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THE MANAGEMENT ENVIRONMENT

1.0 SOURCES OF FINANCE

1.1 Introduction

Finance is the lifeblood of business concern, because it is inter linked with all activities performed by the business concern. In a human body, if blood circulation is not proper, body function will stop. Similarly, if the finance not being properly arranged, the business system will stop. Arrangement of the required finance to each department of business concern is highly a complex one and it needs careful decision. Quantum of finance may be depending upon the nature and situation of the business concern. Financial requirement of the business differs from firm to firm and the nature of the requirements on the basis of terms or period of financial requirement, it may be long term and short-term financial requirements:

1.1.1 Long-term Financial Requirements or Fixed Capital Requirement

Long-term financial requirement means the finance needed to acquire land and building for business concern, purchase of plant and machinery and other fixed expenditure. Long term financial requirement is also called as fixed capital requirements. Fixed capital is the capital, which is used to purchase the fixed assets of the firms such as land and building, furniture and fittings, plant and machinery, etc. Hence, it is also called a capital expenditure.

1.1.2 Short-term Financial Requirements or Working Capital Requirement

Apart from the capital expenditure of the firms, the firms should need certain expenditure like procurement of raw materials, payment of wages, day-to-day expenditures, etc. This kind of expenditure is to meet with the help of short-term financial requirements which will meet the operational expenditure of the firms. Short-term financial requirements are popularly known as working capital.

1.2 Meaning of Finance

Finance may be defined as the art and science of managing money. It includes financial service and financial instruments. Finance also is referred as the provision of money at the time when it is needed. Finance function is the procurement of funds and their effective utilization in business concerns. The concept of finance includes capital, funds, money, and amount. But each word is having unique meaning. Studying and understanding the concept of finance become an important part of the business concern.

1.2.1 Definition of Finance

According to **Khan and Jain,** "Finance is the art and science of managing money". According to **Oxford dictionary**, the word 'finance' connotes 'management of money'. **Webster's** Ninth New Collegiate Dictionary defines finance as "the Science on study of the management of funds' and the management of fund as the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of banking facilities.

1.2.2 Definition of Business Finance

According to the **Wheeler,** "Business finance is that business activity which concerns with the acquisition and conversation of capital funds in meeting financial needs and overall objectives of a business enterprise".

According to the **Guthumann and Dougall**, "Business finance can broadly be defined as the activity concerned with planning, raising, controlling, administering of the funds used in the business".

In the words of **Parhter and Wert**, "Business finance deals primarily with raising, administering and disbursing funds by privately owned business units operating in nonfinancial fields of industry".

Corporate finance is concerned with budgeting, financial forecasting, cash management, credit administration, investment analysis and fund procurement of the business concern and the business concern needs to adopt modern technology and application suitable to the global environment.

According to the **Encyclopedia of Social Sciences**, "Corporation finance deals with the financial problems of corporate enterprises. These problems include the financial aspects of the promotion of new enterprises and their administration during early development, the accounting problems connected with the distinction between capital and income, the administrative questions created by growth and expansion, and finally, the financial adjustments required for the bolstering up or rehabilitation of a corporation which has come into financial difficulties".

1.3 Types of Finance

Finance is one of the important and integral part of business concerns, hence, it plays a major role in every part of the business activities. It is used in all the area of the activities under the different names.

Finance can be classified into two major parts:

Private finance which includes the Individual, Firms, Business or Corporate Financial activities to meet the requirements.

Public Finance which concerns with revenue and disbursement of Government such as Central Government, State Government and Semi-Government Financial matters.

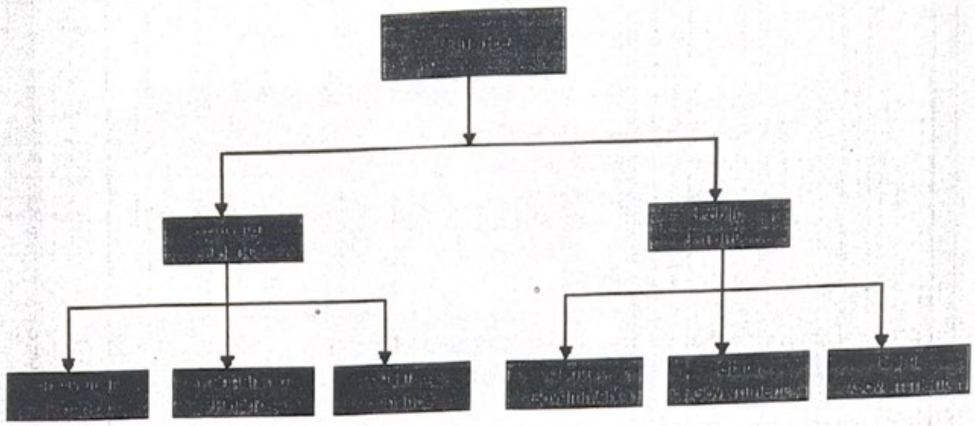

Figure 1.1: Types of Finance

1.4 Loan Financing

Loan financing is the important mode of finance raised by the company. Loan finance may be divided into two types:

a. Long-Term Sources
b. Short-Term Sources

Loan finance can be raised through the following important institutions.

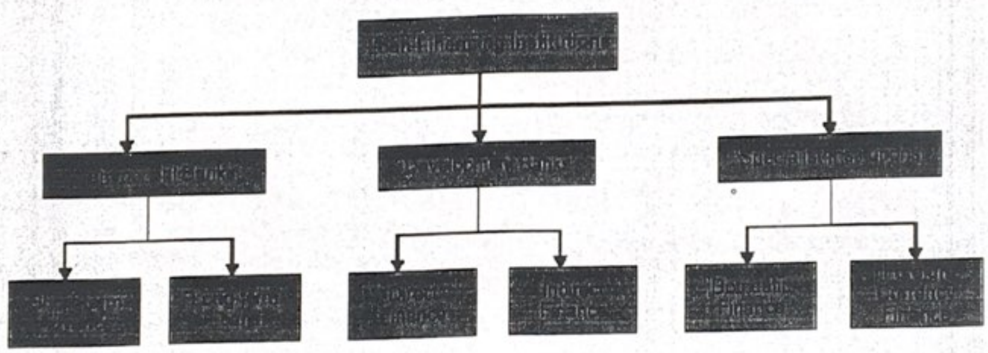

Figure 1.2: Loan Financing

1.4.1 Financial Institutions

With the effect of the industrial revaluation, the government established nation wide and state wise financial industries to provide long-term financial assistance to industrial concerns in the country. Financial institutions play a key role in the field of industrial development and they are meeting the financial requirements of the business concern.

1.4.2 Commercial Banks

Commercial Banks normally provide short-term finance which is repayable within a year. The major finance of commercial banks is as follows:

Short-term advance: Commercial banks provide advance to their customers with or without securities. It is one of the most common and widely used short-term sources of finance, which are needed to meet the working capital requirement of the company.

It is a cheap source of finance, which is in the form of pledge, mortgage, hypothecation and bills discounted and rediscounted.

Short-term Loans: Commercial banks also provide loans to the business concern to meet the short-term financial requirements. When a bank makes an advance in lump sum against some security it is termed as loan. Loan may be in the following form:

a. **Cash credit**: A cash credit is an arrangement by which a bank allows his customer to borrow money up to certain limit against the security of the commodity.
b. **Overdraft**: Overdraft is an arrangement with a bank by which a current account holder is allowed to withdraw more than the balance to his credit up to a certain limit without any securities.

1.4.3 Development Banks

Development banks were established mainly for the purpose of promotion and development the industrial sector in the country. Presently, large number of development banks are functioning with multidimensional activities. Development banks are also called as financial institutions or statutory financial institutions or statutory non-banking institutions.

Development banks provide two important types of finance:

a. Direct Finance
b. Indirect Finance/Refinance

Presently the commercial banks are providing all kinds of financial services including development-banking services. Also nowadays development banks and special listed financial institutions are providing all kinds of financial services including commercial banking services. Diversified and global financial services are unavoidable to the present day economics. Hence, we can classify the financial institutions only by the structure and set up and not by the services provided by them.

2.0 MONEY AND CREDIT

2.1 Money as a Medium of Exchange

The use of money spans a very large part of our everyday life. Look around you and you would easily be able to identify several transactions involving money in any single day. Can you make a list of these? In many of these transactions, goods are being bought and sold with the use of money. In some of these transactions, services are being exchanged with money. For some, there might not be any actual transfer of money taking place now but a promise to pay money later.

Have you ever wondered why transactions are made in money? The reason is simple. A person holding money can easily exchange it for any commodity or service that he or she might want. Thus everyone prefers to receive payments in money and then exchange the money for things that they want. Take the case of a shoe manufacturer. He wants to sell shoes in the market and buy wheat. The shoe manufacturer will first exchange shoes that he has produced for money, and then exchange the money for wheat. Imagine how much more difficult it would be if the shoe manufacturer had to directly exchange shoes for wheat without the use of money. He would have to look for a wheat growing farmer who not only wants to sell wheat but also wants to buy the shoes in exchange. That is, both parties have to agree to sell and buy each others commodities. This is known as **double coincidence of wants**. What a person desires to sell is exactly what the other wishes to buy. In a barter system where goods are directly exchanged without the use of money, double coincidence of wants is an essential feature.

In contrast, in an economy where money is in use, money by providing the crucial intermediate step eliminates the need for double coincidence of wants. It is no longer necessary for the shoe manufacturer to look for a farmer who will buy his shoes and at the same time sell him wheat. All he has to do is find a buyer for his shoes. Once he has exchanged his shoes for money, he can purchase wheat or any other commodity in the market. Since money acts as an intermediate in the exchange process, it is called a **medium of exchange**.

2.2 The Function of Money

2.2.1 The General Economic Conditions for the Use of Money

Where the free exchange of goods and services is unknown, money is not wanted. In a state of society in which the division of labour was a purely domestic matter and production and consumption were consummated within the single household it would be just as useless as it would be for an isolated man. But even in an economic order based on division of labour, money would still be unnecessary if the means of production were socialized, the control of production and the distribution of the finished product were in the hands of a central body, and individuals were not allowed to exchange the consumption goods allotted to them for the consumption goods allotted to others.

The phenomenon of money presupposes an economic order in which production is based on division of labour and in which private property consists not only in goods of the first order (consumption goods), but also in goods of higher orders (production goods). In such a society, there is no systematic centralized control of production, for this is inconceivable without centralized disposal over the means of production. Production is 'anarchistic'. What is to be produced, and how it is to be produced, is decided in the first place by the owners of the means of production, who produce however, not only for their own needs, but also for the needs of others, and in their valuations take into account, not only the use-value that they themselves attach to their products, but also the use-value that these possess in the estimation of the other members of the community.

The balancing of production and consumption takes place in the market, where the different producers meet to exchange goods and services by bargaining together. The function of money is to facilitate the business of the market by acting as a common medium of exchange.

2.2.2 *The 'Secondary' Functions of, Money*

The simple statement, that money is a commodity whose economic function is to facilitate the interchange of goods and services, does not satisfy those writers who are interested rather in the accumulation of material than in the increase of knowledge. Many investigators imagine that insufficient attention is devoted to the remarkable part played by money in economic life if it is merely credited with the function of being a medium of exchange; they do not think that due regard has been paid to the significance of money until they have enumerated half a dozen further 'functions' - as if, in an economic order founded on the exchange of goods, there could be a more important function than that of the common medium of exchange.

After Menger's review of the question, further discussion of the connection between the secondary functions of money and its basic function should be unnecessary. Nevertheless, certain tendencies in recent literature on money make it appear advisable to examine briefly these secondary functions - some of them are coordinated with the basic function by many wnters - and to show once more that all of them can be deduced from the function of money as common medium of exchange.

This applies in the first place to the function fulfilled by money *in facilitating credit transactions.* It is simplest to regard this as part of its function as medium of exchange. Credit transactions are in fact nothing but the exchange of present goods against future goods.

The functions of money *as a transmitter of value through time and space* may also be directly traced back to its function as medium of exchange. The European farmer who emigrates to America and wishes to exchange his property in Europe for a property in America, sells the former, goes to America with the money (or a bill payable in money), and there purchases his new homestead. Here we have an absolute text-book example of an exchange facilitated by money.

Particular attention has been devoted, especially in recent times, to the function of money *as a general medium of payment.* Indirect exchange divides a single transaction into two separate parts which are connected merely by the ultimate intention of the exchangers to acquire consumption goods. Sale and purchase thus apparently become independent of each other. Furthermore, if the two parties to a sale-and-purchase transaction perform their respective parts of the bargain at different times, that of the seller preceding that of the buyer (purchase on credit), then the settlement of the bargain, or the fulfillment of the seller's part of it (which need not be the same thing), has no obvious connection with the fulfillment of the buyer's part.

2.3 Forms of Money

We have seen that money is something that can act as a medium of exchange in transactions.

- Ancient period: Grain and cattle were used as money.
- Medieval period: Metallic coins of gold, silver, copper and lead were used as money.
- Modern period: Paper currency and coins are used as money.

2.3.1 Modern Forms of Money

2.3.1.1 Currency

Modern forms of money include currency — paper notes and coins, bank deposits Unlike the things that were used as money earlier, modern currency is not made of precious metal such as gold, silver and copper. And unlike grain and cattle, they are neither of everyday use. The modern currency is without any use of its own.

Then, why is it accepted as a medium of exchange? It is accepted as a medium of exchange because the currency is authorized by the government of the country.

In Nigeria, the Central Bank of Nigeria issues currency notes on behalf of the Federal Government. As per Nigeria law, no other individual or organization is allowed to issue currency. Moreover, the law legalizes the use of Naira and Kobo as a medium of payment that cannot be refused in settling transactions in Nigeria. No individual in Nigeria can legally refuse a payment made in Naira and Kobo. Hence, the Naira is widely accepted as a medium of exchange.

2.3.1.2 Banks Deposits

The other form in which people hold money is as deposits with banks. At a point of time, people need only some currency for their day-to-day needs. For instance, workers who receive their salaries at the end of each month have extra cash at the beginning of the month. What do people do with this extra cash? They deposit it with the banks by opening a bank account in their name. Banks accept the deposits and also pay an amount as interest on the deposits. In this way people's money is safe with the banks and it earns an amount as interest. People also have the provision to withdraw the money as and when they require. Since the deposits in the bank accounts can be withdrawn on demand, these deposits are called **demand deposits**.

Demand deposits offer another interesting facility. It is this facility which lends it the essential characteristics of money (that of a medium of exchange). You would have heard of payments being made by cheques or through transfer (internet banking) instead of cash. For payment through cheque, the payer who has an account with the bank, makes out a cheque for a specific amount. A **cheque** is a paper instructing the bank to pay a specific amount from the person's account to the person in whose name the cheque has been issued.

Cheque Payments: *A shoe manufacturer, M. Salim has to make a payment to the leather supplier and writes a cheque for a specific amount. This means that the shoe manufacturer instructs his bank to pay this amount to the leather supplier. The leather supplier takes this cheque, and deposits it in his own account in the bank. The money is transferred from one bank account to another bank account in a couple of days. The transaction is complete without any payment of cash.*

Thus we see that demand deposits share the essential features of money. The facility of cheques or through transfer (internet banking) against demand deposits makes it possible to directly settle payments without the use of cash. Since demand deposits are accepted widely as a means of payment, along with currency, they constitute money in the modern economy.

You must remember the role that the banks play here. But for the banks, there would be no demand deposits and no payments by cheques against these deposits. The modern forms of money — currency and deposits — are closely linked to the working of the modern banking system.

Characteristics of Bank Deposits

- People deposit their money in banks by opening a bank account.
- Banks keep the money safe and also provide interest on the deposited amount of money to the depositors.
- The deposited money can be withdrawn from banks as and when required on demand. Hence, bank deposits are also called demand deposits.
- Bank deposits also facilitate easy transfers of money through cheques, demand drafts or internet banking.

2.4 Credits

2.4.1 Loan Activities of Banks

What do the banks do with the deposits which they accept from the public? There is an interesting mechanism at work here. Banks keep only a small proportion of their deposits as cash with themselves. For example, banks these days hold about 15 per cent of their deposits as cash. This are kept as provision to pay the depositors who might come to withdraw money from the bank on any given day. Since, on any particular day, only some of its many depositors come to withdraw cash, the bank is able to manage with this cash.

Banks use the major portion of the deposits to extend loans. There is a huge demand for loans for various economic activities. Banks make use of the deposits to meet the loan requirements of the people. In this way, banks mediate between those who have surplus funds (the depositors) and those who are in need of these funds (the borrowers). Banks charge a higher interest rate on loans than what they offer on deposits. The difference between what is charged from borrowers and what is paid to depositors is their main source of income.

- Banks provide loans to people at some interest rate.
- Banks keep only 15% of their total deposits as cash to meet the day-to-day withdrawal demands.
- Rest of the cash is extended as loans to those who need it (borrowers) at a specific rate of interest.
- The interest provided by banks to depositors is less than the interest charged by banks from borrowers on loans. This difference is the main source of income of banks.
- Banks provide housing loans, vehicle loans, farm loans, education loans, personal loans etc. to meet the specific requirements of borrowers.

3.0 Balance of payments

3.1 Definition of Balance of Payments

Balance of payments (BOP) of a country is a systematic summary statement of a country's international economic transactions during a given period of time, usually a year. The study of balance of payments represents macroeconomic aspect of international economics.

As cited in Lindert (2002) Kindleberger defines " The balance of payments of a country is a systematic record of all economic transactions between residents of that country and the rest of the world during a given period of time."

The International Monetary Fund defines the term Balance of Payments more clearly and explicitly as follows – "the balance of payments is a statistical statement that systematically summarises for a specific time period, the economic transactions of an economy with the rest of the world. Transactions, for the most part between residents and nonresidents, consists of those involving goods, services, and income; those involving financial claims on, and liabilities to, rest of the world; and those (such as gifts) classified as transfers, which involve offsetting entries to balance – in an accounting sense – one sided transaction."

In general, Balance of Payments (BOP) of a country is "a systematic record of all economic transactions between the residents of the reporting country and the residents of the rest of the world for a given period of time usually a year." Thus, it comprises all types of transactions of a country like – exports and imports of goods and services, purchase and sale of foreign assets, foreign direct investment and portfolio investment as well as borrowing from and lending to the rest of the world.

3.1.1 Importance of Balance of Payments

A study of BOP is important because –

i. It serves as an indicator of the changing international economic or financial position of a country.
ii. It helps in formulation of a country's monetary, fiscal and trade policies.
iii. It helps in determining the influence of foreign trade & transactions on the level of national income of a country.
iv. It is useful to banks, firms, financial institutions and individuals which are directly or indirectly involved in international trade and finance.
v. It is an economic barometer of nation's progress vis-à-vis rest of the world.

3.2 Balance of Payments Accounting

The BOP accounts of a country is constructed on the basis of an accounting procedure known as double entry book - keeping. Double entry book keeping means that each international transaction is recorded twice, once as a credit entry and once as a debit entry of equal amount. The reason for this is that in general every transaction has two sides that is credit and debit.

When a payment is received *from* a foreign country, it is a credit transaction or credit entry, while payment to a foreign country is a debit transaction or debit entry. In a country's BOP, credit transactions or entries are entered with a positive sign (+), and debit transactions or entries are entered with a negative sign (-).

In general, the credit transactions would include - exports of goods and services, unilateral receipts such as gifts, grants etc. from foreigners, borrowings from abroad, investments by foreigners in the country, (capital inflows) and official *sale* of reserve assets including gold to foreign countries and international agencies. While, the debit transactions would include - import of goods and services, unilateral payments such as gifts, grants, etc. to foreigners, lending to foreign countries, investments by residents in foreign countries, (capital outflows) and official *purchase* of reserve assets or gold from foreign countries and international agencies.

These credit and debit transactions are shown vertically in the balance of payments account of a country. Horizontally they are divided into three categories:- the current account, the capital account and the official settlements account or the official reserves account.

3.3 Structure of Balance of Payments

The Balance of Payments of a country is mainly divided into two types of accounts – Current Account and Capital Account.

3.3.1 Current Account

The current account of a country's balance of payments consists of all transactions related to trade in goods, services, income and unilateral transfers. The current account includes following items –

(a) ***Merchandise Exports & Imports*** – Merchandise exports and imports are the most important items in the current account. In general, it covers a significant portion of total transactions recorded in the BOP of a country. Generally, exports are calculated on free on board (f.o.b.) basis which means that the costs of transportation, insurance, etc. are excluded. Generally, imports are calculated on carriage, insurance and freight (c.i.f.) basis which means that costs of transportation, insurance and freight are included.

(b) ***Invisible Exports & Imports*** - Invisible exports & imports also known as service exports & imports are another important component of current account. Important invisible items would include – travel, insurance, transportation, investment income in the form of profits, dividends, etc. and Government not included elsewhere.(g.n.i.e)

(c) ***Unilateral Transfers*** – Unilateral transfers or transfer payments are the third important component of current account. Unilateral transfers include gifts, grants, etc. either received from abroad (credits) or given abroad. (debits). They are one sided transactions, without a *quid pro quo* that has a measurable value. The unilateral transfers could be official or private.

3.3.2 Capital Account

The capital account of a country consists of its transactions in financial assets in the form of short term and long term lending and borrowing and private and official investments. In other words, the capital account shows international flow of loans and investments, and represents a change in the country's foreign assets and liabilities. The capital account mainly consists of –

a) ***Borrowing from & Lending to Foreign Countries*** – Borrowing from foreign countries are credit entries because they are receipts from foreign countries. Lending to foreign countries are debit entries because they are payments to foreign countries. This borrowing or lending could be of short term i.e. up to one year or long term i.e. more than one year. Borrowing from & lending to foreign countries could be also called as net sale of assets to foreigners and net purchases of assets from foreigners.
b) ***Direct Investment & Portfolio Investment*** – Direct investment is investment in enterprises located in one country but effectively controlled by residents of another country. As a rule, direct investment takes the form of investment in branches and subsidiaries by parent companies located in another country. Portfolio investment refers to purchases of foreign securities that do not carry any claim on control or ownership of foreign enterprises. In brief, borrowing from foreign countries and direct & portfolio investment by foreign countries represent *capital inflows*. On the other hand, lending to foreign countries and direct & portfolio investment in foreign countries represent *capital outflows*.

In broader terms, real or income creating transactions are entered into current account of BOP, while financial or capital transactions are entered into capital account of BOP. Lindert (2002) remarks that " Balance –of –payments accounting is unique in that it shows all the real and financial flows between a country and the rest of the world."

3.4 Balances within the Balance of Payments Statement

As the BOP statement is constructed on the basis of double entry book keeping, the total credits will be always equal to total debits. We can find out net balances for different items in the balance of payment statement. However, from the policy makers point of view some of the important balances are –

i. **Balance of Trade** - There are two definitions with reference to the concept of balance of trade or trade balance. (a) Narrow definition and (b) Broad definition.
   a. ***Narrow Definition*** – The narrow definition considers "Balance of trade as the difference between the value of merchandise (or goods) exports and the value of merchandise (or goods) imports." In this sense, it can be called as – Merchandise balance or Goods balance.
   b. ***Broad Definition*** – The broad definition of balance of trade is given by economist James Meade and is accepted by most of the modern economists. In the broader sense, Balance of trade is the difference between the value of goods & services exported and imported by a country. Balance of trade in this sense is also known as Balance of Goods & Services. In the familiar macro-economic equation,

$Y = C + I + G + (X - M)$, in which Y = National income, C = Consumption, I = Investment, G = Government expenditure, X = Exports of Goods & Services, M = Imports of Goods & Services, the expression *X – M denotes balance of trade* in Meade's terms. Balance of trade is national income injection and for that reason it is better to use Meade's concept of balance of trade. Equating balance of trade with goods balance alone is to ignore the importance of service balance as a factor determining national income.

ii. **Balance of Current Account** – The concept of balance of current account or current account balance is broader than the concept of balance of trade. It is said to be mirror image of capital account including official reserves. The current account balance includes the sum of three balances – merchandise balance, services balance and unilateral transfers balance. In other words, it includes trade balance (in Meade's terms) and transfers balance.

Balance of Current Account = Merchandise balance + Services Balance + Unilateral transfers balance.

The current account reflects the value of the flow of goods, services, income and gifts between the home country and the foreign countries. Current account balance refers to the net of these flows. The balance of current account can be either *surplus* or *deficit.* A current account *surplus* means an excess of exports over imports of goods, services investment income and unilateral transfers. A current account *deficit* means excess of imports over exports of goods, services, investment income and unilateral transfers. In other words, if the *sum* of the exports of goods, services , investment income and unilateral transfers is *greater than* the *sum* of the imports of goods, services, investment income and unilateral transfers, then there will be current account *surplus* and *vice – versa.*

Importance of the Concept of Balance of Current Account - The balance of current account is a very important concept, as it shows the flow aspect of a country's international transactions. It represents bottom line of a nation's income statement. It shows the change in reporting country's net foreign wealth. As pointed out by Salvatore (2005) –"The current account lumps together all sales and purchases of currently produced goods & services, and investment income, and unilateral transfers and provides the link between the nation's international transactions and its national income. Specifically, a current account surplus stimulates domestic production, while a current account deficit dampens domestic production and income." The concept of current account balance is linked with national income accounting and its components in the following manner:

(a) Link with national saving and domestic investment - A country can do two things with its national savings (S): (i) Invest in home country (I_d) or (ii) Invest in foreign country (I_f). Hence, $S = I_d + I_f$. Therefore, a country's net foreign investment (current account balance - CAB) equals the difference between national saving and domestic

investment. i.e. $CAB = I_f = S - I_d$. Thus, the concept is synonymous with net foreign investment in national income accounting.

(b) *Link with domestic production, income and expenditure* – A country's current account balance is the difference between its domestic production of goods and services and its total expenditure on goods and services.

A country's national output maybe represented as –

$Y = C + I_d + G + X - M$ .... (1).

Where Y = National product / output, C = domestic consumption, I_d = domestic investment, G = Government expenditure, X = exports of goods & services, M = imports of goods & services. C, I_d and G all include purchases of both domestically produced and imported goods & services. But, imports must be subtracted separately because imports are not demand for the home country's products.

A country's total expenditure on goods and services i.e. $C + I_d + G$ is sometimes referred to as absorption (A).

It can be represented as - $A = C + I_d + G$ ... (2)

Therefore, $Y = A + (X - M)$ ... **(3)**

The above analysis implies that national product (Y) differs from national expenditure or absorption ($A = C + I_d + G$) by the amount of current account balance, or the difference between exports and imports of goods and services (including gifts), or X – M.

In a nutshell, the current account balance (CAB) in a balance of payment statement implies –

a) the difference between exports of goods & services & imports of goods & services (X – M),
b) Net foreign investment (I_f),
c) The difference between national savings and domestic investment ($S - I_d$), and
d) The difference between national product and national expenditure / absorption. (Y – A).

iii. **Balance of Capital Account** – Until recently, capital account was not a significant component of balance of payments. This was because of severe restrictions adopted by the countries on international capital movements. However, in due course of time due to liberalization of trade, the countries have also eased or removed their restrictions on international capital movements. Normally, the capital account consists of all types of capital inflows and outflows. In general, it is observed that the developing countries have surplus in their capital account, while the developed countries have deficit in their capital account.

iv. **Overall Balance of Payments** - It is the sum of the balance of current account and balance of capital account (including errors & omissions). In some countries, overall balance is also called as official settlement balance. The overall balance of payments may either balance, or have a surplus, or have a deficit. In general it can be said that

(a) If the overall surplus in the BOP was caused by current account surpluses but not capital account surpluses, then the surplus may be a good sign for the country.

(b) If the overall deficit in the BOP was caused by current account deficit rather than capital account deficits, then the deficit may be considered as a bad sign for the reporting country.

Thus, not only the extent but *location* of overall surplus or deficit is important. It is to be noted that different nations use different measures of the overall balance of payments surplus or deficit. Some compare the net increase in their official reserves with the net rise in a wide definition of liquid foreign claims against the country. Others simply measure the change in official reserves alone.

4.0 Insurance

It is a commonly acknowledged phenomenon that there are countless risks in every sphere of life. For property, there are fire risks; for shipment of goods, there are perils of sea; for human life, there are risks of death or disability; and so on. The chances of occurrences of the events causing losses are quite uncertain because these may or may not take place. In other words, our life and property are not safe and there is always a risk of losing it. A simple way to cover this risk of loss money-wise is to get life and property insured. In this business, people facing common risks come together and make their small contributions to the common fund. While it may not be possible to tell in advance, which person will suffer the losses, it is possible to work out how many persons on an average out of the group may suffer the losses.

When risk occurs, the loss is made good out of the common fund. In this way, each and every one shares the risk. In fact, insurance companies bear risk in return for a payment of premium, which is calculated on the likelihood of loss. In this lesson, you will learn Insurance, its various kinds, premium calculation, calculation of paid up/surrender value etc in details.

4.1 What is an Insurance

Insurance is a tool by which fatalities of a small number are compensated out of funds collected from the insured. Insurance companies pay back for financial losses arising out of occurrence of insured events, e.g. in personal accident policy the insured event is death due to accident, in fire policy the insured events are fire and other natural calamities. Hence, insurance is a safeguard against uncertainties. It provides financial recompense for losses suffered due to incident of unanticipated events, insured within the policy of insurance.

Insurance, essentially, is an arrangement where the losses experimented by a few are extended over several who are exposed to similar risks. Insurance is a protection against financial loss arising on the happening of an unexpected event.

An individual who wants to cover risk pays a small amount of money to an organization called on Insurance Company and gets insured. An insurance company insures different people by collecting a small amount of money from each one of them and collectively this money is enough to compensate or cover the loss that some members may suffer.

The fixed amount of money paid by the insured to the insurance company regularly is called premium. Insurance company collects premium to provide security for the purpose.

Insurance is an agreement or a contract between the insured and the Insurance Company (Insurer).

4.2 Nature of Insurance

On the basis of the definition of insurance discussed above, one can observe its following characteristics:

4.2.1 Risk Sharing and Risk Transfer

Insurance is a mechanism adopted to share the financial losses that might occur to an individual or his family on the happening of a specified event. The event may be death of earning member of the family in the case of life insurance, marine-perils in marine insurance, fire in fire insurance and other certain events in miscellaneous insurance, e.g., theft in burglary insurance, accident in motor insurance, etc. The loss arising from these events are shared by all the insured in the form of premium. Hence, risk is transferred from one individual to a group.

4.3 Principles of Insurance

There are certain principles that may apply to the contracts of insurance between insurer and insured, which are as follows.

i. **Utmost goods faith:** Insurance contracts are the contract of mutual trust and confidence. Both parties to the contract i.e., the insurer and the insured must disclose all relevant information to each other. For example, while entering into a contract of life insurance, the insured must declare to the insurance company if he is suffering from any disease that may be life threatening.

ii. **Insurable interest:** It means financial or pecuniary interest in the subject matter of insurance. A person has insurable interest in the property or life insured if he stands to gain from its existence or loose financially from its damage or destruction. In case of life insurance, a person taking the policy must have insurable interest at the time of taking the policy. For example, a man can take life insurance policy on the name of his wife and if later they get divorced this will not affect the insurance contract because the man had insurable interest in the life of his wife at the time of entering into the contract. In case of marine insurance insurable interest must exist at the time of loss or damage to the property. In contract of fire insurance, it must exist both at the time of taking the policy as well as at the time of loss or damage to the property.

iii. **Indemnity:** The word indemnity means to restore someone to the same position that he/she was in before the event concerned took place. This principle is applicable to the fire and marine insurance. It is not applicable to life insurance, because the loss of life cannot be restored. The purpose of this principle is that the insured is not allowed to make any profit from the insurance contract on the happening of the event that is insured against. Compensation is paid on the basis of amount of actual loss or the sum insured, which ever is less.

iv. **Contribution:** The same subject matter may be insured with more than one insurer. In such a case, the insurance claim to be paid to the insured must be shared or contributed by all insurers.

v. **Subrogation:** In the contract of insurance subrogation means that after the insurer has compensated the insured, the insurer gets all the rights of the insured with regard to the subject matter of the insurance. For example, suppose goods worth Rs. 20,000/- are partially destroyed by fire and the insurance company pays the compensation to the insured, then the insurance company can take even these partially destroyed goods and sell them in the market.

vi. **Mitigation:** In case of a mishap the insured must take all possible steps to reduce or mitigate the loss or damage to the subject matter of insurance. This principle ensures that the insured does not become negligent about the safety of the subject matter after taking an insurance policy. The insured is expected to act in a manner as if the subject matter has not been insured.

vii. ***Causa-proxima*** **(nearest cause):** According to this principle the insured can claim compensation for a loss only if it caused by the risk insured against. The risk insured should be nearest cause (not a remote cause) for the loss. Then only the insurance company is liable to pay the compensation. For example a ship carrying orange was insured against losses arising form accident. The ship reached the port safely and there was a delay in unloading the oranges from the ship. As a result the oranges got spoilt. The insurer did not pay any compensation for the loss because the proximate cause of loss was delay in unloading and not any accident during voyage.

4.4 Payment of Bonus

Financial soundness of a company is determined by comparing all assets with all liabilities. In a valuation of a life Insurance Company, the liabilities pertaining to life Insurance policies are worked out. Other liabilities, like outstanding capital etc. are already determined clearly and don't have to be estimated or assessed every time. The policies liabilities as determined by the valuation have to be compared with all the assets less what is earmarked for other liabilities, which are known. The net figure of assets is equal to what appears as "life fund" on the liabilities side and is the fund set aside for meeting the claim of policyholders. There is surplus if the actual life fund exceeds the liabilities shown by the valuation, which means that the fund set aside for policyholders is more than the need. If the fund is less there is deficit.

If a surplus is shown in a valuation, it has to be distributed amongst the policyholder. Any bonus distribution system should be equitable to existing and new policyholders, simple to operate, easy to understand and flexible. Following are the main systems of distribution of bonus:

1. **Reversionary Bonus:** Under this system, bonus is given as uniform percentage additions to the basic sum assured and is payable with the sum assured. It is called Simple Reversionary Bonus. If the bonus is calculated as a percentage of the basic sum assured plus any existing bonus previously declared it is known as Compound Reversionary Bonus.
2. **Interim Bonus:** Generally the bonus vests on policies that are in force on the date of valuation. Policies resulting into claims by death or maturity subsequent to the policy year containing the date of valuation will not have any bonus that year. Therefore, interim bonus may be declared to be paid along in such claims. This is with a view to facilitate settlement of claims that may arise before the next valuation is completed and avoid reopening of all these cases at a later date.
3. **Terminal Bonus:** This benefit is payable on policies which are in force for the full sum assured for a minimum period of 15 years before resulting into claim by death or maturity. This bonus is in addition to the reversionary or interim bonus, if any. Terminal Bonus is not payable for paid up policies, surrendered, or discounted policies. The bonus is always paid on Sum Assured.

4.5 Calculation of Age of the Life to be Assured

Risk of death is closely related to the age of the life to be assured. Hence, the age at entry into the contract of insurance becomes the most significant factor to determine premium. Months and days over the completed years of age are not taken as such, but the age to be taken is rounded off to the years in integer may be defined as:

(1) Age nearer to the birthday
(2) Age on next birthday
(3) Age on last birthday

If a person was born 22 years 8 months earlier, Then

(1) Age nearer to the birthday is 23
(2) Age on next birthday is 23
(3) Age as on last birthday is 22

If a person is 22 years 5 months 29 days then the age nearer birthday will be 22 years and if the age is 22 years 5 months 30 days the age nearer birthday will be 23 years.

We will explain this with the help of the following examples:

(1) If a person is born on 1/1/1980, then on 1/8/2000 he is 20 years 7 months and 1 day old therefore:
  (a) his age nearer to his birthday 21 years.
  (b) his age as per last birthday 20 years.
  (c) his age as per next birthday 21 years.
(2) If a person is born on 1/1/1980, then on 11/4/2000 he is 20 years 3 months and 11 days old therefore:
  (a) his age nearer to his birthday 20 years.
  (b) his age as per last birthday 20 years.
  (c) his age as per next birthday 21 years.

4.6 Calculation of Actual Premium

After calculating the age, the premium will be calculated as follows:

i. Tabular premium for the age concerned
ii. Loading proposal for reason of health and/or physical impairments. Extras on adverse health features or adverse Medical report e.g. Blood pressure, sugar, diabetic, smokers, etc.
iii. **Extra for occupation:** There are extra premium on hazardous or extra-hazardous occupations e.g. Aviation and defense, mining and other occupational risks.
iv. Extra for accident benefits (if asked and if allowed): To get additional benefit on account of accidental death, the extra premium is to be paid for **Double Accident Benefit (DAB) and Extended Permanent Disability Benefit (EPDB).**

v. **Extra for premium waiver benefit:** If a person becomes disabled then he will not be able to pay the premium because he may not be able to earn because of his disability. Therefore, the company waives off the premium on payment of additional premium.

vi. **Mode of Payment:** Adjustment are made for different mode of payment as per details given below:

Mode	Rebates
1. Yearly	3% of Tabular premium
2. Half Yearly	1.5% of Tabular premium
3. For Quarterly mode and Monthly mode under Salary Saving Scheme (SSS)	No Rebate : No loading
4. For Ordinary Monthly mode except Salary Saving Scheme for monthly payment	Loading of 5% on Tabular Premium

vii. **Rebate for large sum assured:** Adjustments are also made for higher sum assured. For every new policy there are certain:

a. **'fixed costs'** which are uniform for all policies irrespective of sum assured, for example, cost of policy preparation or postal expenses for mailing the policy document.

b. **'variable costs'** depending on the sum assured; for example stamp duty on the policy document or medical examiner's fee.

When the sum assured is large, fixed costs get reduced per thousand sum assured resulting into savings to the insurer. Insurer shares these savings with the policy holders by offering rebate in tabular premium for large sum assured.

4.7 General Insurance

The various schemes of the General Insurance cover

(1) Movable and Immovable Property Insurance
(2) Vehicle Insurance
(3) Goods in Transit Insurance

Let us study something about each one of them.

1. **Movable and Immovable Property Insurance:** Movable and Immovable Property belonging to an individual or an organization can be insured fire, theft, natural calamities, riots etc.
2. **Vehicle Insurance:** There are two types of insurance for vehicle.
   (i) **Act Insurance or the Third party Insurance:** This is compulsory for all vehicles under the Motor Vehicle Act. If a vehicle is insured under "Act Insurance" only, then the damage caused to another person or his property (Including Vehicle) is

payable by the company in case of an accident i.e. the person who suffers the loss is compensated and not the insured. The insured doesn't get any compensation.

(ii) **Comprehensive Insurance :** Under this scheme, the person whose vehicle is assured also gets compensation, in addition to the money paid to the third party. Thus, the insured also gets a cover for the damage or loss suffered by him (or her) or his/her vehicle. **No Claim Bonus:** If no claim is made during the year of comprehensive insurance, the company allows a rebate to the insured (i.e. owner of the vehicle) in the premium to be paid in the successive year. The rate of rebate continues to increase year after year if no claim is made on the policy. This is called "No Claim Bonus". **Note: 'No Claim Bonus' is not given on 'Act Insurance'. 'No Claim Bonus'** is a sort of reward for not claiming any damages by the insured and not for the vehicle.

(4) **Goods in transit insurance :** When goods are sent from one place to another, there is a possibility of loss/damage occurring in transit due to accident, strike, riots etc. The mode of transit could be road, rail, sea or air. To cover such risk, there are many policies with different rates of premium.

Let us take some examples

Example 1: If a car costs #220,000, then what will be the comprehensive insurance of the car if the tabular premium charged is #4113 for #130,000 and 2.95% of the excess amount and the act insurance is #160.

Solution: Tabular premium = #4113

Excess amount = #(220,000 - 130,000) = #90,000

The premium on excess amount = $\# \left(\frac{2.95}{100} \times 90000\right) = \#2655$

Premium = #(4113 + 2655) = #6768

Act Insurance = #160

Premium to be paid = #(6768 + 160) = #6928

Thus, premium to be paid = #6928

Note: If the owner of the car is allowed No Claim Bonus, it will be calculated on #6768 and then Act insurance will be added.