such amounts and at such times as may be required by the directors. This device is sometimes used to guard against underestimates. In such cases if it does not become necessary to make further calls, the shares remain only partially paid. This device is sometimes used to guard against underestimates, the uncalled portion being looked upon as a sort of capital reserve. In some cases the amount called up, especially in the beginning, is to be paid in more than one instalment. This practice is found convenient when the construction stage is spread over a long period. For instance, it is declared in the prospectus that Rs. 50/- will be called up on the share of Rs. 100/- each, but the amount may be paid in instalments of Rs. 10/- at the interval of one or two months. Sometimes the amount of even fully paid shares is realized in this way. This

arrangement is made more or less for the convenience of the share purchasers. But a share to be paid for by fixed and prearranged instalments, is different from an assessable share in which case the time and amount of the payment to be made is not fixed but is uncertain and unforeseen.

As in the case of keeping a certain portion of the authorised capital unissued, so also in the case of issuing assessable stock, our company organisers follow the British practice with disadvantage. The underlying idea in following this practice seems to be to sell off in the beginning as large a number of shares as possible by calling up only a small sum. Sometimes the called up capital is ridiculously low as compared with the financial needs of the undertaking. The organisers perhaps believe, that once the shares are disposed of they can raise the necessary funds by making further calls; but an occasion for further calls usually proves an occasion of disillusion and disappointment. It is forgotten in the beginning that the regular realisation of the calls depends upon factors other than the needs of the concern. For instance, the investors must realise that it is very difficult to make a correct estimate of the costs in the beginning; then they must also realise that in some cases further additions to the capital resources are likely to result in increasing the net returns on the whole. The investors in our country being generally ignorant of business organization and prospects, expect dividends when they meet the calls made in the beginning. And, therefore, whenever further calls are made they, thinking their former payments to have been wasted, refuse to meet them lest the latter payments should meet the fate of the former ones.

The idea that money paid for shares in the beginning is sufficient to bring in dividends leads to another harmful result. The investors spend all their resources in purchasing shares by paying the amounts called up in the beginning. At this stage they do not realise that further demands may be made upon them. And when such demands are made, they find themselves unable to meet them. During the boom period of industrial activity, hundreds of people were ruined owing to their inability to pay up the call moneys.¹ If, therefore, sufficiently large amounts are called up

¹ Cf. The Official Representation of the Bombay Stock Exchange to the Bombay Stock Exchange Enquiry Committee. 1924.

in the very beginning, the concerns as well as the investors will be saved all the future troubles.

How a concern finds itself in financial difficulties owing to the irregularity and uncertainty of realising later calls can very well be seen from the case of the Tata Power Company. The arrears of unpaid calls, in the case of this Company, had once accumulated to a total of Rs. 1.37 crores out of a total subscribed capital of Rs. 4.35 crores. As a result, to complete its construction the Company had to take a debenture loan from the Tata Hydro-Electric Company.¹ Owing to the high credit of the managing agents of this particular concern it was possible for it to surmount the difficulty. But a similar situation in the case of a smaller concern would have proved fatal.

OTHER DISADVANTAGES OF ASSESSABLE STOCK

The practice of issuing assessable stock is fraught with certain other disadvantages, the consideration of which will not be out of place here. The unpaid portion of such stock, for instance, unnecessarily depresses its value. Besides, whenever a call is made the value of the stock becomes unduly lowered. There are two reasons for this. The very fact that a call is made makes the investors nervous about the value of the stock. So also, the investors, who have exhausted their resources, as already mentioned, in paying the first call, are required to unload a portion of their holding on the market. The combination of both these factors brings down the value of the shares. Such occasions provide good opportunities to the directors and managing agents to make profits. They, being the supreme managerial heads, can also manipulate the finances to their advantage. For example, they can make the financial position appear worse than what it is, at the time of making the calls, so that the value of the shares will be unduly lowered, and so also later on they can make the financial position appear better than what it actually is, so that the prices will again soar high. The management can also make money by making the calls when there is financial stringency in the money market. The market condition depresses the security prices in general which become still lowered in the cases of the

¹ Cf. Evidence of Mr. A. D. Shroff. The Central Banking Enquiry Committee Report. Vol. II.

shares on which calls are made, more so as the stringent financial conditions cause big lots of such shares to be thrown on the market. The management of the respective concerns who understand the whole situation better purchase the shares at those unduly low prices and reap good harvest when the market assumes normal tone.

The practice of issuing assessable stock with only a small portion called up in the beginning provides a good field for the activity of fraudulent company promoters. The common practice in such respects is that a large number of shares with a small denomination is issued and only a small part of each share is called up. Twenty thousand shares, for example, may be issued with a face value of Rs. 10/- each, and only one rupee on each share may be called up. Such an issue makes a good appeal to the investing public. In these days when a man's worth in terms of commercial paper and its ownership is important, it gives a sense of satisfaction to think that one holds so many shares, and consequently so much control and ownership in a company with so much capital. Besides, the investor hopes to make speculative profits in due course.

The credulous middle class public usually prove a victim to such fraudulent activities, and it is urgent that they should be given sufficient legal protection in such matters. In France, for instance, it is provided that the nominal value of shares shall not be less than 25 francs; and at least 25 francs must be paid on each share and wherever the nominal value of each share is more than 100 francs, at least, one-fourth of it must be paid. Similarly, in Germany the shares of joint-stock companies must be of a minimum nominal value of 1,000 marks, though this limit may be reduced to 200 marks in special cases. Besides, a company is not legally formed until the whole of its share capital has been subscribed and fully paid up. Similar protection is needed in India too.

THE MINIMUM SUBSCRIPTION CLAUSE

The Indian Company Law has made it compulsory for the company promoters to declare the minimum subscription of the capital on the basis of which they propose to proceed to allot the

shares. If the amount of the subscribed capital does not reach the minimum laid down by the articles the company must return the money received from the subscribers. The underlying motive of this provision is that the prospective shareholders should be able to decide for themselves whether the concern would be in a position to start work if the minimum is fulfilled, because they cannot get their money back when the minimum is fulfilled even if the concern finds it impossible to start work with the amount realized on the subscribed minimum. This provision presupposes a good business knowledge on the part of the investors, who must be in a position to estimate the capital required to start and work the enterprise in which they intend to invest. But our investors, as a rule, are ignorant of such problems, and therefore, this provision proves of little value.

The main defect of this minimum subscription clause is that the minimum is left totally to the will of the organisers, who, being aware of the fact that the investors are not in a position to pass any judgment upon its merits, bring it down to such low level that it hardly remains without being fulfilled. This provision thus only deceives the investors who believe that the fulfilment of the minimum means certainty of the concern being started. Really speaking the minimum is fixed with the intention of raising the expenses incurred and the remuneration of the promoters. If the minimum is fixed at a higher level it perhaps may not be fulfilled, and in that case the promoters will have themselves to bear all the expenses. Thus the promoters are interested in keeping the minimum subscription low. If the investors are to be benefited, this clause must be replaced by some provision on the lines of the English Company Law that the allotment should be undertaken only when the subscription warrants that the funds raised would be sufficient not only to meet the construction cost but also the working expenses.

UNDER-CAPITALIZATION: A COMMON FEATURE

There is one more factor to which the financial difficulties of our concerns are due in many cases. It seems to be a long standing belief of our industrialists that the less the share capital the greater the return on it, and this has resulted in practising under-

capitalization as a definite policy.¹ While capitalizing, therefore, the motive to increase the rate of return by limiting the share capital gets upperhand and the proper consideration viz., whether the raised funds are adequate or otherwise for a smooth and successful working of the contemplated scheme, becomes neglected!

A common argument put forward in favour of this policy is that it is more economic to finance by borrowing as the borrowed funds can be had at less cost than the share capital. It is argued for instance, that funds can be borrowed at 5 to 6 per cent. which is much less than what would have been taken away by the same amount if it had been raised by issuing shares.

This practice of financing even the fixed assets out of borrowed money originated in the peculiar business conditions of the last century. While discussing the managing agency system we have mentioned how the cotton mill companies were started by a few wealthy men more or less on the lines of family concerns, These businessmen being themselves wealthy could attract sufficient money at low rates from the public. Thus it was advantageous for them to raise as small a share capital as possible. Because the less the amount of share capital the greater was the percentage of return on it. Besides, as the total investment in each concern was not large, a greater number of concerns could be started with the same amount of capital, and in this way the percentage of return on the capital could be increased. There was one more advantage of this practice. The share capital being small, it could be supplied by a small group of subscribers and consequently the total profits could be retained, as if in a family. In case the concern had been capitalized for a larger amount it would have been necessary to seek outside subscribers and in that case the profits would have been divided with them.

This system, though it originated with cotton mill companies, was followed by all industrialists without paying any attention to the consequences. The success of the system depends upon the availability of a sufficient amount of money at a low rate of interest, and that is why it works better with regard to big companies

¹ See for example the evidence of the Industrial Surveyor, Delhi, and also that of the Bombay Chamber of Commerce. The Tariff Board Cotton Textile Enquiry Report 1927 Vol. 3.

than with regard to small ones. The big concerns owing to their high credit find it easy to borrow money and also get it at a comparatively low rate. But the small ones are required to offer high rates, and even then they find it difficult to satisfy their small needs, and this not infrequently results in causing their extinction. Even big concerns now find it more and more difficult to get money at a low rate and in sufficient quantities. As a matter of fact the business practice which was suited to the economic conditions existing three quarters of a century ago has now become antiquated and therefore useless. Money is not now so very easily available as it was then. The people, instead of depositing their savings with business firms or businessmen, have now begun to invest them in Government paper or deposit them with banks. The industrial concerns, therefore, are required to offer high rates to attract funds and consequently the shareholders, far from deriving any special advantage only stand to lose owing to this faulty financial practice.

THE AHMEDABAD PRACTICE

The under-capitalization policy is practised by different industries in different ways, and of course with different effects. It is carried almost to an extreme in the case of the Ahmedabad cotton mill companies which are started usually with only one-fourth of the block capital being raised by issuing shares. About one-third of the rest is secured by seven-year deposits and two-thirds by one-year deposits. Those who purchase a certain number of shares and also provide a certain amount as seven-year and one-year deposits are given a proportionate share in the agency commission. The Central Banking Enquiry Committee while discussing the system remark, "As far as the Ahmedabad industry is concerned, the system is reported to have succeeded beyond the ordinary expectations and it is even doubted if the industry would have progressed as well as it has done in recent years, had it not been for the system of giving out shares from the managing agency commission."¹ They seem to have looked only to the bright side of the system, and to have been much impressed by it. The Committee themselves admit that the success of the system

¹ The Central Banking Enquiry Committee Report Vol. 1 Part 1, p. 277.

is due to the practice of giving shares from the managing agency commission. This makes it clear that to get the money some extra allurements are necessary. What actually happens is that the agents finance almost all the long-term deposits and as a special consideration for this charge an exorbitant agency commission. The agents thus get for their funds much higher returns than the market rate; and that is why the industry has been able to get sufficient capital. The concerns on the other hand suffer as they are required to pay too much for the accommodation. The heavy charges in the form of agency commission become a permanent burden upon them so that even though fortunately a concern becomes able to maintain itself without the deposit money owing to reserves from the profits, it cannot get rid of the agency commission. The excess of profits over the interest charges to be paid for the deposits being in this way taken over by the agents, the shareholders do not realise any special benefit out of the under-capitalization policy. This system of industrial finance no doubt encourages a few big capitalists to invest their funds in industries; but, on the other hand, it certainly discourages millions of ordinary investors from investing in Industrial paper owing to the relatively small returns on such investments.

Besides, no student of industrial finance can call a system satisfactory in which about half the block capital is financed by one-year deposits. In the first place this creates a constant feeling of uncertainty. There is no knowing when these deposits may be demanded back. If, for instance, the depositors find that they can have better returns on their money, relatively to the risks undertaken, by investing it in some other way, the deposits are sure to be withdrawn. Under such circumstances in order to retain the deposits the concerns will have to raise the rate of interest. And this will have to be done whether the concern is in a position to pay the charges or not. Not only this but such deposits are sure to be withdrawn when a concern is in financial difficulties. Under such a plight there remains only one way open to avoid immediate winding up and that is to replace the short time loan by the highest type of mortgaged security.

UNDER-CAPITALIZATION IN TEA COMPANIES

The tea companies, especially in Bengal and Assam, too follow this practice of under-capitalization to their great disadvantage. One peculiar feature of the tea plantation industry is that the tea gardens require comparatively large amounts during the cultivating stage i.e. till the gardens come to a crop yielding condition, which takes nearly four to five years. After the gardens reach the crop yielding stage not much working capital is required. The share capital raised being quite insufficient to finance the preliminary expenditure, a novel method is devised by these companies to raise some additional capital. The shareholders are required to pay in addition to the share prices a certain amount as admission fee which ranges from 25 to 100 per cent. of the share prices, and it is utilized to meet the initial capital expenditure. But the share capital is so small that all the admission fee and the amount received on the capital account cannot save the concerns from going into the clutches of the creditors. In many cases after a period of two years or so outside finance is required. Such financial help is secured from the managing agency firms, loan-offices or money-lenders. When an agency firm comes forward to render the necessary financial help it becomes the managing agent of that company and charges from $2\frac{1}{2}$ to $7\frac{1}{2}$ per cent. commission on the gross sale proceeds of tea, over and above the usual rate of interest i.e. 8 to 9 per cent. When accommodation is secured from loan-offices the rate of interest usually varies from 12 to 15 per cent. But the resources of these loan-offices are slender and sufficient only for old established big plantations. New and financially weak gardens cannot get accommodation from them but are required to approach money-lenders or Marwaris who charge sometimes as high a rate as 24 per cent. on the funds advanced by them. Funds even from this source become sometimes unavailable. And the concerns which find themselves in such a plight have to go into liquidation "though there may be the prospects of yielding crops in a couple of years." The loans are usually taken for seven to ten years. After the gardens begin to yield crops the loans and admission fees are

returned and then regular dividends are paid. No interest of course is paid on the admission fee.¹

It is worth noting that the insufficiency of funds does not arise from any difficulty in raising share capital. On the other hand it is admitted by many a witness before the Bengal Provincial Banking Enquiry Committee that the share capital of a tea company could be subscribed two or three times over, and not infrequently the shares are sold at a premium. The financial difficulties of these concerns are, thus, due to the definite policy of under-capitalization followed by their organizers. It is interesting to note that the English tea companies never experience such financial difficulties nor do they follow any extraordinary financial scheme such as charging admission fees. They raise sufficient share capital from both ordinary and preference shares.²

THE COAL INDUSTRY

The coal industry suffers the most owing to this faulty financial policy of under-capitalization. Unlike other industries, the mining industry requires a continuous supply of new capital on block. The proper method of financing this industry, therefore, is to start with sufficient owned capital, and to make liberal provision for depreciation out of which the additions to the block should be met. But the financing methods followed by our coal companies are in no way different from those of the concerns engaged in other industries. They raise a comparatively small amount from share capital and then supplement this by funds borrowed at such high rates of interest which range from 12 to 18 per cent.³ Obviously when the concerns have to depend upon temporary funds and their earnings become burdened with such heavy interest charges, they find it almost impossible to make sufficient provision for depreciation, and therefore they are required to borrow again and again whenever capital expenditure becomes necessary.

¹ See the evidences of Mr. Jogesh Chandra Ghosh, Vice-Chairman, Indian Tea Planters Association, Jalpaiguri; Mr. A. F. Rahman, M. L. C. The Bengal Provincial Banking Enquiry Committee Report Vol. 3. Similarly the evidence of Bengal National Chambers of Commerce, Central Banking Enquiry Committee Report Vol. 2.

² Cf. The Bengal Provincial Banking Enquiry Committee Report Vol. 1, p. 119.

³ Cf. The evidence of the Bengal National Chamber of Commerce: The Central Banking Enquiry Committee Report Vol. 2, p. 505.

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Thus the short-sighted policy of under-capitalization, far from yielding high returns to the shareholders, jeopardizes the very existence of the concerns. Owing to the financial peculiarities of this industry, perhaps, we find that many coal concerns in Bengal, Bihar and Orissa are conducted on proprietary or partnership lines, as under this type of organization it is easy to arrange for additional capital for further developments.

USE OF REDEEMABLE PREFERENCE SHARES

The policy of under-capitalization is in no way peculiar to the cases discussed above, but has a universal following in this country. We have incidentally mentioned in earlier pages how concerns engaged in other industries too suffer from insufficiency of funds raised on capital account. The insufficiency of capital fund no doubt is in some respects due to miscalculation, the effects of which are definitely aggravated by the general policy of under-capitalization which is also responsible in making the calculations invariably err on the side of inadequacy. The underlying motive in under-capitalization, as we have already stated, is to lessen the amount of share capital and thus to increase the percentage of profits on it. The managing agency system has specially fostered this attitude. The agents in order to justify their own gains wish to declare as high dividends as possible. This they hope they can do by limiting the amount of share capital. Besides, as we have shown in one of the earlier chapters the supply of short-time capital to the concerns under their control proves a source of additional income to them, and also keeps the concerns dependent upon them. The agency system thus has preserved and universalized this antiquated and faulty financial policy.

In the interest of the industrial development of the country it is essential that such a faulty practice should be ended as early as possible. If a higher percentage of return on the shares may be the only aim in keeping the share issue low, then it can be achieved in another way without jeopardizing the interests of the concern. While discussing the different types of industrial securities we have mentioned a recent variety called redeemable preference shares.¹ When the share capital becomes exhausted and

¹ See the chapter on Forms of Capital Issue.

need is felt for additional funds for construction or working purposes it can be met by issuing preference shares redeemable at a later convenient date. The rate of return to be offered on such securities will not exceed the rate of interest demanded by the short-time creditors. Besides, this will remove the uncertainty with which short-time borrowing is attended. Slowly as the finances improve the preference shares should be redeemed so that their participation in the profits would cease as soon as the needs are over. This redeemable feature will prove of special benefit in the case of tea industry. We have seen how tea gardens require extra finance during the first four or five years. The best way of meeting such needs is by issuing redeemable preference shares, which should later on be redeemed as the finances permit, and the ordinary shareholders be relieved of the burden. But there are very few chances of this practice being followed so long as the managing agents are interested in keeping the concerns under-capitalized.

EFFECTS OF UNDER-CAPITALIZATION

So far we saw, that for one reason or another, inadequacy of owned capital and too much dependence upon borrowed funds is a common feature of the finances of our industrial concerns. The financial difficulties which arise from such a situation have a very bad effect upon the minds and policy of those who run the business. Excessive reliance on short-term creditors, which gives rise to suspense even about the existence of the concern and also creates permanent burdens of heavy fixed charges, makes the management diffident. They have no freedom in making new departures, in taking risks or in undertaking business that may require further working capital. In fact they lose all the confident self-reliance that a sound financial position brings. Such a concern owing to heavy fixed charges cannot face an immediate loss in the expectation of a greater ultimate gain. In times of depression also a concern which is not burdened with fixed charges can mitigate to some extent the effects of temporary falling off in demand by such expedients as overhauling its plant or increasing the stock. In short, the power of resistance and recuperation are both diminished in the case of an under-capitalized concern owing

to the heavy fixed charges which must be met irrespective of the general condition of the industry.

HOW OVER-CAPITALIZATION TAKES PLACE

In the earlier part of this chapter we have discussed the possibilities of stock watering as they exist in this country. Of course, it is rather difficult to say in the beginning whether stock has been watered or not, unless it is watered lavishly. Besides, if the extent of water is only limited as compared with the total capitalization amount it cannot do much harm. But when this safety limit is transgressed, stock watering is sure to have far reaching effects. In such cases the capital resources left with the concern prove insufficient for the purpose and consequently resort has to be taken to borrowing funds from outside sources. Such concerns shortly are found to be over-capitalized in the sense that the value of the securities as shown in the books prove to be in excess of the value of the assets, which is determined by their income yielding capacity. Over-capitalization in the sense of having the book value of the securities higher than their market value is not an uncommon feature of our industrial finance. There are various reasons for this. The very practice of under-capitalization which we have discussed in the previous pages results in making a concern over-capitalized. This seems rather curious but it is true. When a concern is under-capitalized it has to depend upon outside resources, which usually are secured at a high price, and owing to the high interest to be paid on the borrowed funds, the shareholders cannot get adequate returns on their capital. Besides, such concerns cannot make any provision against the loss of the value of the assets resulting from depreciation, obsolescence, or any other contingency. The efficiency of the assets and along with it the profit yielding capacity thus go on slowly decreasing, and in the end the shareholders realize that the shares are not worth what they had paid for them. Such a concern is called over-capitalized as it cannot pay normal returns on the capital invested in it.

We have already seen how the legal provisions against the over-valuation of the assets passed over to a joint-stock company are not very strict in this country, and therefore there always

exist possibilities of over-capitalization when a private concern is turned into a joint-stock company. The previous owners naturally try to capitalize the company at as high a figure as possible. The usual practice in such cases is to start a concern on a small scale and to show it to be profitable. When it is found by the proprietor, or proprietors, that the concern has made a good impression about its profitableness upon the minds of the investing public, it is turned into a joint-stock company. While doing this the concern is capitalized for a larger amount than its real worth. The investors in such companies do not realize that a concern which is profitable when a certain amount is invested in it cannot remain so when it is bought for a larger amount. They think that as a concern was profitable when run as a private enterprise, it will also be profitable when turned into a joint-stock company. It is altogether overlooked that profitableness is only a relative matter and must be considered in relation to the amount of capital invested. The result of the whole situation is that the total capitalization amount being much larger than the capitalized value of the income-yielding capacity the shareholders to their dismay find that they cannot get the expected income nor can they even hope to get it in future as it is beyond the capacity of the enterprise to yield.

Similarly, companies promoted during a boom period usually suffer from over-capitalization. There are several reasons for this. In the first place, as prices are high the assets are valued at a high price and consequently the capitalization is also high. When the boom is over and prices assume their normal level the total value of the assets falls down but the capitalization remains at the former figure. Secondly, as the boom period prices of manufactured goods rise the profits of industrial concerns also rise, and this means a proportionate increase in the value of the concerns. And if a private concern is capitalized at such an inflated value it proves to be over-capitalized when the prices of the produce and along with them the profits come down. The boom period high prices bring about over-capitalization in the case of some of the old companies too. The management of some concerns revalue their assets according to the then ruling high prices and high profits; the appreciation in the value of the assets is credited as special reserve, subsequently making this reserve a basis of

an issue of bonus shares. When prices fall the profits also fall but the capital amount does not likewise diminish and the concerns consequently become over-capitalized.

Our cotton industry can supply some interesting examples of over-capitalization taken place in more than one of these ways. For example, the total number of cotton mills under joint-stock organization in Bombay City was sixty-six in 1917; and the paid-up capital of all these mills amounted to Rs. 7 crores. In 1920 the number of mills under joint-stock organisation rose to seventy-seven and the total paid-up capital of these mills amounted to Rs. 17 crores.¹ All the additional mills were old ones and their transformation from private ownership to joint-stock ownership was mainly responsible for the increase in the total paid-up capital.² The cost of starting a new mill, fully equipped and of economic size, in those days of high prices did not exceed Rs. 55 lakhs. Thus we can see at what exorbitant figure the concerns must have been capitalized even for the high prices ruling at that time. How actually this was taking place can be seen from the following instances. Some five mills were owned by Messrs. E. D. Sassoon and Co. The value of these mills was computed to be Rs. 2.75 crores according to the boom period high prices.³ Later on a joint-stock company was started to purchase and work these mills with Rs. 6 crores as paid-up capital. Not long afterwards the value of these mills assumed its true level and the capitalization had to be reduced to the great loss of the investors. How even able businessmen had lost their balance in those days can be seen from the following instance. The Tata Sons, Ltd., one of the most important business firms in India, bought the Bombay United Mills, which was started in 1860, at an inflated price of Rs. 150 lakhs. The shareholders of the former company got ten times of the original face value of the shares. This purchase was made in 1920, and in 1925 the Tata Sons sold away this mill for Rs. 36 lakhs, thus sustaining a net loss of 114 lakhs. Such frenzied valuation was not peculiar to Bombay City but was found even outside it.

¹ Cf. Tariff Board Cotton Textile Enquiry Report 1927 Vol. 2. p. 148 (Annexure A.).

² Cf. Evidence of Bombay Millowners' Association Tariff Board Cotton Textile Enquiry Report 1927 Vol. 2.

³ Cf. An article by Mr. J. A. Wadia, The Times of India Oct. 2nd 1923.

The Tariff Board, for instance, in their first cotton textile enquiry report have quoted the following up-country case. A cotton mill company was started in 1921 with an authorized capital of Rs. 50 lakhs of which 40 lakhs were issued and subscribed. "The mill commenced operations in January 1923 with machinery 95 per cent. of which was second-hand and mostly from 30 to 60 years old. The mill was closed in July 1925 and was sold for nine lakhs in August of that year."¹

Over-valuation of the assets was not peculiar to the boom period though then it was found to exist on an extensive scale. We have already shown that our Company Law does not provide any strict measures regarding the valuation of the assets and therefore the possibility of the same being over-valued always exists. When the assets are valued more than their income-yielding capacity warrants the concern naturally becomes over-capitalized.

There is one more point which deserves mention in this respect. It is rather a common feature of our industrial concerns that too much money is spent in the beginning on elaborate establishments and on too expensive a plant and equipment. The buildings, plant and general equipment are planned on such a wide scale that the funds raised on capital account are exhausted even before the concern is brought to working condition. Consequently it so happens that either because funds are not available or because the interest charges prove to be prohibitive, the production can never be commensurate with the capital expenditure. Even the limited production being burdened with interest charges the returns to shareholders become dwindled and the value of the shares fall, and the concern becomes over-capitalized to the extent to which the par value of its shares exceeds the actual value. There seem to be two motives, which actuate our industrialists to follow this faulty practice. Perhaps they think that an imposing appearance creates confidence in the minds of the creditors and so it becomes easy to borrow money when necessity arises, and such necessity is visualised by them definitely, and perhaps even immediately. Secondly, it seems that they wish to take immediate advantage of any opportunity to make profits

¹ Cf. Tariff Board Cotton Textile Enquiry Report 1927 Vol. I. p. 17.

by increasing the output. As regards the first motive, it is true that in some cases the imposing show has the desired effect. But as regards the second motive, experience has proved that the extra plant equipment far from proving of any benefit only becomes a permanent burden. There are reasons for this. The efficiency of the plant whether working or not becomes less and less owing to depreciation and obsolescence. Besides, the weakened financial position owing to the heavy financial burdens on account of the relatively large amount of interest charges and dividends to be paid, makes it difficult to take advantage of the opportunities for business expansion. Of course, it is wise to have some margin for expansion when necessary, but this margin should be created and maintained in such a way that it will not prove a burden upon the finances of the concern. The whole initial plan should be so conceived that it will permit of easy readjustment, as much in the direction of contraction as in that of expansion. The financial difficulties of a large number of our concerns are due to having neglected such conservative financial policy. Our businessmen seem to have been very much led away by the idea of having an imposing outward show by an elaborate establishment, an extensive plant and equipment and impressive buildings. Such a short sighted policy has paralysing effects upon the progress of the concern. The directors of such concerns are required to spend all the profits in distributing dividends, which prove to be too heavy for their limited production. Consequently no reserves can be built up, and therefore, it becomes difficult or even impossible to undertake any renewals or replacements of depreciated or obsolescent parts. The results of financial stringency arising from too heavy dividend burden due to any of the situations discussed above are similar to those mentioned earlier in connection with under-capitalization.

MARKETING THE SECURITIES

After the capital requirements are estimated and the financial plan is outlined, the next stage in the life of an industrial concern is to raise the capital by selling the securities. Whenever a concern is started by a well-known agency firm, a large portion of the shares is usually taken up by the members of the firm, the

directors, and the friends of both these groups. The remaining portion is offered to the public and is purchased by outside investors. At this stage the purchasers are actuated more by the desire of speculation than that of investment. The real bonafide investors come in after the shares are quoted on the stock exchanges. They think that the price which is arrived at on the exchanges is the real value of the shares as it is the result of the opinion of leading businessmen.

If we leave out the schemes supported by big financiers, the rest have got to depend upon public subscription from the very beginning. Out of these some that can show connections of reputed businessmen and are launched under favourable market conditions, can hope to succeed, the rest are foredoomed to fail despite their intrinsic merits. Curiously enough it thus becomes easier to raise capital for a big scheme than for a small one as the latter cannot claim the support of influential names. The shares of small companies either in the big industrial centres or in the mofussil are purchased by middle class persons and persons in the professions. In many cases the shares are purchased out of personal regard towards the organisers, or out of patriotic instincts in order to encourage swadeshi industries. It is obvious that when investment is made somewhat on the lines of charity, the supply of capital to industry becomes very limited. Besides, these shareholders become careless about the future of the concern. Such attitude on the part of the investors, which apparently looks quite praiseworthy being on the whole generous, is harmful from business point of view. The indifference of the shareholders, for instance, sometimes makes many a concern languish for want of proper financial support which would have been available if they were more enthusiastic about the whole affair.¹ Such a situation also gives full scope to the swindling activities of the less scrupulous management with the result that not only these concerns become ruined, but their ruin shakes the confidence of the public in industrial investments in general, and makes it difficult to start new enterprises.

For the efficient working of an industrial concern it is essential that the investors should be interested in its financial future; and

¹ See for instance the C. P. Banking Enquiry Committee Report Vol. I.

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this is possible only if they invest in it with the intention of creating a permanent source of income. But this they will do only if they are convinced of the soundness and profitableness of the industrial schemes placed before them, and how to convince them of this is the greatest difficulty that has to be faced while marketing the shares. The general public cannot for themselves scrutinise the claims of any industrial scheme, nor have they confidence in the words of the organisers of such schemes, with the result that it becomes very difficult to make them purchase the securities. And when it is found that the profit earning desire cannot be moved, attempts are made to appeal to sentiments like patriotism, friendship and so on.

CHAPTER VI

FINANCING OF WORKING CAPITAL

METHODS OF FINANCING WORKING CAPITAL

Besides the finance required to secure the fixed assets, every industrial enterprise needs an additional amount of capital to meet its current expenses such as the purchase of raw materials and stores, the payment of wages, salaries, rents and commission, expenditure for marketing the manufactured goods, and other incidental charges like the taxes, insurance etc. All the outlays that are necessary to meet such recurring expenses are called the working or circulating capital.

There are three different methods of raising the working capital:

- (1) by issuing long-time securities,
- (2) by reinvesting the earnings, and
- (3) by short-time borrowings.

The industrial concerns in the West especially in Great Britain and the U. S. A. finance their working capital by resorting to the first two methods.¹ The third method is resorted to only in cases of emergencies.

Many writers on business finance hold the opinion that the best methods of financing the working capital are by reinvesting the earnings or by issue of securities i.e. shares or debentures. Obviously, a new industrial enterprise cannot re-invest its earnings though an established one can do so and thus not only meet its current expenses but even other capital requirements such as replacement of plant, machinery etc. In India, however, no attempts are being made to save the earnings for such purposes.² As a rule, Indian concerns do not even try to raise their working

¹ "In so far as we can derive a rule of practice or a tendency of policy from the practice of these large companies, it is that sufficient working capital should be provided out of earnings or from the sale of securities, and that Bank borrowing should be resorted to only in emergencies."

Corporation Finance. By E. S. Mead p. 212.

² See the chapter on Administration of Earnings.

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capital by issuing long-time securities. To secure the working capital by short-term borrowing is the universal practice with regard to Indian concerns.

SHORT-TERM BORROWING

The short-term borrowing by Indian industries is made from four main sources: (1) the public, in the form of acceptance of deposits, (2) the managing agents, (3) the indigenous bankers, money-lenders, individual financiers, etc., and (4) the banks.

BORROWING FROM THE PUBLIC

Borrowing from the public in the form of deposits taken directly, forms an important feature of Indian industrial finance. Not only do the industries raise their working capital in this way but some of them even raise their fixed capital similarly. The present position of the cotton textile industry of Bombay and Ahmedabad is in no small measure due to the existence of this deposit system of finance, which, though declining in recent years at the former centre, is still flourishing at the latter. As regards the origin of the system, Mr. Manu Subedar says:—"In its origin, the systems of deposits with industrial concerns was undoubtedly a reflex and a transformation of the old system of money kept for safe custody with the Mahajan. Its survival even in these days, would lead one to believe, that the system must have worked fairly satisfactorily for both sides for long past."¹

The following table will show the importance of public deposits as a source of finance with regard to the cotton textile industry of Bombay and Ahmedabad, and especially as compared with other sources:²

¹ Indian Central Banking Report, Vol. I. Part II. Minority Report, p. 329.

² See Indian Central Banking Report, Vol. I. Part I. Majority Report, p. 278.

of the Government of India. As a result of this therefore, higher rates of interest have got to be offered to induce the public to keep deposits. The position in Ahmedabad, however, is not the same as in Bombay. We have already said that there the deposit system is still flourishing, because the public in Ahmedabad prefer to invest their savings in the mills and not in banks or even in Government securities.

It may be pointed out that, besides the cotton textile industry, other large industries as well depend upon public deposits for their working capital. For example, the Tata Iron and Steel Company, one of our most important national concerns, supplements its working capital by a fairly large amount of unsecured loans or one-year deposits. The three hydro-electric companies, under the management of Tata Hydro-Electric Agencies, raise part of their working capital in the same manner. And, the tea industry of Bengal and Assam not only raises the working capital by public deposits, but also a part of their fixed capital. It may be interesting to note that while the system of public deposits is so popular with industries under Indian management, it is not as popular with the concerns under European management. This is due to the fact that European companies are floated with a large share capital from which both the fixed and working outlays are met; besides they are in a favourable position as regards obtaining bank loans and advances on cheap and easy terms.

TERMS UNDER WHICH DEPOSITS ARE OBTAINED

It may be interesting to note the terms under which the industries obtain deposits from the public. In the first place, it may be stated that these deposits are always obtained as unsecured loans. No security is offered and the public have only to rely on the standing of the concerns and the reputation and financial position of their managing agents as a security for the re-payment of their deposits.

Secondly, as regards the period, the deposits are accepted for six months or one year and are generally renewed thereafter. In Ahmedabad deposits are taken even for seven years, but it must be mentioned that the finance thus raised is utilised to meet a part of the fixed capital expenditure of the mills as well.

And thirdly, the rate of interest paid on these deposits depends upon the credit and standing of the industry concerned as well as upon the reputation and financial position of the managing agents. Sound concerns under managing agents of repute are not only able to attract deposits at low rates of interest but also in large volumes. In Bombay the rate of interest allowed by the mills on deposits varies from $4\frac{1}{2}$ to $6\frac{1}{2}$ per cent.,¹ while in Ahmedabad the rate varies between 5 and 6 per cent.²

The deposit system of finance, in spite of its importance and advantages has its defects. In the first place, as a source of finance the deposit system is very inelastic. The inelasticity arises out of the fact that an industry which relies mainly on public deposits is not able to adjust the funds so raised in accordance with its need for working capital, as it can do in the case of bank loans. For example, if a concern at a particular time needs more working capital, it will not be able to obtain it from the public if the latter are reluctant to give deposits. On the other hand, a concern which does not require a great amount of working capital at a particular time will not be able to return the deposits which it may have on hand, for the simple reason that it may not be able to obtain the same when there is a need for extra funds. The same concern if it had relied on bank loans would have been able to increase or reduce the credit allowed to it in accordance with its need. Besides being unable to return the surplus deposits which have to be held with payment of interest on the same, an industrial concern is further placed in the unenviable position of being unable to refuse fresh deposits that may be offered by the public for fear of displeasing them.

A second defect of the deposit system is its uncertainty. The money deposited may be withdrawn at any inconvenient time to the industry; and that is why this system of finance has been compared with a fair weather friend. When conditions are prosperous and industries make profit the public are quite willing to give deposits. But when a period of depression sets in, the public, far from supplying extra funds which are needed by industries to tide over their difficulties, begin withdrawing the

¹ Evidence of Bombay Millowners' Association, Central Banking Committee, Vol. II. p. 594.

² Evidence of Ahmedabad Millowners' Association, Ibid, p. 585.

deposits, and make matters worse. The depositors are easily led away by rumours and withdraw their deposits on the slightest suspicion, not only from unsound but also from sound concerns. Even when a concern is faced by a temporary financial difficulty the deposits are demanded back. In Bombay, for example, during the post-war boom period when the mills were making large profits the public were eager to give deposits, but when the depression set in, far from supplying extra funds to enable the mills to tide over the difficult times, they made matters worse by withdrawing their deposits from all concerns, irrespective of their soundness. On account of such uncertainty of this source of finance, no industrial enterprise can expect to run smoothly for a long time, without being subject now and then to financial difficulties by sudden withdrawals of deposits on the part of the public.

A third defect of the deposit system is its high cost. It has been mentioned earlier that industries are able to obtain deposits at favourable rates of interest. But this is true only of the larger and well-established industrial concerns, which are under the management of well-known firms of managing agents. The majority of the other concerns have to pay high rates of interest on their deposits, in many cases higher than that charged for bank loans. Besides the fact that the rate of interest varies with different concerns, the worse is, that it varies with the same concern at different times. A concern, even if faced by a temporary financial difficulty, will find that it will be forced to increase the rate of interest not only to retain the deposits kept with it, but also to attract fresh ones from the public. The cost of the deposit system is not only increased by the high rates of interest that have to be paid, but also by the payment of interest that some concerns have to make on the surplus amount of deposits which they have to carry for reasons already given.

From the point of view of the depositors also, the deposit system has its defects. Most of the depositors are ignorant, and hence are unable to gauge the soundness of a concern and know its real financial position. The result is that deposits are often kept with unsound concerns and when these fail the depositors lose their money. The position of the depositors also becomes worse in those cases where the concerns with which the deposits

are kept borrow from other sources, e.g., banks. The banks are careful to demand and take charge of the stocks and other liquid assets of the concerns as security for their advances and loans, and the depositors are thus left without any security for their money. Again, being in the position of unsecured creditors, the depositors cannot prevent the directors of the concerns from otherwise mortgaging, even all the assets of the concerns, for loans obtained from other sources.

Another defect which affects the depositors' position arises out of the fact that some industrial concerns use the deposits to finance their fixed capital expenditure as well. The depositors on account of their position as unsecured creditors are also unable to prevent the concerns from over-trading or otherwise indulging in speculation. There have been cases in Bombay where in the past, mills with the deposits which were sometimes obtained at low rates of interest have speculated in cotton, and have carried larger stocks of manufactured goods than the conditions of the market allowed.¹

It will thus be seen that on account of the defects we have pointed out above, the deposit system of financing working capital cannot but be found disadvantageous by both the industrial concerns and the public.

PRESENT NECESSITY OF THE DEPOSIT SYSTEM

In view of its defects should the deposit system of finance be continued? Is there any alternative source to replace this system of finance?

First, as regards the alternative source of finance, it is often pointed out that since the deposit system is defective, less reliance should be placed upon it, and industrial concerns should henceforth draw their working capital more from banks which are ideally suited to supply short-term finance. But as we shall show presently, banks in India do not interest themselves in the financing of industries, and even whatever little financial assistance they are able to render to industries, in the form of loans, advances and cash credits, is hedged in by restrictions and conditions. The result is that industrial concerns do not rely on banks

¹ See evidence of Mr. A. D. Shroff, Central Banking Committee. Vol. II. pp. 387-88.

for financial assistance. This will become evident from the table which we have given regarding the financing of the Bombay and Ahmedabad cotton textile industry. While 9 per cent. of the total finance required by the mills is secured from banks in Bombay, only 4 per cent. is secured from the same source in Ahmedabad. It may also be noted that even this limited financial assistance rendered by banks to industry in former years has been curtailed in recent years as a result of the depression.

Thus it can be seen that on account of the policy of non-interference in industry by the banks, much reliance at present cannot be placed upon them as a source of finance. Until therefore, the banks realise their responsibilities towards industry and take a greater part in its financing, it seems desirable that the deposit system should be kept up even though it has been characterised as a primitive method of finance. Besides, it will be found that on account of the drying up of this source in recent years due to the economic depression and the counter-attraction of Government loans and Treasury Bills, the rate of interest paid on deposits at present will have to be increased.

BORROWING FROM MANAGING AGENTS

We have already pointed out that the chief source of the power and position of managing agents is the fact that they are able to provide finance to industries from their own private resources or on their own credit. And there can be no doubt that the managing agents do take a large share in the financing of the working capital of a large number of industries. The Bombay and Ahmedabad Cotton mills still depend, to a great extent, on the managing agents for their current finance, as the table which we have given will show. Indeed, in Bombay the amount of finance obtained from managing agents is greater than that obtained from the public. In any case it must be admitted that at both the centres the amount of finance supplied by the managing agents is much larger than that supplied by the banks. Besides the cotton textile industry in the Bombay Presidency, other large industries also depend upon the managing agents for their working capital.¹ In other parts of India as well, large industries like the iron and

¹ See Bombay Banking Committee Report, Vol. I. p. 36.

steel, jute, coal, tea, and hydro-electric, derive much assistance from the managing agents in respect of their current finance.

As regards the rate of interest charged by the managing agents in Bombay, in cases where large loans are advanced to the cotton mills, the rate of interest does not exceed the bank rate.¹ Besides, while loans from the banks have to be guaranteed by third parties, there is no such provision in the case of loans advanced by the managing agents.²

DISADVANTAGES OF BORROWING FROM MANAGING AGENTS

The system of borrowing from managing agents, has also its disadvantages. In the first place, this system is also open to the objection of being a very uncertain source of finance. This arises out of the fact that as the resources of the managing agents are limited, industrial concerns may not be able to obtain from them finance at the requisite time. Some of the industries which rely only on managing agents suffer from many difficulties as a result of being unable to obtain the necessary finance at the proper time to meet the working expenses. In times of prosperity when the industries are making profits and the managing agents' financial position is better, it is possible to obtain from them adequate amounts of finance. But in times of depression the industries have to suffer, because at such times the managing agents are not in a position to advance the necessary amounts. And to make matters worse, the weakened financial position of the managing agents reacts on the concerns, in as much as the latter, however sound they may be, are then unable to obtain funds either from the public or the banks.

A second disadvantage results as follows. The managing agents find that a lucrative form of investment for their funds is to lend the same to industrial concerns under their control. They are therefore tempted to lend to such concerns larger amounts than necessary. The result is that being saddled with surplus funds,

¹ Cf. Answers of Mr. (now Sir) H. P. Medy, President of the Bombay Mill-owners' Association before the Tariff Board, Cotton Textile Industry Enquiry. 1932, Vol. IV. p. 35.

² Cf. Answers of Sir Manmohandas Ramji, *Ibid*, p. 36.

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the concerns will not be able to lessen their volume of business even if trade depression demands it.

A further disadvantage of the system of borrowing from the managing agents is its costliness. With a few exceptions, the agents charge a high rate of interest for the loans advanced by them. It may also be noted that when the managing agents are unable to supply finance, on account of their own resources being exhausted, they borrow from outside sources either from the public or the banks, and then lend the borrowed funds to their concerns at a higher rate of interest than they themselves have to pay. The "commission" that they get as a result of this bargain is justified by them on the ground that it is remuneration for the service that they render. But we must point out that this fact detracts much from their claim as the suppliers of finance to industry. If the managing agents provide finance from borrowed money, then the concerns could as well obtain funds in the same manner, without, at the same time, having to pay higher interest charges.

And lastly, even though the managing agents take no guarantee for the money lent by them, they are otherwise very careful to safeguard their interests in the following manner. As soon as they find that their loans to industrial concerns are in danger they at once convert these loans into debentures. This procedure puts them into the position of secured creditors enabling them to take charge over the assets of the concerns to which the money is lent, in the event of the non-repayment of the loans. In Bombay, for example, in the words of the Central Banking Committee, "there have been a few cases in which these Agents have turned their loans to the mills into debentures, with the result that the concerns have passed into their hands and the shareholders have lost their capital invested in the undertaking."¹ In one case, a certain managing agency firm converted the rupee loans to its mills into gold dollar liability, which step involved the concern into an extra liability of Rs. 85 lakhs on the basis of the rate of exchange prevailing at the close of the year concerned.²

¹ Central Banking Committee Majority Report, Vol. I, Part I, p. 279.

² See Representation of the Bombay Shareholders' Association to the Tariff Board, Cotton Textile Industry Enquiry. 1932, Vol. II, p. 188.

ALTERNATIVE METHODS OF FINANCE

In view of the disadvantages of the method of borrowing working capital from the managing agents, the question arises as to whether this system can be replaced by other and better methods of finance. The alternative methods suggested are: either the working capital should be raised (1) by loans from banks, or (2) by issue of securities. As regards loans from banks, we had something to say about this already, and we may emphasize once more that until the banks give up their conservative attitude towards industry, much reliance cannot be placed upon them as a source of finance. The second alternative suggested above deserves more attention.

The advocates of this method suggest that in view of the difficulties met with by our industries in raising the working capital, henceforth it should be provided by law, that every new industrial concern before starting must provide itself not only with the fixed capital, but also with the working capital by the issue of shares.¹ Further, any new capital demands of the concern in the course of its working should also be met by issuing additional securities, either debentures or shares. It may be noted that the Foreign Banking Experts, associated with the Indian Central Banking Committee, made a similar suggestion. They expressed the opinion that it is not sufficient in itself that an industrial concern should put up its block from its own capital, and then appeal to banks for loans. Not only block but the normal working capital should also be provided out of the concern's own capital.²

BORROWING FROM INDIGENOUS BANKERS,
MONEY-LENDERS, AND INDIVIDUAL FINANCIERS

While the large and well-established industrial concerns under managing agents of repute, raise their working capital from public deposits or managing agents, the majority of the other concerns raise their current finance by borrowing from indigenous bankers, money-lenders and individual financiers. Sometimes

¹ Such a provision has been incorporated in the new English Companies Acts of 1929. See Section 35, Schedule IV. Part I of the Act.

² Report of the Foreign Banking Experts, Indian Central Banking Committee. Vol. I, Part I, p. 610.

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even the well-established concerns have been found borrowing from individual financiers including Indian Princes. Besides, some of the Indian Princes, by taking up debentures, have helped some of the most important of our industries to obtain their current finance. As an example, mention might be made of the Tata Iron and Steel Co. which in order to meet its working capital, was forced to issue debentures, a large block of which was taken up by the Maharaja of Gwalior. The hydro-electric industry and the cotton mills of Bombay have also from time to time received substantial financial help from the Indian Princes. Unlike Bombay, in Ahmedabad the cotton mills have obtained a substantial assistance from the shroffs.

The industries which resort to indigenous bankers and money-lenders are those which are unable to obtain finance from other sources. For the finance which they are thus able to obtain they have to pay high rates of interest, the rates being very high in the case of money-lenders. For example, the tea industry of Bengal and Assam, borrow loans from the money-lenders at interest ranging between 12 and 20 per cent.¹ Other industries as well in these two Provinces are similarly obliged to pay interest ranging between 15 and 36 per cent.² Such high interest rates are not peculiar to Bengal and Assam only, they obtain in the other Provinces as well.

BORROWING FROM BANKS

In the West, banks form the most important source from which the working capital of industries is drawn, but conditions are different in India. Our banks, commercial banks as they are, confine themselves mainly to the financing of trade, and offer limited financial facilities to industries. This latter fact was the cause of general complaint by Indian businessmen, industrialists and Chambers of Commerce before various Commissions, Committees and Tariff Board Enquiries. That the banks play an unimportant part in financing of Indian industries will be evident from the table given at the beginning, which shows that in Bombay only

¹ See evidence of Bengal National Chamber of Commerce, Indian Central Banking Committee, Vol. II, p. 483.

² See Bengal Banking Committee Report, Vol. I, p. 122.

9 per cent. of the total finance is supplied by the banks while in Ahmedabad the percentage comes to only 4.

METHODS OF BANK ADVANCES

That the existing commercial banks supply industries to some extent with working capital is true. Indeed, before the Banking Enquiry Committee, the Imperial Bank produced a long list of industries to which it was giving finance. Let us now note the methods under which the finance is provided.

The advances given by our banks fall under three classes:—

- (1) Advances against tangible and marketable security lodged or pledged with the lender;
- (2) Advances against personal credit with a second signature to the pro-note; and
- (3) Advances against the personal credit of the borrower only.

It may be noted that while in the West advances of class (3) occupy an important place, in India advances are mostly of classes (1) and (2).¹

Advances under the first class are made on such security as stocks or merchandise either manufactured or in process. When advances are made on the security of manufactured goods, the banks maintain a margin of something like 25 to 30 per cent. The margin maintained in the case of semi-manufactured goods is much higher. The secured goods, either manufactured or semi-manufactured, are then deposited in the godowns or warehouses of the banks, if they possess the same, or in the godowns of the borrowers under letters of hypothecation to the lending bank.

Advances under the second class are made against the personal credit of the borrower with a second signature to the pro-note. This second signature in the case of industrial concerns happens to be that of the managing agents, and serves as a guarantee for the repayment of the loan.

Unsecured and unguaranteed advances are not favoured by the Indian banks. It may be noted here that even when the banks make advances under the first class, i.e., against the security of

¹ See Indian Central Banking Committee Report, Vol. I, Part I. p. 381.

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stocks, it is not unusual for them to demand in addition the guarantee of the managing agents.

The cash credit system is, however, the most popular method under which the banks make advances to industrial customers. Under this system an advance is allowed against the promissory note of the borrower, secured by the hypothecation of stocks. It is claimed for the system that it is advantageous both to the banker and the borrower. The latter is benefited inasmuch as he pays interest only on the amount actually drawn by him, and not on the total amount of drawing power allowed to him. Besides, he can reduce his obligation to the bank at any time, though in some cases he has to pay interest on a minimum amount, which generally happens to be one half the amount of the drawing power allowed to him. The banker too stands to gain inasmuch as he can curtail or withdraw the facilities allowed to the borrower any time he chooses to do so.

TERMS OF LENDING MONEY

As regards the terms under which advances and cash credits are granted, it may be noted that the Imperial Bank is debarred from lending for more than six months.¹ In the case of the other banks money is lent for six to twelve months. In both the cases there is the option of renewals for fresh periods, and such renewals are generally granted. The rate of interest charged by the banks depends much upon the credit and standing of the borrowing industrial concern and the reputation of its managing agents, and, in certain cases, is made to vary with the Imperial Bank rate. In Bombay, as regards the textile industry, the rate of interest charged for loans is the Imperial Bank rate if the borrower is of substantial standing, and the rate for cash credits is $\frac{1}{2}$ per cent. over the Imperial Bank rate. It must be mentioned that in both the cases, i.e., loans and cash credits, a minimum interest rate is stipulated and charged.

¹ It may be noted that the position remains unaltered under the Imperial Bank of India (Amendment) Act, 1934.

DEFECTS IN BANKING PRACTICE
RE: GRANT OF ADVANCES

If the general attitude of the Indian banks towards industry is liable to criticism, their practice in the matter of the grant of even the limited advances to industrial concerns made by them is open to still greater criticism.

When advances are granted against tangible and marketable security, the banks insist as security only stocks, either raw, manufactured, or in process of manufacture, and take no notice of valuable fixed assets such as land, buildings and machinery, which the borrowing industrial concern may offer. As we have already mentioned, in the case of manufactured goods or raw materials the margin maintained is 30 per cent., and a much higher margin, as high as 50 per cent., is maintained in the case of semi-manufactured goods. It must be admitted that the maintenance of such high margins, especially in times of depression, cannot but have an adverse effect on industrial concerns.

Besides the high margins insisted upon, the banks increase the difficulties of industrial concerns by making an inconvenient discrimination as regards the kind of stocks to be accepted by them, and generally prefer raw materials to manufactured or semi-manufactured goods. Those industrial concerns therefore, which are hard pressed for funds, and have large stocks of manufactured goods, being unable to obtain accommodation on the security of the same from the banks, are obliged to sell them at any price, and in the days of depression at very low prices, to realise cash.

The practice followed in regard to the secured or hypothecated stocks is again open to objection. The stocks are stored in the lending bank's godown or warehouse, or in that of the borrower under letters of hypothecation to the bank. In the latter case weekly statements have to be submitted to the bank. A complicated procedure in both the cases is followed. When the lending bank possesses a godown, the borrower, every time he needs accommodation, must remove the stocks to be hypothecated from his own godown to that of the bank. If he is in need of the stocks he must again have them removed to his godown. For removing the stocks either way, he has to incur expenditure besides the

waste of time. Conditions are not different when the bank does not own a godown, and consequently the stocks have to be stored in the borrower's godown under letters of hypothecation. Whenever the borrower needs the stock, he has to apply to the bank which deposes a clerk to do the work. Where the stocks hypothecated happen to be raw materials which the borrower may need for manufacture, the above procedure has to be repeated every day. The waste of money and time, besides the inconvenience involved in the above procedure, may well be imagined. It must be admitted that the procedure followed by the banks in both the cases is due to the absence in India of licensed warehouses or other facilities for the storing of goods. As a matter of fact, it must be noted that some of the banks which do not maintain their own godowns flatly refuse to grant advances to borrowers who are willing to hypothecate their goods. Only a few clients are allowed to store the goods in their own godowns and obtain loans on the security of the same.

On account of the above facts, the method of obtaining bank loans by hypothecating stocks is unpopular with Indian industrial concerns. It must be noted that it is not the hypothecation of goods that the concerns object to, but it is the procedure as regards the hypothecated goods that the banks follow which is objectionable, as it entails many hardships on them. It is no wonder therefore to find in some centres, particular industrial concerns opposing this method of obtaining bank loans upon this as well as other grounds. For example, in Ahmedabad in the case of the cotton textile industry, it is considered that the hypothecation of stocks is a sign of weak credit, and hence when it becomes known that a mill has hypothecated its stocks as security for a bank loan, the deposits which are kept with it by the public are withdrawn.¹ And in Ahmedabad we have already seen, that the mills depend to a great extent on public deposits, and hence they do not like this source to be cut off. Another ground upon which the industries oppose hypothecation of stocks is that they think that such a procedure involves some visible control of the banks over them, and this lowers their prestige in the eyes of

¹ See oral evidence of Mr. Kasturbhai Lalbhai, Representative of Ahmedabad Millowners' Association, Indian Central Banking Committee, Vol. III, p. 480.

their creditors and depositors, making it difficult for them to obtain funds.¹

The cash credit system though theoretically advantageous to the borrower is not so under the present practice of the banks. The borrower even if he does not utilize his full drawing power, has to pay interest on a minimum amount which, as we have said, is one-half of the maximum drawing power allowed to him. In most cases this interest is exacted. Besides this fact, it must also be noted that the banks curtail or withdraw the facilities allowed to the borrower at any time they think fit. This uncertainty therefore keeps the borrower in suspense as regards the continuance of the facilities allowed to him by his banker. Another defect which affects the borrower under the cash credit system arises from the security of stocks taken from him by the banks. In times of depression as the value of the secured goods falls, the banks curtail their advances, or demand from the borrower additional security.² The difficulties which industrial concerns have to undergo as a result of the adoption of this course by the banks, especially, in times of depression, must be realised, as it is during this very time that an extension of credit is required to tide over the same. In this connection it may be noted that this defect is also present in the case of advances or loans on the security of stocks.

We now turn to another defect in banking practice, viz., the rule of two signatures on promissory notes. The Imperial Bank by law is forced to demand two signatures on promissory notes, but the other banks have also adopted this rule for no apparent reason. It may be that for their own safety the banks demand the signature of the managing agents as an additional guarantee for the due payment of their loans and advances. But in doing so, they completely overlook the credit worthiness and standing of

¹ See Report of the Tariff Board, Cotton Textile, Industry Enquiry, 1927. Vol. I, p. 92.

² Cf. "The evidence before us tended to show the systems of cash credits has drawbacks in time of depression, when elasticity is specially required, not only because the amount is repayable at short notice, but also because, when prices are falling, the banks have to call on the mills to reduce their cash credits or to increase their securities as the securities on which they have advanced have deteriorated in value, and this happens at a time when it is obviously specially difficult for the mills to adopt either of these courses."

Report of the Tariff Board, Cotton Textile Industry Enquiry, 1927, Vol. I, p. 91.

the borrower. As a result of this, industrial concerns, however sound they may be, are unable to obtain loans on their own security unless the guarantee of their managing agents is forthcoming. And financial facilities are flatly refused to those industrial concerns which have no managing agents, though otherwise they may be financially sound.

The strictness with which the guarantee of the managing agents is insisted upon and taken, has unfortunately strengthened the hold of the managing agency system on the industries. On the other hand, the managing agents have taken advantage of this rule to justify their position and claim that but for their existence and willingness to stand as guarantors, industrial concerns would not be able to get any bank loans or advances at all.

The banks have made matters worse by demanding the guarantee of the managing agents even in those cases where their loans and advances to industrial enterprises are secured by the hypothecation of stocks. The guarantee over and above the hypothecation of stocks can be justified by the banks on no other grounds than that of practice. Indeed when questioned on this point, Mr. (now Sir) S. N. Pochkhanwalla said, "This has been a practice from the beginning. When the textile companies require loans, the security of the company and the agents is always taken into account, although it is more a question of practice than anything else."¹

As a result of the banks' demand for the guarantee of the managing agents another disadvantage arises. We have already seen that some of the industries, e.g., the cotton textile industry and the tea companies, finance their working capital to a large extent from deposits obtained direct from the public. The managing agents, we have already said, play an important part in the securing of these deposits, as the public have greater faith in them rather than in the industrial concerns. Consequently when it becomes known that the managing agents have pledged their name as guarantors of loans from the banks, the public withdraw their deposits and put the industrial concerns into difficulties. The result is that the managing agents' responsibility is increased, and they find it hard to arrange for the required funds.

¹ Oral evidence, Indian Central Banking Committee, Vol. III, p. 45.

Another defect in the banking practice is the observance of personal favours and prejudices by the bank managers. That favouritism and even racial discrimination exist on the part of the managers of the banks was the subject matter of evidence before the Banking Enquiry Committee. This state of affairs is due much to the absence of proper credit departments and technical equipment by which the banks can investigate the credit-worthiness of the borrowers or the parties who stand as guarantors. In the absence of such departments at present, the bank managers who are in charge of the loan operations are much handicapped, and as most of them are Europeans, they are better able to gauge the credit-worthiness of European businessmen than of Indian ones. The result is that the industries in the hands of Europeans are able to obtain better financial facilities than those in the hands of Indians.¹

The practice of leaving the loan operations in the hands of the bank managers has its disadvantages. No fixed rule or policy is followed as regards the terms and conditions under which loans and advances are granted. It is the borrower's position and influence with the bank manager that plays an important part in the matter of obtaining financial facilities on easy and favourable terms or any at all. If a bank manager, for example, thinks that advances or loans should be refused to a particular borrower he can do so in various ways. He can refuse to grant advances unless the borrower hypothecates stock. And if the borrower is willing to do so, he can still refuse on the ground that the hypothecated goods are insufficient or not acceptable at all. When raw materials are offered as security, he may demand only finished goods as security, and vice-versa. Then again as regards the valuation of the secured goods, the decision rests with him. He may purposely value goods at a low price when they are actually worth more.

¹ Cf. "It has been suggested that the European managers of the (Imperial) Bank on account of their methods of living and social habits have greater opportunities of coming in closer personal contact with European clients than with Indians, and that this personal information and contact results in more favourable treatment being accorded to European concerns than to Indian concerns. It is further generally believed that the Banks lend more freely to European concerns than to Indian concerns, and that several Indian concerns which took the Bank's assistance have had bitter experience. It has been suggested that while non-Indian concerns get fuller assistance from the Bank, the assistance rendered to Indian concerns is very small and falls much short of the actual requirements of the concern."

Indian Central Banking Report, Vol. I, Part I, p. 271-72.

Granting that the borrower is able to satisfy the bank manager and fulfil the conditions as regards the hypothecation of stocks, will he then be able to obtain a loan or an advance? No, if the manager is not favourably inclined. And this he can do in the following way. In addition to the hypothecation of stocks he may demand from the borrower a guarantee. And even if a guarantor is found, he may not be satisfied regarding his credit.

Under these circumstances therefore, industries find it very difficult to obtain bank loans, if they are unable to satisfy the fancy of the bank managers. But it must be remembered that if a bank manager wishes to make an advance or a loan he may do so merely on the personal security of the borrower.

Some of the banks again do not follow the same practice in their loan operations at two different places. While in Calcutta no guarantee of the managing agents is taken when stocks are hypothecated, in Bombay, in addition to the hypothecation of stocks, the guarantee of the managing agents is demanded and taken.

Another defective banking practice is as regards the repayment of loans, advances and cash credits. The Indian banks are too strict in demanding the repayment of their advances on the due dates. We have already referred to the fact that all the banks in India follow the practice of the Imperial Bank, in not granting loans and advances for more than six months. On the due date, the banks demand the immediate repayment of their loans or advances, no matter if such a course puts even sound concerns into difficulties. No doubt the banks point out that strict as they are in demanding repayment on the due date, they are always willing to renew the loans and advances, for fresh terms, and industrial concerns can take advantage of this facility. But the fact is that there is always an element of uncertainty as regards this. Renewals can only be obtained at the discretion of the bank managers. Again it is pointed out that if one bank calls back its loans, the borrower is at liberty to approach some other bank, and obtain the same facilities. But the difficulty is that if it becomes known that even due to some imaginary cause, one bank has withdrawn its facility, the other banks will also refuse accommodation.

The real cause, however, of the strictness regarding repayment

of loans and advances, is the notion of the liquidity of assets held by our banks. Commercial banks as they are, drawing the greater part of their resources from short-term deposits, they point out that it is none of their business to finance the long-term capital requirements of industries. By the very nature of their existence they are willing to give only short-term facilities, i.e., for six months or at the most one year. Besides, they point out that advances or loans which they may grant for more than this period may become "locked up" or "frozen".

In addition to the six months' rule and the strictness regarding repayment, the banks make matters worse by sometimes curtailing or even withdrawing the loans, advances and cash credits already granted by them, before the end of the due date, thereby putting many an industrial concern into great difficulties. The example of the Bombay cotton textile industry is the best under the circumstance. It is a well known fact that not only did the banks refuse to renew the loans and advances which they had made to certain mills, but they also made a drastic reduction in the advances and cash credits already granted, and this was done at the very time when the cotton textile industry was hard hit by the depression, and needed financial facilities to tide over the difficult period.

The way in which repayment of loans and advances on due dates is demanded, merely shows how indifferent our banks are towards industry. In bad times this indifferent attitude becomes positively harmful. Instead of helping the industry to tide over difficult times, which should be the ideal before all banks, our banks aggravate the situation and increase the difficulties of the industry by curtailing credits.¹

ABSENCE OF BILL BUSINESS

Finally one more important defect in our banking practice must be noted, viz., the absence of trade bills. At present in India,

¹ Cf. "The banking ideal is that banks should enable their clientele to get over a period of difficulty, consistent of course with adherence to sound banking principles. A closer examination of values and margins, no bank can afford to neglect at any time, whether it is boom or depression, but an undue emphasis on due dates and repayments with regard to loans to industrial concerns can intensify a downward situation, against which industry may be fighting." Manu Subedar, Minority Report, Indian Central Banking Committee, p. 327.

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banking aid is given mostly in the form of loans and advances and cash credits, and not by way of discount of trade bills. This becomes evident from the following figures for the year 1928 regarding the Imperial Bank and six other joint-stock banks.¹

	Imperial Bank.	Six joint-stock banks. ²
Bills	Rs. in lakhs. 1247	Rs. in lakhs. 123
Advances	5185	334 ²

Now it must be noted that banking aid given by way of discounting of bills has special advantages. In the first place, from the point of view of the banker, it is advantageous to lend money by discounting trade bills than by means of direct loans and advances, for the simple reason that he is automatically reimbursed with the maturity of the bills. In the second place, from the point of view of the manufacturer also, it is advantageous to obtain money by drawing trade bills and discounting them with the banks. The manufacturer will certainly find this method more advantageous than the method of obtaining banking aid by means of loans or cash credits, with its attendant paraphernalia, hypothecation of stocks, guarantee of the managing agents, etc. In the case of loans and cash credits, the manufacturer is forced to sell his goods to realise cash for the repayment of the loans or cash credits, even though the market may be unfavourable, but in the case of bills he stands to gain inasmuch as he can sell his goods only when the market is favourable. Besides, in the case of bills he can get accommodation up to the full extent of the value of his goods, whereas in the case of loans and cash credits a margin of 30 to 50 per cent. is kept. Besides, whereas in the case of loans and cash credits there is always the uncertainty of getting the accommodation at the right time, in the case of bills this uncertainty does not arise. And lastly, under a well developed

¹ See Indian Central Banking Committee Report, Vol. I, Part I, p. 408.

² Allahabad Bank, Bank of Baroda, Central Bank of India, People's Bank of Northern India, and Punjab National Bank.

bill market, it becomes easy and cheap to borrow from banks by discounting trade bills; for on account of their liquidity and security banks are prepared to discount them at a lower rate, than they charge in the case of loans and cash credits.

DIFFICULTIES OF BANKS IN FINANCING INDUSTRIES

We have so far seen the attitude of Indian Banks towards industry and the defective practice under which limited financial assistance is rendered as working capital. It is however, proper that we should consider the banks' difficulties in financing industry in India.

In the first place, one of the chief difficulties of the banks is their limited resources which they can use for financing industries. Their paid-up capital and reserves, as compared with the funds which they draw from short-term deposits, is small. This becomes evident from the following figures regarding the Imperial Bank and eight other Indian joint-stock banks for the year 1933.

	Imperial Bank.	Eight joint-stock banks. ¹
Paid-up Capital	Rs. in crores. 10.85	Rs. in crores. 7.32
Deposits	80.75	61.64

As the greater proportion of their resources are obtained from short-term deposits, which may be withdrawn at any time, the banks are forced to lend money strictly for short term, i.e. six months or at the most one year. At the same time this very fact, viz., that their resources are drawn from short-term deposits, makes it impossible for them to lend against immovable property, though to a certain extent this state of affairs is due also to the Hindu and Mahommedan laws relating to succession and transfer of rights. According to Hindu law, if ancestral immovable property belonging to a Hindu joint family governed by the Mithak-

¹ Allahabad Bank, Bank of India, Central Bank of India, Punjab National Bank, Bank of Baroda, Bank of Mysore, Indian Bank (Madras) and Union Bank of India.

shara law (under which all the members acquire a right in the property by birth, the right accruing from the date of conception) is mortgaged for a bank loan or advance, a person born after the transaction can have it set aside. Further, in order to charge a joint estate it is necessary that all the members of the joint family should join in the execution of the deed or give their consent in some other way. Again, in case where a Karta or Manager of a joint family charges the family estate, it is legally binding only if the loan is incurred for family purposes or in discharge of an antecedent debt. In view of these difficulties due to Hindu law, the banks do not wish to make a loan or an advance on the security of immovable property belonging to a Hindu joint family. The worst of it is that under the existing law whenever a bank files a suit to recover money advanced against the joint estate, the onus of proof that the loan was incurred for family purposes lies on it.¹

Much the same kind of difficulty is met with under Mahomedan law. The Mahomedan law allows one to convey property to charitable purposes by verbal wakfs or trusts. If therefore, a bank loan is secured by immovable property belonging to a Mahomedan, and a suit is brought against such property, the defence may be that that property is already endowed for religious purposes. Further, the Mahomedan law of succession does not allow one to dispose of by will more than one-third of his property without the consent of his heirs. And hence, if property belonging to a Mahomedan is secured for a bank loan, the bank will not be able to recover more than a third of that property.²

Though it must be conceded that the Hindu and Mahomedan laws, make it unsafe for the bank to lend on the security of immovable property, which belongs to a Hindu or a Mahomedan, there is no reason why the banks should not advance against the security of immovable property belonging to a joint-stock company governed by the Indian Companies Act. It must be noted that most of our large scale industries are organised on the joint-stock basis and not on the proprietary basis. Large industries belonging

¹ See Indian Central Banking Committee Report, Vol. I, Part I, pp. 386-87.

² See *ibid.*, p. 387.

to individual Hindu or Mahomedan industrialists are things of the past.

The absence of credit departments, and the lack of proper technical equipment in most of our banks create other difficulties. Our banks are not equipped as in the U. S. A. with special credit and technical departments, which collect useful information as regards the credit-worthiness and financial position of their clients and prospective borrowers, as well as collect other statistical information. The usefulness of the information thus gathered will be realised from the fact, that it enables the banks to lend freely to those borrowers whose credit and financial standing has been reported to be sound, and consequently very few of them suffer losses. It is quite possible that the Indian banks find the establishment of these departments costly. But the fact is that in the absence of these departments and the necessary technical equipment, our banks are much handicapped, as they are not able to appraise properly the credit and standing of their clients, with the result that many of them suffer by lending to unsound parties. It is for this reason that the banks do not prefer to lend against personal security alone, unless there is the guarantee of the managing agents and the security of stocks.

In the West, particularly in the U.S.A. and England, the banks are assisted to a great extent by the existence of independent credit investigation agencies which supply the needed information. For example, Dun's and Bradstreets' in the U. S. A., and Seyd's in England, are the most well known credit investigation agencies which supply useful information on payment regarding the credit and standing of the borrowers. No such agencies exist in this country. Our banks rely on information supplied by the shroffs and sometimes on bazaar rumours. As a result of this, the strange fact arises that parties really worth several lakhs are reported to be worth only a few thousands, and parties worth only a few thousands and of no standing, are reported to be worth several lakhs.¹

Another difficulty which our banks have to face is the absence of the policy of "one company, one bank," which prevails in the West. In the West, due to this policy there is always a close

¹ See Central Banking Committee Report, Vol. I, Part I, p. 272.

relationship between banks and industry which benefits both. Unfortunately in India there is no co-operation between banks and industry; the existence of the cash credit system under which banking aid is given forces the industries to have such accounts with a number of banks. For on refusal of financial facilities by one bank, recourse can be had to another. Besides, as most of the industrial concerns are financed by public deposits, they do not wish to disclose their bank borrowings to their depositors. So they borrow from more than one bank, as it is quite possible that if borrowings are made from a single bank, the amount may become known to the depositors. Some share of the blame for the lack of the practice of "one company, one bank" must also be borne by the banks. They refuse to finance a single industrial concern to any great extent, on the principle of distribution of risks, and also because of the general opinion that their credit suffers if they are interested to a great extent in the financing of any one enterprise.¹ They therefore, spread their advances over as large a number of industrial concerns as they can possibly do.

In the last place, the lack of proper warehousing facilities in this country is another difficulty from which the banks suffer. There are no warehouse companies in India as in the West, which provide the necessary facilities for the storing of goods and thus enable the banks to lend on the security of the warehouse receipts. Most of our banks therefore have to maintain their own godowns or warehouses.

SUGGESTIONS FOR INCREASING THE PROVISION OF WORKING CAPITAL BY BANKS TO INDUSTRIES

We have suggested elsewhere the establishment of Industrial Banks in India. These banks should undertake the provision of working capital to industries in addition to fixed capital. But in the meanwhile, the commercial banks can do much by increasing the provision of working capital to our industries. If the banks find that their present resources are insufficient, they can supplement them by increasing their share capital and by accepting long-term deposits.

¹ Cf. Oral evidence of Mr. A. D. Shroff, Central Banking Committee, Vol. III, p. 167.

BANKS SHOULD TAKE UP INDUSTRIAL SECURITIES

The banks without any great risks can take up the securities, either shares or debentures, issued by industrial concerns to raise working capital, and after holding such issues for some time place them among the investing public. The latter will take up industrial securities issued in this way rather than directly by the companies, as they have greater confidence in banks. If the banks show readiness in carrying out the above suggestion, our industries should give up their present methods of obtaining finance from managing agents and public deposits.

NEED FOR RELAXATION OF HYPOTHECATION RULE

Even in the matter of direct loans or cash credits that the banks at present grant to industries, there is room for improvement. The present rule regarding the hypothecation of stocks should be relaxed. The high margins insisted upon by the banks, which entails so much suffering on the part of industries in these days of depression, should be lowered. Further, the banks should not discriminate too much as between raw, manufactured or semi-manufactured stocks. It is also desirable that the banks, which at present insist only on the backing of liquid assets, should also take into account the block capital that the borrowing industrial concerns may offer as security.

NEED OF RELAXATION OF THE SIX MONTHS' RULE

Side by side with the relaxation of the hypothecation rule, there should also be a relaxation of the six months' rule. It must be admitted that the Imperial Bank is debarred by law from lending for more than six months, but there is no reason why the other banks should not lend for a longer period. Further, the Imperial Bank as well as the other banks should follow a more liberal policy especially in these days of depression, as regards repayment of their loans and advances on due dates. Renewals should, as a rule, be granted to sound industrial concerns.

BANKS SHOULD LEND ON PERSONAL CREDIT

Another important suggestion that may be made is that just as in the West, our banks should lend on personal credit of the bor-

rowers. This suggestion is feasible if the banks cultivate the habit of working in closer co-operation with industry, and the rule of "one company, one bank," is followed by both the borrowing industrial concerns as well as the banks. This rule can be easily followed if our industries confine their borrowings to a single bank. At the same time, every bank should see that it meets the demands which its clients may make. Under this system banks are able to keep in close touch with their clients and thus safeguard themselves. Besides, the affinity which will be created will enable banks to have an intimate knowledge of their clients' financial position.

BANKS SHOULD DISCOUNT TRADE BILLS

The present paucity of trade bills, and the disinclination of our banks to discount them is due to the absence in India of a central rediscounting institution. But, now that the Reserve Bank is established, there is no reason why the use of trade bills should not be increased and the banks prepared to discount them. The bills being self-liquidating, the banks will not be put into difficulty by holding them, and besides, they can always be rediscounted at the Reserve Bank.

NECESSITY OF INDEPENDENT WAREHOUSES

Banking aid to industries can be substantially increased if there are proper facilities for the storing of the hypothecated goods. Under the present system of storing the hypothecated goods in the godowns of the banks, the industrial concerns have to incur waste of money and time. Independent warehouses on the American model should be established in all parts of India. A borrower by storing his goods in one of these warehouses, can easily obtain a bank loan by hypothecating the warehouse receipt. Even if the borrower happens to be in a place where there is no bank, but there is a warehouse or a branch of a warehouse, he can still obtain a loan from a distant bank by presenting such warehouse receipts.

A word as regards the type of warehouses that will suit India may be noted. There are two types of warehouses: (1) the one does the work of mere warehousing or storing the goods, and

(2) the other, besides providing this facility, makes advances on the security of the goods stored with it. The latter type of warehouses are certainly desirable in India, but as they require large capital, it would be difficult to establish them at the present time. A good beginning can however be made by starting warehouses of the first type.

There is a conflict of opinion as to whether warehouses should be started on the joint-stock or the co-operative principle. Those who hold the former view think that Government assistance will be required, and it should take the form of subscription of a portion of the share capital of the warehouse companies. Whether warehouses are started on the joint-stock or co-operative principle, it should be seen that they are set up on up-to-date lines; they should provide facilities on easy and cheap terms for the storing of goods without subjecting them to damage or deterioration. Every warehouse should obtain a license from Government, and be subject to Governmental supervision and control, besides periodical inspection.¹

It may be noted, in passing, that the establishment of warehouses in India will not only benefit the large industries, but also the small and cottage industries. These industries can also store their products in such warehouses, and obtain financial facilities from banks.

CREDIT AND INDUSTRIAL SERVICE DEPARTMENT OF BANKS

In connection with our suggestion that advances should be made on personal credit, besides the cultivation of the "one bank, one company," rule, we would like to point out that our banks should be equipped with credit and special industrial service departments. The credit departments should collect useful infor-

¹ The late Mr. B. F. Madan expressed the beneficial effects of Government supervision and inspection over warehouse companies as follows: "Such machinery (Government inspection and supervision) is necessary because the warehouse receipts are to form the basis for advances of large sums of money by bankers, and they would like to feel secure about such advances. Any attempts at supervision by them, however, is likely to be resented as due to suspicion of the honesty or the solvency of the warehouseman or the borrowing customer, while supervision by an impartial authority created for that purpose by Government is not likely to raise any such suspicion and may even be welcomed as inspiring greater confidence in warehouses subject to such supervision." See his Draft Bill for the encouragement of the establishment of independent warehouse, Central Banking Report, Vol. I, Part I. p. 233.

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mation and keep records of the financial position of clients as well as prospective borrowers. All loans and advances should be made only after reference to these records and investigation into the needs of the borrowers. Further, at intervals the banks should demand the balance sheets and other financial statements of their clients which should be carefully scrutinised by the credit departments. If credit departments as we have suggested above are established, not only will the banks benefit but the borrowers would also gain, inasmuch as when their true financial position becomes known, they would obtain greater financial facilities with less formalities from banks than at present.

It is also desirable that the banks should, by mutual co-operation, exchange the information regarding the financial position of borrowers collected by each one of them separately, instead of keeping it secret as is done at present. Further, the practice followed by the Ahmedabad branch of the Bank of India can also be usefully copied by the other banks. Instead of relying on shroffs for information regarding the credit and financial standing of the clients, the manager is assisted by a local Board of Directors, who provide the necessary information and also take responsibility for the same.

The larger banks in the U.S.A. have in recent years developed a new field of service. Not content with the mere granting of loans they have organized special "Industrial Service Departments." These departments render useful business advice to their industrial clients.¹

INDEPENDENT CREDIT INVESTIGATION AGENCIES

The banks would be much assisted in increasing their financial assistance to industries, if independent credit investigation agencies like Seyd's, or Dun's and Bradstreets' are started in this country. If the banks co-operate it would not be difficult to make an experiment and start one or two such agencies.

¹ See Edmond E. Lincoln, *Applied Business Finance*, 1929, p. 421.

CHAPTER VII

ADMINISTRATION OF EARNINGS

INTRODUCTORY

An investor, whatsoever the type of securities he purchases, plans to preserve his principal intact and to receive, in addition, an annual payment. The preservation of capital depends upon the value of the assets, but the value of the assets, in its turn, depends upon their yield. So, in short, the value of the principal depends upon its capacity to yield the expected income. This income-yielding capacity, to a considerable extent depends upon the financial administration of the concern.

As a matter of fact, the problem of administration of earnings is of less significance in the life of a company as compared with its other financial problems. What is essential in this respect is not so much intelligence or foresight, but reasonably conservative policy. Provided the financial management of a company has been sound through all stages of its development from the inception of the enterprise, the management of earnings can be successfully and efficiently carried out by following a well-laid-out plan. And even though a mistake is committed during a certain financial period, it can generally be remedied later on without entailing any permanent or heavy losses.

The administration of earnings becomes complicated, and demands special attention under joint-stock organisation, where the actual management lies in the hands other than those of the owners. The owners are more interested in the long time good of the concern than in the immediate profits as the preservation of capital is their principal motive. The managers on the other hand are not so much interested in the preservation of capital; what they wish is to show that the concern is yielding good profits under their management. The outlook of each of these parties thus is different and somewhat conflicting. From a broad social point of view, the outlook of the owners is more advantageous than that of the managers. It is, therefore, proper that the outlook of

the managers should be homogeneous with that of the owners; and if we cannot have a spontaneous homogeneity between the two, the former should be made subservient to the latter. Really speaking, we cannot expect any spontaneous homogeneity between the outlook of the owners and that of the managers as the interests of both the parties are not always the same; and hence the need for a proper check over the managers. If the long time interest of the owners becomes the dominating factor in the financial administration of an industrial concern, the administration of earnings becomes comparatively a smooth problem. Our discussion of the managing agency system must have made it clear how the management of industrial concerns in India is virtually beyond the control of the owners, and this peculiar feature of industrial organisation has made the administration of earnings a difficult problem in our industrial finance. As the interest of the managers and the owners conflict, and the latter have no control over the former, there always is the possibility of the finances being managed to the disadvantage of the owners. This situation gives rise to another disadvantage, in as much as it removes all the incentive for economy in the operating costs. It is almost forgotten, under such circumstances, that the only justification for the existence of a business concern is its ability to earn profits for the owners.

HOW TO KEEP OPERATING COSTS LOW

When an industrial concern begins work, the first duty of the management is to see that the operating costs are kept at the lowest level without sacrificing efficiency. The size and costs of different departments should be controlled by a central financial authority according to a pre-meditated plan. The managers of every industrial concern, therefore, should try to forecast its peculiar needs, having determined upon a desirable future policy. In all cases an attempt should be made within definite limits to determine what the expenditure of the business must be during a given period. The most expeditious methods of meeting the expenditure should also be decided upon. It is also desirable that no department, under ordinary circumstances, should be allowed to transgress these limits. All businesses cannot plan their opera-

tions in a uniform way. And, therefore, it is not possible to lay down any definite rules of practice in this regard, which will be applicable to every business concern.

This method of planning and co-ordinating a company's affairs is commonly referred to as budgetting. This practice has recently become popular in America. The purpose of the budgetary method is merely to ensure in the highest possible degree the proper co-ordination of the different departments. In the case of enterprises of small size the budget may be unnecessary. It may be possible for the principal executive officer to carry in his head the facts necessary to ensure harmony in the functions of different departments, and to minimise the wastes which unco-ordinated procedure entails. In such cases to ensure co-ordination becomes the principal duty of the executive. But as the enterprise grows, this becomes impossible. As a matter of fact, the bigger the size of the enterprise the greater is the necessity for maintaining co-ordination between different departments. In such cases it becomes necessary to have some special machinery to control the work of the various departments, so that all the activities will be conceived in the light of the same general plans and policy. In large concerns, therefore, it is better to have a budgetary committee. This should be composed in part of various departmental executives. This committee should try to ascertain the most profitable co-ordination of the various departments. The final aim must be to devise a programme which will result in the realisation of the highest net, rather than the highest gross profit.

MAINTENANCE POLICY, ITS THEORY AND PRACTICE

The administration of earnings of an enterprise may roughly be divided into two parts, one concerning the maintenance of the value of the investments of the owners, and the other concerning the payments to be made to them. The former part includes maintenance of the assets in good condition, provision for contingencies, and arrangement for retirement of credit obligations, if any. The latter part is mainly concerned with the payments to the owners and includes fixing a reasonable rate of dividends and arrangements to maintain it without any break.

We shall now turn to each of these items in the allocation of

earnings. The adequate maintenance of the plant and machinery of an industrial concern is very important, and any deficiency in it will have an immediate and lasting effect on its earning capacity. The first charge on the income of an enterprise, therefore, is the expenditure on maintenance, and the amount required for this purpose can easily be known from previous experience. The easy path of under-maintenance is followed by the management of an enterprise to represent its net earnings as being higher than they actually are. In India where the management becomes interested in showing high net earnings, the possibilities of under-maintenance are great. Owing to the managing agency system, the remuneration of the management is very high in India, and in order to justify this high remuneration, and also in order to keep it concealed from the attention of the public, the management is tempted to show as high returns to the owners as possible. Another situation which results in under-maintenance is, that whenever the agents' commission is charged on the basis of profits, the maintenance charges are excluded from the amount on which the commission is to be charged. There is thus a temptation to increase the commission by bringing down the maintenance charges to the lowest limits. It is a faulty system of organisation which does not provide a sufficient incentive to the executive to maintain the concern in a good condition, but on the other hand, makes them interested in neglecting the expenditure for upkeep, repairs and the like.

IMPORTANCE OF DISTINGUISHING BETWEEN CAPITAL AND INCOME

The principal duty of the management of an enterprise is to see that the value of the investment of the shareholders is not allowed to deteriorate. The funds raised from the investors are spent in acquiring different kinds of assets, which as time passes, depreciate, i.e., lose the capacity to yield the expected income to the owners. The assets depreciate in different ways, e.g., (a) wear and tear, (b) obsolescence due to new inventions, new products, or better ways of making the same product, (c) vicissitudes and catastrophes, (d) fluctuations in trade, (e) inadequacy etc. Depreciation, in short, means all losses arising from physical and

functional deterioration of the assets. Physical depreciation means impairment of the physical efficiency of the assets resulting from wear and tear due to the process of manufacture; functional depreciation is a more complicated and difficult problem, and takes place in various ways. Rather the most important of the different ways in which functional depreciation occurs is obsolescence, i.e., decrease in the value of the assets because of improved technological processes. A new invention sometimes revolutionises an industry and necessitates much special equipment; the previous equipment thus becomes functionally less efficient, though in good working condition. Sometimes the value of the assets becomes impaired because their products cannot command market, due perhaps to supply of better articles, or to changed needs or fashions. In short, functional depreciation is said to have occurred whenever the assets, in spite of their physical efficiency, cannot yield the normal rate of return under normal trade conditions.

Physical depreciation is an important problem not only from the point of view of an individual concern but also from that of the whole nation. The capital resources of a nation are every day being consumed in the process of production. If these consumed assets are not replaced, it will mean that the nation lives on its capital resources and not on income. Such a nation cannot make any progress. The underlying principle of economic progress is that the society must live on income and not on capital.

The preservation of wealth cannot be accomplished unless principal and income are clearly distinguished. No enterprise can continue to prosper unless the substance of its wealth is preserved and at the same time made to produce additional wealth. Because an investor continues to derive a satisfactory return, it cannot be said that his principal is intact. If sufficient provision is not made against depreciation, suddenly the investor will find that he cannot get income as his principal has vanished. Then will he realise that what he considered as income was not pure income, but contained some part of the principal, and in this way he has spent, not only income but the principal itself. Once the shares are purchased, the investor can realise his principal in cash, only by selling the shares to others. And so long as the shares continue to get reasonable dividends, the shareholders believe that their principal is intact, especially as they feel sure that they can realise

it by selling the shares. And they are right to some extent, because purchasers of the shares of an old concern are led by the figure of the dividend. Being ignorant of business practice, they cannot distinguish between capital and income in the real sense of the words, and therefore, cannot understand that the dividends may not mean pure profits but might include a part of the capital, and therefore, the shares purchased by them do not represent real wealth.

GENERAL NEGLECT OF THE DEPRECIATION PROBLEM

The problem of depreciation becomes very important under the joint-stock form of organisation. Under the individual or partnership form, in which ownership changes less frequently, the failure to allow for depreciation does not become a matter of serious consideration. In such cases, any default in the depreciation account during a certain period, can be corrected at a later date, by restoring the capital necessary to replenish the assets. But quite different are the conditions in the case of joint-stock companies, where the shares change hands so often. Here it becomes necessary to guard against the distribution of dividends, without making a proper allowance for depreciation, because it is likely to benefit one group at the expense of another.

The neglect of the depreciation provision is a regrettable feature of industrial finance in this country. Our businessmen perhaps do not realise the proper significance of this problem, and faulty ideas give rise to wrong practices. The general belief seems to be that if the property is kept in first class repair, depreciation is adequately cared for through maintenance. It is wrong to suppose that depreciation cannot take place, where maintenance is adequate. Even with current maintenance properly met, depreciation of the whole plant continues, due to the fact that all units, of which it is composed, are approaching the end of their useful life. The aims of the maintenance and the depreciation charges are quite different. The latter is meant for replacing worn out parts and must be available for such purposes. In disregard of all such salutary rules, it seems a common practice in India that minor improvements and major repairs are charged as depreciation and deducted from block value. But no matter how constantly

repaired, there is always a time, after which the economic usefulness of a piece of machinery or even a building is almost exhausted, and replacements become necessary. When such a contingency arises, it is realised that the capital of the concern or the principal of the shareholders, is not kept intact but has been spent away. The shareholders who look to the depreciation account in the balance sheet are perhaps quite ignorant of this fact. When is required to make any replacements or changes in the block, such a concern has to resort to borrowing. A sound depreciation policy dictates that the present block value and the depreciation fund must be equal to the total expenditure on the block or the replacement value including the latest changes in the machinery due to inventions and improvements. The management must remember that not only efficiency must be retained but the investment also, and for continued prosperity one is as necessary as the other.

DEPRECIATION MADE A CHARGE ON PROFIT

Some better managed concerns do set aside certain amounts for depreciation over and above the maintenance charges. But there is no settled policy followed by them, nor does the same concern adhere to the same policy throughout its life. Only one feature seems to be common to all; it is that depreciation is made a charge on profit. The amount to be set aside for depreciation, therefore, usually fluctuates from year to year in accordance with the annual net earnings. It so happens that while some allowance is made in prosperous years practically no allowance is made in lean years. It is quite a wrong method to charge depreciation on profits and not to include it in the cost of production. Depreciation, at least to the extent to which it means physical deterioration of the assets, must be a charge on the cost of production as truly as are fuel and labour. When depreciation is not included in the cost of production, the price cannot be said to be really reflective of the cost. When depreciation is not strictly included in the cost of production, but is made dependent upon the amount of earnings, it becomes easy for the management to misrepresent earnings, by manipulating depreciation charges according to its needs. This danger is especially great in

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India where owing to the managing agency system, the remuneration of the management is not fixed, but, in many cases, depends upon the amount of income, whereby they become interested in showing the income as high as possible.

The Indian income tax system makes certain allowances for depreciation while taxing the profits of any company. What our companies usually do is that they take into account the depreciation amounts while calculating the income tax, but do not actually set aside the same amounts for depreciation. Our companies, thus, do not make allowance even according to the rate allowed by the Income Tax Department which, as we shall see later, is in itself insufficient. Under these circumstances, it is advisable that the Income Tax Law should not allow such exemptions, unless the amounts are actually set apart for depreciation purposes only.

DEPRECIATION POLICY OF COTTON MILL COMPANIES

In the case of cotton mills the Income Tax Department makes the following allowances for depreciation: (1) $2\frac{1}{2}$ per cent. on block cost for buildings; (2) 5 per cent. on block cost of spinning and weaving machinery; and (3) $7\frac{1}{2}$ per cent. on block cost of bleaching and dyeing machinery and electrical equipment. But rarely do our companies follow these rates in practice. The cotton mills in Bombay, for example, set aside for depreciation only 3 per cent. of the original cost of land, building and machinery during the years 1917-25, which might be considered to be the best period in the history of the Indian cotton industry.¹ According to the rate of $2\frac{1}{2}$ per cent. on the building and a flat rate of 5 per cent. on the machinery they ought to have set aside for depreciation Rs. 12.32 crores; but, instead of this, they set aside only 9 crores.² This means that capital resources to the extent of more than three crores were dissipated in these years as dividends. The cotton mills in Japan during the same period saved for deprecia-

¹ "In 1915 to 1922, both years inclusive, they paid an average dividend of 53 per cent. on an average capital of 12½ crores. And they paid away in the eight years ending 1922 a sum of over 50 crores in dividends." The Indian Tariff Board Textile Enquiry Report 1927, Vol. III, p. 468.

² Cf. Appendix VI, p. 241 of the Indian Tariff Board Cotton Textile Report 1927, Vol. I.

tion 4.5 per cent. of the fixed assets every half year,¹ which means 9 per cent. per annum. It may be argued that the Japanese mills work on a double shift system and hence the deterioration of physical assets is greater there than here. Even admitting that the double shift system results in greater deterioration, it cannot be three times as much as it is here. A similar neglect of depreciation is found with regard to the cotton mills in Ahmedabad also. The depreciation charges for certain Ahmedabad mills, for example, for the years 1923, 1924 and 1925, at the rate of 4 per cent. ought to have been something more than Rs. 120 lakhs. But the actual provision made for depreciation amounted to only 81 lakhs. During the same years Rs. 121 lakhs were distributed as dividends by those mills.² This means that Rs. 40 lakhs of the dividends were not profits really speaking, but were paid out of capital. This refers to years of good profits. The situation naturally becomes much worse when the profits dwindle, and under such circumstances sometimes no provision is made for depreciation. Such neglect takes place because depreciation is made a charge on profit, and not included in the cost of production.³

Thus we see that a well-established industry like that of the cotton mill industry is not making depreciation provision even to the extent to which it is allowed by the Income Tax Department. As a matter of fact, 5 per cent. on machinery is a low rate of depreciation. For efficient working, machinery requires renewals and replacements earlier than every twenty years. No doubt it can be made to work even for more than twenty years, but then it will give inefficient work and will consequently increase the cost of production. It was therefore, suggested to the representative of the Ahmedabad Millowners' Association, by the Tariff Board in their first inquiry into the cotton industry, that the rate of depreciation on machinery should be increased from 5 to 10 per cent., to which the witness replied that it would not be possible

¹ Appendix XI, Table II, p. 257 of the Indian Tariff Board Textile Enquiry Report 1927, Vol. I.

² Cf. Annexure A to the Ahmedabad Millowners' Association's Evidence. The Indian Tariff Board Textile Enquiry Report 1927, Vol. II, p. 524.

³ "Both the Bombay and Ahmedabad Millowners' Associations expressed the view that depreciation should be reckoned as a charge on production but the practice in neither centre appears to be in accordance with this view." Ibid, Vol. I, p. 147.

to make such a large allowance. The Bombay Millowners' Association too think that the rates allowed by the Income Tax Department are quite adequate and need not be increased. But it should be remembered that unless the management have sufficient depreciation funds, they will not be eager and able to increase the efficiency by timely renewals and replacements. The increased efficiency owing to such improvements will certainly bring down the cost of production.

DEPRECIATION POLICY OF OTHER INDUSTRIES

A faulty depreciation policy is not a feature peculiar to the finances of the cotton industry. The situation with other industries is in no way better; it is even worse. In some of the paper manufacturing companies, for instance, the depreciation charges do not have any relation to the block value. The usual practice in such cases is to put to depreciation a certain amount of the profits decided upon in an arbitrary way without any definite relation to the block value.¹ A leading paper mill company, the Titaghur Paper Mills Company, for example, has only one reserve for all purposes, depreciation, obsolescence, contingency or dividend equalisation. A certain amount from the profits, as permitted by the dividend distribution policy of the year, is set aside as reserve and used for these purposes.²

Our coal industry too suffers from inadequate depreciation provision. The special feature of coal finance is that coal concerns require a fairly continuous supply of new capital on block; and the proper method of securing this is by charging a sufficiently high rate of depreciation, which should be used to finance further developments. But, as we have mentioned in an earlier chapter,³ these concerns, being started with insufficient share capital, are required to borrow extensively at a high rate of interest, and then owing to heavy interest charges are not able to make any provision for depreciation. The depreciation policy to be followed in the

¹ See for example the evidences before the Indian Tariff Board during their enquiry of the paper industry.

² Cf. Indian Tariff Board Enquiry Paper and Paper pulp Industries. Evidence Vol. I, p. 127.

³ See Chapter V.

case if industries with wasting assets like the coal mining industry is different from that to be followed in the case of other industries. The life of the assets in such cases being short, the amount to be set aside every year must be so adjusted that by the time the assets exhaust their useful life, the owners, over and above the dividends received by them from time to time, will be in possession of the full value of their investments.

CAUSES OF THE NEGLECT OF DEPRECIATION PROVISION

It seems to be a general belief with our businessmen that so long as the machinery is giving work it need not be renewed or replaced. In that way machinery can be made to work, with repairs here and there, for even a hundred years. In fact, some of the Bombay cotton mills are working with machinery sixty or seventy years old. To work with worn out plant means to increase cost of production. As the machinery depreciates, cost increases, and it becomes more and more difficult to provide for depreciation. The situation becomes worse owing to the fact that sufficient provision is not made even when the machinery is in an efficient condition. The usual practice is that when the plant is in good condition a small allowance is made for depreciation, with the hope of increasing the rate as depreciation increases. But this hope remains unfulfilled for ever. As time passes, the plant becomes more and more inefficient, and the rate of depreciation allowance cannot be increased but has got to be decreased. Under such circumstances it is advisable to allow a higher rate in the beginning and to lower it later on.

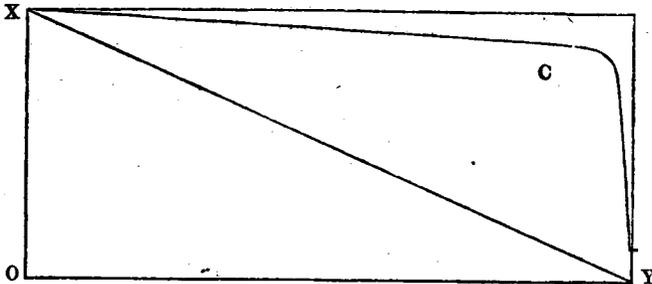
There is one more feature of our industrial organisation which comes in the way of proper depreciation provision. Our industrialists, being fond of extensive plants, spend almost the whole of the share capital in machinery and other equipment. But not infrequently it so happens that it becomes impossible to work the concern to its full capacity, and consequently with limited production it becomes difficult to provide for the depreciation of the whole block. The whole block, though not working to the full capacity, continues to depreciate to the loss of the owners.

**MAINTENANCE CHARGES AND DEPRECIATION
PROVISION**

In America recently it has become a practice to create a maintenance reserve separate from the depreciation reserve. This reserve is intended to meet the expenses on account of usual repairs and improvements necessary to keep the block in good working order and as such its function is quite different from that of the depreciation reserve. The size of the maintenance reserve need not be very big. It has nothing to do with the cost of the assets, but it must be adequate to meet the average expenses on account of repairs, improvements etc. which are necessary to keep the assets in good working condition. The costs of repairs and other minor improvements thus become evenly spread out and do not prove a burden upon the finances of any single year, so also such expenditure need not be deferred owing to lack of funds. This is a good practice and will have salutary effects if followed by our businessmen. But it must be remembered that the creation of maintenance reserve in no way lessens the urgency of maintaining an adequate depreciation reserve which is intended to replace the assets, when it becomes necessary to do so. Maintenance secures daily efficiency but does not prevent the impairment of total investment, and hence the necessity of adequate provision for the replacements of the impaired assets. This is the function of the depreciation fund, which, if properly set up, expresses approximately the amount of normal impairment existing at a given time. It is therefore wrong to mix together the maintenance and depreciation charges and also to suppose that because a plant is well maintained it has not suffered normal depreciation. Because, though efficiency can be maintained for a pretty long time independently of the accruing depreciation, still in the end, it will suddenly come down due to the accumulated wastage of the assets throughout this period. This will be more clear from the following diagram.¹

¹ Taken from "Depreciation, Principles and Application". By E. A. Saliers.

The straight line XY represents the progress of the theoretical



straight line of depreciation, while the curved line XCY indicates the rapidity with which the efficiency declines.

PROVISION FOR CONTINGENCIES

Besides the normal depreciation, the assets lose their value through certain contingencies also. Some of the contingencies like fire are insurable, and it is advisable to insure against them. But to insure the assets against all possible and imaginable contingencies is not an advisable path to follow, because it is likely to entail an unnecessarily heavy burden. If it is intended to make a provision against some remote contingencies, it should be in the form of a contingency reserve. Because in this way the funds assigned for such purposes will be at least in the possession of the concerns themselves.

With regard to industrial concerns in India, insurance against fire has become quite a common feature. But they do not make any provision for other contingencies. Of course, the volume and frequency of contingencies differ according to the nature of the business in which a concern is engaged. No hard and fast rules, therefore, can be laid down in regard to provision for them. But it is advisable that every concern should be prepared to face them, to some extent at least, if required to do so. In Western countries, especially in America, contingency reserves are created. But it is not proper to burden a concern too much on this account. The best way of meeting contingencies where they are quite remote is through having liberal depreciation

reserves. To create big contingency reserves means to take away large amounts from their owners, and entrust them to the managers. Now it is only just that the owners should get as much profit out of their enterprise as possible without risking or hampering its progress. The contingency reserve, therefore, should be only of such size as is absolutely demanded by the circumstances, and should be held in liquid form. It should not be spent on ordinary replacements and renewals, or should not represent mere valuation surplus.

PROVISIONS FOR OBSOLESCENCE

We have already seen that industrial plants prove inefficient not only owing to wear and tear but even owing to invention of more efficient methods of production. And industrial plant thus depreciates in value being obsolete, either in parts or entirely, and its owners to that extent sustain a loss. Now in order to maintain the value of the investments it is necessary to make some provision against such losses. If an industrial concern does not take advantage of the most efficient methods of production, it will sustain losses owing to competition from those who avail themselves of such methods. In these days of fast mechanical progress, in order to be abreast of other competitors, it is necessary to take advantage of every new invention or device. A concern of course cannot afford to do this, unless it is in possession of spare funds which can be used for such purposes. It has, therefore, become a common practice in foreign countries to make some provision for obsolescence along with provision for depreciation. In India, of course, no provision is made for such a contingency. Where even physical depreciation is not properly provided for, it is too much to expect any provision for functional depreciation. This is one of the reasons why we suffer whenever we are required to face foreign competitors, who, by taking advantage of the latest improvements and inventions, keep their plants in the most efficient condition.

The total neglect of obsolescence affects the different industries in different degrees. The industries which have attained somewhat full mechanical development, and in which therefore, new methods and devices are not introduced frequently, can afford to

neglect special provision for obsolescence. On the other hand, industries in which new methods and devices are being introduced at frequent intervals, cannot hope to prosper by neglecting adequate provision for introducing up-to-date methods of manufacture. The steel industry for example, is still undergoing rapid changes in the process of manufacture. A concern engaged in this industry, therefore, must always be ready to adopt the latest changes. Our steel industry does not seem to have paid any attention to this feature. Far from making any provision for obsolescence, our companies do not make sufficient allowance even for depreciation.¹ The American steel companies, on the other hand, keep their costs low by taking advantage of the latest inventions in the process of production which they introduce with the help of such funds.²

Some writers on industrial finance argue that no special provision is necessary for obsolescence. Their argument is that all replacements, renewals etc., due to obsolescence should be charged to the depreciation account. But this argument does not seem to be correct. In the first place, the proper function of the depreciation reserve is to provide for replacement of original cost and consequently changes due to obsolescence cannot be charged to this reserve. A concrete example will make this more clear. Let us suppose that there is a plant costing twenty lakhs of rupees. Its normal life is considered to be twenty years, and therefore, depreciation provision per year is calculated to be one lakh of rupees. After, say five years, a certain part of this plant becomes obsolete, and the replacement of this part with a new one costs four lakhs. If this is paid out of the depreciation reserve, it will be reduced to one lakh, and this will represent the depreciation of the whole plant, excepting the new part, during the period of five years. This means the depreciation of the plant is not properly provided for. Secondly, even if we leave aside such scientific accuracies and distinctions, it so happens that the proposed changes prove to be too heavy for mere depreciation fund, and therefore, it becomes necessary to supplement this fund by other sources. Thus it is necessary to maintain a separate reserve for obsolescence

¹ Cf. Indian Tariff Board Statutory Enquiry 1926, Steel Industry Report, Vol. IV.

² See for example the evidence before the Indian Tariff Board during the statutory steel Enquiry of 1926.

from which costs of discarding obsolete parts might be met. One great difficulty in maintaining the obsolescence reserve is that no one can say definitely, what should be the rate of its accumulation. Fresh inventions and improvements are always uncertain and therefore cannot be properly provided for. A liberal depreciation policy accompanied by some allowance for obsolescence, according to the needs of different industries, will prove an ideal arrangement. The income tax system of certain countries, for instance those of England and the U. S. A., make some allowance for obsolescence while calculating the profits. This is a practice worth following by the Income Tax Department of our country. It will impress upon the minds of our industrialists the importance of making some provision on this account.

UTILISATION OF THE DEPRECIATION RESERVES

So far we considered the quantitative aspect of the depreciation reserve, now we shall turn to its utilisation. The first important point to be remembered in this respect is that just as there is no fixed policy with regard to the accumulation of the depreciation reserves, so also there is no fixed policy which is followed in utilising them. The appropriation of the depreciation fund for repairs, extensions, renewals etc., seems to be more common than any other use. In many cases it so happens that though in the balance sheets sums appear to have been credited to the depreciation account actually no reserve is found to exist. As a matter of fact, the whole depreciation account is nothing but piled up expenditure on repairs, renewals, extensions¹ etc. In some cases the depreciation fund is not used for ordinary repairs but for minor or major extensions and additions. But while setting apart depreciation it is calculated upon the original investment and not on these additions to the block values which also are depreciating. Such wrong appropriation of the depreciation funds takes

¹ See for example, the following statement by a witness before the Tariff Board.

Mr. Walker:— What actually happens is we debit profit and loss account and credit the depreciation fund. The depreciation account will reduce the block account as the years go by.

Mr. Mather:— You have actually got this Rs. 5½ lakhs.

Mr. Walker:— You won't find it on the asset side as a specific investment. It is invested in the business.

place even in the case of big concerns like the Tata Iron and Steel Works, Ltd.¹

MANAGING AGENCY SYSTEM AND DEPRECIATION PROVISION

One of the important causes of the neglect of depreciation problem in this country is the managing agency system. There are three important features of this system which work against proper depreciation arrangement. First, there does not exist homogeneity between the interests of the agents and those of the shareholders, i.e., the management and the owners. This situation is made still worse by the second feature that the owners exert no control over the management. Thirdly, the agents are interested not in net profits but in the mere volume of business. And as they are not interested in net profits it does not concern them much whether the production is carried on efficiently or otherwise. They only wish to increase the business by undertaking extensions and additions with the funds at their disposal. The most important point in this respect is that the management is not interested in the long time welfare of the concern just as the shareholders are. The agents are there by contract and they wish to make the best of their position so long as the contract lasts. Besides, it is to their advantage if they can raise the rate of dividends even at the cost of depreciation provision. It pleases the shareholders and also pays the agents indirectly by enhancing their prestige. There is one more feature of the agency system which comes in the way of proper handling of the depreciation problem. Whenever the agents' commission is charged on the profit basis, the depreciation charges are not excluded from the amount on which the commission is to be calculated. The maintenance charges, including renewals, replacements etc., are excluded from such calculations. This tempts the agents to transfer the maintenance charges to the depreciation account and in this way to increase their commission.

¹ Cf. Report of the Indian Tariff Board on the Iron and Steel Industry 1934. P. 40-42.

MAINTENANCE OF SINKING FUND

The dissipation of the shareholders' investments takes place not only through depreciation of the assets but also from an unwise loan policy. An industrial concern like an individual is required to borrow at certain times and for certain purposes, and there is no harm in doing this if it is done wisely. The underlying principle of a wise loan policy is that it should result in enhancing the value of the capital investments of the shareholders: it should not at least result in diminishing that value. To have the assets encumbered with debts means to diminish their value from the owners' point of view. Whenever any debts are incurred, care should be taken to repay them in reasonable time. Every concern, therefore, that has issued creditorship securities, should make some provision for their redemption before calculating profits.

The best way of doing this is the maintenance of a sinking fund. This is a common practice with American concerns; but we rarely come across such arrangements in India. Besides its use in retiring the creditor obligations, the sinking fund has many other advantages. It may, for example, enable a company to "create market" for its securities through purchase in the open market. This will prove of special advantage in India, where one important complaint against the debentures is that there does not exist a market for them. By creating a sinking fund, the company will be in a position to create some market for such securities. This is specially true in the case of small issues which are little known and possess, as a natural consequence, if at all a narrow market. Such a fund also, gives some assurance to the creditor that definite tangible values are being maintained to support his claims, and that his obligations will be met at maturity. Such an assurance is of special importance in India, where people are not accustomed to permanent bonded obligations but look forward to a definite date for the return of the debt. The maintenance of a sinking fund will prove of advantage to those concerns also, which invest funds received from public deposits in fixed assets, because it will create confidence in the minds of the depositors and will even lessen the difficulties of the borrowing concern by enabling it to meet the depositors' demands, which in turn will be lessened owing to increased confidence. In this way,

the sinking fund, by enabling a company to pay off its creditors, safeguards the interests of the ordinary stockholders in the business.

DIVIDEND POLICY – GENERAL CONSIDERATIONS

Once adequate provision is made to keep the investments intact, the next step is to distribute the income among the owners. The earnings, that remain after meeting the requirements of the different provisions discussed so far, can rightly be divided among the shareholders as dividends. This does not mean that every pie of this amount should be paid to the shareholders. Every company before proceeding to the allotment of dividends must take into consideration the following points: (a) What has been the past record of the earnings, if the company is an old one? (b) What are the future earning prospects? (c) How strong is the company's cash position? (d) What plans does the company have for the future development of its business? (e) Does the company intend to undertake extensions of property with retained earnings or with funds raised in some other manner?

The underlying principle of the dividend policy must be to retain stability of the dividend rate. If the record of a company is consistent in this regard, its stock will be a better investment and will attract a more desirable class of owners. Besides, such stock will naturally be more desirable as collateral for loans. When any occasion for raising more finance arises, a company following a policy of stable dividends can do so on relatively easy terms. An investor too, who holds shares in a company which follows such a policy can rely, under ordinary circumstances, upon a certain income. When the dividends of a company widely fluctuate, the shareholders can never say what they may get in any particular year from their holdings in such a company. Investments in the shares of such concerns become a sort of speculation which only the few rich can afford.

STABILITY OF DIVIDEND RATES

In order to maintain a reasonably consistent dividend policy it is highly essential that a company shall be conservative at all times. Some financiers even suggest that dividends should not be

paid in the beginning even though earned.¹ This postponement should be carried, according to their opinion, until the business becomes 'seasoned' to such a degree that its financial policy can be carefully planned, and the future can be pretty definitely forecast on the basis of past performance. But the practicability or even the wisdom of such a policy is doubtful under the present conditions of this country, where the shareholders are eager to get dividends from the very beginning. Under such circumstances, if a company does not pay dividends for some years after it starts work, the price of its shares will come down and its credit will be lowered.

These considerations are likely to lead one to argue that regularity of dividends from the beginning is unattainable in India. But the situation is not so hopeless. Under the present stage of economic development and with the available supply of commercial statistics and information, the earnings of a concern, barring the periods of trade fluctuations, can be predicted with pretty accuracy. Of course, calculations of this sort are not possible in the case of enterprises of a speculative nature.² Even in such cases an attempt should be made to stabilise the rate of dividend in due course. When a certain rate is decided upon it should be maintained as far as possible. As it is always difficult to reduce a higher rate to a lower one, it is advisable to start with a low rate. Even later on, when prosperous conditions allow greater profits for distribution, the additions to the usual rates should be paid as extra dividends, which have no guarantee whatsoever of continuance. But it must be mentioned here that no arbitrary rules can be laid down in this matter of dividend policy. Stability is at all times to be aimed at. But the actual practice differs from industry to industry, or even from concern to concern.

¹ See for example, "Applied Business Finance" by E. E. Lincoln, p. 714.

² "Earnings of corporations engaged in the production of inexpensive necessities, sold to and immediately consumed by the ultimate consumer, are most regular and subject to reliable prediction; earnings of corporations engaged in the production of costly commodities, sold to other producers and not absolutely necessary for the operations of their business, are least regular and least subject to reliable predictions. These are the extreme cases. Between these extremes lie the majority of corporate business, and the relative predictability of their earnings will be determined according as they tend toward one extreme or the other."

"The Financial Policy of Corporations," by Arthur S. Dewing, p. 557.

DIVIDEND POLICY OF INDIAN COMPANIES

The problem of stability of dividends seems to have been neglected in the financial policy of our companies. Stable dividend rates have become, on the other hand, a common feature of the industrial finance in other countries.¹ But no such policy is followed by our companies. The general tendency in this country seems to be to distribute whatever is available in a particular year without any consideration of the past or the future. The profits of a concern cannot be the same year after year. It is, therefore, necessary to create a reserve to which funds should be credited in fat years for being withdrawn in lean ones. No attempt was made by our concerns to create such a dividend equalisation reserve even in the War and the post-War boom period. And as a result of this, as soon as the boom subsided many a company found itself unable to pay any dividend. The reasons why the boom period high profits were distributed among the shareholders and not retained in the business, were said to be that the high rate of dividend was necessary in order to compensate for the low dividend paid during the earlier years. The other reason forwarded is that the shareholders complain if any part of the profits is withheld from them. Whatever the reason, the fact remains that no attempt was then made, nor has ever been made, to create some sort of stability of dividends. The fluctuating rate of dividends, which has become almost a rule in India, seems to be due to some deeper and more potent reasons than stated here. The shareholders in India are more speculators than investors, and as such, they are naturally more interested in a fluctuating rate of dividends than in a steady one. The same is the case with the management, the managing agents as well as the directors, who not only deal but also speculate in shares.

It is said that the liberal payment of dividends is due in many respects to the system of financing by public deposits. Large

¹ The following remarks by Mr. Edward E. Lincoln about the dividend policy of important industrial companies in the U. S. A. are worth noting. "In the more prosperous years," he observes, "all types of industrial companies were following a reasonably conservative dividend policy. In 1916 and 1917, for example, the proportion of net earnings distributed in dividends was considerably less than half the amount available for this purpose. In the 'lean' years the ratio runs much higher. This fact indicates definite attempt on the part of the companies to keep their dividend record stable." Applied Business Finance By Edmond E. Lincoln P. 725

dividends, it is argued, help to maintain the credit of the concern in the eyes of the depositors.¹ Not only this, but sometimes, it is said, dividends have got to be paid which are not warranted by profits in the real sense of the word. But even from this point of view, a concern, with a stable dividend rate, will be at a greater advantage than the one following a fluctuating rate, though in the aggregate the dividends declared by the former might be less than those declared by the latter. For the purpose of a stable supply of deposits too thus it is advisable to make an attempt from the very beginning to maintain a stable rate of dividends.

PROFITS NOT SAVED EVEN FOR WORKING CAPITAL

Keeping aside stability of dividends, our companies do not care to create a cash reserve out of the profits even to meet short time financial needs. We hear many complaints about the difficulties in getting working capital. These are attributed to the reluctance of the banks to make liberal advances to companies which show low profits, or the lack of confidence shown by the depositors, or the weakened financial position of the managing agents. But it is surprising that our businessmen do not try to relieve the concerns of their dependence on these outside agencies when it is possible to do so. Supposing a concern could not raise a sufficient share capital in the beginning, efforts should be made later to save the profits whenever possible, and to free it from the short time creditors. But such instances are conspicuous in our country by their absence. Many an opportunity of doing this is lost. The cotton mill companies of Bombay, for instance, during the eight years ending with 1922 paid out an average dividend of 53 per cent. on an average capital of 12½ crores, or a total of more than 50 crores.² If the directors of these companies had shown some foresight and saved something out of the high profits, the companies would have been saved the difficulties which they had to face later on. The retention of the profits in the business in order to strengthen its financial position, is a common practice in other industrialised countries. The Japanese cotton mills, for instance,

¹ See for example, Statement of the Bombay Millowners' Association: Indian Tariff Board Cotton Textile Enquiry Report, 1932.

² Cf. Proceedings of the Legislative Assembly on 24th Sept. 1924

created huge reserves during the period of high profits.¹ In America also high profits are utilized in similar manner.²

The financial difficulties that arise owing to too lavish dividend distribution can best be seen in the case of the tea companies. The evidence of these companies before the Bengal Provincial Banking Enquiry Committee shows with what great difficulty they secure the working capital. With all the sympathies for these companies, we cannot help saying that their difficulties are in many respects due to their own faults. The following criticism by the Committee before whom they related a long story of their financial woes is noteworthy in this respect:—"We have, however, been unable to understand why no serious attempts are made for building substantial reserves, when such high dividends as 50 to 150 per cent. are paid. If the dividends be limited to say, 15 per cent., for a few years, and the rest of the profits carried to the reserve, most of the gardens will be able to accumulate a sufficient reserve fund for meeting their annual recurring expenses from this fund. Borrowing them would be unnecessary, and interest on loans saved. The result will be larger dividends in future."³ The continuance of our industrial concerns on borrowed funds for the working costs is perhaps due to the fact that the managing agents are interested in the supply of such funds, either as their owners or as middlemen in securing them.

INTEREST ON THE RESERVES

There is one more point which demands attention in the discussion of the dividend policy of our concerns. Whenever the funds accumulated in the form of depreciation or surplus or any such reserve are utilized in the business no interest is credited to such funds. This is a faulty accounting system. The reserves, really speaking, belong to the shareholders and they have every

¹ Cf. Cotton Industry of Japan and China by Arno Pearse.

² "There are, on the other hand, numerous instances of companies, which retained a large proportion of their earnings during the years of inflated prices in order to increase their working capital to a satisfactory point without endangering their position by excessive borrowing. Such companies, if they were not subject to any considerable loss during the post-war years, probably found that they had within the business a "free" surplus far in excess of all immediate needs." Applied Business Finance: By Edmond E. Lincoln, p. 724.

³ Cf. The Report of the Bengal Provincial Banking Enquiry Committee, Vol. I, p. 121.

right to demand interest on them. Besides, this faulty practice gives a wrong idea about profits, which as a matter of fact include interest on the reserves used in the business.¹ Proper finance demands that interest should be credited to these reserves and should be deducted from the profits in the real sense of the term. This will give a more correct idea about the profitability of the concern.

This faulty accounting practice is mainly due to the fact that the reserves are utilized for extensions, additions etc., and at the time of calculating the profits no distinction is made between the original and the additional investments. When the representatives of the Ahmedabad Millowners' Association were asked why they did so, the reply was that it helped them to show large profits.² This method according to them, helps to attract larger amounts of capital for industrial purposes. This may be true when we take into consideration some immediate cases, but its success is doubtful in the long run. It is just possible that an investor might be tempted to purchase the shares of a new company seeing that the shareholders of a similar old company are getting good dividends. But he will soon be disappointed to find that his new company distributed far less than what the older company was doing. Such cases shake the confidence of the public in industrial investment. The purchase of industrial paper becomes a sort of speculation, and profits become a mystery or a stroke of chance. This naturally will have an adverse effect upon the supply of capital to industry. Even from the point of view of the shareholders, this practice is not of any great advantage. They would be able to get perhaps greater profits if they invest those reserves in some other way.

¹ Q. "You declare now profits or dividends without complying with book-keeping or account transactions by crediting all the funds held by you with their due interest."

A. "Reserve fund you mean?"

Q. "All those funds owned by the shareholders. It is a fund at your disposal on which you do not allow interest in the account books."

A. "If we allow it profits would be much smaller."

Evidence of the Bombay Millowners' Association, Report of the Indian Tariff Board, Textile Enquiry 1927, Vol. II, pp. 210-11.

² Cf. The evidence of the Association: The Indian Tariff Board Cotton Textile Enquiry 1927, Report, Vol. II, p. 445.

RE-INVESTMENT OF THE PROFITS

This discussion gives rise to another minor problem whether the profits should or should not be spent in undertaking extensions. Of course, no objection can be raised against the use of profits for an extension of the business, which is quite a legitimate use of it. But the profits which are to be spent in extensions and the profits which are to be used for maintaining different reserves must be distinctly separated. The funds earmarked for the latter purposes must be always liquid, so that they can be available for the respective purposes for which they are saved.¹ The shareholders at the same time must get a reasonable return on these reserves which really belong to them. When the reserves are invested in block, they are not available for meeting the particular needs for which they were created. The effects of such a practice are felt most glaringly in the case of the dividend equalisation reserve, because when depression comes it affects the original share capital as well as the reserves.

The point as to what extent the profits should be re-invested in the business demands some attention. The re-investment of earnings saved after the distribution of fair dividends to the shareholders is justifiable until such time as the returns on such investments are not less than returns on similar other investments. When investments in the same business bring less than investments outside it, it is time for the directors to stop withholding profits from going into the hands of the shareholders.²

SYSTEM OF INTER-DEPOSITING THE RESERVES

Whenever reserves are not re-invested in the business they are deposited with private parties such as industrial concerns and businessmen, and not with banks. The reason why they are

¹ "Common sense will seem to teach the students of finance that the reserve funds of a company cannot truly be so considered unless it is invested outside the company's own business. From this point of view reserves used for capital purposes had better be transformed into capital." *The Theory and Practice of Finance*: by William Brooks. p. 282.

² In this respect the following remarks by a practical businessman, Mr. Alfred P. Sloan, Jr., President of the General Motors Corporation, are worth noting:—"When we invest our stockholders' money, as trustees, we must do it on the firm belief that the capital is safely invested and that the return to the stockholders as a result of the investment, will be fair and equitable; otherwise we have no right to make the investment." Cf. "Corporation Profits," by L. H. Sloan, p. 138.

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invested in this way is said to be that thereby greater returns are secured on them.¹ These parties pay a higher rate of interest than the banks, and therefore, if the funds are invested with banks the shareholders, it is argued, will be losers to that extent. But in such arguments the risk factor seems to have been completely ignored. It is obvious that under this practice of private deposits there are great chances of personal favouritism prevailing over other considerations such as safety and security. It will not be difficult to find instances in which many sound concerns have been ruined owing to investment of their reserves with weak and unsound parties. Still worse is the practice of depositing the reserves with concerns under the same agency firm or with the managing agents themselves. There are so many cases of sound concerns being ruined owing to such faulty financial practice that they need no comment or enumeration here. The latest important instance of this will be found in the failure of the well-known agency house of Currimbhoy Ibrahim & Sons.

¹ See for example, the evidence of the Ahmedabad Millowners' Association, The Indian Tariff Board, Cotton Textile Enquiry Report, 1927, Vol. II, p. 444.

CHAPTER VIII

THE CAPITAL MARKET

SUPPLY OF CAPITAL TO INDUSTRIES

The industrial development of a country depends, to a great extent, upon sufficiency of capital supply for industrial purposes. If we, therefore, wish a speedy industrial development, we must see that the financial needs of our industrial enterprise are properly met.

Every country possesses a certain amount of capital resources which it does not use for immediate consumption but saves for future needs. These savings are lent for use if the savers get a certain rate of return. To collect such savings and to use them in a way that will increase the total wealth of the society, is the main function of the capital market of a country. The efficiency of the capital market depends upon the extent to which it is able to collect these savings and to make them available to the industry.

SERVICES OF THE CAPITAL MARKET

The capital market is not a passive agent, merely receiving the capital as it comes to it and advancing it as it is demanded. The principal duty of the capital market is to collect the greatest possible amount of capital and to put it to the greatest possible use. It must also see that capital is supplied in response to genuine and sound needs. There is always a difference between the potential demand for capital arising from any venture and the effective demand that it is able to create. The former depends upon the rationally prospective earning power, the latter depends upon the idea of the capitalist about that earning power. Scarcely can a capitalist form a correct idea about the prospective earning power of the proposition placed before him. Usually it so happens that either the risks are magnified so greatly that no capital is forthcoming, or they are concealed so that capital is supplied to ventures with little prospects of success. In either case the flow of

capital into industrial undertakings is not in accordance with the actual prospects of profit offered by the proposed scheme, which means a waste of the social resources in so far as they are spent for unproductive purposes. The capital market, therefore, must be so constituted that it will minimise the waste and make the resources flow in those channels where they will prove of the greatest use to the society. It must thus discharge the functions of an intermediary, who investigates the claim of the venture and presents that claim to the public, supported by its own guarantee. The form and functions of the capital market, therefore, depend upon the social and economic conditions of the country. In India, for instance, owing to the general poverty of the people, the savings are held in small amounts. Besides, the economic gulf between these prospective investors and the businessmen is great as the former have no confidence either in the businessmen or in the efficiency of their propositions. The capital market of our country must, therefore, provide institutions which will meet these difficulties.

CAPITAL RESOURCES OF THE COUNTRY

Our discussion so far must have made it clear that one important factor which hampers the industrial progress of this country is the insufficient supply of capital for industrial purposes. But the scarcity of capital supply to industry is in no way an indication of the capital resources of the country, which certainly are far in excess of the actual supply. Though there may not be big accumulations, the small savings scattered throughout the length and breadth of the country if mobilised, will prove a considerable supply of capital resources for industrial purposes.¹ Our capital market must, therefore, be so organized that it will mobilise these

¹ The Industrial Commission (1926) in their Report observe "The difficulty in raising capital for industries is mainly the measure, even in India, not of the insufficiency or inaccessibility of money, but of the opinion which its possessors hold of the industrial proposition placed before them. We may now consider the extent to which capital to finance new enterprises is available in India. On this subject we have received a large amount of evidence, an analysis of which yields the following facts. There is a considerable accumulation of capital in India, and to this, new savings are being added every year." Similarly the External Capital Committee (1925) too have remarked, "It is recognised in practically all the replies that there is sufficient potential capital in India to meet the larger part of India's industrial requirement, but that it is timid, conservative and requires to be drawn out." Report Para 8.

savings and make them available to industries. One more point to be remembered in this connection is that, making allowance for the unscientific methods in which the whole problem of estimating and raising capital is tackled in this country, the financial difficulties of our industries are also due to the general shyness of our people about industrial investments.

HOW TO REMOVE THE SHYNESS OF THE INVESTORS

In the previous chapters we have seen how sound schemes sometimes have got to be given up owing to lack of capital. This is due, as said above, not to want of capital, but to diffidence on the part of the investors about the soundness of the scheme placed before them. The investing public have no confidence in the words of the industrialists who approach them. If, therefore, the investors can, by reasonable means, be made to believe in the soundness of the scheme, capital will easily come forward. The best way to accomplish this, is to make some independent authority, commanding the confidence of the public, responsible for investigating the profit earning prospects of the proposed scheme. Of course, the best authority for this purpose will be some State agency as its opinion will be taken to be well considered and disinterested. The industrialists who wish to strengthen their case should approach such an agency and place the proposed scheme before it, and its report should be included in the prospectus of the enterprise. This will create confidence in the minds of the investors, who will then readily come forward to invest in the concern. But the investigation of the merits of an industrial scheme cannot be properly carried out without expert technical, economic and financial knowledge. The agency intended to carry out such investigation must, therefore, possess persons who can give expert technical, economic and financial opinions on the industrial propositions presented to them.

The existence of such expert knowledge and guidance will prove beneficial in one more way also. In earlier chapters we have seen that inefficient promotion services, and lack of confidence in the organisers of an enterprise, are two important difficulties in the way of our industrial progress. We have also seen that a good number of industrial failures are due to the lack of efficient techni-

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cal advice in the promotion stage. Efficient technical advice is found to be too costly by a large proportion of our business promoters; sometimes, apart from costs, it cannot be had in this country at all. Under these circumstances, if efficient technical advice, and also financial if necessary, is made available at reasonable costs, it will prove of great benefit. In the first place, concerns started on sound lines will in all probability prove successful, and their success will make the investors bold about industrial investments in general. Secondly, those who can understand the things for themselves will readily come forward to invest in concerns which enjoy the advice and guidance of the experts. In short, if expert technical and financial advice is made available to our industries, it will go a great length in reducing the present shyness of the capital.

THE ESTABLISHMENT OF AN INDUSTRIAL BANK

Of course, all objects will not be served by making available expert advice on technical and financial problems. The fact that an industrial scheme is organised on sound lines, is one factor in attracting capital, but to attract a sufficient quantity of capital, efforts in other directions are quite essential. A great majority of our people do not even dream of investing in industrial paper. One great reason for this is that their savings are small, and naturally the smaller the saving the greater is the hesitation at the time of investment. If we wish to have a rapid industrial progress, we must try to mobilise these resources. Under present circumstances, a semi-Government institution is best suited to accomplish this. An Industrial Bank with Government control will prove an ideal financial intermediary, which will collect the funds from such sources, on the one hand, and will make them available to the deserving industrial propositions, on the other. Such a bank should try to raise its capital by issuing shares and debentures with Government guarantee. The shares and debentures, especially debentures, should be issued in small denominations, so that they should be within the reach of the middle class, and should be made available even in small towns. The funds raised in this way should be made available to industry by purchasing the shares and debentures of approved industrial concerns. The

very fact that the shares or debentures of a concern are being purchased by such a Bank will increase the demand for those securities. The Bank thus, will not be required to invest too much in a single concern, nor will it be required to hold the securities for a long time. In practice, it will be required not to purchase but only to underwrite the issue and this will automatically increase the demand for the same.

Such a Bank will create securities of different degrees of risks for different types of investors. For the most conservative there will be its debentures, for the less conservative there will be its shares, for those who are prepared to invest directly into industrial securities there will be the shares and debentures either purchased or underwritten, or certified by it. The difference in the degrees of risk will have a corresponding effect upon the price of different securities. At present there are prospective investors with little knowledge about industrial schemes and their organisers on the one hand, and the industrialists with good and bad reputation on the other, with a wide gulf between the two. The proposed bank will bridge the gulf and bring the parties together.

THE BANK AND INDUSTRIES

The Industrial Bank will prove beneficial not only to the investors but also to the industries. It will make it possible to secure capital at the proper time, and in sufficient quantity, for really sound propositions. No more will it be necessary, for the organisers of a sound concern to approach the ignorant public who cannot appreciate the merits of the case, and thus be in suspense whether their case gets support or not. The Bank will also exercise a healthy influence upon the industrial organisation in general. It will slowly eliminate all unsound and fraudulent promotions. It will more or less be a common practice to secure from the Bank, if not direct financial help, at least recognition of the merits of the proposal. Thus the waste of funds on unsound and fraudulent schemes will be saved. At present a relatively large amount of social resources is wasted being spent on unsound and fraudulent schemes.¹ Such waste being stopped, the supply to sound propositions will increase to that extent.

¹ See *Supra*, Chapter I.

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An institution meant to render financial aid to industries, either new or old, must be able to command full technical information about the industries to be helped. The organisation for rendering technical aid, and that for rendering financial aid, can, therefore, be co-ordinated with advantage.

The activities which we have here chalked out for the Bank will make it necessary that it should have expert economists and financiers on its staff. The services of these experts should be made available to the outside industrial enterprises as in the case of the services of the technical experts. In short, the Bank will be rendering the following services to industries. It will scrutinise the industrial schemes placed before it for its opinion, and pass certificates about their merits which will serve as guides to public investors; it will give expert technical advice to all who seek it about some definite industrial proposition. It will render financial help either by underwriting or purchasing an issue, or by supplying cash and credit to old and needy concerns. Lastly, it will supply expert guidance on all difficult financial problems.

INDUSTRIAL BANK IN EACH PROVINCE AND THEIR CO-OPERATION

The services that we expect the Industrial Bank to perform clearly show that a single bank will not be sufficient for the whole of the country. There should, therefore, be one Industrial Bank in each Province, with its offices in all the important industrial towns of that Province. It should be a shareholders' bank with State control somewhat on the lines of the Reserve Bank. It is advisable that these Provincial Industrial Banks should be correlated in some way, so that there should be a unity of purpose and policy guiding the industrial activities of the whole country. There should, therefore, be a Central Industrial Board supervising the working and policy of all the Provincial Industrial Banks. The Provincial Banks should be allowed to borrow extensively by issuing debentures with the permission of the Central Board. It is just possible that if our industrialization proceeds vigorously, we may have a scarcity of capital as compared with the demands of old and new industries. Under such circumstances, the Banks should be allowed to approach foreign markets through the Central Board. The

Central Board should be empowered to borrow in foreign markets by issuing bonds with State guarantee. The Provincial Banks should not accept short-time deposits; they might be allowed to accept fixed deposits for long terms. If any depositor requires his funds earlier, he should be paid in the form of industrial securities held by the Banks.

As regards the technical staff, it will be a costly affair, and also involve waste, for every provincial bank to maintain a full staff of technologists in all possible industries. Each Provincial Bank therefore, should try to specialise in the important industries of the Province. When advice on technical matters concerning any outside industry is sought, the Bank should take the help of such other Provincial Bank which maintains the required staff. If in certain cases the necessary advice could not be had in this country, the Central Board should try to secure it from experts in respective industries from foreign countries.

INVESTMENT BANKS

One Industrial Bank in each province on the lines discussed above, even with its offices at different places, may not be able to satisfy our demands. For a vigorous industrial development the work of this Bank must be supplemented by private investment institutions. Investment banks on the lines of those in the U. S. A. will serve a useful purpose in this respect. There is a difference in the spheres of work of the industrial banks and that of the investment banks.

An investment bank is a financial intermediary between the industrial concerns and the investing public. The businessmen who want funds to finance industrial enterprises come to it to secure the same either directly from it or from the investing public through its agency. The investors, on the other hand, who have surplus funds for investment, approach it for advice regarding the securities in which they should invest. When an industrial concern comes to an investment bank for assistance, the latter studies the situation carefully and then determines the lines on which the financing can best be arranged. The securities issued by a concern, as a result of such deliberations, are passed on by the bank to its investing clients. Sometimes, if the needs

of the concern are urgent, the bank supplies the funds immediately by purchasing the securities directly which later on are sold to the individual investors.

Like the industrial banks, as suggested above, the investment banks too render a twofold service to the industrial society. On the one hand, they make capital available to industries when they need it, and on the other they supply to the investors securities backed by their name and guarantee.

The main function of an investment bank, thus, is to deal in long time securities, and therefore, it is necessary that it should carry on its business with permanent funds only. If it disregards this rule and uses short-time funds in holding long-time securities, it runs the risk of getting involved in a financial crisis when these funds might be demanded back. The only way open in such an eventuality will be to unload the securities on the stock market, which not only will entail a loss to the bank but may also have repercussions on the finances and credit of the companies concerned. An investment bank therefore, should never dabble in short time deposits or current deposit accounts. At the most it may accept long-time fixed deposits, which should be always invested in paper of short maturity, say, of three or five years. For the rest it should depend only on the share capital or the reserves. It is essential therefore that every investment bank should raise sufficient share capital. Just as an investment bank should not accept short-time deposits, so also it should not carry on what is commonly called commercial banking. The underlying motive in making this suggestion is that if the investment banks undertake commercial banking, they may give undue importance to it, which is likely to result in limiting its services in the field of investment.

INVESTMENT BANKS AND PROMOTION BUSINESS

As a rule, the investment banks should not take part in promoting a concern. Because when a bank takes part in promotion it becomes, as is common with all the promoters, too optimistic and fails to take a proper perspective of the prospects of the scheme. As promoters usually are more optimistic and less critical, it is possible that in the wave of optimism schemes with unsound

prospects might be promoted. One or two such failures might prove ruinous to the bank, in as much as it will shake the confidence of the investing public. Its participation in promotion should be avoided for one more reason. A bank gets itself identified with the promoted concern, and therefore, is likely to invest in such concerns more than warranted by sound business policy. If anything goes wrong with such a concern the bank will sustain heavy losses. There is one branch of the promotion activity in which the investment banker's co-operation will prove of great use, and that is in connection with the preparation of the financial plan. The earliest stage at which an investment bank should take part in any industrial undertaking is, therefore, the stage of preparing the financial plan.

INVESTMENT BANKER, A DEALER IN SECURITIES

The main function of an investment banker should be to deal in industrial securities. He is to purchase them from industrial concerns and sell to individual investors, in this way making available to the industry the capital resources spread out in small lots throughout the country. Like other merchants he is to see that his stock is composed of the best articles. In order to ascertain the value of industrial securities, it is necessary to have the help of technical and financial experts. Whenever, therefore, an investment banker finds his staff deficient in such matters he should be free to approach the Industrial Banks which should offer him the necessary services at reasonable cost. Such an arrangement obviously will be beneficial to both the parties.

Investment banks are specially useful in countries like ours, where not only the savings are distributed in small lots, but their holders are also unable to decide for themselves the values of industrial investments. To such people an investment banker is a sort of guide serving both the parties at the same time, the industrialists as well as the investors.

INVESTMENT BANK AND THE CLIENT CONCERNS

Like all good merchants an investment banker must stand behind the quality of the articles sold by him. His first important function, therefore, is to make a proper selection of the securities,

on the advice of respective experts. Just as it is necessary to choose articles of quality, so also it is necessary to try to maintain the quality permanently. It is therefore necessary that the banker should have an opportunity to watch the working of the concerns in which he is financially involved. An investment bank, therefore, must try to secure representation on the boards of directors of the client concerns. Such a representation is of great advantage even from the point of view of the client concern, which can, in that case, get considered and expert advice especially on financial matters. The main difference between the banker's and the businessman's point of view is that while the former can take a disinterested review of the whole situation, the latter is likely to be misled by neglect of difficulties in his way. The practice of having expert financial advice has gone to such an extent in America, where investment banking has made a great progress, that it is considered to be distinctly the banker's function to see that the business is properly co-ordinated in all its parts through a central financial control. It is worth noting that the concerns which have been refused help by the banks also stand to gain, in so far as they know their weak points and receive instructions for improvements.

INVESTMENT BANK AND THE PUBLIC

The services rendered to the investing public by these banks are also important. The detailed investigations carried out by the banks protect the investors against running undue risks. Most of the investors in industrial securities are not able to decide for themselves the value of such paper. An investment house being jealous of its reputation does not sponsor a doubtful issue. The investors, therefore, can well consider it a dependable guarantee about the soundness of an issue, if it be backed by such a reputed agency. The business organisers being not interested in creating a permanent good-will, only aim at a temporary success in disposing of the securities. The investment banker on the other hand, being interested in establishing permanent good-will, cannot afford to mislead the public by exaggerating the merits of a weak issue. Not only this, but the investment bankers in America are even ready to re-purchase the securities sold by them, if the hold-

ers grow doubtful about their value. Such a practice is quite essential in India, where the first duty of the State as well as the financial middlemen, under existing circumstances, is to create confidence about industrial investments. The investors must feel that not only can they get full value of their money at present, but can also protect themselves against losses in future.

COMMERCIAL BANKS AND INVESTMENT BUSINESS

The restrictions on investment banks about commercial banking do not mean that commercial banks should not undertake investment banking. On the other hand, it is advantageous from the point of view of the banks as well as the society, that our big and well established commercial banks should undertake investment banking business. There is no danger if they utilise a certain proportion of their paid-up capital and reserves in this line of business. Besides, some efforts in this direction will certainly prove beneficial from the point of view of the banks themselves. Owing to the peculiarity of the business methods followed in this country, and also owing to peculiar relations between the banks and the client concerns, the former have got their funds permanently entangled with the latter. It will be of great benefit from the point of view of the concerns as well as the banks, if the latter try to replace such permanent advances by a debenture issue. The banks should underwrite such debentures and also be the trustees, and sell them to their depositors. They should try not only to replace their own advances by debentures, but should also prevail upon the companies to replace the public deposits, if they have any, by debentures. This will help to put industrial finance on more scientific lines. ¹

The commercial banks might object to this practice on the ground that it will entangle their funds in long time investments which is against the principles of commercial banking. But as a

¹ This new line of business is recommended even by the Central Banking Enquiry Committee. They, for instance observe, "Banks in India do not provide finance for block capital for industries, though there is no reason why such finance should not be provided by them out of their paid-up capital and reserves, if adequate security is offered. It is true that these resources are relatively small, but by utilizing these capital resources for the purchase of debentures of industrial concerns with a view to passing them on to the public, banks could render great assistance to new industries. This process could be repeated continuously with very little risk to the banks and with great advantage to new industries." Central Banking Enquiry Committee Report Vol. I, Part I, para 34c.

matter of fact, our banks have already got some of their funds locked up in long time investments. And it is not possible for them to realise these funds, unless they bring about a financial crisis and greatly disorganise the business world. If at any time the banks find that they have utilized an inconveniently large sum in the securities, they can borrow money by hypothecating them with other banks, especially the Industrial Bank which should liberally come forward either to advance money on such hypothecation, or to purchase the securities outright.

THE DISTRIBUTIVE SERVICES

The commercial banks enjoy certain special advantages in the field of distributing or selling the securities. They can find a clientèle in their depositors. They need not take the trouble of establishing new connections like a newly started investment bank. This distributive function is carried on on most systematic lines by American investment banks. In the U.S.A. every investment bank has an established clientèle and a permanent organisation which is constantly employed in marketing securities. Established banking houses of good reputation have a large number of customers who will buy securities from no one else. The relation between these banks and their customers develops to such an extent that the former can count upon a certain amount of money for investment from these customers at regular intervals.¹ These banks sometimes employ a novel practice of marketing their new issues for which demand may be weak at the outset. They exchange these new securities on a favourable basis for seasoned securities of long standing, which their customers have purchased in the past, and for which a ready market exists in this way, with a large number of satisfied customers, new issues of securities can be quickly sold by exchanges. But this presupposes complete confidence in the bankers on the part of their customers.

¹ "An investment banker has classified in his catalogues the names sometimes of many thousands of people who buy securities; he knows how much money they have to invest and when this money will be available. He has an organisation of salesmen who make regular visits to his customers, and he carries on an extensive correspondence with them to influence their purchasers. If he sells a bond maturing in ten years, he has a record of that sale, and when the bond is paid off, he expects to be on hand with a new bond to take the place of the old one."

Corporation Finance, By E. S. Mead.

INVESTMENT TRUSTS

The Industrial and Investment banks, which we discussed so far, are of greater advantage to the businessman than to the investor. The goal of the banks will be to direct the social resources to those channels where they will prove fruitful. These banks no doubt will reduce the risks that the investors run while purchasing industrial securities, especially so far as their value is concerned. But in these days of industrial fluctuations even sound schemes might come to grief and with them their investors. But there is one more type of investment institutions which gives still further protection to the investors, and that is the investment trust. An investment trust is a financial agency of a quite different type from an industrial or an investment bank. Both the latter institutions do the work of financial intermediaries between the business concerns and the investors. An investment trust, on the other hand, is itself an investor though on a big scale. It is not an intermediary between the suppliers and users of capital, but is itself a supplier of capital. The relation between an industrial or investment bank and an investment trust is that of a dealer and a customer.

An investment trust is a financial institution which sells its securities to the public and employs the proceeds so realised, in the purchase of a considerable number of investments. The word "trust" need not mislead anybody to think that any technical trustee relationships are involved in this organisation. Far from this, an investment trust is purely a business concern conducted for the profit of the shareholders. The main aim of an investment trust company, therefore, is to give the greatest return to the shareholders by a judicious employment of their money in purchasing different types of industrial securities.

In every industrial society we find that there are thousands of companies issuing various types of securities. Evidently, it becomes very difficult for an investor to choose the paper in which he should invest. Large investors can find their way with the guidance of the banks and stock brokers; but this is not possible in the case of small investors. Besides, the savings of a small investor get exhausted in purchasing the paper of any one concern, and if anything goes wrong with this concern he stands to

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lose all his savings. This risk of putting all the eggs in one basket, can be avoided by purchasing the securities issued by an investment trust. Besides the security, he can also get higher returns than what he can expect from trustee securities or savings banks. An investment trust, thus offers special advantages to middle class and other smaller investors.

SOME SPECIAL ADVANTAGES OF INVESTMENT TRUST

Of all the financial institutions or investment agencies, an investment trust comes very near meeting the requirements of small investors. It makes possible to derive the benefits of diversification even in the case of small investments as the trust proceeds which are made up of such investments are utilized in purchasing securities of various types. The complexity of joint-stock finance and also the quantity and variety of new securities, make a more skilled and scientific approach to the problem of investment necessary. The process of investment is giving rise to problems, the significance of which an ordinary investor cannot realise, and even if he does he cannot cope with it. These disabilities are felt more acutely in India, where investors are far less able to deal squarely with such problems than those in other industrialized countries. Another difficulty in the way of Indian investors is that the savings being small, they on their own part cannot reduce the risks by diversification of investments.

The investment trusts play an important part in the security market also, where they work as stabilizing force. When markets are buoyant, they sell securities from their holdings in considerable volume and re-invest their disposable funds in relatively depressed markets, or in securities selling at less than their true value. In their attempts to readjust their portfolios, they tend to steady the stock exchange fluctuations and to reduce the difference between the market prices of securities and their intrinsic value. Ordinarily investors are tempted to act in exactly the opposite way; being unable to estimate for themselves the economic worth of the securities, they make their purchases when the prices are rising, and thus send the securities to dizzier heights, and sell when the markets are falling. An investment trust, if well managed, can

realise profits, by its far-sighted and judicious dealings in both, the "ups" and "downs" of the market.

THE MANAGEMENT OF THE TRUST

The success or failure of an investment trust depends mainly on one factor, and that is management. In capable and honest hands, the investment trust will achieve all the benefits that are claimed for it here. But if its management passes into dishonest hands, or it becomes a victim of weak, unskilled and incompetent direction, it will sustain severe and inevitable losses. Such trust companies, of course, defeat the purpose for which they are started. The most important point in successful management of an investment trust is conservatism. The managers of trust companies should not purchase for the trust any securities which they would not be willing to buy for themselves. They should not also buy such securities, which they would not be willing to hold indefinitely.

The greatest advantage of an investment trust is that it reduces risks by diversification of investments. It is, therefore, necessary that the investment in any particular concern or industry should be restricted to only a small proportion of the total investment funds. In India, where the business affairs—industrial as well as financial—are concentrated in the hands of a few business houses, such precautions are very essential; because there is always a great temptation for the trust managers to invest the trust funds rather lavishly in those concerns in which they are directly or indirectly interested. The managers are likely to be lavish not only with regard to concerns in which they themselves are interested, but even with regard to concerns in which their friends or relatives are interested, because the temptation to help one's friends or relatives with others' money is difficult to overcome. Some safeguard against this can be provided by defining in the Articles of Association the amount that may be invested in any one security. This is the practice followed by other countries also. How wide is the field over which the English investment trusts spread their funds can be seen from the fact that the average number of investments held by them amount to 425.¹ The Articles

¹ Cf. *Investment Trusts*, by Theodore J. Grayson, p. 77.

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should define not only investment in any particular concern or industry, but also investments in particular types of securities, such as ownership and creditorship securities. The trust company organisers naturally will be reluctant to enforce such restrictions upon themselves, especially when the investors cannot realise their significance, and cannot easily differentiate between trusts with and without them. Under such circumstances, the restrictions should be enforced by law. It should be enacted, for example, that an investment trust should not invest, more than, say, five per cent. of its funds in any single concern, or more than fifteen per cent. in any one industry, or more than forty per cent. in ownership securities. It should also be provided by law, that an investment trust should be forbidden from investing in such concerns, in which its directors or managers are interested as directors, managing agents or principal shareholders.

INVESTMENT TRUSTS IN INDIA

There are no two opinions about the advantages that India will derive from the investment trusts, and accordingly some of the Provincial Banking Enquiry Committees have urged the immediate necessity of starting them. The Bengal Committee, for instance, observe, "One of the surest ways of developing the investment habit of people is through the organisation of Investment Trusts."¹ Though there are no two opinions about the advantages of the investment trusts, still there is a section of opinion which doubts the feasibility of starting them under present conditions. The foreign banking experts, for example, observe, "The Investment Trust in its classical scrutiny relies on the possibility of cheap finance in the capital market, the trust borrowing at a cheaper rate from the public, in the form of its own debentures and preference shares, than the yield of the investment securities acquired and held by the trust. It is evident that the rate of interest in India is not and for some time is not likely to be, low enough to warrant the formation of investment trusts."² There is a flaw in this argument. A relatively high rate of interest

¹ Cf. The Report of the Bengal Provincial Banking Enquiry Committee, Vol. I, p. 293.

² Cf. The Central Banking Committee Report, Vol. I, Part I, p. 639.

does not mean that the rate does not change according to the risks undertaken. If we find some industrial concerns borrowing at a high rate ranging from 18 to 25 per cent., we also find that Government can borrow at a low rate of 3 per cent. This means that the rate of interest is liable to be lowered by reducing the risks. What is necessary to make a trust company a profitable business is that it must be able to raise funds at a rate lower than that at which the industrial concerns are able to do. The difference between these two rates is the profit of the trust company. Where such difference does not exist an investment trust can never work, however low the rate of interest may be. The greater the nervousness of a capital market, the larger is the variation in the rate of interest, for a given difference in risk. The investment trusts in India, therefore, if they are able to win the confidence of the public, will be able to raise funds at a far lower rate than the industrial concerns are able to do. They therefore, stand to gain more in India than in other industrial countries, where the difference in rates will be small. But for all this, one thing is necessary, namely, the trust must be able to win the confidence of the public, and this cannot be achieved under the present Company Law. In order to make an investment trust both fool-proof and knave-proof, it is necessary to enact special legislative measures, the nature of some of which we have already indicated.

Another difficulty raised in the way of starting investment trusts in India, is that it will not be possible for them to reduce the risks by undertaking a world wide distribution of investments.¹ It is true that such wide geographical diversification of investments will not be possible immediately; and even though it be possible, it will not be advisable for them to practise it, as India at present cannot afford to send out its capital. At the same time, it is an important point to remember that under the present economic organisation of the world a geographical diversification is losing its importance. Because when any particular industry is overcome by depression it is so throughout the world. The proper method of reducing the risks, therefore, is through diversification of investments according to the types of industry; and India in

¹ See for example the evidence of Mr. MacDonald, the Managing Governor, Imperial Bank, before the Central Banking Enquiry Committee.

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this respect presents good opportunities owing to her large number of industries.

Another noteworthy feature about the industrial organisation of India is that the industries are distributed in more than one financial centres. Thus an investment trust can further diversify its investments by distributing the funds among industries at different financial centres in the country.

THE INDUSTRIAL INVESTMENT TRUST

Recently an investment trust has been started in Bombay¹ under the management of the well-known firm of Messrs. Premchand Roychand & Sons, with an authorised capital of Rs.250 lakhs divided into shares of Rs.100 each. Out of this, shares of Rs.75 lakhs were issued in the beginning and were readily subscribed by the public. It is yet too early to form any opinion about the working of this concern, though certain points from the Articles of Association demand attention. The said firm of Messrs. Premchand Roychand is to work as brokers to the trust, and is to receive the usual brokerage on all the transactions. It is not quite a salutary feature that the management should be interested in the transactions themselves, independently of their financial values. With regard to investment in any particular security, it is provided that not more than 5 per cent. of the total capital funds (including shares, debentures, etc.) of the trust, should be invested in any one security other than a trustee security. But the securities issued by the same concern if they are "of different titles or denominations" are not to be deemed as one. This means that the total percentage of the trust funds that can be invested in any one concern is equal to five times the types of securities issued by that concern. For instance, if a concern issues four different kinds of securities, twenty per cent. of the total funds of the trust can be invested in that one concern. This arrangement gives undue latitude to the discretion of the directors, especially as no restrictions are put on investments in concerns in which they are interested as directors, managing agents or shareholders.²

¹ Since writing the above investment trusts have been started in other parts of the country.

² Cf. The Articles of the Industrial Investment Trust.

CHAPTER IX

THE STOCK MARKET IN INDIA

IMPORTANCE OF THE STOCK EXCHANGE

The stock exchange plays an important part in modern industrial organisation. By providing a market for the purchase and sale of securities, it enables joint-stock industrial enterprises to raise the large capital required by them. There can be no doubt that, but for the stock exchange and the facilities provided by it, modern industrial development would not have been possible.

The study of the stock market in India deserves careful attention. In the absence of institutions like Investment Banks, Issue Houses, Investment Trusts etc., in the Indian Investment Market, the stock exchange is the only institution which facilitates the mobilization of individual savings and makes them available for industrial development.

SERVICES RENDERED BY THE STOCK EXCHANGE

It will be of interest to know the services rendered by the stock exchange. The stock exchange is not an investment institution like the Investment Bank, the Issue House or the Investment Trust, supplying capital funds to the industrial enterprises. The stock exchange is only a kind of intermediary; it provides a continuous and open market for the purchase and sale of securities. The public invest in industrial concerns on the assurance that the continuous market provided by the stock exchange will enable them to cash their investments in such concerns at a moment's notice. Without this facility provided by the exchange, capital would be immobile and industries would find it difficult to raise capital, for the investors would be afraid to invest their capital in industrial securities, which cannot be converted into cash whenever necessary.

The second service of the stock exchange is, that it enables investors to know the price of their securities from day to day. This is achieved by means of its quotation service. The stock

exchange quotations of the prices of scrips represent the average combined judgment of a large number of people, amongst whom are skilled financiers and expert businessmen. Because of the stock exchange, the opinion of these experts is made available even to the ordinary investor. It may be noted that the stock exchange quotations of securities do not merely indicate their present value but also their prospective value.

Another great service of the stock exchange is that it directs the flow of capital from unprofitable to profitable industries. This is also achieved by means of its quotation service. The stock exchange quotations of the value of securities enable the investors to know which industries are profitable and which are not. In the absence of this service, the capital resources of a society are likely to be used less efficiently.

LISTING OF SECURITIES ON THE STOCK EXCHANGE AND ITS ADVANTAGES

The stock exchange performs another useful service through its listing regulations. Before the securities of a company can be dealt in on the exchange they must be "listed", for which they must meet certain requirements of the exchange authorities. When the exchange admits to its "list" any security, it does not guarantee the value of the earning power of that security. But the fact that the exchange has admitted the security to its list carries a presumption in favour of its soundness. This is because of the fact that a company applying for the listing of its securities has to answer questions and supply information regarding its organisation, the nature of the securities issued, description of its property, engraving of its securities, etc. The application of the company and the particulars submitted by it are considered and examined by a special committee of the exchange, which after due consideration, makes a report whether the company's securities should be admitted to the list or not. When the stock exchange admits a company to its list, it does so only after a thorough examination of the particulars submitted to it by the company. This gives a reasonable assurance to the public that the company is legally formed, and that its securities are prepared in proper form.

The procedure followed in listing leads to the publicity of the nature of the Company's work, which is the investor's best safeguard against fraud and irregularities. Sometimes, some of the stock exchanges, e.g. the New York Stock Exchange, make an agreement with the companies which have their securities listed, that they should publish annual balance sheets, besides furnishing to their stock holders periodical reports of their physical and financial condition, and to give other information.

Listing further gives the securities the benefit of the continuous and free market provided by the exchange, and assures their convertibility. Listed securities, on account of their convertibility, can be used as collateral for a loan from a bank.

Among the minor advantages of listing, we may mention that the purchasers and sellers of listed securities are afforded the protection and safeguards of the stock exchange, as regards brokerage transactions, enforcement of the usage and customs of the stock exchange, etc.

From the point of view of the companies also, listing affords certain advantages. They get the benefit of having their securities given a daily quotation which is published by the newspapers, a fact which makes the securities attractive to the investors. And it is because of this, that it is stated in the prospectus of a new company that an application will be made to have the company's securities listed on a stock exchange.

STOCK EXCHANGES IN INDIA

Having seen the importance of the stock exchange and the various services rendered by it, we now turn to the stock market in India. Considering the vast size of the country there are very few stock exchanges in India. In fact the stock exchanges of Bombay and Calcutta are the only two organised stock exchanges. The stock exchange at Madras which was opened in 1920 is now defunct. It consisted of 100 members of whom only 25 were working members. The fee for a membership card was Rs. 1,000/-; and the annual subscription was Rs. 100/-. Besides, every working member had to deposit a security of Rs. 3,000/- which was held by the Committee. The business of the Exchange was regulated by rules drawn by the Directors. The principal securities

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dealt in on this Exchange were those of cotton mill companies. But as the business was never large, and the number of working members fell off gradually, the stock exchange had to be closed. ✓ There is also a stock exchange at Ahmedabad, the principal securities quoted on it being those of cotton mill companies of that centre. We shall however, consider the exchanges of Bombay and Calcutta, giving a fuller account of the former.

THE BOMBAY STOCK EXCHANGE

The Bombay Stock Exchange or to give it its official designation the "Native Share and Stock Brokers' Association,"¹ though now nearly a hundred years old, was formally constituted by an indenture dated the 3rd December 1887. The history of the Exchange has been one of steady development. Its members have steadily increased from 6 in 1840 to 60 in 1860, and to about 478 in recent times. Similarly, its volume of business has also grown. Whereas in the eighties of the last century, the scrips quoted on the Exchange were only those of cotton mill companies, to-day the scrips quoted include those of such companies like iron and steel, hydro-electric, cement, light-railways, sugar, etc.

In the boom days of 1917 another stock exchange, called the Bombay Stock Exchange, Ltd., was established in Bombay. It did very little business, and though it still exists at present, it has ceased to function for all practical purposes.

SPECULATION ON THE EXCHANGE

The boom years following the declaration of the Great War brought large wealth to the people in Bombay. There was an abnormal rise of prices all round; and speculation was rife in the City. At first there was speculation in landed properties and cotton, from[†] which it spread to stock exchange securities. The prices of shares, especially those of cotton mills and of cement and iron and steel companies, went higher and higher. New companies were floated almost daily, whose shares were quoted at high premiums. As a result of heavy speculation in shares, corners which were events of rare occurrences, became frequent phenomena in the share bazaar. When the inevitable crash arrived, it

¹ Popularly known as the Share Bazaar.

brought an all round depression. The prices of shares fell down phenomenally; as a result of this heavy losses were suffered by the speculators as well as by other classes of people. There was naturally great discontent. Those who had speculated heavily on the Exchange and lost, blamed the Association for their loss. Besides, there were others who criticized the management of the Association, and the methods of conducting business in the market. The Association's rules regarding corners were the subject of the severest criticism. On the 18th October 1922, a resolution was passed in the Bombay Legislative Council for the appointment of an Enquiry Committee, and pursuant to this resolution, the Government of Bombay appointed in September 1923, the Bombay Stock Exchange Enquiry Committee with Sir Wilfred Atlay, a former President of the London Stock Exchange, as Chairman. The terms of reference of the Committee were "to inquire into the constitution, government, customs, practices, rules, regulations, and methods of business of the Native Share and Stock Brokers' Association of Bombay, and to investigate any such complaint of the public, and to make any such inquiries with reference to any of the aforesaid matters or any other matter appertaining to the aforesaid Association as the Committee may deem proper, and thereafter with a view to protecting the investing public against the interested or irregular control of business to formulate such definite proposals for the future constitution, control, direction and regulation of the aforesaid Association as the Committee may deem proper."

The Committee submitted its report early in 1924, which was signed by all members except one who submitted a separate Minority Report. The Majority Report, after reviewing the whole position made several important recommendations regarding the introduction of rules to consider complaints from the public by the Association, strengthening and enforcement of discipline, extension of business hours, curtailment of holidays, closing of the market for settlement, abolition of sub-brokers, publication of a daily official list, annual election of the Board of Management, annual declaration by members as to the class of business they propose to undertake, alteration of the regulations relating to the admission of companies to forward dealing etc. The Majority further were definitely of the opinion that the rules regarding corners

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should be repealed. The Minority Report made some suggestions of a minor character. The Association accepted the Minority Report which left the position as before. In 1925, there was heavy speculation again in the market, particularly in certain mill scrips. The usual crisis followed, and once again there was considerable agitation for a reform of the rules and regulations of the Association. This time the Government threatened intervention, if the Association did not modify its rules and regulations. Ultimately the Government introduced in the Bombay Legislative Council, the Bombay Securities Contractors' Control Bill, applicable to the whole of the Bombay Presidency, under which it was open to any stock exchange to apply to Government for recognition and submit for approval, rules for the regulation and control of transactions in securities, other than ready delivery contracts, and furnish other information. Further, every contract for the purchase and sale of securities, other than a ready delivery contract was to be void, unless it was made subject to the above rules, and that too between members or through a member of a recognised stock exchange.

The Bill was in due course passed into law,¹ and the Bombay Stock Exchange had to apply for recognition and get the draft rules sanctioned by Government.

OBJECTS OF THE ASSOCIATION

Before the rules were amended in 1927, the main object of the Association was to protect the character, status and interests of the brokers, and to promote honourable practice etc. It must be noted that the main object of the stock exchange must be the promotion of the interests of the investing public, and the interests of the brokers must come second. It may be that the Association being formed by the brokers themselves, they considered their interests only.

Mr. Bhulabhai J. Desai maintained in his minority report of the Enquiry Committee that the object to "promote honourable practice" afforded sufficient protection to the public. But this does not seem to be quite correct. For instance, the members of the Association can be parties to or encourage speculation without

¹ Bombay Act No. VIII, of 1925.

breach of honourable practice, which usually means committing legal fraud. Mr. Desai, further, himself admitted that, "it may be fairly assumed that the Association is concerned to act honourably to those who employ them, namely, the speculating as well as investing public."¹ Now it must be noted that the provision of facilities for speculation cannot certainly be accepted as a fair object of a stock exchange. The real object of a stock exchange is to provide facilities for investment by the public, and to discourage speculation. Speculation within limits might be allowed only as an unavoidable concomitant of a stock exchange. And from this point of view, a stock exchange which allows equal facilities to the speculators as well as investors cannot be said to be alive to the interests of the public. It must be noted, however, that the Association has tried to remove this defect.²

MEMBERSHIP

The membership of the Association is open to any Indian, or a British subject who has resided for at least ten years prior to his application for membership in the Bombay Presidency. It may be noted that the Association's rules regarding qualification to admission are strict. Insolvents, persons of less than 21 years of age, and persons who are engaged in any business other than that of stock brokers and do not wish to give it up upon admission to the Association, are not eligible for membership. The maximum number of members is fixed by a resolution of the Association. Any person who wishes to become a member should purchase a card or right of membership outright from the Board,

¹ The amended object now runs: "The Association is established to support and protect the character and status of brokers and to further the interests of both brokers and the public dealing in Bombay in stock, shares, and like securities and in exchange to promote honourable practices, to discourage and to suppress malpractices, to settle disputes amongst brokers, to decide all questions of usage, custom or courtesy in conducting brokerage business." See Rule 2.

² The other objects of the Association are (1) To construct and maintain a Brokers' Hall, to be called 'The Sir Dinshaw Petit Native Brokers' Hall'. (2) To borrow with the sanction of the members of the Association, any monies required for the purposes of the Association. (3) To purchase or acquire with the permission of the members of the Association property in Bombay for the purpose of the Association. (4) To take on lease any property. (5) To invest the monies of the Association in suitable investments. (6) To sell or mortgage the property of the Association. (7) To do all such other things as are incidental or conducive to the attainments of the above objects.

if it has on hand such spare cards, or should obtain the nomination of a member who is relinquishing his card. The application of the person for membership must be supported by two existing members of not less than 5 years standing. Objections to the application are invited which are kept confidential. The application is then placed before the Board of Directors, and the candidate can be admitted as a member only if he is supported by three-fourths of the members of the Board. If the application is rejected, the candidate is debarred from putting in a fresh application for two years.

The entrance fee, known as the price of a membership card, for members, other than those who are nominated, is Rs. 30,000/-. The annual subscription is Rs. 5/- only.

One of the complaints against the Bombay Stock Exchange is that it has put undue restrictions upon the membership. Insufficiency of business is said to be one of the reasons for such restrictions. That is also why many of the members carry on other occupations.¹ Some of the members keep themselves out of the Exchange for years together. It is only when times are prosperous that they turn up. Further, many of the present members are wealthy businessmen and do not care much for stock broker's business. One must say that such occasional brokers are undesirable from the investor's point of view. Such brokers are bound to lose the confidence of the investors, and besides, as they cannot always be found on the Exchange, they will not know the exact information about the values of different securities quoted from day to day in the market. Thus these brokers will not be able to establish their clientèle. It is therefore desirable that the members should be prohibited from following any other occupation. The Association has no doubt now made it a rule that no person shall be eligible for membership who is engaged in any other business; but this rule does not apply to the members admitted before 1st March 1926.² Thus the process of making the members follow a single occupation will be very slow, especially as the Association does not wish to sell any new cards. It is necessary

¹ Nearly a quarter of the active members are also commission agents. Cf. L. C. Jain; *The Monetary Problems of India*, p. 147.

² See Rule 7 (b), Rules and Regulations of the Native Share and Stock Brokers' Association.

that the Association should take early steps to bring about the change which we have suggested above. One of the ways of doing this is to sell new cards according to the new rules. These new members will slowly establish their own clientele. Besides, having no other occupation, they will be rendering good service to the investor by being more attentive to the latter's needs. There is no doubt that if the rule of not allowing even the members admitted before 1926 to do any other business be introduced, it will remove many prominent businessmen from membership of the Association. But men with less ability but greater attention to the needs of the investors will prove more useful than able but indifferent persons.

MANAGEMENT AND SUB-COMMITTEES

The management of the Association is entrusted to a Board of Directors consisting of 16 members elected by the General Body; they hold office for two years. The Board of Directors, besides being entrusted with the management of the business of the Association, the management of its funds, income, and properties, are empowered to fix the scale of brokerage, to settle disputes affecting the members, to fix the ordinary settling days, and to grant or refuse admission to dealings in the market, for cash or for the settlement, or permission for dealing in new issues of new or old companies.

There are two sub-committees, namely, (1) Arbitration Committee, and (2) Defaulters' Committee. The Arbitration Committee consists of 16 members elected every two years at a general meeting of the members of the Association. Disputes arising between members must be referred to this Committee, which appoints two of its members to act as arbitrators to go into the matter. A member who is dissatisfied with the award of the two arbitrators, can appeal to the Committee itself. And in case the sum involved in the dispute be over Rs. 1,000/- the member, who may be dissatisfied with the award of the Arbitration Committee can appeal to the Board of Directors whose decision in the matter is final.

The Defaulters' Committee consists of 6 members. The business of the Committee is to take charge of the books of accounts,

documents, papers and vouchers of a member who has been declared a defaulter, and after making an enquiry into his accounts and dealings in the market to make a report to the Board of Directors.

EXPULSION AND SUSPENSION OF MEMBERS

The Association's rules regarding the conduct of members and their dealings are strict. A member who is guilty of any conduct, which in the opinion of other members renders him unfit to be a member, can be expelled by a resolution of the Association. The Board of Directors is also empowered to expel a member who has made a false declaration in his application for membership, who has been convicted for a criminal offence, or who subsequent to his admission as a member becomes a member of another stock exchange, or who has been guilty of fraudulent conduct. Besides, the Board is also empowered to suspend or fine a member who refuses to comply with any of its decision, or violates any rule of the Association, or is guilty of dishonourable and disgraceful conduct.

The rules of the Association as regards dealings have to be strictly followed by members. Fictitious transactions and dealings in the market are prohibited on pain of expulsion or suspension by the Board. Spreading of unfounded rumours may also lead to either form of penalty.

CONDUCT OF BUSINESS

Only the members of the Association and their authorised clerks are allowed into the market for transacting business. Every member can employ four authorised clerks. The authorised clerks have power to make bargains on behalf of their employer, and the latter is bound by such bargains. The transactions made in the market by every broker or his clerk are entered in a memorandum book. When a transaction is made for a non-member, the broker must render to him the contract notes in respect of the transaction, which must state the price at which the transaction has been made. The brokers are allowed to issue net contracts, that is, without showing brokerage separately, if their clients so desire. With a view to prevent errors, the brokers have to compare each

contract entered by them, in the Settlement Room on the business day next after the transaction is made.

Dealings on the Bombay Stock Exchange are of two types:— (1) Ready and (2) Forward. The scrips are placed on the ready or the forward list according to certain rules. The ready list contains the shares of banks and railways, preference shares and debentures of companies, etc. The forward list consists mainly of the ordinary shares of industrial companies which are earning dividends or which might have earned dividends in the past. In ready delivery transactions, the seller has to deliver the necessary transfer forms duly signed, not later than the seventh day from the date of sale. He must deliver the shares on the seventh day after the day on which the transfer forms have been submitted. At the same time, the buyer must accept and pay for the shares purchased by him and delivered within the prescribed time.

The forward business, otherwise known as Vaida business, is settled monthly.¹ The settlement of forward transaction in shares is effected through the Clearing House. The settlement covers about eight days, and is divided into four parts or days. The first day of the settlement is called the Comparison Day. It is the day for comparing contracts and for issuing memorandum slips, by the buying to the selling brokers, showing the number of shares outstanding to be taken delivery of. On the second, or Clearance or Ticket Day, a member who has bargains to be cleared through the Clearing House, has to send a clearance list in a certain form which will show the balance of securities, delivery of which is to be given to or taken from other members. On the next or Pay Day, payments have to be made to the Clearance House. Payments and delivery of securities to the Clearance House have to be made on the last or Settling Day.

As regards the conduct of business by the brokers in the market, every broker keeps a Souda book, in which are entered all the transactions of the day.² Two such books are kept, one for the transactions entered into with other brokers, and the other

¹ It may be noted that the settlement on the London Stock Exchange is fortnightly, while on the New York Stock Exchange it is daily.

² The following information is taken from a thesis "Methods and Machinery of Investment in India", by S. A. Haque, kept in the library of the University School of Economics, Bombay.

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for the dealings entered into on behalf of the clients in their names. The brokers' book, also known as the contract book, which forms the basic document in cases of dispute, is more elaborate and the entries in it try to eliminate all chances of misquotations and mis-understanding. The clients' book is however not so elaborate. For example, it has no signature column due to the reason that the clients are not on the spot, and the book cannot be sent to them individually every day. Again, as the order of the clients are conveyed by correspondence, the precaution to write in words also is dropped.

CLEARING HOUSE

The Bank of India performs the services of a Clearing House for the Bombay Stock Exchange, for which the Bank is paid Rs. 55,000 annually. The Clearing House acts as a common agent of the members in settling transactions between them, taking delivery of securities, making and accepting payments for the same and clearing the differences.

HOLIDAYS AND BUSINESS HOURS

Besides Sundays and Bank holidays, the Bombay Stock Exchange observes numerous other sectional holidays due to the fact that the members belong to diverse communities. One of the complaints of the public has been that the Exchange is closed for many days in the year, and the Atlay Committee recommended the curtailment of some of the holidays, though they left the final decision in the matter to the Association itself. Formerly the Exchange used to be closed the whole day on the death of a member, but now it closes only one hour earlier on that day.

The hours of forward business in the market are from 12 noon to 3 p. m. on all working days, and 12 noon to 2 p. m. on Saturdays. The hours of business for forward business in Government securities are from 12 noon to 5 p. m. on every working day, except on Saturdays, when the business hours are from 12 noon to 2 p. m.

LISTING REGULATIONS

We have already seen the importance and advantages of listing. The listing regulations of a stock exchange afford a sort of

protection to the investing public against fraud and irregularities on the part of company promoters. The Bombay Exchange also provides certain rules and conditions for listing. But it must be noted that they are not as exhaustive and searching in nature as those of the London and New York Stock Exchanges. Further, the New York Stock Exchange, for example, makes an agreement with the companies whose shares are listed, that they should publish and submit annual reports to their shareholders, at least 15 days before their annual meeting, showing an income account and balance, and a statement as to the physical condition of their properties. No doubt in India the Companies Act requires that every company should prepare an annual audited balance sheet which must contain a summary of its property and assets, and of its capital and liabilities. Further, every public company must file a copy of such balance sheet with the Registrar of Joint-Stock Companies.¹ The Bombay Stock Exchange would be doing a great service to the investors and affording them more protection, if its listing regulations were widened and more particulars demanded from the companies applying for the quotation of their securities. Adequate publicity on the part of companies will be ensured, if the Exchange incorporates into its listing regulations a provision on the lines of those of the New York Stock Exchange mentioned above, and makes public all the facts required in the process of listing.² If this suggestion be followed by not only the Bombay Stock Exchange, but also by the other Indian Stock Exchanges the problem of industrial finance will be solved to some extent. If the investors think that in listing the securities of companies the stock exchanges have ensured publicity, they will be more willing to invest in such companies.

We shall now make a few suggestions whereby improvements can be made in the present listing regulations of the Bombay Stock Exchange. It is provided by the Exchange, for example, that vendors' shares cannot be dealt in, in the market within six months from the date on which permission has been granted for dealings in shares of the same kind issued to the public.³ We

¹ See section 131 of the Indian Companies' Act of 1913.

² See S. S. Huebner: *The Stock Market*, p. 120.

³ See Rule 251, Rules and Regulations of the Native Share and Stock Brokers' Association.

think that the limit of six months is too short, as the vendors can deceive the public by spreading false rumours about the prospects of the company, or by entering into fictitious sales and purchases in the market with regard to the listed portion of the issue. The Indian investors, ignorant as they are, can be easily deceived by such manoeuvres. They think that they should purchase only those securities which are in great demand, though that demand may be quite fictitious. The vendors will thus be able after the lapse of six months, to unload their holdings and reap large profits. Therefore, the vendors' shares should not be allowed to be dealt with on the Exchange until at least the first annual report of the working of the company is published. Thereby the investors will be able to gauge whether the company is a profit earning concern or not. It would be still better, if the period of the prohibition to deal in vendors' shares is extended to the date of the publication of the second balance sheet. This is because of the fact that as the vendors in this country happen to be the first directors of the company, and sometimes its agents also, they can manipulate the first balance sheet and show higher profits.

One of the conditions of listing is that the Company's Articles of Association should contain a provision that the borrowing powers of its Board of Directors are limited.¹ It would be better if this rule mentions specifically the limit. It is vague and does not afford much protection to the investors.

Another condition is that a new company, desirous of issuing the full number of its authorized shares or a part thereof, shall have invited applications from the public and have allotted them at least 33 per cent. of the number of shares issued, in equal proportion of any class or kind, of course, vendors' shares not being considered to form a part of such public allotment for the purpose of this rule.² We think that the 33 per cent. limit is too low and should be raised to at least 66 per cent. as in the case of the London Stock Exchange.³ It is also desirable that the Bombay Stock Exchange should lay down that at least 50 per cent. of the authorised capital of companies should be issued, and of this at

¹ See Rule 252, (c), (11).

² See Rule 252, (d), (i)

³ See A. P. Foley and Carrutters Gould: *The History, Law, and Practice of the Stock Exchange* (1924) pp. 72-73.

least 50 per cent. be paid up.¹ This will put a stop to reckless company promotion, the evil effects of which have been to a large extent responsible for the shyness on the part of Indian investors.

And lastly, one of the conditions is that every company desirous of being quoted on the Exchange must provide information with regard to the following points, viz. (1) the number of shares allotted to the vendors and their distinctive numbers, (2) the number of shares offered to the public, (3) the number of shares applied for by the public and the number of shares allotted to them unconditionally pursuant to such applications, and the proportion to the allotment, and (4) the total number of allottees and the largest number of shares applied for and allotted to any one applicant.² The above information is insufficient to serve the purpose for which it is demanded. It seems that the underlying purpose of the Exchange is to see the extent of the concentration of shares. But the information that will be supplied by a company according to the above requirements will not give a fair idea of the concentration. This will become clear from the following example. Suppose a Company has issued 10,000 shares of Rs. 100 each, allotted as follows:—

No. of holders.	Shares allotted to each.
1.	2,001
2.	2,000
2.	1,000
500.	odd lots.

What the Exchange authorities come to know from its listing requirement about the above allotment is: (1) total number of allottees 505, (2) largest number of shares allotted to any one person 2,001. Besides this information the Exchange authorities will not know how far the shares are concentrated in a few hands as can be seen from the actual allotment in the above example.

The concentration of shares in a few hands, and that too in the hands of the vendors who happen to be the managing agents, is a state of affairs which is certainly not desirable in India. It will

¹ The London Stock Exchange provides that at least 50 per cent. of the authorized capital must be issued and that 10 per cent. of the amount subscribed be paid up. See A. P. Poley, *Ibid.*, p. 75.

² See Rule 252, (g).

be better therefore, if the Exchange demands the names of the vendors and also the number of shares purchased by them on cash payment. In this respect, we may copy the New York Stock Exchange. When a Company applies to have its securities listed on this Exchange, it has to delegate its representative who may be the treasurer, president, or other officer to appear before the Committee of the Exchange, and answer such questions as the Committee may ask regarding any fact mentioned in the application. The most important questions relate to the distribution of the shares sought to be listed. The Company has to submit a list showing the number of shareholders each holding 1,000 shares or more, 100 shares or more, or less than 100 shares. Secondly, it has to answer the question as to how many holders of these various amounts hold their stock absolutely free and clear of any engagement not to sell it, so that the stock shall not be tied up in a pool. And further, it has to answer whether there is any syndicate interested in any of the stock, and if so, how much stock is tied by a syndicate agreement.¹ As the New York Stock Exchange does not propose to make an initial market for securities, therefore this detailed information is demanded. It also seems that in order to ensure a fair market a sufficient amount of the securities sought to be listed must have been sold to the public, and that a few persons by virtue of their large holdings are not allowed to control the market and unduly raise the price of the securities. But the Bombay Stock Exchange does not refuse to make an initial market. In spite of this, it is better that the Bombay Stock Exchange should demand full information on the lines of the New York Stock Exchange and thus ensure publicity on the part of our companies.

CORNERS IN THE MARKET

We have already made reference to the fact that there was heavy speculation on the Bombay Stock Exchange during the War and the post-War boom period. And recent events show that speculation on the Exchange is not a thing of the past. In the words of the Atlay Committee, "the most sinister manifestation of speculation in Bombay is the frequent occurrence of corners in

¹ See S. S. Huebner: *The Stock Market*, p. 135.

the market." And it is upon this vexed question of corners, and the measures that have been taken by the Board of Directors to check them that opinions differ. The majority of the Atlay Committee were of the opinion that the measures which the Board adopted to combat corners especially in the post-War boom days had encouraged rather than checked their growth. And further, they were of opinion that if the evil of corners is not suppressed it will demoralize and finally destroy the share market in Bombay.

Before we enter into the discussion of the steps taken by the Board of Directors of the Bombay Stock Exchange, and the steps which should be taken to counteract corners, we shall define what a corner is and how it arises. S. S. Pratt in "The Work of Wall Street," defines a corner as "that condition of a stock in which the supply is held by one operator or a clique of operators and in which many have contracted to deliver to the operator or the clique what they can only obtain from the operator or the clique." In other words a corner occurs when more shares than are available for delivery on the settlement day have been sold. As the buyers demand delivery the prices of the shares rise very high. What really happens when a corner occurs is, that an individual or a syndicate succeeds in obtaining possession of all the shares of a certain issue, and at the same time they enter into contract with others, viz., the short sellers, to buy shares of the same issue. When the time comes for delivery, the short sellers are unable to deliver the shares (as the shares are all held by the individual or syndicate), with the result that they have to buy the shares from the very individual or the syndicate, at a price dictated by them. It may be noted that when a corner occurs, its evil effect does not remain restricted to a particular scrip, but spreads to other scrips as well. As the cornered party, viz., the short sellers, have to pay the high price which the individual or the syndicate demand for the shares, they are forced to sell other shares in their possession with the result that the price of these shares falls. The panic naturally spreads, and in a short time there is a crisis in the whole market.

What are the measures devised to combat corners? It is recognized on all stock exchanges of repute, that it is the cardinal principle of business that the sellers must be prepared to deliver that which they have sold, and the buyers must be prepared to

pay for that which they have agreed to buy. Strict observance of this principle exerts a sort of check upon those who sell short, as they have to bear the consequences of their own dealings, i.e. for having sold that which they have not in their possession. But the non-observance of this principle by the Bombay Stock Exchange has been the cause of general complaint and was also the subject of enquiry by the Atlay Committee. Before 1918, corners were of rare occurrence in the Bombay share market. There were, therefore, no specific rules to deal with such situations. But corners became frequent after 1918 and the Board of Directors had to interfere and take measures. The Board passed rules which gave them power to interfere and fix rates in case of an existing or contemplated corner in any scrip dealt in on the Exchange. Whenever the Board declared a corner in a particular scrip, forward dealings in that scrip were prohibited and all unsettled transactions had to be settled at a price determined by the Board. In the boom period following 1918, many corners, either existing or contemplated, were declared, and prices were fixed by the Board. This price fixing regulation was the subject matter of much criticism, for according to some the rules regarding corners favoured the bears (the short sellers), while according to others the rules favoured the bulls. The Atlay Committee were of opinion that the rules encouraged the bears to an unusual activity as the fixing of maximum prices by the Board limited their loss.¹ The Committee also agreed with the opinion of the President of the Bombay Stock Exchange, Mr. K. R. P. Shroff, that "the existence of the present rules about corners has encouraged corners and will continue to do so in the future."²

In support and in justification of the price fixing rule, the Share Brokers' Association in their representation before the Atlay Committee argued that the rules were meant to protect the investing public. On the other hand it was urged that in permitting, what are believed to be fictitious prices, to be quoted in the market, the Association was a party to the circulation of a lie. The Atlay Committee, however, saw no force in these arguments. As regards the protection of investors the Committee was of

¹ Report, p. 15.

² See Mr. Shroff's pamphlet, "Corners in the Share Bazaar".

opinion that the bona fide investors do not sell what they do not possess, and that if they did so, they should bear the consequences of their recklessness. The Committee further thought that short sales were made more by the members of the Association, themselves than by the public, and hence the Board interfered out of regard for them. Regarding the second point, viz., that the Association becomes a party to fictitious prices being quoted on the Exchange, the Committee observed: "It is not for the Association to control the prices of the securities bought and sold in the market for which they provide facilities. It is not incumbent upon the Association to guarantee that the market price approximates to an intrinsic value which none can suggest a satisfactory means of ascertaining. And if this principle be accepted, whenever the market price moves above or below a price deemed for the time being to be intrinsic value, the Committee (the Board of Directors) are party, to the circulation of a lie. The absurdity of this contention needs no demonstration."¹

Another argument in justification of the price fixing rules was, that, if the bears were to be left to the mercy of the bulls, all forward business would be killed. But it must be noted that forward business must always be carried on with great care and prudence, and must be kept within bounds. The protection afforded by the price fixing rules, no doubt to a certain extent, enabled reckless speculation to be carried on in the market.

It cannot be denied that corners in the Bombay Share Market are created by the activities of the bears, and that the only method to combat corners is to put a check on their operations. The bears make fictitious sales in a particular scrip. The holders of that scrip in order to arrest the falling price go in to support the price of their scrip. The bears, however, go on making short sales and do not attempt to cover their sales, as they think they can buy the scrip at a low price. But if the price rises they can say they are cornered and take advantage of the protection afforded by the rules. What is therefore wanted in order to check corners, apart from the suggestion that the price fixing rules should be abolished, is the provision of rules to arrest bear raids. And in

¹ Report, p. 16

this connection it may be noted that the Bombay Stock Exchange has now provided a new rule to arrest such bear raids.¹

NEED FOR CHECKING SPECULATION.

There is no doubt that the new rule which the Bombay Stock Exchange now provides to arrest bear raids will to a certain extent check corners, but it will not carry us far. Corners are brought about as a result of speculation carried on by reckless operators. Unless, therefore, their activity is stopped corners cannot be checked. The real remedy to check corners is to stop speculation. We have no hesitation to say that in modern economic society a certain amount of speculation, carried on within limits, is necessary. Without speculation modern industrial development would not have reached the present stage. But stock exchange speculation has its effects, on the investing public, upon whom modern industry depends much. Consequently, if they are scared away the industries would be starved for want of finance. The ordinary investor knows little of bears and bulls, and their respective activities. If the bears are in ascendance in the market, the investor stands to suffer as he finds that the value of the scrips which he holds has fallen. It is suggested by some that when prices of scrips are depressed, the investors should keep their value up by purchasing them. But we cannot expect the Indian investors to enter into such transactions as they are not conversant in stock exchange intricacies. The investors go in for shares when prices are rising, for they think that industrial conditions have improved and there are prospects of getting good dividends. When prices of shares are falling, they sell off their holdings to minimise their loss. They do not know that the prices of securities are raised and lowered by interested operators to the latter's

¹ The new Rule 188 runs: (a) In case of bear raids or when prices of shares and stocks are unduly depressed in a crisis by means of reckless short sales, the Board may by a resolution of not less than one-half of the total number of members of the Board, at a special meeting at which not less than three-fourths of the total number shall have been present, suspend all forward business for such time as the Board may decide. All transactions before the date of suspension shall be concluded by delivery and payment as usual on the settlement date, unless the Board by a Resolution passed in like manner extends the time for payment of the said shares to the next settlement, or if necessary to the following settlement, and at the same time suspends the selling out rule with respect to all unsettled contracts in such scrip. The liabilities of intermediaries shall continue during such suspension.

advantage. As a result of this manipulation, the ignorant investors do not know that the prices of securities do not represent the true intrinsic value. Further, they do not know that the managing agents, who are in charge of the industrial concerns, can carry on manipulations. As these agents always hold large blocks of shares in the concerns that they manage, they are consequently able to raise or lower the prices of shares of such concerns, to the detriment of the public.

The evil effects of speculation on the stock exchange do not remain restricted, but spread and affect the whole economic organisation. Speculation tends to create artificial prices, and thus disturbs the natural distribution of fresh capital. One of the functions of the stock exchange is to utilize the total capital resources of the society in the most productive way. But this cannot be achieved when, as a result of speculation, the prices of securities do not represent their true intrinsic value.

It is therefore essential that speculation should be suppressed by all possible methods. Some form of legitimate speculation should be allowed; but speculation which differs little from gambling should be rooted out. As the main purpose of a stock exchange is to provide facilities to the public for investment and to discourage speculation stock exchange speculation should be discouraged and suppressed by the stock exchanges themselves. When the stock exchanges refuse to do so the intervention by an outside authority, viz. the Government, is desirable. And in this connection it may be noted that, in spite of the recommendation of the Atlay Committee that the Bombay Stock Exchange should discourage speculation, we find speculation still carried on in the market with inevitable consequences.¹

¹ On the occasion of the unveiling of the statue of Sir Shapurji Broacha (a former President of the Bombay Stock Exchange) on 4th April 1931, His Excellency the Governor of Bombay in the course of his speech said: "There is still, unfortunately, too much gambling and speculation in the markets of Bombay, and it is as necessary as ever that the public should be assured that speculation in stock and shares is being kept within healthy limits. I would put it this way, that on your Association rests the duty not merely of maintaining and consolidating the position it has already won, but of widening its sphere of influence and increasing its reputation for responsibility". A few days before this speech the President of the Exchange itself had also uttered a note of warning, and in spite of his and the Governor's warning, within a few days there was heavy speculation in the market which resulted in a crisis.

SUGGESTIONS TO CHECK SPECULATION.

What are, therefore, the methods by which speculation can be checked on the Bombay Stock Exchange? It was suggested before the Atlay Committee, that if the security market in Bombay be established on a cash basis as in Calcutta, speculation would cease and corners would not occur. But it was the opinion of the Committee that by following this method speculation would not cease, inasmuch as money and scrip could be borrowed for speculation purposes. The Committee, however, observed that corners in a cash market would be matters of great difficulty.¹

It was also suggested before the same Committee that corners could be checked by lowering the high denominations of shares of the companies on the forward list. If the denomination of the shares of a Company is high, say, Rs. 500, the total number of shares issued by it would be small. It would then be possible to concentrate all the shares of the company in a few hands and create a corner. If shares of lower denominations, viz. Rs. 50, 25 or 10 are introduced, a corner would be difficult, for the shares would be more widely distributed in the hands of small investors. Short sellers would be more cautious before they effected their short sales, as they would find it difficult to obtain a large number of shares. There can be no doubt that if this suggestion had been followed, corners would have been matters of great difficulty, and speculation discouraged to a large extent. Though more than a decade has passed since the suggestion was made, the denominations of shares of companies quoted on the Bombay Stock Exchange remain at the same high level.

Another suggestion which was in the form of a proposal put forward for the consideration of the Corner Committee, which was constituted by the Association itself in the boom period to suggest remedies for corners, was that the members of the Association should desist from doing business for any syndicate or person for more than 50 or 100 shares.² If the members of the Association adhere to this rule, it would not be possible for syndicates or groups of persons to enter into purchases and sales of thousands of shares, which transactions invariably result in a

¹ Atlay Committee Report, p. 17.

² See Atlay Committee Report, p. 15.

crisis in the market. If the above rule was strictly adhered to, a syndicate wishing to purchase say, 700 shares would have to catch hold of 7 to 10 members, which would always be a difficult matter. Thus volume of speculative dealing would be curtailed and corners avoided.

But the Atlay Committee thought that these suggestions were mere palliatives and not cures for speculation and corners. They were of the opinion that the best cure for corners was that the short sellers should in the absence of fraud, be left to pay the penalty. They further thought that the policy and practice of the Bombay Stock Exchange should be the same as that of the London Stock Exchange, viz. that "all contracts entered into for the sale or purchase of shares must be fulfilled by the delivery of the shares or by payment of the purchase price. And if he who has sold shares cannot, on the day of settlement, deliver the shares which he has sold, he must submit to the ordinary procedure of the Exchange, whereby the shares are bought in against him in the open market, unless he can prove to the complete satisfaction of the Committee that he has been the victim of fraud." The Committee therefore recommended that the rules of the Bombay Stock Exchange regarding corners should be abolished.

Of course, the best cure for corners and speculation is the prohibition of all forward business in the market. The Atlay Committee went to the length of suggesting that it should be the duty of Government in the interests of the community at large, by means of prohibition of all forward trading in stocks and shares, to prevent the conversion of legitimate business into a gamble in differences.¹

It may be interesting to note that the new Rules and Regulations of the Bombay Stock Exchange, sanctioned by the Government contain provisions as regards corners.² The Board of Directors is henceforth, save as otherwise provided in the Rules, prohibited from fixing prices at which shares shall or shall not be bought or sold, and from fixing rates at which or above which or below which sales or purchases in shares shall or shall not be made. The Board may intervene under the rules only, when it is in the public interest and prohibit further dealings

¹ Report, p. 2.

² See Rules 334 and 335.

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in a scrip that is admitted to forward dealing, and remove it from the forward list, when they are satisfied that a single person or a syndicate has acquired control over the scrip, and as a result of which the scrip cannot be obtained for delivery on existing contracts, except at prices arbitrarily dictated by the person or syndicate. The Board may intervene also when they are satisfied that there is a fraud connected with dealings in the scrip. When the Board does intervene, it has to fix a price for the scrip, which must be the highest one reached at any time during the settlement, prior to the day on which the Board intervened, and at this price all the unsettled contracts in the scrip must be finally settled and concluded. Whenever the Board intervenes, the circumstances and reasons for intervention must be set out and recorded in the proceedings of the Board, and a copy of the minutes must be forwarded to the Government of Bombay.

JOBBERS AND THE EXCHANGE.

On the London Stock Exchange the business is divided between jobbers and brokers. Both of them are members of the Exchange. The former are stock dealers, while the latter are stock brokers as usual. The jobbers deal among themselves or with brokers, and have no outside clients. They specialise themselves in one market, i.e. deal in, for example, only mining shares, or oil shares, or other industrials. They buy and sell for themselves; the difference between the price they buy and sell constitute their gross profit. This difference is technically known as "jobbers' turn." The brokers do not specialise. They deal with the investing public and buy and sell all kinds of shares, and live by brokerage only.

The division between jobbers and brokers is peculiar to the London Stock Exchange, and is not found on the Indian stock exchanges. The Atlay Committee recommended this division between jobbers and brokers for the Bombay Stock Exchange; but did not think it advisable to introduce such a change immediately, as the volume of business on the Exchange was insufficient. The Share Brokers' Association did not favour this division, as they were afraid that if the jobber buys or sells shares to speculate on his account he will do more harm than good.

There are certain advantages in having jobbers on the ex-

change. In the first place, they keep a free and continuous market. This will be of special advantage when the business that a broker should do for any particular individual is limited. Besides, the dealings in a particular scrip will be distributed in many hands and hence it will be troublesome for the broker to find out parties to execute the orders he has accepted. The presence of jobbers thus makes the work of the broker more easy. He knows exactly where to go to deal in securities which he wants to purchase or sell. In the absence of the jobber, the broker would have to go on hunting out another broker, who wants to deal with him in the same stock. This naturally results in waste of time and also haggling about the price. If a broker is relieved of all this trouble, he will bring down the rate of his commission also. And thus the "jobbers' turn" will not be an extra burden to the investors. The jobbers will make the business quick and easy and keep the market free. Further, as the business is divided between jobbers and brokers, the broker becomes a disinterested middleman, and hence can be looked upon with confidence by the investors for advice, because the personal gains of the broker are not affected whether his clients purchase this or that security. But when the broker is also a dealer, his advice cannot be looked upon as disinterested. The situation becomes worse, when, as in Bombay, the brokers do the work of underwriters. The brokers under such circumstances will naturally be eager to sell the underwritten securities.

It is possible to check the speculative activities of the jobber by imposing certain restrictions on his business. He should be forbidden to initiate any dealings. He should make purchases and sales only on demand or offer from the brokers. The brokers too should be forbidden from doing business as principals. There is no doubt that with these restrictions it will not be possible for the jobbers to speculate. Further, the presence of jobbers will more or less act as a check upon the speculators. As their resources are limited and also divided among various securities, the jobbers will have to think twice before entering into any speculative contract.

One of the difficulties mentioned by the Atlay Committee, that comes in the way of having jobbers on the Bombay Stock Exchange is insufficiency of business. But it does not seem correct

that the volume of business now on the exchange is small. Of course in the beginning, we can have only a small number of jobbers, who will have to deal in all kinds of securities. Specialisation as on the London Stock Exchange can come later on.

Another difficulty mentioned with regard to having jobbers on the Bombay Stock Exchange is that the jobber must have a strong financial position, besides possessing ample resources. But it does not seem difficult for Bombay to provide such men.

THE CALCUTTA STOCK EXCHANGE.

The Calcutta Stock Exchange Association was formed in 1908, though before this date dealings in shares were carried on by a few brokers in the open. The Calcutta Stock Exchange Association was incorporated into a limited liability company in June 1923, under the Indian Companies Act, with an authorized capital of Rs. 3 lakhs divided into 300 fully paid shares of Rs. 1,000 each. No member of the Association is entitled to hold more than one share. The total number of members including partners and assistants of members' firms is at present a little above 500.¹ A person wishing to become a member must purchase a share from an existing member who intends to resign, and pay an admission fee of Rs. 5,000/-.

The main object of the Association is "to facilitate the transaction of business on the Stock Exchange and to make rules and bye-laws regulating the mode and conditions in and subject to which the business on the Stock Exchange shall be transacted and the conduct of the persons transacting the same and generally for the good order and government of members of the Association." Bye-laws have been framed to control the conduct of members and of business; but customs and usages are also respected.

The management of the Association is in the hands of a Committee which is elected at a general meeting of the shareholders annually. The Committee itself elects several sub-committees and the honorary office bearers. The Committee is empowered to do all work on behalf of the Association, and this is usually done by sub-committees. Disputes between members are adjudicated upon by the Committee itself.

¹ Indian Year Book, 1934-35, p. 721.

The Calcutta Stock Exchange has no settlement days like the Bombay and London Stock Exchanges. The transactions are on a cash basis. Delivery is due to the second day after the contract is made, and sales of securities are effected for most part under blank transfers.¹ It is usually supposed that in the absence of settlement days, business on the stock exchange is apt to run smoothly. But it is not so on the Calcutta Stock Exchange. Months sometimes pass, before the shares are actually delivered.² The present system is defective and there is room for much improvement.

NEED FOR STATE REGULATION OF THE STOCK EXCHANGES.

Both the Bombay and Calcutta Stock Exchanges are well-known for their speculative tendencies. We have already made a study of speculation on the former stock exchange. We need not go into the details of the other. We believe that in India some sort of State regulation of the stock exchanges is quite essential, because the investors are scared away by the constant crisis on the stock exchanges, and industries consequently have to suffer.

Indeed, on the Continent of Europe there is a strict supervision and control of the stock exchanges by the State. Speculation is discouraged on the German stock exchanges. It is usually argued that State regulation of the stock exchanges will hamper industrial development. But German experience shows that this has not been so.³ In Germany all the stock exchanges are established with the permission of the State, which exercises control over their operations. The State is represented on the directorate of the exchanges either by the State Commissioner or other officials. All regulations of the exchanges must be approved by the State.

In the U.S.A. the interests of the public investing through the stock exchanges are guarded by the State in another way. The stock exchanges are private institutions over which the State has no control. But through the Penal Laws of the country, the State has sought to protect the interests of the investing public. Two such laws may be mentioned. The manipulation of prices of

¹ See Indian Year Book, 1934-35, p. 721.

² See Pat Lovett: *The Mirror of Investment*.

³ See Hartley Withers: *Stocks and Shares*, pp. 252-253.

securities or rigging the market is discouraged by section 953 of the Penal Law, which penalises any person who influences or attempts to influence the market price of securities by means of fictitious purchases, sales or other transactions or devices.¹ Similarly "bucket shop" dealings are discouraged by the New York State which prohibits all transactions in securities which are meant to be settled without a bona fide sale or purchase.²

It is therefore desirable that there should be State regulation of the stock exchange in India similar to that in other countries. There is no doubt that there is some sort of State regulation of the Bombay Stock Exchange since the passing of the Bombay Securities Contracts Control Act in 1925. But there is need for still greater control of the Exchange. The Government of Bombay has just appointed a committee to review the working of the Bombay Exchange, and suggest improvements.

OTHER SUGGESTIONS.

We have already observed that there are only two organised stock exchanges in this country, and in the mofussil there are absolutely no stock exchange facilities for investment in industrial securities. There is no doubt that much of the present industrial backwardness of India is due to the absence of adequate stock exchange facilities. It is therefore desirable that stock exchanges should be established in the important industrial centres like Cawnpore, Nagpur, Sholapur etc. Indeed it is very desirable that a stock exchange should be established in every province. In this connection the recommendation of the Bombay Committee for the Rehabilitation of Government Securities of 1919, that the Government of every province should give a grant for land and buildings for the establishment of the stock exchange may be given effect to. It must of course be emphasized that if stock exchanges are established in India, whether with or without State aid, they should be under the control and supervision of the representatives of the Government, the Commercial bodies, the Legislatures, the Commercial banks and Industrial Banks, and the investing public should be given seats on the Committees of

¹ See Samuel P. Goldman: *Stock Exchange Law*, p. 73.

² *Ibid*, pp. 73-74.

Management of these exchanges. Further, the listing regulations of these exchanges should be scrutinised and sanctioned by the Government, which should also at the same time exercise supervision over the listed securities. This will naturally create confidence in the minds of the investing public, and enable them to invest their savings in industrial securities.

CHAPTER X

ORGANISATION AND FINANCE OF SMALL SCALE INDUSTRIES

We have so far dealt with the organisation and finance of large scale industries. In this chapter we propose to deal with the organisation and finance of small scale industries such as rice, flour, and oil mills, cotton gins and presses, glass, brick and tile works, hand-loom weaving, brass and bell metal, gold and silver thread, *gur* making, dairy farming etc.

IMPORTANCE OF SMALL SCALE INDUSTRIES

In spite of the development of modern large scale industries, small scale industries occupy an important place in the economic life of India. Statistics regarding the number of workers engaged in the various small scale industries are not available, but there is no doubt that these industries employ a much larger number than those employed by the large organised industries. In the urban towns such industries as rice and flour mills, glass works, hand-loom weaving, brass and bell metal ware etc., support a large number of workers, who depend exclusively for their living upon their industrial work. In the rural areas, such industries as *gur* making, rice pounding and husking, cotton ginning, flour grinding, toy making, carpet weaving and basket making support a large number of agriculturists, who carry on these industries as a subsidiary occupation. The many useful and artistic products manufactured by the small scale industries are in great demand, by all classes of people. For example, the specialised types of cloth like saris, shawls etc., that are woven on the hand loom are in special demand by the richer class of people, while the coarse cloths are consumed by the poorer classes. During the marriage season and at festivals, there is a great demand for the products of many small scale industries.

ORGANISATION OF THE SMALL SCALE INDUSTRIES

The small scale industries can be divided into the following three broad groups:—

- (1) Factory industries, i.e., those carried on in small factories.
- (2) Small or workshop industries, i.e., those carried on in workshops or Karkhanas.
- (3) Cottage industries, i.e., those carried on in the homes or cottages of the workers.

The factory type of industries include such industries as rice, flour and oil mills, cotton gins and presses, soap and match factories, chemical, brick and tile works, printing presses, etc. Though these industries are run on small scale, they approach the large scale industries in the matter of organisation; they employ modern machinery and methods of production, and a large number of workers; besides, they require fairly large amounts of capital. At present most of these industries are on the proprietary basis; the rest being on the partnership, joint family or joint-stock principle. In the case of the proprietary form of organisation, the proprietor combines in himself the role of the entrepreneur and the capitalist. He promotes the factory by investing his own capital; equips it with plant and machinery; employs workers, and supplies himself the technical and business knowledge for running the concern. But the defects in this form of organisation are apparent. The proprietor's financial resources are limited, and he lacks the technical and business knowledge for conducting the factory. Both these defects he tries to make good by admitting partners, and thus the proprietary form gives way to the partnership form of organisation. This latter form of organisation is now becoming popular for it has many advantages. Some of the partners bring in capital, others supply business knowledge, technical skill etc. This form of organisation is in some cases giving way to the joint-stock principle which has undoubted merits. The joint-stock principle has not made the same headway with regard to the small scale industries of the factory type as it has made with regard to the large scale industries. Mention must be made of the fact that some of the factory type of small scale industries are under joint families. This is due to the law of succession as it obtains especially among the

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Hindus. According to the Hindu law, on the death of a person his sons or legal descendants by reason of their birth acquire a right in his property. So that many of the concerns which were once owned by a single individual have now become the property of joint families.

The organisation of the small or workshop and cottage industries is simple. These industries include such industries as handloom weaving, brass and bell metal ware, gold and silver thread, gur making, carpet weaving, basket and toy making, dairy and poultry farming, oil crushing, pottery, etc. The small or workshop industries are run either by Karkhandhars or master-craftsmen. The Karkhandar or master-craftsman equips the workshop with the necessary implements, tools and appliances, such as looms in the case of a weaving workshop, furnaces, hammers, etc., in the case of a brass and bell metal ware workshop, and so on. He employs other workers under him, whom he supplies with the necessary raw materials, and pays wages on piece rates or on some other basis as he thinks best. In some cases he allows the workers to take the help of the members of their family, in which case the workers are paid on piece rates. The finished goods are sold by the Karkhandar or master-craftsman himself; though the usual process is to sell the same to or through some dealer or merchant.

In the cottage industries, the workers belong to one of two classes, viz. (1) independent, (2) dependent. The independent cottage workers carry on production with the members of their family, purchasing the raw materials from the local dealers. They sell the finished goods in the local markets, or by hawking-from door to door. In some cases they sell the finished goods to the dealers. The dependent cottage workers are also assisted by members of their family, but they work for a master-craftsman, a dealer or a merchant. They get the raw materials from the latter to whom they have to return the finished goods, and by whom they are recompensed by the payment of wages, generally on piece rates.

FINANCIAL NEEDS OF THE SMALL SCALE INDUSTRIES

We have already remarked that the factory type of small scale industries require fairly large amounts of capital. They require

initial or fixed capital to finance fixed assets such as land, buildings, plant and machinery. In view of the small size of the factories this initial or fixed capital does not run to more than a lakh of rupees. Capital is also required by them for the purpose of extensions and improvements of their fixed assets. And finally, they require working capital to meet the current expenses like the purchase of raw materials, the payment of wages, and the financing of the marketing of the manufactured goods. (It may be noted that in the case of the factory type of small scale industries the working capital that is required assumes a greater proportion to the initial capital than in the case of the large scale industries. This is due to the fact that the marketing facilities in the mofussil, where most of these industries are situated, are not as efficient as in the big cities; and therefore large amounts of stocks have to be carried, with the result that the amount of working capital is increased.)

The financial needs of the small industries of the workshop type and the cottage industries are identical, except that the former require a somewhat larger amount of capital. Both these types of industries require only small amounts of fixed capital. Only the Karkhandar or master-craftsman needs some capital for the equipment of the workshop with the necessary implements, tools, etc. The cottage worker's fixed assets, which consist of a few tools and other implements, cost very little. It must of course be admitted that some of the cottage worker's appliances and tools are a little expensive.

The capital that is required both by the Karkhandar or master-craftsman and the cottage worker for the purpose of improvements and replacement of the fixed assets is also small. The tools and implements do not wear out quickly, and even if this happens, they can be repaired or replaced at a small cost. It is of course true that this small cost for repairs and replacements means much to the cottage workers as they are generally poor. Besides, as they are not able to do the repairs of their tools and implements themselves, they are put to unnecessary expenses.

The problem of working capital both to the Karkhandar and the cottage artisan is an important one. The Karkhandar or master-craftsman necessarily needs a larger amount of working capital as he has to purchase the raw materials, maintain the

workers working in the workshop, during the period of production, and market the finished products. The independent cottage worker also requires a fairly large amount of working capital to purchase his raw materials, to meet the working expenses during the period of production, and for financial accommodation between the period of production and final disposal of the goods.

EXISTING CREDIT AGENCIES

We shall now take stock of the existing credit agencies for the small scale industries. The fixed capital of the small scale industries of the factory type is generally provided by the proprietors, partners or the joint-stock companies. So also is the provision of capital for extensions and improvements. It is only for the provision of working capital that these industries depend upon outside credit agencies.

The fixed capital of the Karkhandars or master-craftsmen is also provided by themselves. So also is the capital for extension and improvement, when their resources allow them. The independent cottage workers purchase the tools and the implements by their own means. The dependent cottage works are provided with the necessary tools and implements by their employers, or are given loans for purchasing the same. For the working capital both the Karkhandar and the cottage worker have to resort to outside agencies, just as in the case of the factory type of industries. These credit agencies are:—

- (1) The indigenous banker and money-lender.
- (2) The joint-stock banks.
- (3) The managing agents and other private firms.
- (4) The local dealer.
- (5) The Karkhandar or master-craftsman.
- (6) The co-operative banks and producers' societies.
- (7) The Government.

(1) THE INDIGENOUS BANKER AND MONEY-LENDER

The importance of the indigenous banker and money-lender in the financing of small scale industries is very great. Indeed, they form the most important source of finance. The indigenous bankers chiefly confine their activities in the finance of the factory

type of small scale industries. The money-lenders finance all the three types of industries. Indeed, they are indispensable to the Karkhandars, the master-craftsmen, and the cottage workers.

The indigenous bankers when they advance loans to the factory type of industries do so upon the personal security of the owners. In some cases, in addition to the personal security, the mortgage of immovable property such as buildings, machinery, land, etc. is also taken. That these indigenous bankers, under different names, are active in every province in providing finance to different industries can be seen from the following. In Madras, the Nattui-Katai Chetties provide financial facilities to such industrial concerns as rice mills, cotton gins, etc.¹ In Bombay, the Shroffs render financial assistance to such concerns as ginning and pressing factories, rice and flour mills, etc.² The indigenous bankers in Bihar and Orissa provide finance to the coal and mica mines, sugar and lac factories, and other industries.³

The money-lenders are active both in the urban and rural areas. Though the factory type of small scale industries also receive financial assistance from these money-lenders, their main business is confined to the smaller industrialists and the cottage workers. The money-lender goes through few formalities; he is accessible at all times of the day; he requires very little of security. He makes advances both of cash and kind. But he charges a very high rate of interest, and in addition, he stipulates that the finished products should be sold to him at a price determined by him.

(2) THE JOINT-STOCK BANKS

The joint-stock banks, including the Imperial Bank of India, play a small part in the financing of small scale industries. It is only the factory type of industries that receive loans and advances from the banks; the smaller industrialists and the artisans do not receive any help from them at all. In the Punjab some of the joint-stock banks advance loans to such industries as cotton ginneries, or oil and flour mills.⁴ The loans are advanced against block as

¹ See Madras Banking Committee Report, Vol. I, p. 30.

² See Bombay Banking Committee Report, Vol. I, p. 199.

³ See Bihar and Orissa Banking Committee Report, Vol. I, p. 221.

⁴ See Punjab Banking Committee Report, Vol. I, p. 275.

well as stocks, though the latter type of security is generally preferred. The loans against block are made up to 20 to 30 per cent. of the value; while loans against stocks are made up to 60 to 70 per cent. of their value. The rates of interest charged vary between 9 to 12 according to the standing of the borrowing concerns.¹ In Bengal, some of the joint-stock banks also grant loans to small scale industries. The advances are made against the personal security of the proprietors, or in case the industries are joint-stock concerns, against the guarantee of the directors supplemented by stocks as collateral security. The Bengal Banking Committee observe that these banks, as a general rule, do not entertain any proposals for a grant of a loan, either against block or against stock of raw materials or finished goods.²

As regards the Imperial Bank, Mr. (now Sir) K. M. MacDonald in his evidence before the Indian Central Banking Enquiry Committee gave a list of industries to which the Bank was giving financial assistance.³ These industries included, for example, rice, flour, tea, coal and timber in Bengal; rice and oil mills, and mica and sugar factories in Bihar and Orissa; sugar, flour and leather works in the United Provinces; paper, printing, hosiery and timber in the Punjab; rice mills and sandal wood factories in Madras.

(3) THE MANAGING AGENTS AND OTHER PRIVATE FIRMS

We have already seen that the managing agents play an important part in the financing of large scale industries. ~~Some~~ of them also finance small scale industries of the factory-type. For example, in Bihar and Orissa, most of the sugar mills manage to obtain finance through their managing agents at Calcutta or Cawnpore.⁴ Besides the managing agents, there are private firms which interest themselves in providing finance to some of the small scale industries. For example, the exporting firms of Calcutta advance money to the shellac makers of the Central

¹ See *ibid.*

² See Bengal Banking Committee Report, p. 121.

³ See Mr. K. M. MacDonald's Evidence before the Indian Central Banking Enquiry Committee, Vol. II.

⁴ See Bihar and Orissa Banking Committee Report, p. 97.

Provinces.¹ So also in the case of the tanning industry in the Madras Presidency, money is borrowed from the firms of exporters.²

(4) THE DEALER

The local dealer in raw materials or the finished products, also plays an important part in the financing of small scale industries. Though he provides finance to the bigger industries also, his main business is confined to the smaller industrialists, i.e. the Karkhandars or master-craftsmen, and the cottage workers.

Where the dealer happens to deal in raw materials, he sells the same to the smaller industrialists and the cottage workers on credit, for which the latter have to pay a high rate of interest. Sometimes he supplies the raw materials on the condition that the finished products should be sold through him. Where the dealer happens to deal in the finished products he furnishes funds both to the smaller industrialists and the cottage workers, to enable them to purchase their raw materials, and to meet their working expenses during the period of production. The funds are advanced, in most cases, at a high rate of interest; besides, there is the stipulation that the finished products should be sold to the lender at a price to be determined by him.

(5) THE KARKHANDAR OR MASTER-CRAFTSMAN

The Karkhandar or master-craftsman who owns a workshop is also a useful financing agency. He supplies the workers who work in his workshop with the necessary raw materials, and provides them with funds to enable them to maintain themselves during the period of production. Sometimes, instead of working in his workshops, the workers are allowed to work in their own homes, in which case also, they are provided with raw materials and funds.

The Karkhandar or master-craftsman is generally his own financier, but sometimes he too has to resort to the money-lender and the big capitalist dealer.

¹ See Central Provinces Banking Committee Report, p. 222.

² See Madras Banking Committee Report, p. 133.

(6) THE CO-OPERATIVE BANKS AND PRODUCERS' SOCIETIES

The co-operative movement in India was started to ameliorate the condition of the agriculturists, and it has achieved some success in this direction. But the extension of the movement to the smaller industrialists and the cottage workers has not been attended by any important results. The urban co-operative banks, which have made considerable development, try to meet the financial needs of, amongst others, the small entrepreneurs and the artisans. Co-operative societies of artisans, such as weavers, brass workers, conch shell makers, etc. have also been formed. Most of them aim principally at the supply of credit; only some undertake the purchase of the raw materials and the sale of the finished products. We shall attempt a rapid review of the industrial co-operative movement in the different provinces, which will give an idea of the place occupied by this source in financing small industries.

In the Bombay Presidency, in 1932-33 there were 52 societies of weavers with a membership of 2,154. The working capital of these societies amounted to about Rs. 2½ lakhs, and the sales to Rs. 1.44 lakhs.¹ Besides, there were other societies of brass workers, leather workers, coir makers, etc.

The industrial co-operative movement has advanced more in Bengal than in Bombay. In that Province, there were in 1932-33, 330 weavers' societies with a membership of 5,850, share capital of Rs. 77,434 and a working capital of about Rs. 5½ lakhs. These societies sold to their members goods to the value of Rs. 53,928 and purchased their products worth Rs. 7,893. There were 106 fishermen's societies with a membership of 3,914 and a working capital of more than Rs. 1½ lakhs. The cocoon rearers' societies numbered 77, with a membership of 1,222, a share capital of Rs. 16,014, and a working capital of 93,384. Further, there were 13 societies of conch shell makers with a membership of 293, a share capital of Rs. 98,014 and a working capital of nearly Rs. 2 lakhs. In addition to the above societies, there were 5

¹ See Annual Report of the Working of Co-operative Societies in the Bombay Presidency for 1932-33.

societies of such workers as of toy makers, blacksmiths, mattress makers, etc.¹

In Madras also the industrial co-operative movement has made some progress. In 1933-34 there were 27 societies exclusively for weavers, with a working capital of more than 1 lakh of rupees. Out of these, 17 remained dormant, the rest purchased raw materials worth Rs. 7,811, and finished products to the value of Rs. 56,517 from their members; besides they managed to sell to the public, finished products to the extent of Rs. 71,083.² In addition to the above exclusively weavers' societies, there were 74 other societies in which weavers contributed more than 60 per cent. of the membership. These societies had a paid-up share capital of Rs. 60,045 and a working capital of more than Rs. 3½ lakhs. There were also 28 societies for the benefit of fishermen and 2 for coir workers.

In the Punjab, the number of industrial societies in 1932-33 was 300, with a membership of 5,243 and a working capital of more than Rs. 5½ lakhs, of which owned capital represented a little more than Rs. 2 lakhs.³ These societies advanced to their members raw materials to the value of more than 1 lakh of rupees, and sold members' goods to the value of Rs. 48,000.

In the United Provinces, in 1932-33 the co-operative cottage industrialists numbered 1,727. There were 51 societies for weavers, 49 for leather workers, and 6 for other manufacturers.⁴

The Registrar of Co-operative Societies, Bihar and Orissa, in his report for the year 1933 remarks that the artisans' societies in that province generally worked unsatisfactorily.⁵ There were 53 societies of fishermen, 3 of bell metal workers, and others of weavers, oil men, etc.

Similarly in other provinces and some of the Indian States,

¹ See Annual report of the working of Co-operative Societies in Bengal for 1932-33.

² See Annual Report of the working of the Madras Co-operative Societies' Act VI of 1932.

³ See Annual Report on the working of Co-operative Societies in the Punjab for 1932-33.

⁴ See Annual Report of the working of Co-operative Societies in the United Provinces of Agra and Oudh for 1932-33.

⁵ See Annual Report on the working of Co-operative Societies in Bihar and Orissa for the year 1933.

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there are industrial co-operative societies, which are composed of such artisans as weavers, metal and leather workers, toy makers, etc.

(7) THE GOVERNMENT

In recent years the Government has been giving financial assistance to small scale industries. State aid to Industries Acts have been passed in some of the provinces, e.g., Madras, Bihar and Orissa, and Bengal, which regulate such assistance. A detailed account of State financial assistance to industries has been given in the next chapter.

ORGANISATION AND FINANCE OF A FEW TYPICAL INDUSTRIES

(a) *Handloom Industry.*

We have so far dealt with the organisation and finance of the small scale industries in general. We shall now select a few of the small cottage industries, and see how they are organised and financed.

The most important of the small cottage industries is handloom weaving.

In the Bombay Presidency this industry, according to a recent survey, supports about 5.23 lakhs of people.¹ There are about 990 weaving centres spread over the Presidency, employing about 2 to 5 thousand hand-looms.² There are three classes of weavers:— (i) Those who work in their own homes on their own looms, and are economically independent. (ii) Those who are dependent on a Karkhandar or dealer for their supplies, and constantly indebted to him. (iii) Those who own Karkhanas or workshops, with a group of weavers working under their supervision. According to the Bombay Banking Committee Report, the weavers in the second class form about 75 per cent. of the whole group, those in the first class 20 per cent., and those in the third class 5 per cent.³

¹ S. V. Talang: Report on Hand-loom weaving in the Bombay Presidency, 1932, p. 2.

² Ibid.

³ See Bombay Banking Committee Report, p. 130

The weavers belonging to the first class receive their yarn on credit subject to the condition that the manufactured cloth should be sold through the lender. Where this condition does not obtain, the weavers sell their goods, in a few cases, to customers direct, and mostly to merchants.

The weavers in the second class are generally from a financial point of view in a depressed condition. They work in their own homes or at quarters provided by the dealer or Karkhandar. They contract debts from him, and pledge their looms and other property. When they do not work on their own account, they are paid according to piece-work, and their individual income varies from Rs. 15/- to Rs. 20/- per month.¹ Only the skilled worker amongst them gets Rs. 30/- per month. On the whole, 75 per cent. of their population are barely able to earn a living.²

The weavers in the third class who own workshops have to maintain the weavers working under them during the period of production. They also receive the yarn on credit subject to the condition that the cloth should be sold through the lender.

Hand-loom weaving in the Madras Presidency is also an important industry. Here there are four classes of weavers:— (i) Those who work for the ryots from whom they get yarn to be made into cloth and receive payment for their labour. The weavers in this class are not so numerous now. (ii) Those who buy yarn, make cloth, and sell it directly to the consumers by hawking or in local "shandies," and with the sale proceeds carry on further production. (iii) Those who buy yarn from a local dealer on credit and sell the cloth to him. (iv) Those who get yarn and advances from a "sowcar" or master weaver, and return the cloth to him. The weavers in this class are generally in debt.³

(b) *Brass and Bell Metal ware.*

Another important industry is the brass and bell metal ware. In the Madras Presidency the brassware industry is principally carried on in Kumbakonam. In this place, there are about 1,500 workmen. There are 100 smithies, with three workmen in each,

¹ Bombay Banking Committee Report, p. 130.

² S. V. Telang: Op, cit, p. 6.

³ See Madras Banking Committee Report, p. 135.

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run by the workmen themselves, 75 with six workmen in each and 50 with fifteen workmen in each run by the master workmen. The industry is mainly financed by the capitalist traders, who supply the brass sheets both to the independent and the master workmen, pay them wages in advance, either in lump or in instalments at stipulated rates, and receive back the manufactured goods from them. The goods have to be manufactured according to the traders' specification and must be delivered to them within a month, failing which they charge interest at 12 per cent. The dependent workmen in this industry get advances and payment of wages from the master workmen. The wages paid by the latter are lower than those paid by the capitalist traders. It may be noted that the whole brass industry of Kumbakonam is controlled by the local traders. It has been estimated that their owned capital is about Rs. 10 lakhs with a borrowed capital of the same amount.¹ The bigger traders who have sufficient capital do not borrow, but the smaller traders do so from the local banks at 9 per cent. interest and sometimes from indigenous bankers at 12 per cent. Some of these traders take deposits from the landholders and others who have surplus cash to invest and pay 9 per cent. interest on such deposits.

In the Bombay Presidency the brass and copper vessel industry maintains a large number of people. In the villages the industry is carried on by coppersmiths and artisans who satisfy the local demand. In the cities the industry is more organised. There are two classes of producers:—(i) Those who get their work done in factories, (ii) those who get it done at the home of the workers. The producers who own the factories employ workers to whom they pay wages. They purchase the metal sheets to be worked into vessels from the wholesale dealers in Bombay, either on credit, or with borrowed money, paying interest in both cases. The producers who get their work done at the homes of the workers have to pay the latter their wages and in some cases make them advance payments. Sometimes the producers entrust their work to a master workman who employs other workers under his supervision. The merchant and the money-lender are indispensable in this industry also. They buy the finished goods

¹ See Madras Banking Committee Report, p. 139.

from the producer and also supply him with finance. The Bombay Banking Committee observe that the money-lender charges an exorbitant rate of interest.¹

In the Central Provinces a large number of people are employed by the brass and bell metal industry. In the brass and copper industry there are two systems for the supply of raw materials and the sale of the finished goods, viz., the "Kachcha" (wages) and the "zuzawan" (weight for weight). In the "kachcha" system the artisans are supplied with the metal sheets as an advance, and when the finished articles are returned, they receive wages at the rate of Rs. 4/- per maund of the finished articles. In the "zuzawan" system the artisans weigh their finished articles against the purchasers' metal sheets, and receive a certain amount of money for their manufacturing charges. The artisans in this industry are left with a small profit, with the result that those who resort to the money-lenders have to pay interest at the rate of 9 to 15 per cent. on the loans that are advanced to them.²

(c) *Gold and Silver Thread Industry.*

The gold and silver thread industry is principally carried on in Bombay Presidency. The industry is concentrated chiefly in the cities of Surat and Poona. There are three classes of workers:— (i) Those who work independently with their own tools and sell their finished goods. (ii) Those who work to order in their own homes. (iii) Those who work in Karkhanas on wages. In this industry a considerable amount of money is required to make the purchase of raw materials. Both the small and big merchants who own the Karkhanas do not try to obtain funds from banks but manage to obtain the same from other sources. The small merchants sometimes purchase the raw materials on credit or else borrow the necessary funds to purchase the same from the indigenous bankers and bigger merchants who charge interest at the rate of 6 to 9 per cent. The bigger merchants who are financially better off, have sometimes to supplement their resources by accepting deposits from the public at 3 to 4½ per cent.³

¹ See Bombay Banking Committee Report, p. 133.

² See C. P. Banking Committee Report, Vol. I. p. 233.

³ See Bombay Banking Committee Report, p. 132.

(d) Silk Industry.

The silk industry of Bhagalpur in Bihar and Orissa is also an important industry. This is carried on partly in cottage and partly in factories, 1,600 hand-loom being owned by the weavers and 250 by factories. The weavers who work in their own homes are financed by the factories or the capitalist merchants to whom they are always indebted. Those working in the factories are also indebted. The independent weavers borrow money against personal security or against jewellery. The Bihar and Orissa Banking Committee observe that only 30 per cent. are free from debt.¹ As regards the rest, they are all heavily indebted to the Mahajans who, the Committee further observe, have a sort of trade combination to protect their unsecured debts. No weaver can go to another mahajan without a certificate of discharge from his old mahajan.

NEED FOR THE BETTER ORGANISATION AND FINANCE OF SMALL-SCALE INDUSTRIES

The position of small scale industries is far from satisfactory. Indeed, most of the small and cottage type of industries such as hand-loom weaving, brass and bell metal, oil pressing, rice husking, cotton ginning, etc. are declining either through neglect or due to the competition of the modern large scale factories. It is necessary that these industries should be revived and rehabilitated. Various Commissions and Committees have expressed the opinion that the small scale industries of India should not only be preserved but also developed. But it is regrettable to note that till recently, little has been done by the Government or the public in this matter.

There is no doubt that if the small scale industries of India are developed they will solve many of our problems. It is well-known that in this country there is a pressure of population on the land. If the village industries are revived and developed, the surplus population that now depends upon agriculture can usefully take to some of these industries. Besides, such industries as hand-loom weaving, pottery making, dairy farming, mat making, rice husking etc. can serve as a useful by-occupation to the agricul-

¹ See Bihar and Orissa Banking Committee Report, p. 92.

tourists, who have much spare time during the year, at their disposal, which at present they have to waste for want of suitable work. The amount of such spare time at the disposal of the agriculturist, in the words of the Royal Commission on Agriculture, "varies very greatly according to the local agricultural conditions, but it may be assumed as a broad generalization that by far the greater number of cultivators have, at least from two to four months of absolute leisure in the year."¹ The cultivators, by taking to some of the industries we have mentioned above, can, not only utilize their spare time, but also augment their present low income.

The rehabilitation of the small scale industries in the rural areas will help another class of people, viz., the landless labourers, who at present get employment for only a few months in the year on the land or on the construction of public works. Again in the urban areas, these industries will give employment to large numbers of people at present unemployed.

Reference must now be made to the recent official and non-official efforts that have been made to develop the small scale industries. The Government of India has decided to set aside a sum of one crore of rupees from its balances for the express purpose of improving the cottage industries and for rural uplift.² A non-official body called the All-India Village Industries Association has been formed under the inspiration and guidance of Mahatma Gandhi. It seems that the objects of the Association are to promote village industries, to bring improved methods of production to the notice of the artisans and to arrange for the marketing of their finished goods. If it is thus acknowledged that the small scale industries should be developed, the need arises for their better organisation and finance.

At present these small industries are carried on under crude and wasteful methods of production, there being an absence of a proper division of labour. The cottage workers use primitive and inefficient implements and tools. The result is that the production is low. To give only one instance, the hand-loom weavers

¹ Report of the Royal Agricultural Commission, p. 566.
See also Bombay Banking Committee Report, p. 128.

² See Sir James Grigg's Speech in introducing the Budget for 1935-36.

still use the old type of looms which are very cumbersome in construction, with none of the labour saving devices which are found in the modern fly-shuttle looms.¹ Consequently the production is slow and the weavers have to suffer.

Both the factory and the non-factory type of small scale industries suffer greatly from the absence of proper financial facilities. In most cases, they resort to the indigenous bankers, money-lenders and the capitalist dealers who exact a high rate of interest for their advances.² Even when the joint-stock banks give advances to them, they do so for short terms, and prefer liquid to other forms of securities. The interest charged by them, as the Bengal Banking Committee observe, appears to be too high for industrial purposes, ranging as it does between 15 to 18 per cent.³

The smaller industrialists and cottage workers, on account of the lack of finance, have to suffer much with regard to the purchase of their raw materials and the sale of their finished goods. They have to depend on the local dealers, who provide the funds for the purchase of raw materials or supply the same themselves, and undertake to sell the finished goods. But it must be noted that they take undue advantage of their position. For example, when they advance funds or raw materials on credit, besides charging a high rate of interest, they further stipulate that the finished products should be sold through them. In some cases, for example in the case of the hand-loom weaving industry, they advance the yarn to the weavers on the condition that the cloth must be woven according to their direction and design and sold to them at a price fixed by them. The above arrangements always result in the artisans being bound for life to the dealers.⁴

¹ Cf. "Primitive pit-throw shuttle looms are still largely in vogue in this (Bombay) Presidency. These are of a very remote and old type and do not give sufficient output per day. The weaver has to incline himself on the right and the left side of the loom in order to pass the weft yarn by hand, which is a very slow and tiring process and prevents him from producing cloth of wider width." S. V. Telang: Report on Hand-loom Weaving in the Bombay Presidency, p. 2.

² For example in Bengal the indigenous Bankers and money-lenders charge 15 to 36 per cent. interest, while in Bihar and Orissa they charge 12 to 24 per cent. See Bengal Banking Committee Report p. 122. and Bihar and Orissa Banking Committee Report, p. 102.

³ See Bengal Banking Committee Report, pp. 120-122.

⁴ Cf. "They (artisans) borrow money from the capitalist trader in the particular industry in which they are engaged, as agriculturists borrow from the village money-lender

It is therefore essential that the financial facilities to the small scale industries should be increased. So far as the factory type of industries are concerned, their financial problem can be solved by the extension of banking facilities to them. As regards the small cottage industries, their financial as well as other problems can be solved by co-operation.

SUGGESTIONS FOR INCREASING BANKING FACILITIES

We have suggested elsewhere the establishment of Industrial Banks in India. Should these be established, they should grant financial assistance, whether for fixed or working capital, to the small scale industries of the factory type.¹ But in the meanwhile the commercial banks, the joint-stock banks including the Imperial Bank, should increase their present financial facilities to these industries by providing working capital on more liberal terms, even if they are not able to supply the fixed capital. Advances should be given not only against stocks but also against the block capital of the borrowers. Of course a proper margin must be maintained when such advances are made. The present high margins kept in advancing against stocks should be lowered. Further, the practice of keeping the secured stocks under lock and key of the banks should be done away with. Instead, they should be stored in the warehouses, the establishment of which we have suggested elsewhere, and a receipt obtained, which should be accepted by the banks as a good security for their advances.

✓ The banks should also cultivate the habit of advancing against personal security. There is no doubt that the banks will find it risky to lend money to the proprietors of the small factories, either against personal security or the security of the block or

and endeavour to pay off the debt by work. The merchants who advance them money for their ordinary necessities of life, not only charge them a substantial amount by way of discount, but while they advance money they charge a fairly high rate of interest; their accounts are never honestly made and so long as the artisans are in their grips as debtors they are not able to settle their terms on which they would work for them on a fairly and equitable basis." Evidence of C. M. Ghandi, Chairman, Surat District, Co-operative Bank, Ltd., before Bombay Banking Committee, Vol. III, p. 20.

✓ If Provincial Industrial Corporations are established as recommended by the Indian Central Banking Committee they too should provide both long and short-term finance to these industries.

stocks. They have no agency at present to enable them to ascertain the credit-worthiness, and reputation for honesty and punctual payment, of their borrowers. In this regard, the Indian Industrial Commission considered a proposal which attempted to supply this deficiency and to bring the proprietors of the small factories and the banks into close touch. The Provincial Director of Industries, assisted by his technical staff and by the advice of a committee of businessmen, among whom a representative of the leading bank might well find a place, should examine the financial position and reputation of applicants, and should certify those persons whose position was found satisfactory as suitable recipients for a loan. This would take the form of a cash credit with a bank for a definite period and amount. Any bank of repute might participate in this scheme, and the applicants would select the bank with which they liked to deal. In order to reduce the risk of the banks the Government should guarantee the principal sum advanced with interest at a rate to be agreed upon with the banks. Government would decide the rate of interest to be paid by approved applicants. The former might desire a rate somewhat higher than the rate guaranteed to the bank. It could then retain some portion of this margin for its trouble, and the rest could be used as a set-off against possible losses. The Commission observed that the above scheme deserved consideration, at any rate as an interim measure until industrial banking facilities could be extended.¹ There can be no doubt that if the scheme worked successfully, the banks would be induced gradually to grant loans and advances direct, free of Government guarantee.

CO-OPERATION AS A REMEDY FOR SMALL COTTAGE INDUSTRIES

Co-operation offers the best solution to the financial and other problems of the small cottage industries. We have already seen that co-operative societies of artisans have been formed in most provinces. But their number is small and most of them are mainly credit societies. The industrial co-operative movement has not

¹ See Indian Industrial Commission Report, p. 218.

developed satisfactorily in this country, as still a large number of the artisan population is out of the co-operative organisation.

What are the causes for the slow development of industrial co-operation in India? In the first place, the movement has been opposed by the capitalist dealers and merchants who at present finance the artisans, and whose interest it is to keep the latter always in subjection to them. They therefore prevent the formation of industrial co-operative societies by coercing the artisans, or otherwise by misleading them regarding the true objects and benefits of co-operation. A second reason is the ignorance and illiteracy of the artisans who do not know the true value of co-operation. When again the disloyalty and dishonesty of the members have proved a stumbling block in the way of the successful working of societies. This defect has been specially noticeable in the case of the weavers' societies.¹ The weaver members evade the rules and resort to all sorts of dishonest practices, e.g., they sell outside at a higher price the yarn which they get at a cheap rate from the society. After making the cloth they do not sell it to the latter, but sell it outside if higher prices can be obtained. In other cases, when they get yarn from the society on the condition that the cloth must be sold to the society only, they resort to another dishonest practice. They weave the cloth by substituting coarse yarn, and with fewer picks per inch than those in the sample given to them.² Still another reason why some of the artisans' societies have failed, is the absence of a proper knowledge of marketing on the part of the members or those connected with the management of the societies.

It is essential that the above defects should be removed if industrial co-operation is to succeed in India. Industrial co-operation in other countries has succeeded in meeting the requirements of the small cottage industries, and there is no reason why it should not attain a similar object in this country.

INDUSTRIAL CO-OPERATION IN OTHER COUNTRIES

On the Continent of Europe, besides the modern large scale industries, there are a large number of small industries. These

¹ See Report on the Working of Co-operative Societies in Bihar and Orissa for the year 1933, p. 26.

² Cf. D. M. Amalsod: Hand-loom weaving in the Madras Presidency pp. 53-54.

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have successfully held their own against the competition of the factories, because the workers in them have taken advantage of co-operation.

In Italy, for example, the workers in many small industries have formed themselves into co-operative societies either for production or sale. There are societies of printers, electricians, glass blowers, tile makers, and textile workers.¹ One of the printers' societies in Milan has nearly 3,000 members. There are societies for fruit selling, wine and oil pressing, wool marketing etc. The fruit societies have evaded the charges of 3 or 4 middlemen, who formerly monopolized the farmers' products, and super-imposed the profits on the selling price.² Co-operation has also succeeded in ameliorating the condition of the workers in many of the small industries of Italy. Whereas formerly they were badly paid, now co-operation has improved their economic condition.

In France the producers' societies predominate. In fact, producers' co-operation originated in France. At present there are societies of workers in tanning, metal works, printing, etc. The producers' co-operative movement in its early stages in France received the active help of the State in the form of subventions and loans. The latter were mainly given through the co-operative bank on reasonable terms, and were repayable within periods ranging from 5 to 25 years, according to the amount of the loan. The rate of interest charged on such loans was only 2 per cent.³

In Germany too, the small industries owe much of their present flourishing condition to co-operation. The societies are of the Schultze-Delitzsch type, and receive active help from the urban banks.⁴ One of the large joint-stock banks of Germany is serving as the financial apex of the societies.⁵

Japan has many small industries. These are financed by the co-operative organisation which has made rapid strides in that

¹ See C. F. Strickland: *Studies in European Co-operation*, p. 56.

² *Ibid.*, p. 65.

³ See Otto Rothfeld: *Impressions of the Co-operative Movement in France and Italy*, p. 54.

⁴ See M. L. Darling: *Co-operation in Germany and Italy*.

⁵ See *Foreign Experts Report—Memorandum on Industrial Banking, Indian Central Banking enquiry Committee Report, Vol. I, Part 1, p. 640.*

country. The co-operative societies receive long-term loans from the Post Office Savings Banks,¹ which shows that the movement is receiving the active encouragement of the State.

SUGGESTIONS FOR THE DEVELOPMENT OF INDUSTRIAL CO-OPERATION IN INDIA

Having seen the development of industrial co-operation in other countries, we shall now make suggestions for its development in India. It may be asked as to what type of artisans are fit for industrial co-operation. It must be noted in this connection that the co-operative principle will work well, only if all the members of a society work in close co-operation and harmony. It is therefore desirable that the societies must be formed among artisans in the same industry. For example, the workers in the bell metal industry of a particular locality, working together, can form themselves into a co-operative society. It is only in the villages or in the small urban towns, that we find the workers in the same industry living and working together. In the bigger urban towns the workers are scattered and it would be difficult to form a society among them. In such places therefore, these workers should be helped by co-operative urban banks, which already exist in most of the provinces. These banks should also meet the financial requirements of the Karkhandars, who may not be willing at the present time to join a co-operative society.

The Co-operative Department must take an active part in encouraging the artisans to form themselves into co-operative societies. As most of the artisans are ignorant, conservative and addicted to drink, it will be necessary for the department to remove these defects by propagaṇḍa and spread of education. The active assistance of the Industries Department will also be necessary.

In the beginning, it is better to form co-operative societies among the artisans for credit only. As the Industrial Commission observed, co-operative credit is the simplest and most readily accepted form of co-operation in this country.² The artisans' greatest difficulty at the present time is the lack of credit for

¹ See K. Ogata: *The Co-operative Movement in Japan*.

² See Industrial Commission Report, p. 168.

production purposes. The societies should therefore supply cheap credit for this purpose. Besides, most of the artisans are heavily indebted to the money-lenders or the traders; the societies should try to reduce these debts.

If the credit societies work satisfactorily and successfully, then societies for other purposes, viz., purchase of raw materials and sale of finished products, should be formed. Co-operative purchase of the raw materials will benefit the artisans much, as at present they have to depend on the dealers, who charge high prices for the materials supplied and in addition stipulate that the finished products should be sold through them. The societies should purchase the raw materials direct from the producers, and every attempt must be made to eliminate the middlemen. Co-operative purchase is profitable in two ways: first, the raw materials can be bought wholesale and therefore at a cheaper price; and second, the materials bought are of good quality.

Co-operative marketing of the finished products will also benefit the artisans, as at present they have to sell their products at low prices to the merchants or dealers, or do the selling themselves by going from market to market and door to door, and thus waste a lot of time. The Co-operative sale societies should take over the products of the artisan members and arrange for the sale of the same in better markets. The members should be advanced a part of the value of their products to enable them to proceed with further production, and the rest should be paid when the sale is effected. Of course, the societies should charge a small commission for effecting the sale. Co-operative sale is advantageous to the artisans in two ways: they can get better prices for their products,¹ and second, the range of the market for their products is widened.

In the development of industrial co-operation in India, the District Central Banks should take an active interest. They should finance the primary artisans' societies which may be formed in all the provinces. The Provincial Co-operative Banks, which at present finance the Central Banks, should in addition to this work, help the primary artisans' societies to make their purchases of raw materials and the sale of finished products. It must be noted

¹ Even if the market is unfavourable, the societies can withhold the products until better prices can be realised.

that something in this direction has been done by the Bombay Provincial Co-operative Bank. This bank helps several groups of weavers' co-operative societies by collectively purchasing yarn for them, and selling their finished products through some of its branches in places where there is a demand for the same. The example of the Bengal Provincial Co-operative Bank should also be usefully copied by the other Provincial Co-operative Banks. This Bank takes an active interest in the financing of the industrial unions of that Province.

OTHER SUGGESTIONS

Need for forming Industrial Unions.

Federations of agricultural co-operative societies which have been formed in this country are working successfully. It is therefore obvious that federations of industrial or artisans' co-operative societies should be formed in all the provinces. Indeed, these federations or industrial unions, as they are more commonly known, have been formed in a few provinces.¹

The industrial unions can be of help to the societies in various ways. For example, they can help the societies in the purchase of raw materials² and the sale of finished products. Again, they can arrange for the finance of the societies with the Central Banks.

Need for starting Co-operative Industrial Banks.

In the Punjab, there is a separate Co-operative Industrial Bank at Amritsar. The Bank is principally interested in the financing of the weavers' societies and in helping them to purchase raw materials. The Bank has a business branch "Sales Depot" at Lahore. The depot keeps the societies in touch with the market by sending them weekly quotations.³ Co-operative industrial banks similar to the Punjab Co-operative Bank should be started in all the Provinces. These Banks should provide finance to the various industrial societies. Besides, they should also undertake the

¹ For example, in Bengal there are 8 industrial unions with 292 constituent societies.

² In the United Provinces the two Co-operative Industrial Central Societies which have been formed, supply raw material to the primary societies.

³ It has now been decided to close the Depot.

purchase of raw materials and the sale of finished products on behalf of the societies.

Need for Establishing Warehouses, Stores and Emporia.

The problem of the marketing of finished products of the small cottage industries can be made easier by the establishment of warehouses, stores and emporia. We had suggested in an earlier chapter the establishment of warehouses in India. These warehouses should offer storing facilities to the finished products of cottage workers, so as to enable them to realise better prices. We would suggest that a move to start warehouses should be made by the co-operative societies themselves. It will not be difficult to start one such warehouse in each district if the societies of the district join hands.

Stores and emporia where the artistic and useful products of artisans can be exhibited and sold should also be started at all important places in every province. To start such institutions, in the beginning Government assistance will be required. It may be noted that in some provinces, stores and emporia have been established either by the Government or through private effort; for example, the Government Emporium and Central Stores at Gauhati (Assam), the Arts and Crafts Emporia at Lahore and Lucknow, the Bombay Co-operative Swadeshi Stores at Bombay, and the Victoria Technical Institute at Madras. Recently, an organisation known as the "Good Companions" has opened a depot at Chowringhee in Calcutta, where craft products are displayed in an attractive fashion.¹ Mention may also be made of the fact that some of the Provincial Departments of Industries have taken advantage of the various fetes and exhibitions,² by exhibiting the products of cottage industries. It is only through such stores, emporia and exhibitions that the products of cottage workers can be placed before the public.

State Aid.

State assistance in some form or other will be required by the small scale industries. This problem has been deferred to the

¹ See Annual Report of the Department of Industries, Bengal, 1933-34, p. 13.

² For example, the H. O. H. Fete at Bombay, the Dussera Exhibition at Mysore, etc.

next chapter, but we must here emphasize that it is only by the active assistance of the State, that the small scale industries of India can be revived and made to prosper again. Besides the financial assistance that it may be able to grant, the State must take an active interest in educating the cottage workers to use better tools and implements, to take to modern methods of production, and to introduce new and up-to-date designs and patterns.

CHAPTER XI

FINANCIAL ASSISTANCE TO INDUSTRIES BY THE STATE.

NEED FOR STATE AID TO INDUSTRIES

While dealing with the financing of both large and small scale industries, we have pointed out that they experience great difficulty in obtaining the necessary finance. This fact had been the subject matter of evidence by Indian industrialists, Chambers of Commerce and other witnesses before different Commissions and Committees.¹ There is no doubt that much of the financial difficulty of our industries is due to the lack of proper banking facilities. Besides, there do not exist, in this country, institutions like Investment Banks, Investment Trusts, Issue Houses etc., which play such an important part in the West in enabling industries to raise their capital. Due to these facts, there has been a demand for financial assistance to our industries by the State. Having regard to this, since the beginning of this century, and more especially after the Report of the Indian Industrial Commission in 1918, the State has been taking some part in granting financial assistance to industries.

FINANCIAL ASSISTANCE TO INDUSTRIES BY THE CENTRAL GOVERNMENT

The Reform Act of 1918 left to the Provincial Governments the development of industries, including technical education and industrial research. The Government of India was left with the development of industries in a general and indirect way. Thus, the main activity of the State was in the provinces. It must however be noted that the Central Government could assist the industries directly by means of tariffs, stores purchase, bounties etc., and the achievements of the past few years show that something has been done in this direction. For example, so far as

¹ e. g. Indian Industrial Commission and the Indian Banking Enquiry Committee.

direct financial assistance to industries by the Government of India is concerned, mention must be made of the bounties granted to the steel industry. The total amount paid on the production of steel ingots between October 1924 and March 1927 was Rs. 1 crore and 10 lakhs. Bounties to the extent of Rs. 33 lakhs were sanctioned on wagons and underframes for which orders were placed the same year. The Central Government also helped financially the Calcutta Soap Works with a loan of Rs. 25,000 to enable the concern to undertake the manufacture of dynamite glycerine. The concern, however, soon after went into liquidation. A paper mill which had successfully tendered for the supply of paper to Government, was in need of funds. It applied to the Government of India for assistance, and the latter agreed to take, in advance of their immediate requirements, paper up to the value of Rs. 8 lakhs, and to make immediate payment for the same, subject to a discount of $6\frac{1}{2}$ per cent. In short the transaction was equivalent to a loan of money at $6\frac{1}{2}$ per cent. interest. The loan was employed usefully and subsequently repaid in full with interest.

FINANCIAL ASSISTANCE BY THE PROVINCIAL GOVERNMENTS.

MADRAS STATE AID TO INDUSTRIES ACT

Amongst the provinces Madras was the pioneer to take an active interest in the development of industries even before the Reforms of 1921. It was also the premier province to pass a State Aid to Industries Act in 1923. Under the Act financial assistance can be given to (1) new or nascent industries, (2) industries to be newly introduced into areas where such industries are undeveloped, and (3) cottage industries. The assistance can be given in any one or more of the following ways:— (1) by granting a loan, (2) by guaranteeing a cash credit, overdraft, or fixed advance with a bank, (3) by paying a subsidy for the conduct of research or for the purchase of machinery, (4) by subscribing to shares or debentures, (5) by guaranteeing a minimum return on part of the capital of a joint-stock company, and (6) by making a grant on favourable terms of land, raw materials, fire-wood, etc., belonging to the Local Government. In order to deal with

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the applications, the Act also set up a Statutory Board of Industries.

On a review of the working of the Madras State Aid to Industries Act, it must be admitted that a large number of industrial concerns have received financial assistance under it. But recently on account of the depression, the number of applicants has fallen off, and the Director of Industries observes in a recent report that "the results of the working of the Act continued to be disappointing and the position of the great majority of the concerns to which financial assistance has been rendered affords little ground for satisfaction."¹ It must be noted that though the Madras Act has helped a considerable number of small scale industrial enterprises, no active assistance has been rendered to the cottage industries. The reason is obvious. Under the provision of section 9 of the Act, every industrial concern that applies for aid must show assets equivalent to double the amount of loan asked for. Cottage industries are not able to fulfil the provisions of this section. Not only that, but this section does not permit the grant of aid towards the establishment of even new small scale industrial concerns, which can have no assets in the beginning. Besides this there is another defect. Under section 11 of the Act, and rules 16 and 17 framed under it, every industrial enterprise that receives help must furnish and maintain proper accounts, which must be duly audited by approved and certified auditors. A cottage worker ignorant as he is cannot obviously be expected to maintain detailed accounts, or incur the expenses which auditing involves. In order to remove these defects, the Act has been suitably amended recently. In 1928 the Act was amended with a view to exempt industries with a capital outlay not exceeding Rs. 1,000, and cottage industries from the operations of certain sections, viz., 9, 10, 11, and 14. Again in 1930, section 9 of the Act was amended to empower the grant of a loan to a concern up to the limit of Rs. 40,000, even if it exceeded 50 per cent. of the value of its net assets. It should also be noted that the Government have now made certain concessions, viz. (1) amended rule 24 (d) directing that, in the case of any industrial enterprise with

¹ Report of the Department of Industries Madras, for the year ending 31st March: 1933, p. 4.

a capital outlay not exceeding Rs. 500, it shall not be necessary, unless the Director of Industries otherwise directs, to insure the properties mortgaged to Government against loss or damage by fire; (2) arranged with the Government of India to exempt from payment of stamp duty, the mortgage deeds, securing the repayment of loan advances under the Act to cottage industrialists or the owners of small concerns, the capital outlay of each of which does not exceed Rs. 1,000; (3) agreed to the adoption of a simplified form of mortgage bond to suit the requirements of cottage industries, and (4) directed that in the case of applications for encumbrance certificates made by the Director of Industries in respect of any industrial concern with a capital outlay not exceeding Rs. 1,000 and of cottage industries, when the amount of loan applied for under the Act does not exceed Rs. 750, the Industries Department shall pay the fees thereof according to the ordinary rate prescribed in article 13 (2) of the table of fees regarding encumbrance certificates.

BIHAR STATE AID TO INDUSTRIES ACT

The Bihar and Orissa State Aid to Industries Act was also passed in 1923. The Act was modelled on the lines of the Madras Act. The object of the Act is to give long term finance to suitable industrial undertakings in the shape of direct advances at low rates of interest, subscription to debentures, guarantee of cash credits with banks, grant of land and other property on favourable terms, and also a provision which is not included in the Madras Act, viz. that relating to the supply of machinery on the hire purchase system. Applications for assistance for Rs. 10,000 or more, in any of these forms have to be advertised and objections invited in three consecutive issues of the local Gazette.

Since the passing of the Act in 1923, the total amount given out as State aid comes to Rs. 7,91,000 of which about Rs. 3,38,000 has been realised, leaving outstanding overdues at the end of the year 1933-34 of Rs. 1,06,000 both on account of principal and interest. The Government helps the industries by giving direct loans or by supplying on hire purchase system machinery and plant for making matches, buttons, hosiery etc. In many cases the persons to whom the machinery and plant was supplied have

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defaulted and the Government have sustained losses. A substantial amount of money has thus been lost by the Bihar and Orissa Government. Since 1932-33 the Act has been in abeyance, no loans having been made as no provision for the same was made in the budget.

Though the Government have sustained some losses, on the whole the Bihar and Orissa State Aid to Industries Act has done some good as it has rendered help to a large number of industries. These industries include oil milling, saw milling, tanning, comb manufacture, fire brick forming, soap, weaving, bone crushing, printing, etc. But there is one great defect in the Act, viz., that subject to a few exceptions, it limits the power of the Government to give assistance to any industry except in accordance with its provisions. As the Director of Industries says in his Report, "except in the case of a guarantee of a cash credit, overdraft or fixed advance with a bank, or the payment of a subsidy for the conduct of research, state aid can only be given to a new or nascent industry, an industry to be newly established in an area where such industries are undeveloped or a cottage industry."¹ The hire-purchase system has worked satisfactorily, and some of the small industries have benefited from the same.

PUNJAB INDUSTRIAL LOANS ACT

The Punjab Industrial Loans Act, which was also passed in 1923, "to encourage industrial development," is a much less elaborate measure than the Madras Act. The assistance provided by it is in the form of loans only, and the detailed provisions as regards the grant of these loans are left for the most part to rules. Up to 1926-27 no loans were granted, and in that year six applicants received Rs. 5,000 each. In 1927-28, loans were granted to twelve applicants amounting to Rs. 54,300. In 1928-29, a large number of applicants viz. thirty, were given assistance, the total amount of money advanced that year being Rs. 1,08,000. Among the industries to which the loans were given, were weaving, oil milling, hosiery, furniture and wood work, tennis gut, *durri* making, dairy farming, pottery, etc. In recent years financial assistance has also been given to other industries. For example,

¹ Report for 1923-24, p. 29.

Rs. 1 lakh was advanced in 1931-32, Rs. 75,000 in 1932-33, Rs. 81,000 in 1933-34; the industries aided being such as manufacture of chemicals, dry battery cells, razor blades, electric motors, power weaving, etc. The total amount disbursed under the Act by the end of the year 1933-34 was Rs. 6,17,950 in 186 cases, and the outstanding amount stood at Rs. 3,36,184.

STATE AID IN THE U. P.

Though State Aid to Industries Acts do not exist in other provinces, yet some of them have given financial assistance to industries under one form or another. For example, in the United Provinces, assistance in the form of loans and grants have for a long time been given. As Mr. Clow says, "indeed the Government of the United Provinces, where there is not Act on the subject, have given more financial assistance to industries than any other local Government."¹ Between 1922 and 1927, five large loans were given as follows: (1) Rs. 6 lakhs to the Lucknow Sugar Works, Ltd., (2) Rs. 4 lakhs to the Karaudia Development Corporation, Ltd., (3) Rs. 1.20 lakhs to the Mahalaxmi Sugar Corporation, Ltd., (4) Rs. 1 lakh to a glass works, and (5) Rs. 80,000 to a Bobbin Company. Smaller loans have also from time to time been given, e.g. Rs. 22,000 to the Allahabad Law Journal Press, Rs. 12,000 to an ink manufacturer, Rs. 10,000 to a match factory, etc. Loans have been given to the cottage industries through the co-operative societies. Besides the loans, the United Provinces Government have also given grants-in-aid, principally to those who wish to start new industrial concerns. For example, in 1928-29 a grant of Rs. 5,000 was given to an individual for running a power hosiery plant and the venture was successful, resulting in the development of the hosiery industry. In 1931-32, Rs. 5,000 was given to an electric works for the manufacturing of electric table fans; in 1932-33, Rs. 3,500 was given to a lace factory to enable it to set up new types of machines; and in 1933-34, a sum of Rs. 2,000 was given to an individual to enable him to conduct experiments on the manufacture of glass from some Indian minerals as a substitute for soda.

¹ A. G. Clow: *The State and Industry*, p. 108.

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OTHER PROVINCES

State aid to industries has been given in Assam and Burma. In Bombay, such assistance has been very limited.

Recently in Bengal, a State Aid to Industries Act has been passed by the Legislative Council which came into force from 15th January 1932. Up to now no loans have been granted under the Act due to financial stringency, but a fund called the Bengal State Aid to Industries Act Fund has been created by contributions and donations from the public. Loans from this fund will be given to deserving industrialists in accordance with the provisions of the Act.

FINANCIAL ASSISTANCE BY INDIAN STATES

Some of the Indian States have also been taking a keen interest in industrial development and have given financial assistance to industries. The State of Mysore has been the pioneer in this matter, and indeed, its example has been followed by the British Provincial Governments and other Indian States. The Mysore Government grant loans under certain rules for any or all of the following purposes:—(1) The purchase and erection of machinery for agricultural and industrial undertakings up to a limit of Rs. 10,000 in each case. (2) The construction of wells or tanks, of mills, warehouses and other structures necessary for agricultural and industrial operations. (3) The provision of raw materials, working capital or appliances other than those specified above, required for the carrying on of industrial operations up to a limit of Rs. 5,000 in each case. The Director of Industries and Commerce is empowered to sanction loans not exceeding Rs. 1,000; loans exceeding this amount are granted with the permission of the Government. The loans are granted for five years and must be repaid by annual instalments. The Department of Industries also undertakes, if the borrower so requires, the erection of the work for which the loan has been sanctioned and hand it over in good working condition. Under the rules large and small loans have been granted regularly from year to year, and machinery supplied on the hire-purchase system. Established industries have developed much and new ones have been set up in the State. Since the passing of the rules in 1913 till 1932-33, the total amount

of loans sanctioned come to Rs. 8½ lakhs, the industries developed or set up being rice and oil mills, tile factories, printing presses, saw mills, hosiery factories, etc. In 1932-33, loans to the extent of Rs. 29,085 were sanctioned in thirty-two cases; and in 1933-34, loans amounting to Rs. 30,905 were given to fourteen applicants.

The Baroda State has also been taking an active interest in industrial development. It has also a separate Industries and Commerce Department. Up to July 1933, the total amount advanced as loans was Rs. 2,96,952 in eleven cases.

Some other Indian States are also rendering financial assistance to industries. For example, in Travancore the State assisted in the establishment of Travancore Sugars, Ltd. Financial assistance in the form of loans has also been given. Among the industries which have received loans from the State may be mentioned, cotton weaving, rice hulling, soap making, cabinet workshops, bell metal, match, coir, ivory workshops and dairy farming.

NEED FOR INCREASING STATE AID TO INDUSTRIES :

EXAMPLE OF OTHER COUNTRIES

Though since 1921 the State in India has done much to develop industries by way of direct financial assistance, and tariffs, it must be pointed out that the progress is slow. There is a great need for increasing the present assistance, both by the Central and Provincial Governments, to industries. The question is often asked as to why State aid to industries is necessary. It must be noted that though it is more than half a century since India started her industrial career, yet she does not stand comparison with Japan and other countries, which started late in the industrial race. There is no doubt that especially since the beginning of this century a large number of industrial undertakings have been established in this country; but as compared with the Western countries, India is still industrially backward. This can be easily seen from our dependence on foreign products, even for such articles as razor blades, electric bulbs, umbrellas, etc., we have to depend on other countries. In spite of the establishment of cotton mills in this country, cloth is imported from England and

Japan. It may be said that only cloth of finer variety is imported. But we must remember that cotton mills were established in India as early as 1850, at a time when the cotton textile industry was not established in Japan, and yet, within a few years this very country has been able to produce finer varieties of cloth and export the same to our country.

There is a general feeling in India that the State must take an active part in the industrial development of the country. Successful industrialisation will solve many of our present-day problems, and will bring about many beneficial results. In the first place, rapid industrialisation will solve the problem of the pressure on the land. The excessive dependence of India on agriculture, as the only source of livelihood, is not in the best interests of the country.¹ Besides, the excessive subdivision and fragmentation of holdings has made the cultivation of the land uneconomic, and the cultivators are barely able to eke out their living. Having no other source of income, they fall into the clutches of the money-lenders. If the lot of the cultivators can be improved it is mainly by industrialization, that is, by inducing them to take to some of the cottage industries. In the second place, with the establishment of more industries the national dividend will be increased. This will lessen the present poverty of the people and raise their standard of living. Further, successful industrialization according to the Fiscal Commission may bring appreciable capital resources, that are now being wasted, into use.² And lastly, the most important beneficial result of rapid industrial development is its effect on national character. In the words of the Fiscal Commission, "it is hardly too much to say that a certain measure of industrial life and opportunity is an essential condition for building up a vigorous national character. And with regard to India the effect on the national character is likely to be particularly marked and particularly beneficial."

In support of the view that the State in India must take a greater interest in industrial matters, the attitude of the State

¹ Cf. "The economics of a country which depends to so great extent as in the case of India, on agriculture, must be unstable." Report on Indian Constitutional Reforms. (Montagu-Chelmsford Report)

² Report, p. 4.

towards industrial development in other countries may be briefly reviewed.

GERMANY

The present industrial position of Germany has been principally due to the active interest of the state in industrial matters. In the beginning of the 19th century Germany was a poor country, most of her people depending on agriculture. But the Government took an active interest in the industrial development of the country. The Government itself started and fostered a number of industrial undertakings. Bounties and subsidies were given to the established industries. By the end of the nineteenth century Germany had completely industrialized herself.

State assistance in Germany has become much more in evidence since the beginning of this century and especially after the War. Both the Federal and Local Governments played an important part in power development, and assistance has been rendered to exploit the working of lignite and the unification of the electrical supply. After the War, the re-organization of German industry was largely undertaken with the active support of the Government. The State has rendered assistance especially to the heavy industries and shipping. Further, it carries large risks in many industrial enterprises through holding large blocks of shares in them. Besides, direct subventions have also been given to large manufacturing firms.

JAPAN

When she began her industrial career, Japan was a poor country. Agriculture was her principal industry, most of the peasantry being very poor. Yet within a short time, Japan was able to transform herself and become a great industrial country, competing with the highly industrialized countries of the West. It was the state here, as in Germany, that was responsible for the rapid transformation of the country from an agricultural into a manufacturing one. The state, on account of the lack of initiative on the part of the people, pioneered and undertook the establishment of many industries such as textile mills, iron and steel works, railways, shipyards, shipping lines, copper and coal mines, etc.

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In order to make credit easily obtainable the state established the Bank of Japan. The Industrial Bank of Japan was also established under Government control and supervision.

After successfully working the industries that it had set up, the State handed them over to the people. Even after they were so handed over, the state did not lose its interest in them. To these as well as to the other established industries, the state rendered financial and other assistance. Bounties and subsidies have been the favourite form in which financial assistance has been given by State to industries in Japan.¹ This can be seen from the large amounts of subsidies given to the shipping and other industries.

It must be noted that the Japanese Government does help not only the large industries but the small and cottage industries as well. State financial assistance to these industries is given principally through the co-operative societies.

FRANCE

In France too, state assistance has been given to large and the small industries. As in Germany, the post-war industrial reconstruction has been undertaken largely with state assistance. For instance, recognising its liability for the reconstruction of wrecked or damaged mines, the financing of the coal industry in the years 1919-24, was largely undertaken by the state.² Similarly, the French nation financed on a very large scale the post-war reconstruction of the iron and steel industry. In recent years the state has taken a large interest in the promotion of the hydro-electric industry. Its contribution takes the form of subsidies for the construction of the power stations, for scientific investigation and research, etc. In the three years, 1930-31, 1931-32, 1932 (9 months) the total allocations were 73 million francs of which 67 million francs were for the construction of works.³ The State also participates in refineries, as can be seen from the law of

¹ "The granting of subsidies was so firmly established as an integral part of the Government policy towards industry during this early period, that it still persists."

J. E. Orchard. 'Japan's Economic Position,' p. 90.

² See Report of the Department of Overseas Trade. (Economic Conditions in France) by Sir R. Cahill, 1934, p. 135.

³ Ibid, p. 184.

30th March 1930, article 8 of which laid down that in the event of a modern refinery being erected on French territory, "with a view to the execution of contracts of national interest," the Government might participate in its capital, within a limit of 50 millions.¹

The small cottage industries have been also helped by the state in France, the assistance being chiefly given through the co-operative societies. The state has taken an active part in the formation of industrial co-operative societies, as can be seen from the fact that in 1917 it created and endowed a system of co-operative short term credit societies of artisans, small manufacturers, etc. These societies called "banques populaires" were to have as their exclusive object "the acceptance and endorsement of small credit instruments, created, signed or endorsed by members of a banque populaire and relating to business operations." The state provided the scheme which has as its object the supplying of short term facilities to the artisans and small manufacturers, with an advance of 18 million francs. Each society could obtain from the state twice the amount of its paid-up capital for 5 years; this loan was however renewable. A central federation in Paris created by law in July 1929, to which the banques populaires are affiliated, controls the operations of the individual banques and acts as a distributor of state advances. The number of these banques populaires in 1933 was 95, to which were affiliated in all about 500 branches.²

Besides the establishment of banques populaires, the state has passed a Credit Artisanat Law in 1923. Under this law craftsmen are able to obtain loans for a maximum period of 5 years through a co-operative society of workers, or through a federation of such societies, or through a banque populaire, for the purpose of buying machinery, raw materials etc. The loan must be repaid by annuities and must be guaranteed by a banque populaire. The central organization which controls the state endowment, supplies the funds at low rates of interest to the societies.³

¹ Ibid, p. 164.

² See Report of Department of Overseas Trade, (Economic Conditions in France) 1934, p. 619.

³ Ibid, p. 620.

ENGLAND

Even in England, the home of laissez-faire, in recent times, the state has taken an active interest in industrial development. Even as early as 1903 the British Government gave direct financial assistance to the ship-building industry. And the policy of giving direct financial assistance has been much in evidence since the War. To give only two instances, in 1915 the British Dyes, Ltd., was organized. The Government in order to help the concern undertook to subscribe £1 for every £1 of the capital subscribed by the public. Again, in 1920 the Home Grown Sugar, Ltd., was floated with a capital of £300,000 and the British Government undertook to subscribe for a number of ordinary shares not exceeding 250,000 at £1 each, equivalent to the number of shares allotted to the public. Not only this, but the Government also guaranteed interest at 5 per cent. for 10 years on the shares allotted to the public, and agreed not to take any interest on its own shares, until the public subscribers had received 5 per cent. It was stated that "the object of the guarantee of the Government was to subsidize the industry during the earlier years on a profitable commercial proposition, by ensuring a certain 5 per cent. dividend to the public shareholders, and when so established, to encourage the company to divest itself of Government control consequent upon the investment of State funds in the enterprise."¹ It may be noted that even later on the beet-sugar industry has been subsidized by the Government, the amount of subsidy given in 1930-31 being £5,400,000.

SUGGESTIONS FOR INCREASING FINANCIAL ASSISTANCE BY THE STATE TO INDUSTRIES

We have seen that direct state assistance has been responsible for the industrial development of many countries. Even England has made a departure towards this policy in recent years. In view of this, it is desirable that the state in India should also take an active interest in the industrial development of the country. It cannot be denied that some measure of financial assistance has been rendered to industries, but it has been haphazard and with-

¹ See Indian Tariff Board Report on the Cotton Textile Industry. 1929, Vol. I, p. 193.

out regard to a fixed policy. Besides, some of the industries, e.g., the large organized and the cottage, have been completely neglected. We shall now make some suggestions for increasing the financial assistance of the State to industries.

FINANCIAL ASSISTANCE TO THE LARGE SCALE INDUSTRIES

Up to now state assistance to the large scale industries has taken the form of protection. There is no doubt that protection has done much to help the industries which have received it. But besides protection, other forms of state assistance, chiefly financial assistance, are required by our industries. On account of the peculiar economic conditions obtaining in this country, direct financial assistance and participation by the state will be essential to stimulate industrial enterprise.

In the first place, the impediment to the rapid industrialization of this country and the establishment of new industries is the lack of supply of capital. It is not the lack of capital as such, but the shyness of the Indian investors to invest in industrial enterprises generally that is responsible for such a state of affairs.¹ It is necessary to induce the investors to invest in new ventures by state participation. There can be no doubt that if the Government takes up shares of otherwise guarantee dividends on the shares of a new industrial concern, capital from the public would be forthcoming easily.

Secondly, financial assistance is also required by established industries. Most of them find it difficult to obtain the necessary finance due to the reluctance of the banks to provide funds, or due to the reluctance of the investors to invest their capital. The state can assist these industries in the following way:—If those large organized industries which are on the joint-stock basis wish to obtain funds, they should issue additional securities, shares, or debentures. The Government can guarantee the dividends or the interest, as the case may be, on these securities, so as to induce the public to take them up. In cases where the industries concerned are of national importance, the Government should take a part of the issue of additional securities. If some of the indus-

¹ See the Chapter on Capital Market.

trial concerns do not think it desirable to issue additional securities, the state should help them by granting loans on easy terms. This can be done by encouraging the establishment of industrial banks, which would serve as the agencies of government for such help to industries.

And lastly, bounties and subsidies must be given to important industries. In one way, bounties and subsidies are a better form of state aid than import duties in that they give a greater stimulus to industry.¹ The Japanese Government favoured this form of assistance the most, as can be seen from the large amounts of bounties that it has granted to the ship-building and other industries. In India, in accordance with the Tariff Board's recommendation bounties were given to the steel industry. But this method has not yet been largely adopted in India.

FINANCIAL ASSISTANCE TO THE SMALL SCALE INDUSTRIES

With reference to the small scale industries, it must be noted that at present there are no organized credit agencies available to them. So far as the factory type of the small scale industries are concerned, some of them do derive financial assistance from the Provincial Governments either directly or under the State Aid to Industries Act. But the majority of them suffer financial difficulty. The grant of financial assistance to them by the state should be increased. Direct loans should be advanced to them, until industrial banks or Provincial Industrial Corporations are established as recommended by the Indian Central Banking Committee.

Amongst the small scale industries, the cottage industries experience the greatest difficulty in obtaining credit on easy terms. Most of the small industrialists and cottage workers are indebted to the money-lenders or the capitalist dealers.

These industries have a definite place in our national economy, and early efforts must be made to revive and rehabilitate them. Small cottage industries still survive even in the most industrially advanced countries of the West and in Japan, chiefly due to

¹ See Report of the Indian Tariff Board, (Cotton Textile Industry) 1929, Vol. I, p. 185.

state aid. In India also the state must take an active interest in these industries, and provide financial assistance to them.

The financial assistance may be given direct to these industries, or through co-operative societies. As regards direct financial assistance, the State should advance loans on easy terms both to the small industrialists and the cottage workers to enable them to buy the raw materials, to meet the expenses during the period of production, and to purchase better implements and tools. The Government can by following the rules prevalent in Mysore State as regards the hire-purchase system, supply the artisans the tools and implements under the same system.

As regards the grant of loans through co-operative societies, the state in India should copy the example of France. The state should encourage the formation of artisans' co-operative societies, and grant them loans on easy terms. Further, it must assist the societies to make the purchases of raw materials, tools and implements, and the sale of finished products. If industrial unions are formed, the state should also help them in a variety of ways. For example, the unions should be assisted in the purchasing of raw materials and the sale of finished products. If co-operative warehouses are established, the state should give financial assistance to them also, besides giving them other facilities, such as grant of land free of rent, etc.

SUGGESTED IMPROVEMENTS IN STATE AID TO INDUSTRIES ACT.

The Industrial Commission recommended long ago that state assistance to the small industries, whether in cash or by way of hire-purchase, should be made under a special Act providing suitable means for the recovery of outstandings. They were further of opinion that in the absence of such provision, the difficulty of recovery would tend unduly to restrict the giving of advances. We have already noted that State Aid to Industries Acts have been passed in some of the provinces. The utility of these acts being obvious, similar State Aid to Industries Acts should be passed in the other provinces as well. It is desirable that there should be a uniform Act in all the provinces, and for this purpose the Madras Act, may be taken as a good model.

We have already pointed out the defects in the working of State Aid to Industries Acts in some of the provinces. In order that greater assistance should be given under these Acts to industries, they need certain improvements.

In the first place, under the Madras and Bihar and Orissa Acts, the industries to which financial assistance may be given are limited to new or nascent industries. The result is that established industries cannot obtain any assistance unless they are started in a new area. As these industries also experience serious financial difficulty for want of credit facilities, we suggest that the Acts should be amended so as to include these industries also within their purview.

Another defect is that, as in Madras, Local Government is unable to use discretion in giving assistance to industries, as the Act is rigid. This defect should be remedied as in the Punjab where the Government has the discretion regarding the kind of industries to which help may be given.

One of the reasons why the small industrialists do not take greater advantage of these Acts is that they dislike the publicity, and formality that attends their applications for loans. They further think that their credit will be injured in the market by the Government inviting objections to their applications. We therefore suggest that these formalities should be so arranged that the difficulties be minimised.

The reluctance of the small industrialists to take advantage of the Acts is also due to the coercive methods adopted for the recovery of the loans advanced. Some of the concerns which had obtained loans and could not pay the instalments regularly had to close down. In order that a large number of small scale industries may take advantage of the facilities provided by the Acts it is desirable that the present coercive measures should be relaxed. As the Director of Industries of Assam observes: "In order to encourage the spirit of enterprise among deserving persons, it is necessary to refrain from taking extreme coercive measures in cases in which it can be proved that the failure of the business was not due to misapplication of the loans or to any neglect on the part of the borrowers, but to circumstances beyond their control."¹

¹ Report of the Department of Industries, Assam, for 1933-34, p. 20.

We have already noted that the cottage workers have not been helped by the State Aid to Industries Acts. This is due to the fact that the applicants have to show assets twice the amount of the loan for which they apply, to maintain detailed and audited accounts, besides being required to furnish various returns. It is obvious, as we have noted, that the cottage workers cannot show the necessary assets nor can they incur the expense of maintaining detailed accounts. It is necessary therefore, that some exemption should be made in the case of the cottage workers. Besides, under the Punjab Industrial Loans Act, the minimum of the amount of loan that can be granted by the Government has been fixed at Rs. 500. This limit, the Punjab Banking Committee considered to be too high, in view of the size of the industrial concerns.¹ The limit should be lowered so as to enable the cottage workers also to obtain the financial assistance.

Finally, we would suggest that provisions regarding the supply of machinery and plant on the hire-purchase system should be incorporated in those Acts which do not at present provide for this form of assistance.²

CONCLUSION

We consider that financial assistance by the state to the industries is essential, in view of their present difficulty to obtain the necessary credit facilities. We have no doubt also that with active state aid, the pace of industrialization in this country will be increased. State assistance should be withdrawn only when the banking and the co-operative organizations have developed to meet the financial needs of the large and small scale industries respectively. Both the people and the Government must whole-heartedly co-operate in the work of industrial development; then alone we shall have that net work of efficient organisation and mobilised finance, which will help to lift this country above the poverty line.

¹ See Report, Vol. I, pp. 82-83.

² It may be noted that the Madras Government has under consideration a Bill to amend the State Aid to Industries Act with a view to providing machinery on the hire-purchase system. It may also be noted that the Government has under consideration a bill to amend the State Aid to Industries Act so as to provide for the grant of electric power on favourable terms to industries eligible for assistance under the Act.

See Report of the Department of Industries, Madras, 1934.

APPENDIX

THE INDIAN COMPANIES' AMENDMENT ACT, 1936

While the book was in the press the Indian Companies' Act was amended by the Indian Legislature. This Act, which is known as the Indian Companies Amendment Act of 1936, has, we are glad to say, brought about in the industrial organisation of the country certain salutary changes, the necessity of many of which we had occasion to indicate in the body of the book. The new Act no doubt is a great step forward on the former legislation and should, if ingenious businessmen and lawyers are not able to find loopholes frustrating its aim, prove helpful in bringing about a healthy growth of joint-stock organisation. And we have every hope that Government will not lose time in removing the loopholes, if any, that may defeat the intentions of the Legislature.

We propose to review briefly the more important changes made by this Act. The extent of the changes effected can well be imagined by the fact that it runs into 123 sections with a considerable number of subsections in some of them. We do not wish to discuss here all these changes. In the first place, with many of them, especially with those concerning Banks and Private Companies, we are not directly concerned; secondly, certain sections deal with details of legal and accountancy provisions, which need not be discussed here. We propose to discuss only those sections which are likely to bring about in the organisation and finance of industrial concerns changes which are important from an economic point of view.

These changes can be divided into certain groups such as those concerning (1) mushroom companies, (2) fraudulent companies (3) the issue and contents of prospectuses, (4) disclosure of financial position to shareholders, (5) shareholders' control over the management, (6) managing agents (7) winding up of companies, (8) banks and so on.

MUSHROOM COMPANIES

The first thing that any legislation in matters economic must aim at is to stop the wastage of existing resources of material well-

being. Such wastage takes place, in the field of industries, when ever any industrial scheme is not able to add to the wealth of the nation. The first duty of a piece of economic legislation, therefore, is to stop the expenditure of resources on all such unfruitful schemes. The Act under consideration attempts to do this, so far as joint-stock organisation is concerned, by discouraging mushroom companies. Such companies not only result in wastage of the assets expended on them, but they entail still greater loss in so far as they frighten the investing public, and make it difficult to find capital even for deserving industrial schemes. This impediment in the way of industrial progress must therefore be checked as effectively as possible. The checks exerted by the former Company Law were weak, and hence the history of the industrial progress of our country shows that whatever advancement we have made is at a great cost. The present legislation no doubt is an improvement in this respect over the former one.

The companies which owing to insufficiency of funds are not able to start work or even though they start working are required to close down soon owing to financial difficulties, are called mushroom companies. Such companies are started with a motive, usually an honest one, to work some attractive schemes but they rarely achieve the goal owing to insufficiency of funds. Naturally the resources spent on such schemes are lost as they are not able to yeild any return to the owners. In our first chapter we have shown that the promotion of such mushroom companies cost the Indian investing public nothing less than 64 crores during the short post-war boom period.

In the fifth chapter, while discussing the problem of raising initial capital we have shown how companies are started without raising sufficient capital. Such enterprises are of course foredoomed to fail; some of them do not even start work but are wound up before that. The former law had no provision to check such activities; on the other hand it encouraged them. The peculiar provisions of the minimum subscription clause contained in it made it possible for the organisers of such schemes to get out of the activities without any loss to themselves. We have already shown in the said chapter how by keeping the minimum low, the organisers could utilise the money raised from the shareholders to defray the payment to be made to them, on account of their

personal and material services. The organisers of unsound companies thus did not run any great risk. In such cases it is the outside investors who lost their money, and in order to avoid such loss we had suggested that no company should be allowed to proceed to allotment of shares unless the subscription guaranteed the supply of funds sufficient to satisfy the needs for fixed and working capital. And we are glad to say that the new Act contains provisions on these lines.

The amended Act now lays down that in fixing the minimum subscription, the directors must see that the raised funds would provide (a) the purchase price of any property purchased or to be purchased; (b) the preliminary expenses; (c) commission for procuring subscriptions for any shares in the company; (d) repayment of moneys borrowed by the company in respect of any of the foregoing matters; and lastly (e) working capital.¹ This provision will no doubt make it difficult to start concerns with insufficient funds; but it will not prove as beneficial as it seems at first sight. Its effect is weakened to a great extent by the proviso which leaves the directors free to raise the necessary capital in ways other than by issuing shares, for instance, by issuing debentures or by accepting deposits or borrowing loans.²

This freedom to raise capital in ways other than by issuing shares not only weakens the provision but may even frustrate its aim. The directors, for instance, may declare that they have secured a certain proportion as deposits from the agents, and require only a certain proportion as share capital, and when they have secured subscription for that small amount of shares, may proceed to allotment. Later on it may so happen that the managing agents who are the promoters and creditors may decide to wind up the concern, and may withdraw their deposits and appropriate the share money for their expenses and commission, the shareholders in the end losing their money.

In the same chapter on Initial Capital, we have also shown how certain other countries have made legal provision regarding raising

¹ cf. Section 10 I (2).

² "..... the amount stated in the prospectus as the minimum amount which in the opinion of the directors must be raised by the issue of share capital in order to provide the sums or, if any part thereof is to be defrayed in any other manner, the balance of the sum required to be provided in respect of the matters specified in subsection (2)" Section 101 (1).

a substantial portion of capital out of share issue. Such a provision is quite necessary in this country, and this would have been achieved if the suggestion in the Bill as originally introduced had been accepted. It was originally suggested that the subscribed capital must either be sufficient to meet the expenditure for all the heads mentioned above or "83½ per cent. of the share capital offered to the public for subscription whichever is higher." It was also suggested that at least 25% of the subscribed capital must have been paid for or received in cash by the company. This part of the section would have ensured financial soundness to a greater degree, but unfortunately it was deleted by the Select Committee.

This provision is likely to result in one more disadvantage. It gives good opportunity to the agents to keep the concerns indebted to them. In one of the sections¹ relating to the managing agency contract, it is provided that at the time of determination of the contract, the agents must be paid back all dues belonging to them. The clause relating to minimum subscription as finally passed gives the managing agents an opportunity to keep the concerns heavily indebted to them from the very beginning. As such loans would be spent in fixed assets it will be impossible to pay off the loans without winding up the concerns unless some other financier comes forward to advance the necessary amount, or it is raised by issuing debentures. In the former case the financier will demand the agency rights and in that case it will mean little benefit. As regards the second possibility it is easy to imagine how difficult it is for the disorganised and scattered shareholders to carry out such a financial scheme in the face of opposition from well organised and powerful management. This clause thus gives a good opportunity to the managing agents to make their contracts almost permanent. These defects could have been avoided by making it obligatory to start a company only with owned capital, or at least with a large proportion of owned capital.

PREVENTION OF FRAUDS

Another way in which the waste of assets is prevented is through suppression of fraudulent concerns. Like mushroom concerns fraudulent concerns also involve a great loss of capital

¹ cf. Section 87A (4).

resources. The harm done by both these types of companies does not remain restricted only to the actual loss of capital involved in them but spreads much beyond that. They create a bad name for industrial investments and discourage the supply of capital for industrial purposes.

Just as under the former Act there was no direct check over promotion of mushroom companies, so also there was no special provision to check the activities of fraudulent company organisers and managers. The only way open for the aggrieved party under the existing conditions is to seek redress under the Penal Code. But to file a criminal suit against a man in a responsible position involves great difficulty. The amendments introduced by the new act have made it more easy to check the perpetration of frauds.

According to the new Act the Registrar of joint-stock companies is authorised to investigate into cases of fraud brought to his notice by any creditor or contributory and after enquiring to make a report to the Local Government.¹ The Local Government on its part has been authorised to launch a prosecution at the cost of the state against those, who as a result of investigations are considered guilty of any offence.² According to this Act the responsibility of the aggrieved party ends on bringing to the notice of the Registrar the suspected acts of fraud.

THE ISSUE AND CONTENTS OF THE PROSPECTUSES

After suppressing the mushroom and fraudulent concerns, the next step is to see that the rest of the concerns are conducted on honest and efficient lines. The most important feature of joint-stock organisation is that those who supply the capital cannot have a direct and constant control over the management of the concern. The management thus having no financial stake in the concern are likely to be careless and even fraudulent in their work. The best way to check and suppress such activities is to bring the affairs under greater supervision and control of the shareholders. The shareholders being scattered and unable to go into the details of the working of the concern, it must be made legally binding upon the management to keep the owners informed of their activities.

¹ cf. Section 137 (a) (3) and (b) (6).

² cf. Section 141 (a)

Under the former Company Law there was no provision whereby the managers were required to keep the owners informed of the affairs, and consequently the shareholders generally did not know anything except that they received or did not receive dividends. As a result, there was a great demand for greater control by the shareholders on their concerns, and the new Act is a great step forward in that direction.

The first provision in this respect is in regard to the particulars to be disclosed in the prospectus. The prospectus is the document which gives the necessary information about the proposed company to the prospective investors. It is therefore only just that the shareholders should get accurate and honest information about the enterprises in which they intend to participate. In order to meet this demand certain provisions are made in the new Act to make the information more exhaustive and accurate. For instance, it is made necessary to disclose in the prospectus the agreement regarding the appointment and remuneration of the managers or managing agents.¹ In our chapter on the Managing Agency System we have shown how the different provisions relating to the appointment and remuneration of the agents were not disclosed to the shareholders, who, going by the statements in the prospectus, remained almost in the dark about such matters. The managing agents by different provisions in the agency agreement usurp too much power and render the shareholders powerless in controlling them. Similarly, by different financial provisions the agents involved the concerns under great financial obligation to themselves. This agreement being not easily available to them, the shareholders used to purchase the shares in blissful ignorance about all these conditions. An agency agreement is a contract between the shareholders and the managing agents; and it is therefore only just that both the parties should be fully aware of the conditions of the contract.

The provision made by the new Act in this respect is not quite satisfactory. The relevant section only says that the prospectus should contain "any provision in the articles or in any

¹ Section 93 (1) (C) states that the prospectus must contain "any provision in the articles or in any contract as to the appointment of managers or managing agents and the remuneration payable to them."

contract as to the appointment of managers or managing agents and the remuneration payable to them." This provision is likely to be interpreted as requiring statements of the names of the agents and the percentage of the profits to be paid to them as remuneration for managerial services. But in our chapter on the Managing Agency System, we have shown how the managing agents make money in so many different ways. They want commission for securing capital, fixed and working, for purchasing machinery and raw materials, for arranging sales, for carrying out insurance, for maintaining a head office, and sometimes even for labourers employed and the payments made to them. Such commissions are likely to be considered as payments not for managerial services, but for each different respective service, and therefore need not be included in the prospectus which requires the statements of payments for managerial services only. It is of course difficult to understand what is the managing agents' conception of their managerial duties and functions. It would have been better therefore, if it were specifically provided that the prospectus should mention all sorts of payments to which the managing agent is entitled. No fair minded person would say that the managing agents should render any service gratis to the client concern. What is equally fair is that the shareholders should have a clear idea of the financial obligations that they undertake when they purchase the shares.

Whenever underwriters are employed, the directors must disclose in the prospectus the names of the underwriters and their remuneration. Besides this the directors must also include a statement to the effect that the underwriters possess sufficient means to fulfil the obligations undertaken by them.¹ This provision regarding underwriters is important. When it is declared that the issue has been underwritten, it means that the enterprise will not remain without being started for want of funds. Naturally, it becomes easy to sell the shares of such a concern. In the end if the underwriters are not able to fulfil their undertaking and the outside subscription does not warrant a successful conduct of the enterprise, those who had purchased the shares on the understanding that the whole issue had been underwritten stand to suffer. It is therefore

¹ cf. Section 93 (ee).

proper that the investors should know more about the financial and social position of the underwriters, so that they might be in a better position to decide about the possibility of the undertaking being fulfilled by them.

All these provisions are intended to give the prospective investor more or less a clear and accurate idea as to the financial position of the concern in which he intends to invest his money. But we do not think that they will serve any great purpose.

In our chapter on Initial Capital we have shown how the properties are likely to be transferred to a new company at an exorbitant price and in that case the concern is likely to suffer from financial scarcity if not bankruptcy, and stressed the necessity of ascertaining the propriety of the price to be paid in such cases. But this suggestion does not find a place in the new Act. The provisions described above will at the best enable the prospective investors to form some idea as to whether the price paid or to be paid is reasonable or otherwise. These provisions thus will prove useful only from the point of view of those who can understand such things; for others it is of little use. In all probability those provisions will prove as useless and unimportant as that about the minimum subscription in the former Act. Legal provisions which are meant to be of use to guide those who understand the things generally prove useless in the case of those who do not understand the same. In the latter case the law must not only provide for the disclosure of the facts, but must also provide for passing a judgment on the same. In the book while discussing the problem of stock-watering, we have described how in other industrialised countries, the state has made provisions to ascertain that the prices paid for properties acquired by joint-stock companies are not unreasonable¹. Some provision on these lines is quite essential in this country; and it is regrettable that an opportunity to accomplish this was lost. Owing to the general ignorance of business matters on the part of our investors, such a provision was all the more urgent.

DISCLOSURE OF FINANCIAL POSITION TO SHAREHOLDERS

Just as the new Act intends to give the prospective investor full information about the financial position of the concern in

¹ See the chapter on Initial Capital.

which he intends to invest, so also it contains certain provisions which are intended to keep the shareholders fully informed about the financial position of the concerns in which they have already invested their money. As the shareholders cannot themselves manage the affairs of the company, the same has got to be left in the hands of the executive appointed by them. And the question of seeing that the executive work is done in the interest of the shareholders has proved a hard nut to crack in the field of company law. Two different ways are devised to accomplish this. Either the executive is obliged by the law to manage the concern in a way which is considered to be beneficial to the owners, or they are obliged to keep the owners informed of the affairs, so that the latter being fully aware of the working of the concern should be in a position to bring about changes which they deem to be desirable. The provisions made by our company law in this respect belong to the latter type. The rules regarding the periodical supply of information about the finances of the concern to the shareholders have been made much more strict under the new Act.

Under the old Act the only source for the shareholders to get information about a going concern was the balance sheets published by it. But the balance sheets, as they are published at present, are aimed more at hiding the situation than at disclosing it. It will be difficult even for an expert accountant, not to speak of a layman, to form a correct opinion about a concern by reading balance sheets in the present form. The new Act has brought about some salutary changes in this situation. First of all, it has improved the form of the balance sheet to some extent.¹ The new form provides for greater details regarding certain points such as reduction of capital assets, debts, investments etc., which will prove useful to the shareholders. But still the supply of information provided by that form is not exhaustive and clear. The only noteworthy feature about the form is that its observance has been made more strict.

But the Act has made some important improvements in other directions. So far the shareholders had to remain satisfied only with the balance sheet. But under the new Act the compilation and circulation of three other documents have been made com-

¹ See Section 132 (1) and (2) and the form F from Schedule III.

pulsory. For instance, every balance sheet must be accompanied by a copy of the auditor's report.¹ Hitherto the shareholders were required to go to the registered office of the company to see the auditor's report. The auditor's report if it is drawn carefully and conscientiously, will help the shareholders to study the balance sheets more correctly. The auditors must also certify as to the correctness of the accounts and also their conformity with the law.² Besides, they are entitled to receive the notice of and to attend any general meeting of the company, at which any accounts examined or reported on by them are to be considered. In such meetings they are entitled to make any statement or explanation they desire with respect to the accounts.³ But this provision is not likely to be effective. The auditor's report to be of any importance must contain an impartial scrutiny of the actions of the management, and the satisfactory discharge of this duty depends upon the extent to which they are free from the control of the management. Not much importance can therefore be attached to this provision, until the management is deprived of their voice in the election of the auditors. Owing to the same circumstances, nothing important can be expected even from the provision entitling the auditors to appear before the shareholders in the general meetings. Here also they cannot be ordinarily expected to be impartial to the management. All the same it would have been better if the appearance of the auditors in the shareholders' meeting had been made compulsory. Under the provision explained above the appearance of the auditors has been left to the will of the auditors who except under very exceptional circumstances cannot be expected to attend the meetings and to incur the odium of the displeasure of the management by criticising their actions.

As a matter of fact it ought to have been made compulsory for the auditors to appear before the shareholders and to explain to them their findings. In short, the provisions regarding the written and oral report of the auditors will not prove effective. In the second chapter of the book while speaking about the auditors we have shown how even some big concerns reduce auditing to a mere farce. And this they can do as they wield a preponderant voice

¹ cf. Section 131 (3).

² cf. Section 145 (2) (b).

³ cf. Section 145 (4).

in the appointment of the auditors, and naturally the latter cannot be expected to be impartial to the former under such circumstances. If the auditors are to be of any use, they must be made quite independent of the management. Only then can they be expected to discharge their duties efficiently and impartially.

The new Act has made it necessary for the management to prepare and circulate profit and loss account in addition to the balance sheet.¹ Under the old Act the submission of profit and loss account was left to the will of the management. This account must show, in a classified form, the amount of gross income, distinguishing the several sources from which it has been derived, and the amount of gross expenditure, distinguishing the expenses of establishment, salaries and other matters.² Such an account of income and expenditure will be more comprehensible to the shareholders than the too technical and obtruse balance sheet. The profit and loss account must also contain particulars regarding the total of the amount paid whether as fees, percentage commission or otherwise to the managing agents, if any, and the directors respectively as remuneration for their services, and the total of the amount written off for depreciation.³ The importance of this provision will depend upon the extent to which it will be able to reveal the amount of money made by the agents in different ways out of the client concerns. For instance, if it means a complete disclosure of the total income of the managing agent from that particular concern, then it will have some salutary effects. In our chapter on the managing agency system, we have shown in how many different ways, the agents derive income from the client concerns. The disclosure of all such payments received by the managing agents will prove beneficial, in so far as it will exercise an indirect check upon the tendency of the agents to squeeze money out of the client concerns. The disclosure of the payment made to the directors will also prove useful in so far as it will make it possible to compare the total costs of the directorate with the services received from that body. This will discourage the practice of forming too large a board, for considerations other

¹ cf. Section 131 (1).

² Section 17 (2) has made compulsory the Regulation 107 which contains the above provisions.

³ cf. Section 13 (32).

than its services to the concern. Another noteworthy provision about the profit and loss account is the statement of the depreciation written off. This provision is not likely to prove of any great use. It will have at the best only an indirect effect in so far as it will give prominence to the depreciation item. But this cannot mend the present negligence regarding depreciation provision. The absence of a proper provision for depreciated assets is one of the greatest defects of our industrial finance,¹ and this situation can be improved only by making it compulsory for every concern to set aside every year, a certain percentage of the assets as depreciation reserve. So long as this has not been done, mere disclosure of the facts will prove of little use.

Besides these documents, the directors must work out and circulate among the shareholders their own report, which was not compulsory under the old Act, regarding the financial condition of the concern.² This report must contain statements regarding the amount which they recommend should be paid by way of dividends and the amount which they propose to carry to the different reserves. This compulsion upon the directors to inform and explain their policy to the shareholders is likely to yield a double advantage. It will exert an indirect influence upon the attitude of the directors in so far as they will have to be more careful about their actions, being required to intimate and explain the same to the shareholders. From the point of view of the shareholders, it is always advantageous to have as much information as possible about the concerns in which they have invested their money.

One more important provision to be mentioned in this connection is that all these reports and statements must be sent to the shareholders at least fourteen days before the meeting at which they are to be discussed. Previously, this time limit was only of seven days and the shareholders hardly got any time to consider the information supplied to them before the meeting was held.

One noteworthy addition belonging to this group of informative provisions discussed so far deserves mention here. The new Act provides that a register should be maintained containing the particulars of the contracts entered into between the company and

¹ See the chapter on Administration of Earnings.

² cf. Section 131 A (1).

any of its directors, and it should be open to the inspection of the shareholders.¹ This provision will give the shareholders an idea of the financial relations of the directors with the concern. Besides, it will make the directors more cautious about their dealings and also will give an opportunity to the shareholders to scrutinise and if necessary to nullify or rectify any unfair bargains.

All these provisions are intended to enable the shareholders to have as clear an idea as possible about the finances of their enterprise. Formerly, a balance sheet, which was prepared more to misguide than to guide, was the only source of financial information for the shareholders. Some better managed concerns no doubt supplemented the balance sheet with profit and loss account. But there being no obligation to issue the latter statement, most of the companies avoided the trouble of preparing and issuing it. The information supplied by both these documents will be made more comprehensible by the directors' report, which will enable the shareholders to know the policy and actions of the executive which were responsible for the position stated in these documents.

All the provisions regarding the supply of financial information to the investors, at all stages, which we have discussed so far, are of an informative nature. They are only intended to supply the information to the prospective as well as existing shareholders. The supply of such information is useful only if the persons for whom it is meant are able to read it in the proper light. Besides, it can prove of any use only when the shareholders wield effective control over the executive, and can bring about desirable changes. But where the owners do not wield an effective and immediate control, the actions of the executive must be restricted and directed by the law. In the second chapter, we have shown how the shareholders even in forward countries like England, find it difficult to exercise an effective control over the management. In India the management is still more beyond the control of the shareholders, first, owing to the existence of the managing agency system and secondly, owing to the general ignorance and inefficiency of the shareholders. Under these circumstances, it would have

¹ cf. Section 91 (A) (3).

been better if the management had been obliged to follow certain salutary financial policies laid down by law.

SHAREHOLDERS' CONTROL OVER THE MANAGEMENT

After enabling the shareholders to have a full knowledge of the financial position of a concern, the next sphere for reforms was to enable them to have control over its management. In a joint-stock company the shareholders who are the owners cannot have a direct control over the enterprise. Their powers are delegated to the boards of directors who manage the affairs of the concerns on their behalf. The management and ownership of a joint-stock company being thus separated, the managers are likely to be careless and fraudulent in their work. And in order to avoid such a situation it is necessary to bring the management as much under the control of the owners as possible. The management of a joint-stock company is ordinarily vested in the hands of the board of directors and the control of the owners over the affairs of the company will depend upon the extent of their control over these boards of directors. Under the former law the boards of directors were formed in such a way that the shareholders could exert very little control over them. This control was materially curtailed owing to the present form of the managing agency system, whereby the majority of the directors were nominated by the managing agents. Such directors being beyond the control of the shareholders, the concerns were managed by persons who could hardly be called the representatives of the shareholders. But the new Act brings about some improvement in this situation. In the first place it is provided that every company, must have at least three directors.¹ No more will it be possible to manage a company with only two directors. It is further provided that two-thirds of the directors of a company started under the new Act shall be liable to have their office terminated by rotation.² By another provision it is laid down that the managing agents cannot have more than one-third of the directors nominated by them.³ This is a step in the right direction, because it will act as a check on the directors who cannot have a permanent position. Besides

¹ c.f. Section 83 (A) (1).

² cf. Section 83 (B) (2).

³ cf. Section 87 I.

it may be noted that in view of regulations 78 and 81 all the directors will have to retire at the first annual general meeting.

The control of the shareholders on the directors is further strengthened by enabling them to remove an undesirable director by passing an extraordinary resolution to that effect.¹ Under this provision the directors will have to think twice before disregarding the will of the shareholders. A director will have to vacate his office even if he absents himself from three consecutive meetings of the Board, or for a continuous period of three months, whichever is longer, without leave of absence from the board.

The new Act not only attempts to make the directors more active in their duties but it has also increased the responsibilities of their office. No more is it legal to exempt the directors, managers, auditors or any other officers of the company from, or indemnifying him against, any liability in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company.² In the second chapter while discussing the relations of directors with companies, we have shown how the directors were relieved of their responsibilities by special provisions in the Articles of Association. We have suggested that such attempts to relieve the directors of their proper responsibility should be made illegal. The present section carries out this suggestion. The effect of this provision will be to eliminate from the boards of directors persons who do not understand their duties properly; and those who accept the responsibility of directorship will be more vigilant about the acts of the managers or managing agents.

Not only has it been made more difficult for the directors to shirk the responsibility of discharging their duties carefully and conscientiously, but many additional responsibilities are also imposed upon them by the new Act. For instance, the responsibility of keeping proper books of account has been cast upon them, and if any director fails to take reasonable steps to secure compliance by the company with the requirements of this section he is liable to a heavy fine.³ In cases where there are managing agents, the managing agents are held responsible for keeping proper books

¹ cf. Section 86 (G).

² cf. Section 86 (C).

³ cf. Section 130 (3).

and the directors are relieved of this responsibility.¹ This provision will result in the maintenance of books of accounts in proper order. Under the former Act there was no such obligation upon the directors. Though Section 230 of that Act provided that every company should maintain proper account books, still neither the agents nor the directors were held responsible for the maintenance of such books. They were relieved even of what indirect responsibility they bore in this respect being the supreme managerial authority, by providing an indemnity clause in the Articles. Under these circumstances, proper account books were not maintained, with the result that in many cases of frauds, it was difficult to trace the culprits.² In this connection, the directors are further required to supply to the Official Liquidator a full statement disclosing in detail the affairs of the company to enable him to have a clear idea as to the company's financial position.³

When the shareholders elect a director they do so because they have confidence in the honesty, integrity and business ability of the person. It showed therefore a complete disregard of duty and responsibility for a director to assign his office to any person who was not able to win the confidence of the shareholders. Such acts on the part of the directors testify the general complaint that though in theory the directors are the representatives of the shareholders, in practice they completely disregard them. But the new Act makes certain provisions whereby the directors cannot afford to forget that they are the representatives of the shareholders. No more, for instance, is it possible for the directors to assign their office to any other person, without the consent of the shareholders expressed by a special resolution.⁴

The provisions discussed so far attempt to bring the directors under a greater control of the shareholders and to increase the responsibilities of their office. The Act further attempts to restrict the directors from taking undue advantage of their position in

¹ cf. Section 130 (3).

² Some interesting examples of such mismanagement will be found in the lecture of Mr. S. S. Engineer, a member of a well-known auditing firm in Bombay, delivered on 25th April 1930, at the time of the first Annual Social of the Incorporated Accountants' Association, Bombay.

³ cf. Section 177 (1) (2).

⁴ cf. Section 86B.

making money. They are, for instance, prohibited from holding any office of profit under the company except that of a managing director or manager or a legal or technical adviser or a banker without the consent of the company in a general meeting. The office of managing agents is not considered an office of profit under the company.¹ So also the directors are precluded from entering into any contract for sale, purchase, or supply of goods and materials with the company without the Board's consent.²

In our chapter on the managing agency system, we have shown how the managing agents and their friends or nominees on the board entered into contracts with the company for the sale of the manufactured goods or the supply of raw materials or machinery, usually to the disadvantage of the shareholders. Under the former Act when the managing agents could have a majority of their nominees on the board all such contracts meant more or less a distribution of spoils among themselves. But the situation will be different under the new Act. Now there will be a majority of the representatives of the shareholders who can ordinarily be expected to protect the interests of their electors. It is further provided that an interested director shall not be counted for the quorum, which will make it difficult to pass such a resolution in the absence of some directors.³ The protection given by these sections gains strength from the obligation to disclose all such contracts to the shareholders, a provision which we have already discussed. All the same it must be admitted that the protection given by the necessity of securing the consent of the board for such contracts cannot be said to be adequate under the existing circumstances. It would have been better if the consent of the shareholders were made necessary in such matters.

The present Act prohibits a company from advancing loans to a director or guaranteeing any loans made to him or to a firm of which he is a partner or to a private company of which such a director is a director.⁴ This provision is important in so far as it precludes the directors from utilising the funds belonging to the companies under their direction for their personal use. Such trans-

¹ cf. Section 86E.

² cf. Section 86F.

³ cf. Section 91B (2).

⁴ cf. Section 86D.

actions were not rare, and their effects were not infrequently detrimental. The money was usually lent at a very low rate, and losses from default were not uncommon.

Two more important amendments were moved containing further limitations on the powers of the directors, but they were thrown out by the Assembly. One of them attempted to limit the number of concerns of which a man could be director. For instance, it was suggested that a man could not be a director of more than twenty companies. In the second chapter of the book while referring to this question we have shown how companies cannot derive benefit even from able directors if they serve on the boards of many companies at the same time. It does not require any great imagination to realise that a man, whatever his ability, cannot discharge his duties efficiently if he is required to serve on the boards of 60 to 80 companies at a time. The result is that such a person, in spite of his ability, proves of little use to any of them. These persons would have proved more useful if they had restricted their activities to a limited number of concerns voluntarily. The present method has created almost a class of directors in industrial centres like Bombay and Calcutta. The business ability of many able persons outside this class is being wasted for want of opportunity. If these directors had restricted their activities to a few concerns, their own services would have been more effective, and this would have left opportunities for other persons with merit and ability. Of course it must be admitted that the provisions of the new Act discussed so far, which increases the responsibilities and duties of the directors, will have an indirect effect upon checking this tendency. So also the provisions intended to bring the directors under a greater control of the shareholders will make it difficult for a few favourite persons to secure membership of the boards. Henceforward the election of the directors will be related to a greater extent to the active services that they can render to the concerns under their directorship. Similarly the increased responsibilities of the director's office will have an effect upon limiting the number of boards on which a man can serve. But this result would have been more assured if the law had limited the number of directorships that a man can undertake.

The second provision which was thrown out by the Assembly,

was regarding the disclosure by a director every year of his dealings in the shares of the company. The underlying idea in making this suggestion was to prevent directors from speculating in the shares of the companies of which they were the directors. In the second, the third and the fifth chapters we have shown how the directors and managing agents by taking advantage of their position and knowledge of the financial conditions of the concerns, deal in the shares, generally to the detriment of the interests of the outside shareholders. It is quite essential to have some legal check on such activities. It is argued in this respect that if they are prohibited from doing this themselves, they will do the same through their nominees. Though this is true to some extent, a legal provision restricting the directors from such activities with heavy penalty for any attempts to frustrate it would have proved of great benefit. There being at present no restrictions on their activities in this matter, they take an undue advantage of their position. The directors, having greater knowledge of the finances of the concern can know the future trend of the prices of the company's shares and use this knowledge in share speculation, making profits at the cost of the shareholders. Sometimes they go still further and actually manipulate the finances so as to be advantageous for their dealings. The result of all such practices is that they create a bad name for industrial investment; the persons who are expected to encourage industrial investment thus in practice discourage it. The existing conditions therefore prove the necessity of prohibiting the directors from dealing in the shares of the companies under their directorships.

MANAGING AGENTS

It is for the first time in the history of company legislation in India that statutory recognition has been given to managing agents and the managing agency system.¹ Though the managing agency system has been a feature of joint stock organisation in India ever since its introduction, still strangely enough this institution was not recognized in law till recently. This is a good example of how legislation in India is many times of imitative and exotic nature without proper co-ordination of the circumstances existing in this country. It is believed by some that this

¹ cf. Section 2 (9A).

"definition makes it clear beyond doubt that except to the extent to which the directors might themselves delegate their functions to the agents the agents would be under their control and direction."¹ But this is a wrong idea. The definition as such makes no changes in the past and present position of the agents and the directors respectively. The definition as given in the Act runs as follows, "managing agent means a person, firm or company entitled to the management of the whole affairs of a company by virtue of an agreement with the company, and under the control and direction of the directors except to the extent, if any, otherwise provided for in the agreement". This definition clearly shows that far from the powers of the agents being limited by the directors the powers of the directors are limited by the will of the agents as formulated in the agency agreement. The directors will have to accept their appointment with their powers vis-a-vis those of the agents as specified in the agency agreement. The definition of the managing agents, therefore, in no way brings the agents under greater control of the directors, it only gives legal recognition to an institution which so far was not recognised in law at all.

The important provisions applicable to managing agents are contained in subsections 87A to 87 I. The first provision in this respect relates to the period of managing agency contract. It is provided that a managing agent shall not be appointed to hold office for a period of more than twenty years at a time;² so also no managing agent appointed before the commencement of the Act can continue after twenty years from its commencement.³ It is further provided that the termination of the managing agents' office under the above rule shall not take effect until moneys payable to the managing agents for loans or remuneration are paid.⁴

In our chapter on the Managing Agency System we have shown how the agency agreements under the old Act were formed for long periods of forty to sixty years, and in some cases they were even permanent and non-terminable. After showing the dis-

¹ cf. Indian Companies Act overhauled and Amended, Article V, Times of India Nov. 11, 1936.

² cf. Section 87 A (1).

³ cf. Section 87 A (2).

⁴ cf. Section 87 A (4).

advantages of such long period contracts, we stressed the necessity of limiting these contracts to shorter periods. We therefore welcome the change introduced by the new Act. But we are doubtful about the efficacy of these provisions in practice.

The termination of the managing agents' contract, as, said above, is to be effective only when all moneys payable to the managing agents for loans or remuneration are paid. We have more than once shown how the managing agents try to keep the client concerns deeply indebted to them.¹ Under these circumstances it will be very difficult for any concern to pay off the loans due to the agents.² This provision will give a greater impetus to the tendency of keeping the client concerns indebted to the agents; and in this respect it is likely to prove more harmful than beneficial as it encourages unsound financial practices.

A transfer of office by a managing agent has been made void unless approved by the shareholders in a general meeting.³ This provision is important. In our chapter on the managing agency system we have shown how by one of the sections of the agency agreement the managing agents took to themselves the right of transferring the agency to any party they liked, and the shareholders were rendered powerless in such matters. After discussing the injustice and ill effects of such practice, we suggested that such transfers should be rendered void unless approved by the shareholders and this is accomplished by the said provision. Similarly, a charge or assignment of managing agents remuneration has also been rendered void.⁴

By a further clause it is provided that if a company is wound up either voluntarily or by the court before the termination of the contract with the managing agents, then the managing agents have a right to receive compensation provided that the winding up is not due to negligence or default on their part.⁵ As in business matters it is very difficult to prove negligence or default in a court of law, the payment of compensation in all such cases will be a

¹ See for instance our chapters on Managing Agency System and Initial Capital.

² See *Supra* discussion regarding the Minimum Subscription Clause.

³ cf. Section 87 B. (C).

⁴ cf. Section 87 B. (d).

⁵ cf. Section 87 B (d).

permanent feature. It is also a point worth considering whether the possibility of getting compensation will not tempt the agents to accelerate the downward movement of the business in order to wind it up before the termination of the agency contract. Besides, as the remuneration of the agents is payment for their active services to the business during a specific period, there does not seem to be sufficient ground for compensation when the business ceases to exist and the services end. If at all any compensation was thought proper the law, in view of the too heavy compensation demanded by the agents in such cases, ought to have restricted the limit of such compensation. For instance, it ought to have been laid down that the compensation should not exceed the annual minimum remuneration or the average annual remuneration.

It is further provided that the appointment, dismissal and variation of the contract of the managing agents cannot be valid, unless approved by the company by a resolution to that effect.¹ But a proviso has been added to this clause to the effect that it does not apply to the appointment of a company's first managing agent made prior to the issue of the prospectus. This proviso which was introduced by the Select Committee has deprived the clause of most of its importance. We do not therefore agree with those who call this "an extremely important provision." It only means that the dismissal of the existing managing agents or the appointment of new ones or any changes in the agency contract must be referred to the shareholders for their approval and cannot be carried out by the directors themselves. But when the shareholders have a majority of their representatives (under this Act) on the board, and the interested parties are prohibited from voting it is of little importance to refer such matters to the shareholders when it has been approved by their representatives.

This section would have proved of great importance had it been kept as introduced in the original Bill, in which case, it would have been applicable even to the appointment of the first managing agent. The select committee by introducing the proviso eliminated the appointment of the first managing agent from the provision of this section. The Select Committee perhaps thought that as the preliminary appointment is announced in the prospectus

¹ cf. Section 67 B (f).

it becomes known to the shareholders when they purchase the shares.¹ But we have already shown how scanty information regarding the agency contract is supplied in the prospectus. There is no exaggeration if we say that the shareholders purchase the shares with gross ignorance about the contents of the agency contract. As the shareholders are a party to the contract it is proper that they should have a full knowledge of its contents. With the same view we suggested that the agency contract should not be considered valid unless it was approved by the shareholders in the first general meeting.² Supposing there arises disagreement between the proposed managing agent and the shareholders, the former should sever his connection with proper remuneration for his services rendered up to that time. This will even be in keeping with the principles of sound finance. It is always better that the preliminary expenses should be met in the beginning and should have no connection with the later finance of the company. The select Committee by introducing the proviso lost a great opportunity of bringing about an important change in our industrial organization and finance.

After making provisions for appointment, duration and removal of the managing agents the act refers to the problem of the remuneration of the agents. And in this respect it is laid down that the remuneration of the managing agents shall be a sum based on a fixed percentage of the net annual profits of the company, with provision for a minimum payment, together with an office allowance.³ It is further provided that any stipulation for remuneration additional to that provided by this section shall not be binding on the company unless sanctioned by a special resolution of the company.

In our chapter on the Managing Agency System, while discussing the respective merits of the three principal systems of remunerating the managing agents, viz. commission on production, commission on sales, and commission on profits, we have shown that

¹ The Select Committee have made the following remarks regarding this section, "We," they observe ".....have also saved from its operation those preliminary appointments announced in a prospectus, which it would be impracticable to hold in abeyance until the first general meeting." Report of the Select Committee.

² See the chapter on the Managing Agency System.

³ cf. Section 87 C (1).

⁴ cf. Section 87 C (2).

the system of paying in the form of a certain percentage on the profits is the best of the three. It is therefore good that this system has been made obligatory on all companies, unless otherwise sanctioned by the shareholders themselves. Another salutary feature about this provision is the definition of "net profits." Under the former law the definition of the term net profits was left to the sweet will of the managing agents, and as we have shown in the third chapter it was often defined in a way prejudicial to the shareholders. From this point of view, it is good that the Act has laid down a definition of the expression "net profits" for the purpose of calculating the remuneration of the managing agents. This definition is an improvement over the one usually laid down by the managing agents in the agency contract. It is now laid down that "net profits" means the profits of the company calculated after allowing, inter alia, for depreciation and bounties or subsidies received from Government.¹ The exclusion of depreciation charges from 'net profits' though theoretically correct is likely to have a bad effect under the existing circumstances. The managing agents, as they stand to lose commission on the amounts set aside for depreciation, will always attempt to lessen the depreciation charges in order to increase their commission, and this will result in causing a greater neglect of the depreciation provision than is found at present. The only check on the managing agents in this respect will be the possible majority of the directors elected by the shareholders. But nothing great can be expected from this possibility. This exclusion of depreciation charges would have been all right if the law had made a specific provision for building up an adequate depreciation reserve. In the absence of any such provision the new Act will have the effect of encouraging the neglect of a proper provision for depreciation.

Besides the commission on profits, the agents are entitled to get additional remuneration in the form of an office allowance. In our chapter on the Managing Agency System we have shown how the office allowance means nothing but extra remuneration for the agents. The new Act by giving legal sanction to office allowance will make the practice universal. At present many big concerns do not charge anything on this account. The Ahmeda-

¹ cf. Section 87 C (3).

bad mill agents, for instance, so far did not stipulate for an office allowance. If at all it was thought improper to burden the agents with expenses incurred on account of the client concerns, it ought to have been provided that the office allowance should be certified by the auditor as bona fide expenses incurred for the particular concern.

A company is prohibited from making or guaranteeing any loan to the managing agents.¹ This is rather an important provision. In our chapter on the Administration of Earnings we have shown how the managing agents sometimes borrow money out of the reserves of a client concern on a nominal rate of interest, and how afterwards if the agents are not able to meet their liabilities the concerns become ruined. Similarly the client concerns are made to guarantee the loans incurred by the agents for their personal use. In such cases too the concerns not quite unoften are required to sustain a heavy loss owing to the inability of the agents to meet their liabilities. It is therefore a good thing that companies are saved from such losses in future.

By a further subsection it is provided that the managing agents shall not enter into any contract for the sale, purchase or supply of goods and materials with the company except with the consent of three-fourths of the directors present and entitled to vote on the resolution.² In our chapter on the managing Agency System we have shown how the agents entered into contracts with the companies for the sale of manufactures, or the purchase of raw materials or machinery. In all such contracts there arises a conflict between the interests of the company and those of the agents, and consequently invariably the interests of the former suffer. It is therefore good that certain restrictions are put on all such contracts. But it is doubtful whether the protection given by the restrictions provided by this section will prove quite effective under the existing circumstances. Of course the adequacy or otherwise of the protection given by this provision will depend upon the composition and integrity of the board of directors. It, no doubt, would have been better if such contracts were subjected to the approval of the shareholders, and were made liable to be renewed every year.

¹ cf. Section 87 (D) I.

² cf. Section 87 D (5).

In our chapter on the Administration of Earnings we have shown how the funds belonging to one company were being lent to or deposited with another company under the same management. But such practices will not be possible under the new Act which provides that no company shall make any loan to or guarantee any loan to any company under the management of the same managing agent.¹ This provision thus puts an end to what is known as inter-depositing system, the evil effects of which we have discussed in the above mentioned chapter. One important evil effects of this practice was that it often ruined a good concern which was entangled, to save a bad one, in the interests of the managing agents. The prohibition of such inter-lending therefore will prove of great value.

Similarly a company is prohibited from purchasing shares or debentures of any company under the management of the same managing agent, unless the purchase has been previously approved of by a unanimous decision of the board of directors of the purchasing company.² No more will the managing agents, thus, be able to invest the funds of one company into another and in this way to add to their own business.

A managing agent is prohibited under the new Act from issuing debentures.³ While discussing the financial relation between the agents and their client concerns we have shown how the agents change their loans into debentures to the loss of the shareholders.⁴ It is a good thing that such practices are now rendered illegal. The managing agent's power of investing the funds of the client concerns has also been restricted by the new law. They have now no power to invest the funds except with the authority of the directors and within the limit fixed by them.⁵ This restriction on the powers of agents regarding the investment of the funds belonging to the client concerns will have a salutary effect in so far as the investment of such funds cannot be influenced by the personal interests of the agents.

By one of the sections, which was considered by the select committee to represent "an entirely new departure,"⁶ it is provided

¹ cf. Section 87 E.

² cf. Section 87 F.

³ cf. Section 87 G.

⁴ See the chapters on Managing Agency System and Working Capital.

⁵ cf. Section 87 G.

⁶ See the report of the Select Committee on the Bill.

that the managing agents should not on his own account engage in any business which is of the same nature as and directly competes with the business carried on by the client company.¹ The aim of this provision is quite obvious. When the personal interest of the managing agent conflicts with that of the client concern, it is but natural that the agent's personal interests should predominate and the interest of the client concern should suffer. It is therefore good that such conflicts are avoided and the interests of the client concern are freed from being made subservient to those of the agents.

The provisions regarding the managing agency system which we discussed so far show that the present Act, is a great step forward in this matter. It, first of all, as previously mentioned, gives statutory recognition to the institution of managing agents and then attempts to purge the system of certain features, which experience had shown to be harmful. Though there is room for further improvement, a step in the right direction has been taken, and let us hope that this legislation will prove of benefit to the healthy growth of industries in the country.

¹ cf. Section 87 H.

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