RAS Mains 2018 Edition

# Management Accounting & Auditing

Book by RajRAS

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# Management: Concept & Principles

Management is required in all kinds of organisations— whether government or private, whether business or non-business. It is necessary so that individuals make their best contribution towards group objectives. It consists of a series of interrelated functions that are performed by all managers.

## Concept of Management

Management is a very popular term and has been used extensively for all types of activities and mainly for taking charge of different activities in any enterprise.

**Definition:**

"Management is the process of designing and maintaining an environment in which individuals, working together in groups, efficiently accomplish selected aims". - Harold Koontz and Heinz Weihrich

"Management is the process of working with and through others to effectively achieve organisational objectives by efficiently using limited resources in the changing environment." - Kreitner

### Characteristics of Management

- Management is a goal-oriented process
- Management is all pervasive
- Management is multidimensional
  - Management of work
  - Management of people
  - Management of operations
- Management is a continuous process
- Management is a group activity
- Management is a dynamic function
- Management is an intangible

## Importance of Management

- Management helps in achieving organisation's goals
- Management creates a dynamic organisation and promotes Stability and Growth
- Management helps in achieving personal objectives as well as development of society
- Management increases Efficiency and Effectiveness.

## Nature of Management

### As a Process

- Management consists of a series of inter-related activities of planning, organising and controlling. All activities are undertaken in a proper sequence with a systematic approach so as to ensure that all actions are directed towards achievement of common goals. Thus, it is regarded as a process of organising and employing resources to accomplish the predetermined objectives.

### As a Art

Management can be Art on account of following features:

- **Existence of theoretical knowledge** - There are various theories of management, as propounded by many management thinkers, which prescribe certain universal principles.
- **Based on practice and creativity** - A manager applies this acquired knowledge in a personalised and skillful manner in the light of the realities of a given situation.
- **Personalised application** - A successful manager practices the art of management in the day-to-day job of managing an enterprise based on study, observation and experience

### As Science

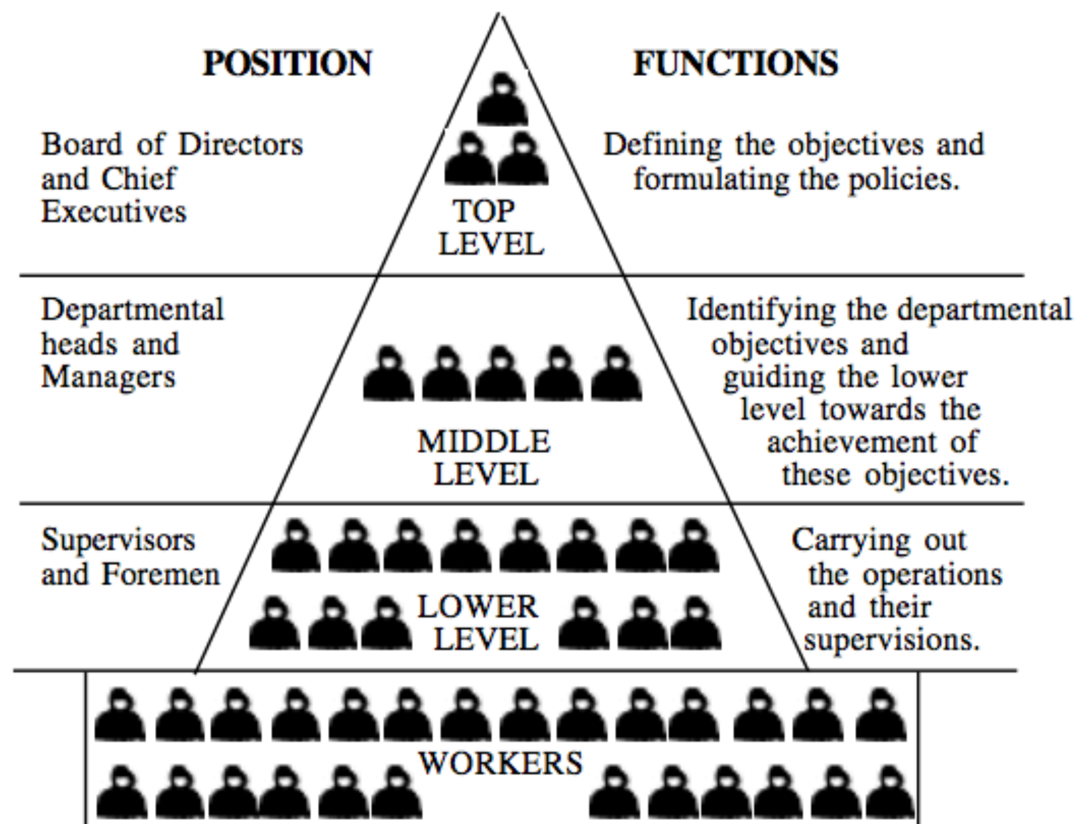
- **Systematised body of knowledge** - Management has a systematised body of knowledge. It has its own theory and principles that have developed over a period of time, but it also draws on other disciplines such as Economics, Sociology, Psychology and Mathematics.
- **Principles based on experimentation** - The principles of management have evolved over a period of time based on repeated experimentation and observation in different types of organisations. Despite the limitations of applying on human beings, management scholars have been able to identify general principles of management.

- **Universal validity** - Since the principles of management are not as exact as the principles of science, their application and use is not universal. They have to be modified according to a given situation. However, they provide managers with certain standardised techniques that can be used in different situations.

## Levels of Management

There are certain levels of management with varying degree of authority and responsibilities. Managers performing different types of duties may be divided into three categories:

- Top-Level Management
- Middle-Level Management
- Lower-Level Management



## Functions of Management

- Planning,
- Organising,
- Staffing,
- Direction,
- Coordination and Control

*Discussed in detail in next Chapter*

## Principles of Management

A managerial principle is a broad and general guideline for decision-making and behaviour. There is a long history of management principles and with time these processes are in the continuous process of evolution. As these principles deal with human behaviour & technology, both of which are never static, so management principles are not as rigid as principles of pure science.

The principles of management should be distinguished from techniques of management. Techniques are procedures or methods, which involve a series of steps to be taken to accomplish desired goals. Principles are guidelines to take decisions or actions while practicing techniques.

### Principles of Scientific Management:

In the early 20th Century, *Fredrick Winslow Taylor*, foreman and later the chief engineer of a steel company in U.S.A., suggested a new approach to management known as 'Scientific Management'.

- **Science not Rule of Thumb**: Development of a true scientific approach to management replacing the old rule of thumb method, which would enable managers, among other things, to determine the best method of performing each task
- **Harmony, Not Discord**: Scientific selection and placement of workers so that each worker could be assigned the task for which he is best suited
- **Cooperation, Not Individualism**: Close co-operation between management and labour to ensure that work is carried out in accordance with the scientific principles which are developed.

- **Development of Each and Every Person to His or Her Greatest Efficiency and Prosperity**: Scientific training and development of workers so as to achieve the highest level of efficiency.

### Fayol's Principles of Management

Scientific management was primarily concerned with increasing the efficiency of individual workers at the shop floor. It did not give adequate attention to role of managers and their functions. Around the same time, *Henry Fayol*, Director of a coal mining company in France made a systematic analysis of the process of management. Fayol explained what amounts to a managers work and what principles should be followed in doing this work. The 14 principles of management given by him are:

1. **Division of Work**: Work is divided into small tasks, such that a trained specialist is required to perform each job. Thus, division of work leads to specialization.
2. **Authority and Responsibility:** There should be a balance between authority and responsibility. An organisation should build safeguards against abuse of managerial power. At the same time a manager should have necessary authority to carry out his responsibility.
3. **Discipline:** According to Fayol, discipline requires good superiors at all levels, clear and fair agreements and judicious application of penalties.
4. **Unity of Command:** According to Fayol there should be one and only one boss for every individual employee. If an employee gets orders from two superiors at the same time the principle of unity of command is violated and this results in undermining of authority, lack of discipline and instability.
5. **Unity of Direction:** All the units of an organisation should be moving towards the same objectives through coordinated and focused efforts.
6. **Subordination of Individual Interest to General Interest:** Every worker has some individual interest for working in a company. However, in all the situations the interests of the organization should supersede the interest of any one individual.
7. **Remuneration of Employees:** The overall pay and compensation should be fair to both employees and the organization.
8. **Centralization and Decentralization:** There is a need to balance subordinate involvement through decentralisation with managers and retention of final authority through centralization.

9. **Scalar Chain:** Organisations should have a chain of authority and communication that runs from top to bottom and should be followed by managers and the subordinates
10. **Order:** People and materials must be in suitable places at appropriate time for maximum efficiency. In other words 'A place for everything (everyone) and everything (everyone) in its (her/his) place'.
11. **Equity:** There should be kindliness and justice in the behavior of managers towards workers. All employees should be treated fairly.
12. **Stability of Tenure of Personnel:** Personnel should be selected and appointed after due and rigorous procedure. However, once selected should be provided a minimum fixed tenure. In other words, Employee turnover should be minimised to maintain organisational efficiency.
13. **Initiative:** Workers should be encouraged to develop and carry out their plans for improvements
14. **Team Spirit (Esprit de Corps):** Management should promote a team spirit of unity and harmony among employees.

### Comparison between Fayol's & Taylor's Principles of Management

| S. No. | Basis of difference | Henri Fayol | F. W. Taylor |
|---|---|---|---|
| 1 | Perspective | Top level of management | Shop floor level of a factory |
| 2 | Unity of Command | Staunch Proponent | Did not feel that it is important as under functional foremanship a worker received orders from eight specialists. |
| 3 | Applicability | Applicable universally | Applicable to specialised situations |
| 4 | Basis of formation | Personal experience | Observations and experimentation |
| 5 | Focus | Improving overall administration | Increasing Productivity |

| | | | |
|---|---|---|---|
| 6 | Personality | Practitioner | Scientist |
| 7 | Expression | General Theory of Administration | Scientific Management |

# Functions of Management

Planning | Organizing | Staffing | Directing | Controlling

Management is described as the process of planning, organising, directing and controlling the efforts of organisational members and of using organisational resources to achieve specific goals. Different experts have classified functions of management.

*Henry Fayol* distinguishes between the principles and elements of management. Principles are the rules and guidelines, while elements are the functions of management. He has grouped the elements into five managerial functions — planning, organizing, commanding, coordinating, and controlling.

According to *George & Jerry*, "There are four fundamental functions of management i.e. Planning, Organising, Actuating and Controlling.

The controlling function comprises co-ordination, reporting and budgeting, and *Luther Guelick* coined the word **POSDCORB** where:

- **P**lanning
- **O**rganising
- **S**taffing
- **D**irecting
- **Co**ordination
- **R**eporting
- **B**udget

The most useful method of classifying managerial functions is to group them around the components of planning, organizing, staffing, directing, and controlling. The above functions of management are common to all business enterprises as well as to organizations of other fields, but the manner in which these are carried out will not be the same in different organizations.

Let us now look at each function in detail:

## Planning

Planning is the basic function of management. It implies decision-making as to what is to be done, how it is to be done, when it is to be done and by whom it is to done. Planning is thus, the preparatory step for actions and helps in bridging the gap between the present and the future.

Planning, thus, involves setting objectives and developing best courses of action to achieve these objectives.

### Features of Planning

- Primary function of management - as every activity needs to be planned before it is actually performed.
- Focus on achieving objectives - goal directed
- Planning is persuasive - at all levels of management and at also at all functional areas.
- Continuous Process -
- Planning is futuristic
- Involves decision making
- Intellectual Activity - Requires certain conceptual skills, good foresight and sound judgment to anticipate future events, develop alternative courses of action.

### Importance of Planning

- Planning gives direction
- Planning reduces the risks of uncertainty
- Planning reduces overlapping and wasteful activities
- Planning promotes innovative ideas
- Planning facilitates decision making
- Planning establishes standards for controlling.

### Process of Planning

1. Setting Objectives/Goals
2. Developing Premises
3. Identifying alternative courses of action
4. Evaluating alternative courses
5. Selecting an alternative
6. Implementing the plan
7. Follow-up action

## Organizing

### Process of Organising

- Identification and division of work
- Departmentalisation
- Assignment of duties
- Establishing reporting relationships

### Importance of Organising

- Benefits of specialisation
- Clarity in working relationships
- Optimum utilization of resources
- Adaptation to change
- Effective administration
- Development of personnel
- Expansion and growth

## Staffing

After planning and selection of the organisation structure, the next step in the management process is to fill the various posts provided in the organisation. This is termed as the management of staffing function. In the simplest terms, staffing refers to the managerial function of employing and developing human resources for carrying out the various managerial and non-managerial activities in an organisation.

### Importance of Staffing

No organisation can be successful unless it can fill and keep filled the various positions provided for in the structure with the right kind of people.

- Proper Staffing helps in discovering and obtaining competent personnel for various jobs;
- Staffing makes for higher performance, by putting right person on the right job;
- Staffing ensures the continuous survival and growth of the enterprise through the succession planning for managers.
- Staffing helps to ensure optimum utilisation of the human resources.
- Staffing improves job satisfaction and morale of employees through objective assessment and fair reward for their contribution.

### Process of Staffing

1. Estimating the Manpower Requirements
2. Recruitment
3. Selection
4. Placement and Orientation
5. Training and Development
6. Performance Appraisal
7. Compensation
8. Promotion and career planning

### Aspects of Staffing

There are three main aspects of staffing:

- Recruitment
- Selection
- Training & Development.

## Directing

While managing an enterprise, managers have to get things done through people. In order to be able to do so, they have to undertake many activities, like guide the people who work under them, inspire and lead them to achieve common objectives. All these activities of a manager constitute the directing function. Thus, directing is concerned with instructing, guiding, supervising and inspiring people in the organisation to achieve its objectives. In simple terms. directing means giving instructions and guiding people in doing work.

### Characteristics of Directing:

- Directing initiates action

- Directing takes place at every level of management
- Directing is a continuous process
- Directing flows from top to bottom.

## Importance of Directing

- Directing helps to initiate action by people in the organisation towards attainment of desired objectives.
- Directing integrates employees efforts in the organisation in such a way that every individual effort contributes to the organisational performance.
- Directing guides employees to fully realise their potential and capabilities by motivating and providing effective leadership.
- Directing facilitates introduction of needed changes in the organisation.
- Effective directing helps to bring stability and balance in the organisation.

## Principles of Directing

- **Maximum individual contribution**: Directing techniques must help every individual in the organisation to contribute to his maximum potential for achievement of organisational objectives.
- **Harmony of objectives**: Directing should provide harmony by convincing that employee rewards and work efficiency are complimentary to each other
- **Unity of Command**: A person in the organisation should receive instructions from one superior only.
- **Appropriateness of direction technique**: Appropriate motivational and leadership technique should be used while directing the people based on subordinate needs, capabilities, attitudes and other situational variables.
- **Managerial communication**: Effective managerial communication across all the levels in the organisation makes direction effective

- **Use of informal organisation**: A manager should realise that informal groups or organisations exist within every formal organisation. He should spot and make use of such organisations for effective directing.
- **Leadership**: While directing the subordinates, managers should exercise good leadership as it can influence the subordinates positively without causing dissatisfaction among them.
- **Follow through**: Mere giving of an order is not sufficient. Managers should follow it up by reviewing continuously whether orders are being implemented accordingly or any problems are being encountered. If necessary, suitable modifications should be made in the directions.

### Elements of Directing

The process of directing involves guiding, coaching, instructing, motivating, leading the people in an organisation to achieve organisational objectives. The activities can broadly be grouped into four categories which are the elements of directing. These are:

- Supervision
- Motivation
- Leadership
- Communication

## Co-ordination & Controlling

In every organisation, different types of work are performed by various groups and it becomes essential that the activities of different work groups and departments should be harmonised. This function of management is known as 'co-ordination'. In other words, coordination is the orderly arrangement of individual and group efforts to provide unity of action in the pursuit of a common goal.

According to Henri Fayol, "Control consists in verifying whether everything occurs in conformity with the plan adopted, the instructions issued and principles established." In simple terms, controlling means ensuring that activities in an organisation are performed as per the plans.

## Importance of Controlling

- Accomplishing organisational goals
- Judging accuracy of standards
- Making efficient use of resources
- Improving employee motivation
- Ensuring order and discipline
- Facilitating coordination in action.

## Process of Controlling

Controlling is a systematic process involving the following steps.

1. Setting performance standards
2. Measurement of actual performance
3. Comparison of actual performance with standards
4. Analysing deviations
5. Taking corrective action

## Techniques of Control

**Traditional Techniques**

- **Personal observation**
    - Enables the manager to collect first hand information
    - Creates a psychological pressure on the employees to perform well as they are aware of being observed.
- **Statistical reports**
    - Statistical analysis the form of averages, percentages, ratios, correlation, etc., present useful information regarding performance of the organisation in various areas.
- **Breakeven analysis**

- Breakeven analysis is used to study the relationship between costs, volume and profits.
- It determines the probable profit and losses at different levels of production.

$$\text{Breakeven Point} = \frac{\text{Fixed Costs}}{\text{Selling price per unit} - \text{Variable cost per unit}}$$

- **Budgetary control**

**Modern Techniques**

- Return on investment (RoI)
- Ratio analysis
- Responsibility accounting
- Management audit
- PERT and CPM
- Management information system (MIS)

## Relation between Planning & Controlling

Planning and controlling are closely related and reinforce each-other. Once a plan becomes operational, controlling is necessary to monitor the progress, measure it, discover deviations and initiate corrective measures to ensure that events conform to plans.

- Planning based on facts makes controlling easier and effective;
- Controlling improves future planning by providing information derived from past experience

Planning without controlling is meaningless. Similarly, controlling is blind without planning.

# Decision Making

Making decisions has been identified as one of the primary responsibilities of any manager. Decisions may involve allocating resources, appointing people, investing capital or introducing new products. Decision-making is at the core of all planned activities. Decision-making is a process of selection from a set of alternative courses of action which is thought to fulfill the objectives of the decision problem more satisfactorily than others.

## Process of Decision Making

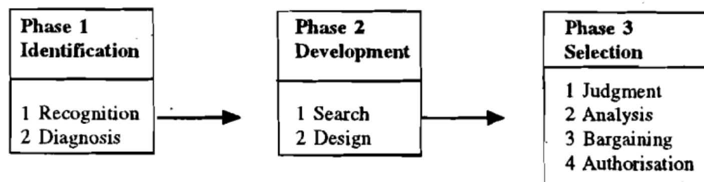
There are generally eight steps in the process of decision-making but all decisions might not fully conform to the neat eight step pattern. The steps, however, may be skipped or combined. These steps are:

1. Identifying the problems.
2. Defining the objectives to be met in solving the problem.
3. Making a pre-decision
   - Taking a decision about how to make a decision.
4. Generating alternatives
5. Evaluating alternate solutions
6. Choice to be made
7. Implementation of the chosen alternatives
8. Follow up
   - Monitoring the effectiveness of any attempted solution

*Herbert Simon*, described the activities associated with three major stages in the following way:

- **Intelligence Activity:** Simon describes this initial phase as an attempt to recognise and understand the nature of the problem, as well as search for the possible causes.
- **Design Activity**: During the second phase, alternative courses of action are developed and analysed in the light of known constraints.
- **Choice Activity**: The actual choice among available and assessed alternatives is made at this stage.

*Henry Mintzberg* and some of his colleagues (1976) have traced the phases of some decisions actually taken in organisations. They have also come up with a three-phase model:




- **The identification phase**, during which *recognition* of a problem or opportunity arises and a *diagnosis* is made.
- **The development phase**, during which there may be a *search* for existing standard procedures, ready-made solutions or the *design* of a new, tailor-made solution.
- **The selection phase**, during which the choice of a solution is made. There are three ways of making this selection:
  - by the judgement of the decision maker, on the basis of experience or intuition rather than logical analysis;
  - by analysis of the alternatives on a logical, systematic basis; and
  - by bargaining when the selection involves a group of decision makers.

## Types of Managerial Decisions

There are multiple categories of managerial-decisions. Five most widely recognised classifications are:

- Personal and Organisational Decisions.
- Routine & Strategic Decisions
- Programmed and Non-programmed Decisions
- Individual and group decisions
- Policy and operating decisions

This above classification, ignores the dimension of *how complex the problem is* and *how much certainty* can be placed with the outcome of a decision. Considering, these two dimensions four kinds of decision modes can be identified:

- **Mechanistic**
    - Decisions that are routine and repetitive in nature
- **Analaytical**
    - Decision that involves a problem with a large number of decision variables, where the outcomes of each decision alternative can be computed.
- **Judgemental**
    - A judgemental decision involves a problem with a limited number of decision variables, but the outcomes of decision alternatives are unknown.
- **Adaptive**
    - An adaptive decision involves a problem with a large number of decision variables, where outcomes are not predictable. because of the complexity and uncertainty of such problems, decision makers are not able to agree on their nature or on decision strategies.

## Models of Decision Making

Models of the decision making process help one understand how decisions are made. These models are:

- Contingency model
- Economic man model
- Administrative man model
- Implicit Favourite Model or Gamesman Model
- Social man model

### Contingency Model

*Beach and Mitchell* (1978) felt that the decision maker uses one of three general types of decision strategies:

- Aided analytic
    - The aided analytic strategy employs some sort of formal model or formula, or an aid such as a checklist.

- Unaided analytic
    - An unaided analytic strategy is one in which the decision maker is very systematic in his or her approach to the problem and perhaps follows some sort of model, but does it all in his or her head.
- No analytic
    - Here the decision maker chooses by habit or uses some simple rule of thumb ("nothing ventured, nothing gained" or "better safe than sorry") to make the choice.

### Economic Man Model

The economic man-model assumes that people are *economically rational* and so people attempt to maximise outcomes in an orderly and sequential process. Hence, people will select the decision or course of action that has the greatest advantage or payoff from among the many alternatives. This model suggests the following orderly steps in the decision process:

- 1. Discover the symptoms of the problem or difficulty,
- 2. Determine the goal to be achieved or define the problem to be solved,
- 3. Develop a criterion against which alternative solutions can be evaluated,
- 4. Identify all alternative courses of action,
- 5. Consider the consequences of each alternatives as well as the likelihood of occurrence of each,
- 6. Choose the best alternative by comparing the consequences of each alternative (step5) with the decision criterion (step3), and
- 7. Act or implement the decision.

### Administrative man model

This model was presented by *Simon* as is also called as *Bounded Rationality Model*. This model assumes that people, while they may seek the best solution, usually settle for much less because the decisions they confront typically demand greater information processing capabilities than they possess. The following three steps are involved in the process of this model.

- Sequential attention to alternative solutions:

  - In this step, all the alternatives are identified and evaluated one at a time. If one of the alternatives fails then the next alternative is considered
- Use of heuristics:
  - A heuristic is a rule which guides the search for alternatives into areas that have a high probability for yielding satisfactory solutions. In this step if the previous solution was working then a similar set of alternatives are used in that situation.
- Satisfying:
  - Here the alternatives which are workable are found to be satisfying.

## Identification of Alternatives

In order to generate alternatives three main processes are generally used.

**Brain storming:**

- This was developed by *Alex F. Osborn*.
- It is the best technique in stimulating creative thinking.
- The objective of this method is to produce as many ideas as possible.
- In this method:
  - 'Criticism' is prohibited.
  - 'Freewheeling' is welcome.
  - Generating a number of alternatives is the motto.
  - Combination and improvement are sought.

**Synectics:**

- This was Developed by *William J.J. Gordon*.
- Here members are selected from different backgrounds and training.
- The leader poses the problem in such a way that the members deviate from traditional ways of thinking.

**Nominal Grouping:**

- Developed by *Andre Delbecq* and Andrew *Van De Ven*.

- Nominal grouping has been found to be particularly effective in situations requiring a high degree of innovation and idea generation.

# Leadership

Leadership is often regarded as the important modifier of organisational behaviour. The success of an organisation depends much on the quality of a leader and thus a strong leadership can contribute to the overall effectiveness of the organisation. Effective leadership is based upon ideas, but will not happen unless those ideas can be communicated to others in a way that engages them.

**Definition:**

Leadership has been defined in different ways by different set of scholars. In simple terms, Leadership is defined as the ability to influence a group towards the achievement of a vision or set of goals.

## Leadership Qualities and Characteristics

According to *Chester Barnard*, six qualities are essential for a leader and such qualities, as per his order of importance include (Fadia & Fadia, 2006):

- Vitality and Endurance
- Decisiveness
- Persuasiveness
- Stability in Behaviour
- Intellectual Ability; and
- Knowledge

The leadership qualities as suggested by *Millet* include:

- Good health
- Sense of mission
- Interest in other people
- Intelligence
- Integrity
- Persuasiveness

- Judgement
- Loyalty

*Terry"s* list of leadership qualities includes (Fadia & Fadia, 2006):

- Energy
- Emotional stability
- Knowledge of human relations
- Empathy
- Objectivity
- Personal motivation
- Communicative skills
- Teaching ability
- Social skill; and
- Technical Competence

## Styles of Leadership

**Factors influencing Styles of leadership**

The behavioural pattern, exhibited by a leader is influenced by various factors, including:

- Personality of Leader
- Personality of Group Members
- Nature of Tasks
- Nature of Environment

### Styles of Leadership

- **Feudal Type**

- In the feudal type of leadership, the relationship that exists between a leader and follower is that of a lord and his subject.

- **Paternal Type:**
  - In this type of leadership, the leader"s relationship with the employee is that of a father and son. Here the employees of the organization are seen as family members.
- **Dictatorial Type:**
  - Here a leader dictates terms to the employees and demands obedience of the employees in carrying out the orders.
- **Participatory Type:**
  - In this, the leader tends to adopt a flexible approach, wherein the employees of the organisation are allowed to participate in decision making process.
  - The leader shares his/her vision and ideas to the employees and the decisions are arrived at by having a group discussion.
- **Developmental Type:**
  - Here, the leader feels that it is his/her duty to develop people.
  - The leader considers his/her subordinates to have vast potentialities for improvement and thus the focus of this leader is laid on promoting the subordinates to highest performances.
- **Bureaucratic Type:**
  - Under this type of leadership, a leader is bound by strict rules and regulations and they expect their employees to follow the procedures in a prompt manner.
- **Manipulative Type:**
  - In this case, the leader manipulates the employees of the organization so as to attain his own personal goals.
- **Charismatic Type:**
  - Charismatic leaders are regarded as of divine origin and the recognition of the followers depends upon the demonstration of constant proof, which in turn, augments follower devotion and enthusiasm.

## Theories of Leadership

- Great Man Theory
- Trait Theory
- Behavioural Theories
  - The Managerial Grid Model
  - Role Theory
- Participative Theories
  - Lewin's leadership styles
  - Likert's leadership styles
- Contingency Theories
  - Fiedler's contingency theory
  - Hersey-Blanchard Situational Theory
  - Path-goal theory
  - Vroom-Yetton-Jago decision-making model
  - Cognitive Resource Theory
  - Strategic Contingencies Theory
- Transactional Theories
  - Leader-Member Exchange (LMX) Theory
- Transformational Leadership
  - Bass' Transformational Theory
  - Burns' Transformational Theory
  - Kouzes and Posner's Leadership Participation Inventory

### Great Man Theory

The Great Man theory assumes that the traits of leadership are intrinsic. That simply means that great leaders are born, they are not made. This theory sees great leaders as those who are destined by birth to become a leader.

### Trait Theory of Leadership

The trait leadership theory believes that people are either born or are made with certain qualities that will make them excel in leadership roles. Hence, according to this model :a leader must have certain traits and qualities. Leaders like Mahatma Gandhi, Indira Gandhi, Margaret Thatcher, Nelson Mandela, Narayana Murthy of Infosys, Apple‟s Cofounder Steve Jobs etc. has been identified, based on the traits that they displayed.

### Behavioural Theories

In the 1940s, apart from the research studies being conducted on the traits displayed by leaders, research was also conducted on the behaviours exhibited by leaders. While the assumption behind traits theory is that „leaders are born, rather than made‟, behavioural theories assume that specific behavioural patterns of leaders can be acquired through learning and experience. While the trait theory concentrates on "what the leaders are‟, the behavioural theories concentrate on "what the leaders do‟.

### Contingency/Situational Theories

Sometimes the success of a leader does not depend upon the qualities, traits and behaviour of a leader alone. The context in which a leader exhibits her/his skills, traits and behaviour matters, because same style of functioning may not be suitable for different situations. Thus the effectiveness of leadership also depends upon situations.

### Cognitive Resource Theory

In this model, the focus has been laid on the role of stress as a form of situational unfavourableness and how a leader‟s intelligence and experience influence her/his reaction to stress.

### Transactional Theories

Transactional theories are also known as *exchange theories or Management theories* of leadership. These theories state that the leaders guide or motivate their followers in the direction of established goals by clarifying role and task requirements. The transactional leaders tend to be highly directive and action oriented and their relationship with the followers tends to be transitory and not based on emotional bonds.

### Transformational Theories

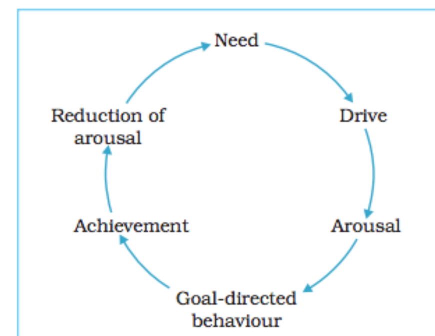
The essence of transformational theories is that leaders transform their followers through their inspirational nature and charismatic personalities. These are also known as *Relationship theories*.

# Motivation

The concept of motivation focuses on explaining what "moves" behavior. In fact, the term motivation is derived from the Latin word 'movere', referring to movement of activity. Working, studying, playing and caring are some important daily activities which are considered purposeful. Motives help explain our movement towards the chosen goals. Hence, motivation is one of the determinants of behavior. Instincts, drives, needs, goals, and incentives come under the broad cluster of motivation.

### The Motivational Cycle

- A need is lack or deficit of some necessity. This condition leads to drive, which is a state of tension or arousal.
- Drive energises random activity. When one of the random activities leads to a goal, it reduces the drive, and the organism stops being active. The organism returns to a balanced state.




## Types of Motives

Basically, there are two types of motives: biological and psychosocial.

### Physiological / Biological Motives

Biological motives are also known as physiological motives as they are guided mostly by the physiological mechanisms of the body. It is the earliest attempt to understand causes of behaviour. This theory states that organisms have needs (internal physiological imbalances) that produce drive, which stimulates behaviour leading to certain actions towards achieving certain goals, which reduce the drive.

The earliest explanations of motivation relied on the concept of instinct. The term instinct denotes inborn patterns of behaviour that are biologically determined rather than learned.

Some of the basic biological needs explained by this approach are hunger, thirst, and sex, which are essential for the sustenance of the individual.

## Psychosocial motives

Psychosocial motives are complex forms of motives mainly resulting from the individual's interaction with her/his social environment. Social motives are mostly learned or acquired. Social groups such as family, neighbourhood, friends, and relatives do contribute a lot in acquiring these motives.

**Need for Affiliation**

- Need for affiliation is aroused when individuals feel threatened or helpless and also when they are happy.
- People try to get close to other people, to seek their help, and to become members of their group. Seeking other human beings and wanting to be close to them both physically and psychologically is called affiliation. It involves motivation for social contact.

**Need for Power**

- Need for power is an ability of a person to produce intended effects on the behaviour and emotions of another person.

**Need for Achievement**

- Achievement motivation refers to the desire of a person to meet standards of excellence. Need for achievement, also known as n-Ach, energises and directs behaviour as well as influences the perception of situations.

**Curiosity and Exploration**

- Often people engage in activities without a clear goal or purpose but they derive some kind of pleasure out of it. It is a motivational tendency to act without any specific identifiable goal.
- The tendency to seek for a novel experience, gain pleasure by obtaining information, etc. are signs of curiosity. Hence, curiosity describes behaviour whose primary motive appears to remain in the activities themselves.

## General Motives

- This is an intermediate category of motives between the physiological and socio-psychological.
- The motives in this category are unlearned but not physiologically based.

## Work Motivation

Katzell and Thompson (1990) define Work Motivation as a "broad construct pertaining to the conditions and processes that account for arousal, direction, magnitude, and maintenance of effort in a person's job". More recently, *Robbins* (2005) defines work motivation as "the willingness to exert high levels of effort towards organisational goals, conditioned by the effort's ability to satisfy some individual needs".

### Classification of Motives at Work:

**Primary & Secondary Motives:**

Primary motives are unlearned, physiological needs that include hunger, thirst, sleep, sex, avoidance of pain etc. These needs are important for survival and are virtually universal, but they vary in intensity from one person to another.

Secondary motives are learned, social motives that arise as a result of interaction with other people and develop as people mature. Included in this category are affiliation – desire to associate with others; recognition – need for frequent tangible proof that one is getting ahead; status – need to have a high rank in society etc.

**Extrinsic and Intrinsic Motivation**

Extrinsic motivation is related to tangible rewards such as salary and fringe benefits, promotion, contract of service, the work environment and conditions of work.

Intrinsic motivation is related to psychological rewards such as the opportunity to use one's ability, a sense of challenge and achievement, receiving appreciation, positive recognition and being treated in a caring and considerate manner.

## Importance of Motivation in Organisations:

Employee motivation is essential to the success of any organisation, big or small. In the modern workplace, human resources are valued above all others. Motivated employees are productive, happy and committed. The spin-off of this includes reduced employee turnover, results-driven employees, company-loyalty and workplace harmony.

Motivation is very important for an organisation because of the following benefits it provides:

- Increased productivity and improved employee performance
- Stability of workforce
- Positive workplace culture
- Better teamwork
- Workplace harmony

## Theories of Motivation:

There are many competing theories, which attempt to explain the nature of motivation. These theories centre on three different aspects of motivation: the individual's predisposition, the cognitive process, and the consequences deriving from the individual's action. Based on these aspects, there are three types of theories of motivation:

- **Content theories** – These theories are concerned with identifying people's needs and their relative strengths, and the goals they pursue in order to satisfy these needs.
- **Process theories** – These theories are concerned more with how motivated behaviour is initiated, directed and sustained.

## Content Theories

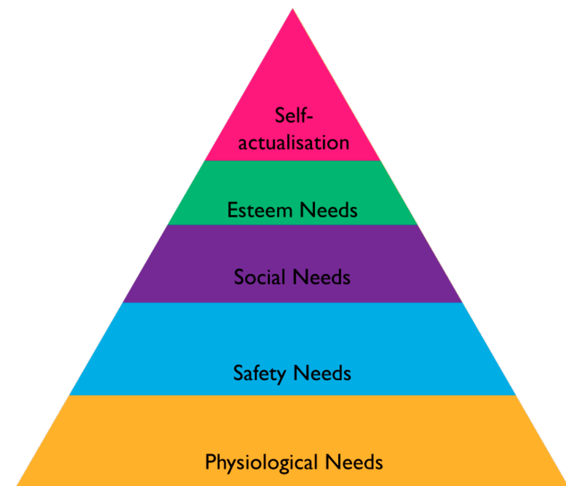
### 1. Maslow's Hierarchy of Needs

Abraham H. Maslow attempted to portray a picture of human behaviour by arranging the various needs in a hierarchy. His viewpoint about motivation is very popular because of its theoretical and applied value, which is popularly known as the "*Theory of Self-actualisation*".

Maslow's model can be conceptualised as a pyramid:

- Bottom/base of the pyramid hierarchy represents basic *physiological* or biological needs which are basic to survival such as hunger, thirst, etc.
- Once these needs are met, need for *safety* arises. In the absence of physical safety – due to war, natural disaster, etc people may experience stress etc and take steps to ensure physical safety. In the absence of economic safety – there will be preference for job security.

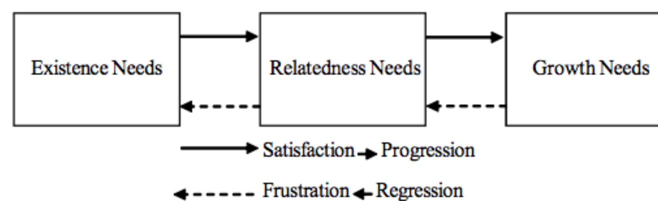
- Once these needs are met, there is need to seek out other people, be *social* and involves feelings of belongingness.
- After these needs are fulfilled, the individual strives for *esteem*, i.e. the need to develop a sense of self-worth.
- The next higher need in the hierarchy reflects an individual's motive towards the fullest development of potential, i.e. *self-actualisation*. A self-actualised person is self-aware, socially responsive, creative, spontaneous, open to novelty, and challenge.




Lower level needs (physiological) in the hierarchy dominate as long as they are unsatisfied. Once they are adequately satisfied, the higher needs occupy the individual's attention and effort.

### 2. Alderfer's ERG Theory

The ERG theory is an extension of Maslow's hierarchy of needs. Clayton Alderfer (1972) suggested that needs could be classified into three categories, rather than five. These three types of needs are:




- **Existence Needs**: physiological and safety needs (such as hunger, thirst and sex).
- **Relatedness Needs**: social and external esteem (involvement with family, friends, coworkers and employers).
- **Growth Needs**: internal esteem and self-actualisation (the desire to be creative, productive and to complete meaningful tasks).

Peculiar features of ERG theory include:

- The ERG theory allows for different levels of needs to be pursued simultaneously.
- The ERG theory allows the order of the needs be different for different people.

- The ERG theory acknowledges that if a higher level need, remains unfulfilled, the person may regress to lower level needs that appear easier to satisfy. This is known as the frustration-regression principle.

### 3. Herzberg's Motivator-Hygiene Theory

Herzberg concluded that there are two sets of needs: *the hygiene needs*, which produce job dissatisfaction and *the motivator needs*, which produce job satisfaction. Taken together, the hygiene factors and motivators are known as Herzberg's two-factor theory of motivation.

| **Motivation factors - job satisfaction** | **Hygiene factors - job dissatisfaction** |
|---|---|
| Achievement | Supervision |
| Work itself | Company policy |
| Recognition | Working conditions |
| Added Responsibility | Relationship with supervisor, peers, subordinates |
| Advancement & Growth | Salary & Security |

### 4. McClelland's Learned Needs Theory

David McClelland proposed that an individual's specific needs are acquired over time and are shaped by one's life experiences. Most of these needs can be classed as:

- **Need for achievement** – The desire to excel, to achieve in relation to a set of standards and to purse and attain goals.
- **Need for affiliation** – The desire for friendly and close interpersonal relationships.
- **Need for power** – The desire to control one's environment and to influence others.

## Process Theories:

Process (or cognitive) theories of motivation focus on conscious human decision processes as an explanation of motivation.

### Reinforcement Theory:

B.F. Skinner and his associates proposed the Reinforcement Theory of Motivation, which posits that behavior depends on its consequences. Behaviour that is accompanied by favourable consequences is likely to continue, while behaviour that is followed by unfavourable consequences is not likely to be repeated. Based on this principle, reinforcement theory describes four contingency methods of shaping behaviour:

- **Positive reinforcement** – It occurs when behaviour is followed by a favorable consequence that encourages the repetition of that behaviour. For example, recognition, promotion, money, approval, fringe benefits etc.
- **Negative reinforcement** – It occurs when behaviour is accompanied by the removal of an un-favorable consequence that results in strengthening of that behaviour. For example, Salary Cut, etc.
- **Punishment** – It occurs when the administration of an un-favorable consequence discourages certain behaviour. For Example: Suspension conditions
- **Extinction** – It occurs when the target behaviour decreases because no reinforcement follows it. For example, research suggests that when mangers stop congratulating employees for their good performance, that performance tends to decline.

### Carrot & Stick Theory:

The Carrot and Stick approach of motivation is based on the **principles of reinforcement** and is given by a philosopher Jeremy Bentham, during the industrial revolution. In this, an individual is given carrot i.e. reward when he performs efficiently and is given a punishment in case of non-performance.

### Expectancy Theory

Victor Vroom (1964) suggested that motivation is a product of three factors: expectancy, instrumentality and valence. This means that if any of these is zero, then the motivation to do something will be zero as well. In simple terms:

*Expectancy × Instrumentality × Valence = Motivation*

- **Expectancy** – Is the belief that more effort will result in success.
- **Instrumentality** – the person's belief that there is a connection between activity and goal. If one performs well, one will get reward.

- **Valence** – the degree to which a person values the reward, the results of success.

### Equity Theory

The theory was suggested by Adams (1965) and is based on Social Exchange theory. According to this theory, people compare their contribution to work and the benefits to the contribution and benefit of relevant other persons. If people perceive that the ratio of their inputs-outputs to the ratio of referent other's input-output is inequitable, then they will be motivated to reduce the inequity. There are two types of inequity—under-reward and over-reward. Individuals may attempt to reduce inequity in various ways:

- **Change the inputs** – A person may change his or her level of effort. Ex. an employee who feels under-rewarded is likely to work less hard.
- **Change the outcomes** – A person may try to change his or her rewards. Ex. asking for a raise
- Change the comparison other's inputs – A person may change the behaviour of the reference person. Ex. By encouraging that person to put forth more effort.
- **Change the comparison other's outcomes** – A person may change the outcome of the reference person. Ex. By asking the boss to stop giving favourable treatment to him/her.
- **Change the comparison other** – A person experiencing inequity may change the reference person and compare him or herself to a different person to assess equity.
- **Change one's perception** – A person may believe that the co-worker is doing more or that the higher outcomes that the other receives are no better that his/hers.
- **Quit the Situation** – A person may avoid thinking about the inequity by keeping away from the situation. Ex. Quitting the job.

### Goal-Setting Theory

Locke and Latham (1990) primarily developed the goal-setting theory. It states that specific, measurable and attainable goals motivate an employee to achieve the goal. The basic components of goal-setting theory are:

- Set challenging but attainable goals -
- Set specific and measurable goals -

- Goal commitment should be obtained - allow employees to have a role in setting goals and making decisions and obtain commitment.
- Support elements should be provided – material resources and moral support required for attaining goals.
- Knowledge of results is essential - goals need to be quantifiable and there needs to be feedback.

## Other Important Motivation Theories:

### McGregor's Participation Theory or XY Theory:

Douglas McGregor proposed the X-Y theory in his 1960 book "The Human Side Of Enterprise." The theory formulated two distinct views of human being based on participation of workers in the organization.

Theory X assumes that the typical employee has little ambition, avoids responsibility and do not want to associate themselves with the organization's goals. Consequently, Theory X concludes the typical workforce operates more efficiently when all actions are traceable to the individual responsible. This allows the individual to receive either a direct reward or a punishment, depending on the outcome's positive or negative nature.

Theory Y managers assume employees are internally motivated and enjoy their job. Employees additionally tend to take full responsibility for their work and do not need close supervision to create a quality product.

Managers who choose the Theory X approach have an authoritarian style of management. On the contrary, managers who choose the Theory Y encourage participation and values individuals' thoughts and goals. Since, there is no optimal way for a manager to adopt either Theory X or Theory Y, it is rational that a manager will need to adopt both approaches depending on the evolving circumstances at the workplace.

### Theory Z

Theory Z was given by William Ouchi. Theory Z promotes stable employment, high productivity and high morality and employee satisfaction. The loyalty of employees is increased by offering them a job for life with a strong focus on employee well-being both on the job as well as in their private lives.

# Communication

Communication plays key role in smooth functioning of organisation. Success of '*Direction*' depends on the effectiveness of communication. Proper communications in organisations at all levels and between all levels can improve both the quantity and quality of output.

**Definition:**

The word communi'cation has been derived from the Latin word 'communis' which means 'common' which consequently implies common understanding. Generally, Communication is understood as a process of exchange of ideas, views, facts, feelings etc., between two or more individuals to reach common understanding.

## Elements of Communication

- Sender: Communicator/Transmitter
  - The person who intends to convey the message with the intention of passing information and ideas to others is known as sender or communicator
- Message
  - It is the content of ideas, feelings, suggestions, order etc., intended to be communicated
- Encoding:
  - It is the process of converting the message into symbols such as words, pictures, gestures etc.
- Medium/Channel
  - It is the path through which encoded message is transmitted to receiver. Example - Written - in a letter or verbal in form of speech
- Decoding
  - It is the process of converting encoded symbols of the sender
- Receiver
  - Receiver is the person who receives the message or for whom the message is meant for.
- Reaction/Feedback

- Feedback is the process of ensuring that the receiver has received the message and understood in the same sense as sender meant it.

- Noise/Interference:
  - It includes any factor that inhibits the conveyance of a message.
  - This hindrance may be caused to sender, message or receiver.

## Importance of Communication

Communication is one of the most central aspects of managerial activities. Effectiveness of a manager depends significantly on his ability to communicate effectively with his superiors, subordinates and external agencies etc. Its importance in management can be judged from the following:

- *Helps in smooth working of an enterprise*: It helps employees to understand their role clearly and perform effectively.
- *Boosts morale and provides motivation*: An efficient system ofcommunication enables management to motivate, influence and satisfy the subordinates.
- *Increases managerial efficiency*: It is the means through which delegation and decentralisation of authority is successfully accomplished in an organisation.
- *Promotes cooperation and industrial peace*: It helps in achieving co-ordination and mutual understanding which in turn, leads to industrial harmony and increased productivity.
- *Establishes effective leadership*:
- *Acts as basis of decision making*

## Types of Communication

In an organisation communication can be made from supervisor to subordinate, from subordinate to supervisor and also between two supervisors at the same level. It can be done orally or in writing or even through gestures. It may be made through formal or informal channels. Thus, the various types are as follows:

| Basis of Channel Used | Basis of Direction | Basis of Mode Used |
|---|---|---|
| • Formal<br>• Informal | • Upward<br>• Downward<br>• Horizontal<br>• Diagonal | • Verbal<br>• Non-Verbal |

## Formal and Informal Communication

In every organisation we have both formal and informal channels.

**Formal Communication**

- Paths ofcommunication are based on relationship which is established formally i.e. it flows through official channels designed in the organisation chart.
- It may take place between a superior and subordinate, a subordinate and superior or among same cadre employees or managers.
- It may be oral or written but generally recorded and filed in the office.

**Informal Communication**

- It takes place on the basis of informal or social relations among staff.
- The informal communication arises out of needs of employees to exchange their views, which cannot be done through formal channels.

## Upward, Downward, Horizontal and Diagonal Communication

**Upward Communication**

- It refer to flow of communication from subordinate to superior.
- It is generally in form of request, appeal, report, suggestion or ideas.
- This encourages employees to participate actively in the operations of their department.

**Downward Communication**

- Indicates communication from a superior to subordinate.

- Examples include: sending notices, assigning work etc.

**Horizontal Communication**

- It is communication amongst members at the same level in the organisation.
- Such communication facilitates coordination of activities that are interdependent

**Diagonal Communication**

- When communication is made between people who are neither in the same department nor at the same level of organizational hierarchy, it is called diagonal communication.
- For example, cost accountant may request for reports from sales representatives not the sales manager for the purpose of distribution cost analysis.

## Verbal and Non-verbal Communication

**Verbal**

- Verbal communication is the use of words to share information with other people.
- It can therefore include both spoken (Oral) and written form.

**Non-Verbal**

- Sometimes verbal communication is supported by non-verbal communication such as facial expressions and body gestures.
- For example – wave of hand, a smile or a frown etc

## Barriers to effective Communication

It is generally observed that managers face several problems due to communication breakdowns or barriers. These include:

**Semantic Barriers**

Semantic barriers are concerned with problems in encoding and decoding of message. These result on account of use of wrong words, faulty translations, different interpretations etc.

- Badly expressed message
- Symbols with different meanings

- Faulty translations
- Unclarified assumptions
- Technical jargon
- Body language and gesture decoding.

**Psychological barriers**

- Premature evaluation
- Lack of attention
- Loss by transmission and poor retention
- Distrust.

**Organisational barriers**

- Organisational policy
- Rules and regulations
- Status
- Complexity in organisation structure
- Organisational facilities.

**Personal barriers**

- Fear of challenge to authority
- Lack of confidence of superior on his subordinates
- Unwillingness to communicate
- Lack of proper incentives

## How to improve effectiveness of Communication

- Clarify the ideas before communicating
- Communicate according to the needs of receiver
- Consult others before communicating
- Be aware of languages, tone and content of message
- Convey things of help and value to listeners
- Ensure proper feedback
- Communicate for present as well as future
- Follow up communications
- Be a good listener

# Aspects of Staffing

The prime concern of the staffing function in the management process is the timely fulfilling of the manpower requirements within an organisation. It starts with ascertaining the required number of various categories of employees for the organisation. This is done through several methods like job analysis, workload analysis, etc. The next thing is the recruitment exercise, followed by selecting the right person through tests and interviews and making their appointments. This is followed by necessary introduction of the work environment and the rules of compensation, promotion, transfer etc. Thus, the various steps involved in the process of staffing are as follows.

## Recruitment

The objective of recruitment is to attract potential employees with the necessary qualification, in the adequate number for the jobs available. Hence, recruitment may be defined as the process of searching for prospective employees and stimulating them to apply for jobs in the organisation.

### Process of Recruitment

The various activities involved with the process of recruitment includes

- Identification of the different sources of manpower supply,
- Assessment of their validity,
- Choosing the most suitable source or sources
- Inviting applications from the prospective candidates, for the vacancies.

### Sources of Recruitment

The requisite positions may be filled up from within the organisation or from outside. Thus, there are two sources of recruitment:

**Internal Sources:**

- There are two important sources of internal recruitment, namely, *transfers* and *promotions*.

**External Sources:**

- The various external sources of recruitment are:
    - Direct recruitment notice placed on the notice-board of the enterprise specifying the details of the jobs available.

- Media Advertisements - Newspapers
- Campus Recruitment
- Recommendations of Employees
- Employment Exchange run by government - Example Rajasthan Employment Exchange
- Publishing on company website.
- Unsolicited Application - Many reputed business organisations keep a database of unsolicited applicants in their offices. A list of such job-seekers can be prepared and can be screened to fill the vacancies as they arise.
- Through Private Employment Agencies.

## Selection

When an adequate number of applications/names of interested candidates have been collected through the recruitment exercises the selection process starts. Selection is the process of choosing from among the pool of the prospective job candidates developed at the stage of recruitment. The effectiveness of the selection process would ultimately be tested in terms of on-the-job of the chosen person.

### Process of Selection

The important steps in the process of selection include:

- Preliminary Screening
- Selection Test: Various tests employed include:
    - Intelligence Tests
    - Aptitude Tests
    - Personality Tests
    - Trade Tests
    - Interest Tests
- Selection Interview
- Reference and Background Checks

- Medical Examination
- Job Offer - Issue of Appointment letter

## Induction

Induction or Orientation is the process of introducing new employees to the organisation and familiarising him/her with the rules and policies of the organisation. A proper induction programme is likely to reduce his anxiety on how to cope with the work and how to become part of the organisation and helps in development of a favourable attitude towards the organisation and the job.

## Training & Development

Training and Development is an attempt to improve the current or future employee performance by increasing an employee's ability to perform through learning, usually by changing the employee's attitude or increasing his or her skills and knowledge.

Every one must have the opportunity to rise to the top. The best way to provide such an opportunity is to facilitate employee learning. Organisations have either in-house training centers or have forged alliances with training and educational institutes to ensure continuing learning of their employees.

### Education

- Education is the process of increasing the knowledge and understanding of employees.
- It does not provide definite answers, but rather develops a logical and rational mind.
- Education is broader in scope than training. Training is tied to the goals of organisations more than to the goals of the individual.

### Training

- Training is any process by which the aptitudes, skills and abilities of employees to perform specific jobs are increased.
- It is a process of learning new skills and application of knowledge.

**Methods of Training:**

There are different methods of giving training to the employees, which can be divided into two broad categories.

- On-the-Job methods
    - Apprenticeship Programmes
    - Job Rotation
    - Internship Training
    - Mentorship/ Coaching
- Off-the-Job methods
    - Class Room Lectures/ Conferences
    - Case studies
    - Movies & Video shows
    - Vestibule Training: Employees learn their jobs on the equipment they will be using, but the training is conducted away from the actual work floor.
    - Programmed Instructions

## Development

- Development refers to the learning opportunities designed to help employees grow. It covers not only those activities which improve job performance but also those which bring about growth of the personality and actualisation of their potential capacities.

## Difference between Training & Development

| Training | Development |
|---|---|
| • It is a process of increasing knowledge and skills. | • It is a process of learning and growth. |
| • It is to enable the employee to do the job better. | • It is to enable the overall growth of the employee. |

| • It is a job-oriented process. | • It is a career-oriented process. |
|---|---|

## Appraisal System

All organisations have some formal or informal means of appraising their employee's performance. Performance appraisal means evaluating an employee's current and/or past performance as against certain predetermined standards.

The performance appraisal process, includes defining the job, appraising performance and providing feedback.

## Compensation

No organisation can attract and retain qualified employees without offering them a fair compensation. Compensation, therefore, refers to all forms of pay or rewards going to employees.

Compensation may be in the form of:

- Direct financial payments like wages, salaries, incentives, commissions and bonuses or
- Indirect payments like employer paid insurance and vacations.

Compensation may be divided into two categories:

- Base/primary compensation.
  - It is a fixed amount paid every month to an employee. It includes wages, salary and allowances paid to an employee irrespective of his performance.
- Supplementary compensation.
  - It refers to the compensation paid to the employees to motivate them to work more efficiently.
  - It is also known as incentive compensation.
  - The incentives may be monetary or non-monetary.

## Promotion & Transfer

It becomes necessary for all organisations to address career related issues and provide avenues for promotion to their employees. When an employee is assigned a job involving greater responsibilities, more pay, higher status and prestige than his/her present job, it is known as promotion. Promotion generally mean more pay, responsibility and job satisfaction. This practice helps to improve the motivation, loyalty and satisfaction level of employees. It has a great psychological impact over the employees because a promotion at the higher level may lead to a chain of promotions at lower levels in the organisation.

Transfers involves involves shifting of an employee from one job to another, one department to another or from one shift to another, without a substantive change in the responsibilities and status of the employee. Thus, transfer does not usually involve any increase in pay or a superior status.

# Marketing

Marketing refers to the process of ascertaining consumers' needs and supplying various goods and services to the final consumers or users to satisfy those needs.

## Traditional Concept of Marketing

Traditionally, marketing means selling goods and services that have been produced. Thus, all those activities, which are concerned with sale of goods and services, have been called marketing.

| Traditional Concept of Marketing | |
|---|---|
| Focus on | Product |
| Means | Selling |
| Ends | Profits through maximisation of sales |

## Market

In the traditional sense, the term 'market' refers to the place where buyers and sellers gather to enter into transactions involving the exchange of goods and services.

## Modern Concept of Marketing

The modern concept of marketing considers the consumers' wants and needs as the guiding spirit and focuses on the delivery of such goods and services that can satisfy those needs most effectively. Similarly, in modern marketing sense, the term market has a broader meaning. It refers to a set of actual and potential buyers of a product or service.

## What is Marketing?

Marketing is a broad concept that starts with identifying consumer needs, then plan the production of goods and services accordingly to provide them the maximum satisfaction. *Phillip Kolter* defines marketing as, "a social process by which individual groups obtain what they need and want through creating offerings and freely exchanging products and services of value with others".

***Market Offering***: are some combination of products, services, information, or experiences offered to a market to satisfy consumer needs or wants. They are not just limited to physical products; they can also include services such as intangible like activities or benefits offered for sale.

## Important features of Marketing:

- **Needs and Wants:** The process of marketing helps individuals and groups in obtaining what they need and want.
- **Creating a Market Offering:** Market offering refers to a complete offer for a product or service, having given features like size, quality, taste, etc; at a certain price; process of purchasing, available at a given outlet or location and so on.
- **Customer Value:** A product will be purchased by customers only if it is perceived to be giving greatest benefit or value for the money. The job of a marketer, therefore, is to add and convey this value of the product to the probable customers, so they may prefer the particular product against competing items.
- **Exchange Mechanism:** The process of marketing works through the exchange mechanism. The individuals (buyers and sellers) obtain what they need and want through the process of exchange.

## Objectives of Marketing:

- Provide satisfaction to customers.
- Increase in demand
- Provide better quality product to the customers
- Create goodwill for the organisation
- Generate profitable sales volume

## Importance of Marketing:

- Marketing helps business to keep pace with the changing tastes, fashions, preferences of the customers. Additionally, it also helps the business in meeting competition most effectively.
- Marketing helps the business in increasing its sales volume, generating revenue and ensuring its success in the long run.
- Marketing also contributes to providing better products and services to the consumers and improve their standard of living.

- Marketing helps in making products available at all places and throughout the year.
- Marketing plays an important role in the development of the economy. Various functions and sub-functions of marketing like advertising, personal selling, packaging, transportation, etc. generate employment for a large number of people, and accelerate growth of business.

## Difference between Marketing and Selling

The terms 'marketing' and 'selling' are related but not synonymous. 'Marketing' emphasises on earning profits through customer satisfaction. In marketing, the focus is on the consumer's needs and their satisfaction. 'Selling' on the other hand focuses on product and emphasises on selling what has been produced. Hence, Selling is a small part of the wide process of marketing.

| **Marketing** | **Selling** |
| --- | --- |
| Marketing includes selling and other activities like various promotional measures, marketing research, after sales service, etc. | Selling is confined to persuasion of consumers to buy firm's goods and services. |
| It starts with research on consumer needs, wants, preference, likes, dislike etc., and continues even after the sales have taken place. | Selling starts after the production process is over and ends with the handing over the money to the seller by the buyer. |
| Priority is needs of buyer. | Priority is the seller. |
| Focus is on earning profit through maximisation of customers' satisfaction. | Focus is on earning profit through maximisation of sales. |
| It is an integrated approach to achieve long term goals like creating, maintaining and retaining the customers. | All activities revolve around the product that has been produced. |

## Functions performed in Marketing

- Marketing Research - Gathering and Analysing Market Information

- Marketing Planning
- Product Designing and Development
- Standardisation and Grading
- Packaging & Labelling
- Branding
- Pricing the Product
- Promotion of the Product
- Storage and Warehousing
- Transportation
- Physical Distribution
- Selling
- After-Sale Services/ Customer Support Services

## Marketing Management Philosophies

The concept or philosophy of marketing has evolved over a period of time as follows:

### The Production Concept

- During the earlier days of industrial revolution, the demand for industrial goods started picking up but the number of producers were limited. As a result, the demand exceeded the supply. Selling was not an issue.
- It was believed that profits could be maximised by producing at large scale, thereby reducing the average cost of production.
- It was also assumed that consumers would favour those products which were widely available at an affordable price.
- Thus, availability and affordability of the product were considered to be the key to the success and hence greater emphasis was placed on improving the production and distribution efficiency.

## The Product Concept

- Mere availability and low price of the product could not ensure increased sale as customers started looking for products which were superior in quality, performance and features.
- Therefore, the emphasis of the firms shifted from quantity of production to quality of products.
- Hence, product improvement came to be considered as the key to profit maximisation of a firm.

## The Selling Concept

- With the passage of time, supply of goods improved resulting in increased competition among sellers.The product quality and availability did not ensure the survival and growth of firms.
- This led to greater importance to attracting and persuading customers to buy the product.
- Hence, the focus of business firms shifted to pushing the sale of products through aggressive selling techniques.

## The Marketing Concept

- In Selling Concept, making sale through any means became important but in long-term it was realised that the customer satisfaction matters the most and this gave way to new paradigm of Marketing Concept.
- This assumes that in the long run an organisation can achieve its objective of maximisation of profit by identifying the needs of its present and prospective buyers and satisfying them in an effective way.
- In this, customer's satisfaction becomes the focal point of all decision making in the organisation.

## The Societal Marketing Concept

- The marketing concept cannot be considered as adequate if we look at the challenges posed by social problems like environmental pollution, deforestation, shortage of resources, population explosion and inflation.

- The societal marketing concept holds that the task of any organisation is to identify the needs and wants of the target market and deliver the desired satisfaction in an effective and efficient manner so that the longterm well-being of the consumers and the society is taken care of.
- Thus, the societal marketing concept is the extension of the marketing concept as supplemented by the concern for the long-term welfare of the society.

## Marketing Mix

There are large number of factors affecting marketing decisions. Some of these are controllable factors like brand-name, location, price, where to advertise etc and others are non-controllable factors like government taxes, policy, inflation etc. Thus, from a number of alternatives available a firm chooses a particular combination to develop a market offering. The combination of variables chosen by a firm to prepare its market offering is also called marketing mix.

**Definition:** The marketing mix refers to the set of actions, or tactics, that a company uses to promote its brand or product in the market.

### Elements of Marketing Mix:

#### 4P Model:

The marketing mix consists of various elements, popularly known as four Ps of marketing. These are:

1. Product,
2. Price,
3. Place,
4. Promotion

**Product:**

- Product means goods or services or 'anything of value', which is offered to the market for sale.

**Price:**

- Price is the amount of money customers have to pay to obtain the product.



RAJRAS RAJRAS

- It depends on costs of production, segment targeted, ability of the market to pay, supply - demand and a host of other direct and indirect factors.

**Place:**

- Place refers to the point of sale.
- In every industry, catching the eye of the consumer and making it easy for them to buy it is the main aim of a good distribution or 'place' strategy. Retailers pay a premium for the right location.

**Promotion:**

- Promotion of products and services include activities that communicate availability, features, merits, etc. of the products to the target customers and persuade them to buy it.

### 7P Model:

In services marketing, an extended marketing mix is used, typically comprising **7 Ps.**

- Including the original **4 Ps** and
- ***P**rocess*, ***P**eople*, and ***P**hysical evidence*.

Occasionally service marketers will refer to **8 Ps**, comprising these 7 Ps and ***P**erformance*.

### 4C Model:

Robert F. Lauterborn proposed a 4 Cs classification in 1990. His classification is a more consumer-orientated version of the 4Ps. It includes:

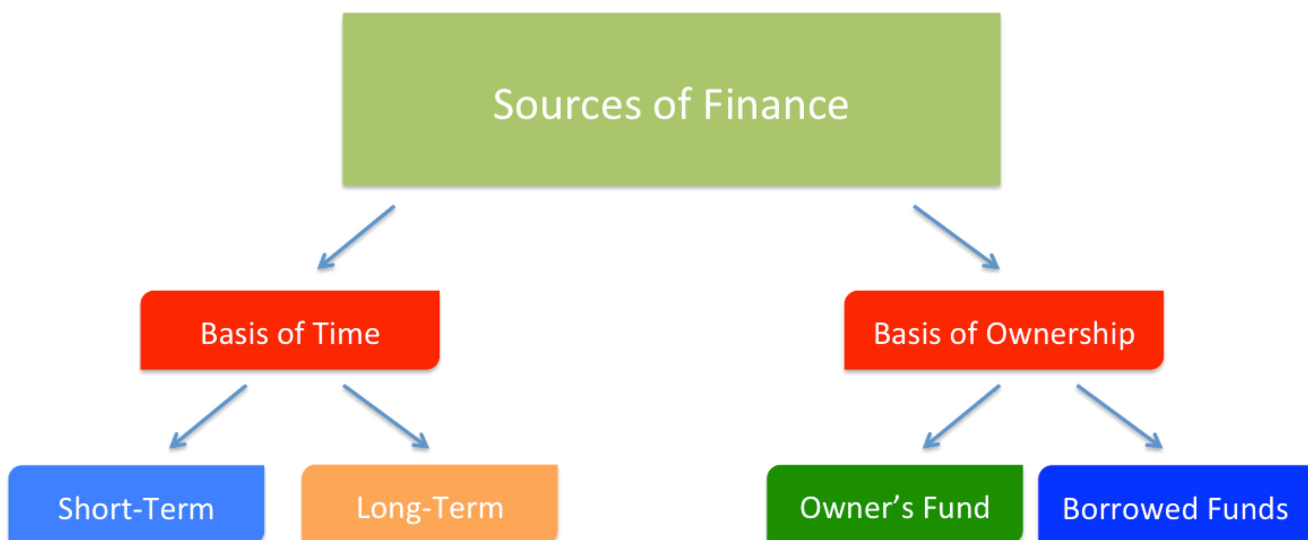
- Product → *Commodity*
- Price → *Cost*
- Promotion → *Communication*
- Place → *Channel*

# Sources of Finance

Any type of business or occupation requires money at every stages of its operation. Whether it is a small business or large, manufacturing or trading or transportation business, money is an essential requirement for every activity. Money required for carrying out business activities is called *business finance*. Finance is needed to establish a business, to run it, to modernise it, to expand, or diversify it. This chapter deals with various aspects and sources of finance.

## Types of Business Finance:

The type and amount of funds required usually differs from one business to another. Hence, there exists multiple classification of business finance based on different selected parameters.




Based on the *period* for which the funds are required, the business finance is classified into three categories.

- Short-term Finance
    - The short-term finance is required for a period of one year or less
- Medium-term Finance
    - Investments/Finance are required for more than one year but less than five years.

- Long-term Finance
  - The amount of funds required by a business for more than five years is called long-term finance

On the basis of *ownership*, the sources of business finance can be broadly classified into two categories:

- Owner's funds
  - It consist of equity share capital, preference share capital and reserves and surpluses or retained earnings.
- Borrowed funds
  - It can be in the form of loans, debentures, public deposits etc.

## Sources of Short-Term Finance

- Trade credit
- Bank credit
  - Loans and Advances
  - Cash Credit
  - Bank Overdraft
  - Discounting of Bills
- Factoring
- Customers' Advances
- Instalment Credit
- Loans from Unorganised sectors

## Sources of Long-Term Finance

**Owner's Capital**

- Issue of Shares
- Retention of Profit

**Borrowed Capital**

- Issue of Debentures
- Loans from financial institutions
- Public Deposits
- Lease financing
- Foreign Investment

## Sources of Short-Term Finance

### Trade credit

- Trade credit refers to credit granted to manufacturers and traders by the suppliers of raw material, finished goods, components, etc.
- Usually business enterprises buy goods on 30 to 90 days credit.
- This means that the goods are delivered but payments are not made until the expiry of the period of credit.

### Bank credit

Commercial banks usually provide short-term finance to business firms, known as bank credit. When bank credit is granted, the borrower gets a right to draw the amount of credit as and when needed. Bank credit may be granted in any of the following ways:

#### Loans and Advances

- When a bank advances a certain amount of money, repayable after a specified period, it is known as bank loan.
- Such advance is credited to a separate loan account and the borrower has to pay interest on the whole amount of loan irrespective of the amount of loan actually drawn.
- Usually loans are granted against security of assets.

### Cash Credit

- Arrangement whereby banks allow the borrower to withdraw money upto a specified limit.
- This facility is granted against the security of goods in stock or promissory notes or other marketable securities like government bonds.
- Interest is charged only on the amount actually withdrawn and not on the amount of entire limit.

### Bank Overdraft

- In this case, bank allows its depositors or accountholders to withdraw money in excess of the balance in his current deposit account, upto a specified limit.
- Limit is decided by credit worthiness of the borrower. Interest is charged only on the overdrawn money.

### Discounting of Bills

- Banks also give advance money by discounting bill of exchange.
- On maturity of the bill, the payment is received by the bank from the drawee.

*Bill of Exhcange: A bill of exchange is a written order once used primarily in international trade that binds one party to pay a fixed sum of money to another party on demand or at a predetermined date. Bills of exchange are similar to cheques.*

## Factoring

- The business can take advance money from the bank against the amount to be realised from the debtors.

## Customers Advances

- Customers' advance represents a part of the payment towards sale price of the product(s), which will be delivered at a later date.

## Loans from Unorganised sectors

- In addition to the above methods of raising funds, the businessmen always have the option to take the money from the unorganised sector like loans from the moneylender (called indigenous bankers), friends and relatives.

## Sources of Long-Term Finance

### Owner's Capital

#### Issue of Shares

Share is the smallest unit into which the total capital of the company is divided. The investors who have purchased the shares or invested money in the shares are called the shareholders. They get dividend as return of their investment.
A company can issue two types of shares, - Equity Shares and Preference shares.

**Equity Shares:**

- Equity shares are shares that do not enjoy any preferential right in the matter of claim of dividend or repayment of capital.
- The equity shareholders get dividend only after making the payment of dividends on preference shares.
- The equity shareholders are the owners of the company and exercise their authority through the voting rights.
- There is no fixed rate of dividend as it depends on surplus profits.

**Preference Shares:**

- Preference Shares are shares that carry preferential rights in respect of dividend and return of capital.
- Before any dividend is paid to the equity shares, the dividend *at a fixed rate* must be paid on the preference shares. However, this dividend is payable only if there are profits.
- Also in case of winding up of company, preference shareholders get priority over equity shareholders, on the return of their capital.
- Preference shares do not have any normal voting right. So, they cannot take part in the management of the company. Only in case of special circumstances, they get right to vote in general meetings.

**Types of Preference Share**

A company has the option to issue different types of preference share:

- Convertible and Non-convertible Preference Share:
    - The preference shares, which can be converted into equity shares after a specified period of time, are known as convertible preference share. Otherwise, it is known as non-convertible preference share.
- Cumulative and Non-cumulative Preference Share:
    - In cumulative preference shares, the unpaid dividends are accumulated and carried forward for payment in future years. On the other hand, in non-cumulative preference share, the dividend is not accumulated if it is not paid out of the current year's profit.
- Participating and Non-participating Preference Share:
    - Participating preference shares have a right to share the profit after making payment to the equity shares. The non-participating preference shares do not enjoy such a right.
- Redeemable and Irredeemable Preference Share:
    - Preference shares having a fixed date of maturity is called as redeemable preference share. Here, the company undertakes to return the amount to the preference shareholders immediately after the expiry of a fixed period. Where the amount of the preference shares is refunded only at the time of liquidation, are known an irredeemable preference shares.

### Retained Earnings / Retention of Profit

- Retained earnings refer to part of profit that was not distributed as dividend, which is usually kept in the form of general reserve.
- It is an internal source and does not involve any cost of floatation and the uncertainties of external financing.
- Advantages:
    - Regarded as the most dependable source of long-term finance.
    - Also strengthens the firm's equity base, which enables to borrow at better terms and conditions.
- Drawbacks:
    - Dependent on the accuracy of profits
    - Possibility of reckless use of funds by the management.

## Borrowed Capital

### Issue of Debentures

The companies can raise long term funds by issuing debentures that carry assured rate of return for investors in the form of a fixed rate of interest. A debenture is a written acknowledgement of money borrowed. It specifies the terms and conditions, such as rate of interest, time of repayment, security offered, etc.

The debenture-holders are the creditors of the company and are entitled to get interest irrespective of profit earned by the company. They do not have any voting right. So they do not interfere in the day-to-day management of the business.

Ordinarily, debentures are fully secured. In case the company fails to pay interest on debentures or repay the principal amount, the debenture-holders can recover it from sale of its assets.

**Types of Debentures:**

Debentures may be classified as:

- Redeemable and Irredeemable Debentures:
  - Redeemable debentures are repayable on a specified date. On the other hand, there is no fixed time to pay back the money in case of irredeemable debentures. These debenture-holders cannot demand to get back their money as long as the company does not make any default in payment of interest. Hence, these debentures are also called perpetual debentures.
- Convertible and Non-convertible Debentures:
  - Convertible debentures-holders are given the option to convert their debentures into equity shares. But incase of non-convertible debentures the company does not give any such option.
- Secured and Unsecured Debentures:
  - Secured debentures are issued with a charge on the assets of the company as security. This charge may be fixed i.e., on specified asset, or it may be floating. Secured debentures are also known as mortgaged debentures. On the other hand, unsecured debentures are issued with merely a promise of payment without having any charge on any assets as security. So these debentures are also known as naked or simple debentures.

- Registered and Bearer Debentures:
    - For registered debentures the issuing company maintains a record of the debenture-holders. Any sale or transfer of such debentures must be registered with the company. On the other hand, bearer debentures are just like negotiable instruments and transferable by mere delivery. The company keeps no record of such debenture-holders. Interest coupons are attached to them and anybody can produce the coupon to get the interest.

**Difference Between Shares & Debentures:**

| Basis | Share | Debenture |
|---|---|---|
| Status | Shareholders are the owners of the company. They provide ownership capital which is not refundable unless the company is liquidated | Debenture-holders are the creditors of the company. They provide loans generally for a fixed period, which are to be paid back. |
| Rights | They have the right to vote and say in management of the company | They do not have right to vote and no say in management of company. |
| Returns | They get dividends but returns are not fixed.<br>Return payable only when company makes profit. | Interest is paid on debentures at a fixed rate.<br>Interest is payable even when company operates at loss. |
| Priority of Repayment | Share capital is paid back only after paying the debenture-holders and creditors. | Debenture-holders have the priority of repayment over shareholders. |
| Risk | High, no certainty of return. | Low, certainty of return |

### Loans from financial institutions

Financial institutions grant loans for a maximum period of 25 years. These loans are covered by mortgage of companies property and/or hypothecation of stocks shares etc. The rate of interest payable is lower than the market rate and the amount of loan is large. Example of financial institutions are –

- Industrial Finance Corporation of India (IFCI)

- Industrial Credit and Investment Corporation of India (ICICI)
- Industrial Development Bank of India (IDBI)
- Small Industries Development Bank of India (SIDBI)
- Export and Import Bank of India (EXIM Bank)
- Venture Capital Institutions

### Public Deposits

Under this method companies can raise funds by inviting their shareholders, employees and the general public to deposit their savings with the company. To attract the public, the company usually offers a higher rate of interest than the interest on bank deposit.

### Lease financing

Sometimes, a company, to meet its financial requirements, may sell its own existing fixed asset (machinery or building) to a leasing company at the current market price on the condition that the leasing company shall lease the asset back to selling company for a specified period. Such an arrangement is known as 'Sell and Lease Back'. The company in such arrangement gets the funds without having to part with the possession of the asset involved which it continues to use on payment of annual rent for the lease.

### Foreign Investment

Foreign Sources also play an important part in meeting the long-term financial needs of the business in India. These usually take the form of

**External borrowings**

These include loans obtained at concessional rates of interest with long maturity period and commercial borrowings. The major sources of concessional loans have been the International Monetary Fund (IMF), Asian Development Bank (ADB), and World Bank etc.

ECB is basically a loan availed by an Indian entity from a non-resident lender. Most of these loans are provided by foreign commercial banks and other institutions. It is a loan availed of from non-resident lenders with a minimum average maturity of 3 years.

**Foreign investments**

Foreign Direct Investment (FDI) is the investment through capital instruments by a person resident outside India (a) in an unlisted Indian company; or (b) in 10 percent or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company.

Foreign Portfolio Investment is any investment made by a person resident outside India in capital instruments where such investment is (a) less than 10 percent of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company or (b) less than 10 percent of the paid up value of each series of capital instruments of a listed Indian company.

*Fully diluted basis means the total number of shares that would be outstanding if all possible sources of conversion are exercised.*

**Deposits from NRIs**

Non-Resident Indians (NRIs) constitute an important source of long-term finance for industries in India. The most common form of their contribution is in the form of deposits under Foreign Currency Non-Resident Account (FCNRA) and Non-Resident (External) Rupee Account (NRERA).

# Capital Structure

One of the important decisions under financial management relates to the financing pattern or the proportion of the use of different sources in raising funds. Most companies plan to raise funds for their capital needs using a judicious mix between owners funds (equity) and borrowed funds (debt). This mix of equity and debt actually used by a company for meeting its requirement of capital is known as its *capital structure*.

Capital structure of a company, thus, affects both the profitability and the financial risk. it is considered be optimal when the proportion of debt and equity is such that it results in an increase in the value of the equity share. In other words, all decisions relating to capital structure should emphasize on increasing the shareholders' wealth.

Thus, capital structure of a company affects the rate of return on owners' capital (shareholders' funds). This in turn, determines the earnings per equity share (EPS) and has its effect on the market value of company's shares. Hence, the choice of an appropriate capital structure becomes a very important decision for the finance manager of any company.

## Importance of Capital Structure:

- Increase in value of the firm:
    - An optimal capital-structure of a company leads to increase the market price of shares, which results in increase in the value of the firm.
- Maximization of return
- Minimization of Cost of Capital
- Provides Risk information:
    - An analysis of Capital-Structure of Business, can help in determining how risky it is to invest in a business.

## Affecting Factors:

Deciding about the capital-structure of a firm involves determining the relative proportion of various types of funds. This depends on various factors. Important factors, which determine the choice of capital-structure, are as follows:

**Internal Factors:**

- Cash Flow Position:
- Return on Investment (RoI):
- Cost of debt
- Tax Rate
- Interest Coverage Ratio (ICR)
- Debt Service Coverage Ratio (DSCR)
- Cost of Equity

**External Factors:**

- Floatation Costs:
- Risk Consideration
- Capital Structure of other Companies

## Trading on Equity

Trading on Equity Trading on Equity refers to the use of high debt for ensuring higher returns for the equity shareholders. This is workable when the profitability is high and the rate of return on investment of funds is higher than the rate of interest to be paid on the borrowed money.

## Optimal Capital-Structure

Situation where income of shareholders is maximised and cost of capital is minimised.

# Cost of Capital

The cost of capital is the cost of a company's funds (both debt and equity). In words of *Solomon Erza* "The cost of capital is the minimum required rate of earnings or the cut-off rate of expenditure". From Investor's point of view, it is the **rate of return** that must be received by the firm on its investment projects, to attract investors for investing capital in the firm and to maintain its market value. In simple terms, it may be described as the expected return appropriate for the expected level of risk. It is also termed as cut-off rate, the minimum rate of return, or hurdle rate.

## Importance

- Useful in determining company's capital structure.
- Deciding future projects/investments - For an investment to be worthwhile, the expected return on capital has to be higher than the cost ofcapital.
- Helps to evaluate a company's investment program and its competitive position.
- Helpful in capital budgeting decisions regarding the sources of finance used by the company.

### Cost of Capital and Capital Structure

Cost of capital is an important factor in determining the company's capital structure. Companies look for the optimal mix of financing (Debt+Equity) that provides adequate funding and that minimizes the cost of capital.

## Factors affecting cost of capital:

- Capital Structure
- Dividend Policy
- Financial and Investment Decisions
- Interest Rates

## Types of Cost of Capital

**Implicit & Explicit Capital Costs**

- Implicit cost also known as the *opportunity cost* is the of the opportunity foregone in order to take up a particular project. It is the rate of return associated with the best investment opportunity for the firm and its shareholders that will be forgone if the project presently under consideration by the firm were accepted.
- Explicit cost of any source may be defined as the discount rate that equates the present value of the funds received by a firm with the present value of expected cash outflows.

**Historical & Future Capital Costs:**

- Historical costs are those costs which have already been incurred in order to finance a particular project.
- Future Costs are the expected costs of funds for financing a particular project.

**Weighted average cost of capital (WACC)**

WACC is the combined cost of each component of funds raised by the firm. The weights are the proportion of the value of each component of capital in the total capital.

**Marginal Capital Costs**

Marginal capital cost is defined as the cost of obtaining one additional unit (1 rupee in India) of new capital.

**Specific Capital Cost:**

The cost of each component of capital is known as specific Capital Costs. Companies raise capital from different sources such as equity, debentures, loan etc. It is the cost of equity capital, cost of debentures, etc., individually.

**Cost of Debt**

- It is the interest rate that a company pays on its existing debt.
- However, since interest expense is tax-deductible, the debt is calculated on an after-tax basis as follows:
  *Cost of Debt = Interest Expense * ( 1- Tax Rate)/ Total Debt*

**Cost of Equity:**

- It is the expected rate of return for the company's shareholders.

**Cost of Retained Earnings:**

- Retained earnings refers to the portion of net income which is retained by the corporation rather than distributed to its owners as dividends.

# Profit Vs. Wealth Maximization

For optimal financial decisions, it is essential to define objectives of financial management. These objectives serve as decision-criterion. Financing is a functional area of business and, therefore, the objectives of financial management must be in tune with the overall objectives of the business. The main objectives of business are survival and growth. In order to survive in the business and to grow, a business must earn sufficient profits. It must also maintain good relations with investors, employees, customers and other groups of society. It should also provide maximisation of owners' economic welfare. Consequently, there are two well known criteria in this regard:

- Profit Maximisation
- Wealth Maximisation

## Profit Maximisation

According to this criterion, the financial decisions (investment, financing and dividend) of a firm should be oriented to the maximisation of profits (i.e. select those assets, projects and decisions which are profitable and reject those which are not profitable). Hence, actions that increase the firm's profit are undertaken while those that decrease profit are avoided.

### Merits of Profit Maximisation:

- Excellent allocation of resources
- Main Source of Inspiration
- Maximum Social Welfare
- Basis of Decision-Making

Under perfect competition, profit maximisation behaviour by firms leads to an efficient allocation of resources with maximum social welfare. Since, the capital is a scarce material, the financial manager should use these capital funds in the most efficient manner for achieving the profit maximisation. It is, therefore, argued that profitability maximisation should serve as the basic criterion for the ultimate financial management decisions.

### Drawbacks of Profit Maximisation

- It is vague
- It ignores time value of money
- It ignores risks
- It ignores social responsibility

### Wealth Maximisation

Considering the shortcomings of profit maximisation, wealth maximisation is taken as the basic objective of financial management. It is also known as 'Value Maximisation' or 'Net Present Value Maximisation'. The wealth maximisation goal states that the management should seek to maximise the present value of the expected returns of the firm. The present value of future benefits is calculated by using its discount rate (cost of capital) that reflects both time and risk.

### Superiority of Wealth Maximisation

- It measures income in terms of cash flows, and avoids the ambiguity now associated with accounting profits as, income from investments is measured on the basis of cash flows rather than on accounting profits.
- It recognises time value of money by discounting the expected income of different years at a certain discount rate (cost of capital).
- It analyses risk and uncertainty so that the best course of action can be selected from different alternatives.
- It is not in conflict with other motives like maximisation of sales or market value of shares. It helps rather in the achievement of all these other objectives.

## Comparison of Profit Maximisation & Wealth Maximisation

| Profit Maximisation | Wealth Maximisation |
|---|---|
| • Its main objective is to earn large amount of profits. | • Its main objective is to achieve highest market value of common stock. |
| • It emphasises short term | • It emphasises long term |
| • It ignores time value of money | • It considers time value of money |
| • It ignores risk and uncertainty | • It recognises risk and uncertainty. |
| • It ignores timing of return | • It recognises the timings of return. |

It should be clear that profit maximisation is a strictly short-term approach to managing a business, which can be damaging over the long term. On the other hand, Wealth maximisation, which focuses attention on the long term, increases the value of the business and eventually pays-off better.

# Accounting & Financial Statements: Basics

Accounting is the systematic and comprehensive recording of financial transactions pertaining to a business. *According to Bierman and Drebin:*" Accounting may be defined as identifying, measuring, recording and communicating of financial information."

Accounting can also be defined as the process of identifying, measuring, recording and communicating the required information relating to the economic events of an organisation to the interested users of such information.

## Objectives of Accounting

Primary objectives of accounting include the following:

- Maintenance of Records of Business Transactions.
- Calculation of Profit and Loss
- Depiction of Financial Position
- Providing Accounting Information to its Users

## Principles of Accounting

Generally Accepted Accounting Principles (**GAAP**) are basic accounting principles and guidelines which provide the framework for more detailed and comprehensive accounting rules, standards and other industry-specific accounting practices. In India, financial statements are prepared on the basis of accounting standards issued by the *Institute of Chartered Accountants of India* (ICAI) and the law laid down in the respective applicable acts.

**Generally Accepted Accounting Principles (GAAP)**

- **Business Entity Assumption:** It states that every business entity should be treated as an entity that is separate from its owners.
- **Monetary Unit Assumption:** All the financial transactions of a business should be capable of being expressed in a monetary unit (Example INR for India).
- **Accounting Period:** This principle entails that the accounting process of a business should be completed within a certain time period which is usually a financial year or a calendar year.

- **Historical Cost Concept:** According to this, when certain economic resources or assets are acquired by an enterprise, they are recorded as per the cash or cash equivalent actually spent to acquire that resource or asset on the transaction date, even if the transaction happened the previous day or twenty years ago.
- **Going Concern Assumption:** The business entity is assumed to be a going concern, i.e., it will continue to operate for an indefinite amount of time.
- **Accrual Basis of Accounting:** This principle requires all revenue and expenditure to be recorded in the period it is actually incurred and not when cash or cash equivalent has been received/spent.
- **Matching Concept:** This concept requires the revenue for a particular period to be matched with its corresponding expenditure so as to show the true profit for the period.
- **Conservatism**: While accounting for a particular transaction, all anticipated expenses or losses will need to be accounted for but all potential income or gains should not be recorded until actually earned/received.

### Process of Accounting:

The process of accounting consists of number of steps or stages. However, we can identify 3 main steps as:

- Recording - Transaction is identified and recorded.
- Classification - Journal entries are classified into appropriate ledger accounts.
- Summarisation - Ledger balance is “summarised” and converted into trial balance.
- Preparation of financial statements.
- Closing

## Financial Statements

The financial statements are the end products of accounting process. They are prepared following the consistent accounting concepts, principles, procedures and also the legal environment in which the business organisations operate.

**Definition:**

Financial statements are the basic and formal annual reports through which the corporate management communicates financial information to its owners and various other external parties which include investors, tax authorities, government, employees, etc.

## Objectives of Financial Statements

- To provide information about economic resources and obligations of a business.
- To provide information about the earning capacity of the business.
- To provide information about cash flows.
- To judge effectiveness of management.
- To provide information about activities of business affecting the society.
- To disclose accounting policies

## Importance or Uses of Financial Statements

- **Report on performance:** Financial statements report the performance of the management to the shareholders. The gaps between the management performance and ownership expectations can be understood with the help of financial statements.
- **Basis for fiscal policies:** The financial statements provide basic input for industrial, taxation and other economic policies of the government.
- **Basis for granting of credit**: The financial Statements provide information to credit granting institutions like Banks etc to take decisions on provide funds to company.
- **Basis for prospective investors**: Financial statements help the investors to assess longterm and short-term solvency as well as the profitability of the concern.
- **Guide to Shareholders**: Financial Statements serve as guide to shareholders of companies, who are interested in knowing the status, safety and return on their investment.
- **Aids trade associations in helping their member**s: Trade associations may analyse the financial statements for the purpose of providing service and protection to their members. They may develop standard ratios and design uniform system of accounts.

- **Helps stock exchanges**: Financial statements help the stock exchanges to understand the extent of transparency in reporting on financial performance.

## Types of Financial Statements:

They generally refer to:

- Balance Sheet
- Statement of profit and loss

Apart from these, there is also a need to know about movements of funds and changes in the financial position of the company. For this purpose, a statement of changes in financial position of the company or a *cash flow statement* is prepared.

## Balance Sheet

The balance sheet shows all the assets owned by the concern, all the obligations or liabilities payable to outsiders or creditors and claims of the owners on a particular date.

### Preparing a Balance Sheet:

The two most common formats of reporting the balance sheet are:

- The vertical balance sheet
- The horizontal balance sheet
-

**Horizontal Balance Sheet**:

In this, asset line items are listed down the first column and liabilities and equity line items are listed in a later column

**Balance Sheet for Wal-Mart**
*As of Jan 31, 2006*

| Assets | | Liabilities and Shareholders' Equity | |
|---|---|---|---|
| *Current Assets:* | | *Current Liabilities:* | |
| Cash and Cash Equivalents | 6,414 | Commercial Paper | 3,754 |
| Receivables | 2,662 | Accounts Payable | 25,373 |
| Inventories | 32,191 | Accrued Liabilities | 13,465 |
| Prepaid Expenses and Other | 2,557 | Accrued Income Taxes | 1,340 |
| **Total Current Assets** | 43,824 | Long-term Debt, due within one year | 4,595 |
| | | Obligations Under Capital Leases, due within one year | 299 |
| *Property and Equipment, at cost:* | | **Total Current Liabilities** | 48,826 |
| Land | 16,643 | | |
| Buildings and Improvements | 56,163 | Long-term Debt | 26,429 |
| Fixtures and Equipment | 22,750 | Long-term Obligations Under Capital Leases | 3,742 |
| Transportation Equipment | 1,746 | Deferred Income Taxes and Other | 4,552 |
| **Total Property and Equipment, at cost** | 97,302 | Minority Interest | 1,467 |
| Less Accumulated Depreciation | 21,427 | | |
| Property and Equipment, net | 75,875 | *Shareholders' Equity:* | |
| | | Preferred Stock | 0 |
| Property Under Capital Lease: | 5,578 | Common Stock | 417 |
| Less Accumulated Amortization | 2,163 | Capital in Excess of Par Value | 2,596 |
| | | Accumulated Other Comprehensive Income | 1,053 |
| Property Under Capital Lease, net | 3,415 | Retained Earnings | 49,105 |
| Goodwill | 12,188 | | |
| Other Assets and Deferred Charges | 2,885 | **Total Shareholders' Equity** | 53,171 |
| **Total Assets** | 138,187 | **Total Liabilities and Shareholders' Equity** | 138,187 |

**Vertical Balance Sheet:**

Here, all line items are presented down the left side The vertical format is easier to use when information is being presented for multiple periods.

## How to read Balance Sheet

The balance sheet is divided into two parts that, based on the following equation, **must equal** (or balance out) each other. The main formula behind balance sheets is:

Assets = Liabilities + Shareholders' equity

| Balance Sheet as at 31st March 2015 | |
|---|---|
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | |
| **Shareholders funds** | |
| Share Capital | 48 |
| **Reserves & Surplus** | **2,156** |
| **Net Worth** | **2,205** |
| **Current Liabilities & Provisions** | |
| **Current Liabilities** | |
| Trade payables | 1,194 |
| Other Current Liabilities | 1,585 |
| Short term borrowings | 1,485 |
| Short term provisions | 90 |
| **Total Current Liabilities and Provisions** | **4,355** |
| **Non Current Liabilities** | |
| Long term borrowings | - |
| Deferred Tax Liability | 0 |
| Other Long Term Liabilities | 248 |
| Long term provisions | 13 |
| **Total Non Current Liabilities** | **261** |
| **Total Liabilities & Shareholders' Equity** | **6,820** |
| | |
| **Current Assets, Loans & Advances** | |
| Current investments | 0 |
| Cash & Bank balance | 266 |
| Inventory | 2,920 |
| Trade receivables | 1,386 |
| Loans and Advances | 1,209 |
| Other Current Assets | 6 |
| **Total Current Assets** | **5,789** |
| **NON CURRENT ASSETS** | |
| Long term loans and adv | 70 |
| Other Non Current Assets | 209 |
| Non current Investments | 15 |
| **Fixed Assets** | |
| Tangible Assets | 689 |
| Intangible assets | 2 |
| Capital Work in Progress | 47 |
| **Total Fixed Assets** | **739** |
| **TOTAL NON CURRENT ASSETS** | **1,032** |
| **TOTAL ASSETS** | **6,820** |

## Statement of Profit and Loss

The Statement of profit and loss is prepared for a specific period to determine the operational results of an undertaking. It is a statement of revenue earned and the expenses incurred for earning the revenue.

PROFIT AND LOSS ACCOUNT

Rs. '000

| For the year ended | Schedule | 31st March, 2008 | 31st March, 2007 |
|---|---|---|---|
| **INCOME** | | | |
| Gross sales | | 26,176,594 | 23,172,131 |
| Less : Excise duty | | 328,728 | 1,179,275 |
| Net sales | | 25,847,866 | 21,992,856 |
| Other income | N | 501,944 | 314,687 |
| | | 26,349,810 | 22,307,543 |
| **EXPENDITURE** | | | |
| Consumption of materials | O | 15,553,213 | 14,003,598 |
| Staff cost | P | 905,267 | 766,680 |
| Expenses | Q | 7,072,035 | 5,934,498 |
| Depreciation and amortisation | D | 290,832 | 252,712 |
| Financial expenses | R | 97,321 | 88,982 |
| | | 23,918,668 | 21,046,470 |
| **Profit before taxation and exceptional items** | | 2,431,142 | 1,261,073 |
| Exceptional items | S | 108,543 | 76,951 |
| **Profit before taxation** | | 2,322,599 | 1,184,122 |
| Income tax expense | | | |
| - Current income tax | | 356,025 | 84,354 |
| - Fringe benefit tax | | 66,652 | 51,348 |
| - Wealth tax | | 1,224 | 1,224 |
| - Deferred income tax, net | | (11,333) | (29,339) |
| **Profit after taxation** | | 1,910,031 | 1,076,535 |
| Profit brought forward | | 600,000 | 500,000 |
| **Profit available for appropriation** | | 2,510,031 | 1,576,535 |
| **Appropriation** | | | |
| Transfer to general reserve | | 1,406,926 | 557,281 |
| Proposed dividend | | 430,023 | 358,352 |
| Tax on proposed dividend | | 73,082 | 60,902 |
| Profit carried forward | | 600,000 | 600,000 |
| | | 2,510,031 | 1,576,535 |

## Limitations of Financial Statements

- Do not reflect current situation
- Accounting is done on the basis of certain conventions, hence some of the assets may not realise the stated values.
- Financial statements are the outcome of recorded facts, accounting concepts and conventions used and personal judgements made in different situations by the accountants.
- Financial statements show aggregate information but not detailed information.
- Financial statements contain only monetary information but not qualitative information like industrial relations, industrial climate, labour relations, quality of work, etc.
- Statement of Profit and Loss discloses the profit/loss for a specified period. It does not give an idea about the earning capacity over time.

# Analysis of Financial Statements

Financial statements are mainly prepared for decision-making purposes. But the information as is provided in the financial statements is not adequately helpful in drawing a meaningful conclusion. Thus, an effective analysis of financial statements is required. This process of critical evaluation of the financial information contained in the financial statements in order to understand and make decisions regarding the operations of the firm is called 'Financial Statement Analysis'.

## Benefits of analysis of Financial Statements

- *Measuring Profitability*: Analysis of financial statement helps in ascertaining whether adequate profits are being earned on the capital invested in the business or not. It also helps in knowing the capacity to pay the interest and dividend.
- *Estimate Growth Potential*: The trend and other analysis of the business provides sufficient information indicating the growth potential of the business.
- *Comparison*: The purpose of financial statements analysis is to help the management to make a comparative study of their firm in respect of sales, expenses, profitability and utilising capital, etc with the competition.
- *Assess Financial Strength*: The purpose of financial analysis is to assess the financial strength of the business.
- *Anticipate Solvency*: The different tools of an analysis reveal information whether the firm has sufficient funds to meet its short term and long term liabilities or not.

## Tools of Analysis of Financial Statements

The most commonly used techniques for analysis of financial statements are as follows:

- Comparative Statements
- Common Size Statements

- Trend Analysis
- Ratio Analysis
- Cash Flow Analysis

### Comparative Statements

Comparative Statements are the statements showing the profitability and financial position of a firm for different periods of time in a comparative form to give an idea about the position of two or more periods. Comparative figures indicate the trend and direction of financial position and operating results. This analysis is also known as 'horizontal analysis'.

Practically, two financial statements (balance sheet and income statement) are prepared in comparative form for analysis purposes.

### Common Size Statements

These are the statements, which indicate the relationship of different items of a financial statement with a common item by expressing each item as a percentage of that common item.

The percentage thus calculated can be easily compared with the results of corresponding percentages of the previous year or of some other firms, as the numbers are brought to common base. This analysis is also known as 'Vertical analysis'.

One advantage of common size statement method analysis is that it allows an analyst to compare the operating and financing characteristics of two companies of different sizes in the same industry. Thus, common size statements are useful, both, in intra-firm comparisons over different years and also in making inter-firm comparisons for the same year or for several years.

### Common size balance sheet

A statement where balance sheet items are expressed in the ratio of each asset to total assets and the ratio of each liability is expressed in the ratio of total liabilities is called common size balance sheet.

The common size statement may be prepared in the following way. –

- The total assets or liabilities are taken as 100

- The individual assets are expressed as a percentage of total assets i.e. 100 and different liabilities are calculated in relation to total liabilities.

### Trend Analysis

The trend analysis is a technique of studying the operational results and financial position over a series of years. Using the previous years' data of a business enterprise, trend analysis can be done to observe the percentage changes over time in the selected data.

In this analysis the trend percentages are calculated for each item by taking the figure of that item for the base year taken as 100. Generally the first year is taken as a base year. The analyst is able to see the trend of figures, whether moving upward or downward. From this observation, a problem is detected or the sign of good or poor management is detected.

### Ratio Analysis

- Described in detail in next-chapter

### Cash Flow Analysis

It refers to the analysis of actual movement of cash into and out of an organisation. The flow of cash into the business is called as cash inflow or positive cash flow and the flow of cash out of the firm is called as cash outflow or a negative cash flow. The difference between the inflow and outflow of cash is the net cash flow. A Cash flow statement is prepared to project the movement of cash.

#### Cash Flow Statement:

Cash Flow Statement deals with flow of cash, which includes cash equivalents as well as cash. This statement is additional information made available to the users of Financial Statements by classifying cash flows into operating, investing and financing activities.

**Classification of Activities for the Preparation of Cash Flow Statement**

Activities are to be classified into three categories:

- *Operating activities* are the principal revenue generating activities of the enterprise.

- *Investing activities* include the acquisition and disposal of longterm assets and other investments not included in cash equivalents.
- *Financing activities* are activities that result in change in the size and composition of the owner's capital (including Preference share capital in the case of a company) and borrowings of the enterprise

**Statement of Cash Flows**

**Cash flows from operating activities**

Cash received from customers
Cash paid for merchandise
Cash paid for wages and other operating expenses
Cash paid for interest
Cash paid for taxes
Other

Net cash provided (used) by operating activities

**Cash flows from investing activities**

Cash received from sale of capital assets (plant and equipment, etc.)
Cash received from disposition of business segments
Cash received from collection of notes receivable
Cash paid for purchase of capital assets
Cash paid to acquire businesses
Other

Net cash provided (used) by investing activities

**Cash flows from financing activities**

Cash received from issuing stock
Cash received from long-term borrowings
Cash paid to repurchase stock

## Limitations of analysis of Financial Statements

- Analysis of financial statements is based on the information available in financial statements. Consequently, the financial analysis also suffers from various limitations of financial statements.
- Financial analysis does not consider price level changes.
- Financial analysis may be misleading without the knowledge of the changes in accounting procedure followed by a firm.

- Financial analysis is just a study of reports of the company.
- Monetary information alone is considered in financial analysis while non-monetary aspects are ignored.
- The financial statements are prepared on the basis of accounting concept, as such, it does not reflect the current position.

# Ratio Analysis

Liquidity R. | Solvency R. | Activity R. | Profitability R. | Leverage R

Ratio Analysis describes the significant relationship, which exists between various items of a balance sheet and a statement of profit and loss of a firm. Ratios provide clues to the financial position of a concern. It enables to assess the profitability, solvency and efficiency of an enterprise.

## Types of Ratios:

There is a two-way classification of ratios:

- **Traditional classification.**
  - Statement of Profit and Loss Ratios: A ratio of two variables from the statement of profit and loss is known as statement of profit and loss ratio
  - Balance Sheet Ratios: In case both variables are from the balance sheet, it is classified as balance sheet ratios
  - Composite Ratios: If a ratio is computed with one variable from the statement of profit and loss and another variable from the balance sheet, it is called composite ratio
- **Functional classification.**
  - Liquidity Ratios
  - Solvency Ratios
  - Activity (or Turnover) Ratios
  - Profitability Ratios
  - Leverage Ratios

## Liquidity Ratios

Liquidity ratios are calculated to measure the short-term solvency of the business, i.e. the firm's ability to meet its current obligations.

## Current Ratio

Current ratio is the proportion of current assets to current liabilities. It is expressed as follows:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Examples of Current assets

- Current investments,
- Inventories,
- Trade receivables (debtors and bills receivables),
- Cash and cash equivalents,
- Short-term loans and advances
- Prepaid expenses,
- Advance tax
- Accrued income

Examples of Current liabilities:

- Short-term borrowings,
- Trade payables (creditors and bills payables),
- Other current liabilities and short-term provisions

### Significance of Current Ratio:

- It provides a measure of degree to which current assets cover current liabilities.
- The excess of current assets over current liabilities provides a measure of safety margin available against uncertainty in realization of current assets and flow of funds.
- The ratio should be reasonable. It should neither be very high or very low. Both the situations have their inherent disadvantages.

- A very high current ratio implies heavy investment in current assets, which is not a good sign as it reflects under utilization or improper utilisation of resources.
- A low ratio endangers the business and puts it at risk of facing a situation where it will not be able to pay its short-term debt on time.

### Quick Ratio

It is the ratio of quick (or liquid) asset to current liabilities. It is expressed as:

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$

Also called as – Acid Test Ratio

*Quick Assets*: Those assets, which are quickly convertible into cash. Example:

- Cash and cash equivalents
- Current investments
- Trade receivables (debtors and bills receivables),
- Marketable securities

## Solvency Ratios

Solvency ratios are calculated to determine the ability of the business to service(ability to pay) its debt in the long run.

### Debt-Equity Ratio

$$\text{Debt-Equity Ratio} = \frac{\text{Long-Term Debt}}{\text{Shareholder's Fund}}$$

Where:

- Shareholders' Funds (Equity) = Share capital + Reserves and Surplus + Money received against share warrants
- Share Capital = Equity share capital + Preference share capital

Or

- Shareholders' Funds (Equity) = Non-current Assets + Working capital – Non-current liabilities
- Working Capital = Current Assets – Current Liabilities

## Debt to Capital Employed Ratio

$$\text{Debt to Capital Employed Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

## Proprietary Ratio

$$\text{Proprietary Ratio} = \frac{\text{Shareholder's Funds}}{\text{Capital Employed}}$$

## Total Assets to Debt Ratio

$$\text{Total assets to Debt Ratio} = \frac{\text{Total Assets}}{\text{Long-Term Debts}}$$

## Interest Coverage Ratio

$$\text{Interest Coverage Ratio} = \frac{\text{Net Profit before Interest and Tax}}{\text{Interest on Long-Term Debts}}$$

## Activity (or Turnover) Ratios

The activity ratios express the number of times assets employed is turned into sales during an accounting period. Higher turnover-ratios mean better utilisation of assets and signifies improved efficiency and profitability, and so are also known as efficiency ratios.

### Inventory Turnover

- **Inventory Turnover Ratio** = Cost of Revenue from Operations ÷ Average Inventory.

### Trade receivable Turnover

- **Trade Receivable Turnover ratio** = Net Credit Revenue from Operations ÷ Average Trade Receivable

Where

- **Average Trade Receivable** = (Opening Debtors and Bills Receivable + Closing Debtors and Bills Receivable)/2

### Trade payable Turnover

- **Trade Payables Turnover ratio** = Net Credit purchases ÷ Average trade payable

Where

- **Average Trade Payable** = (Opening Creditors and Bills Payable + Closing Creditors and Bills Payable) ÷ 2
- **Average Payment Period** = No. Of days/month in a year ÷ Trade Payables Turnover Ratio.

### Investment (Net assets) Turnover

- **Net Assets or Capital Employed Turnover ratio** = Revenue from Operation ÷ Capital Employed

### Fixed assets Turnover

- **Fixed asset turnover Ratio** = Net Revenue from Operation ÷ Net Fixed Assets

### Working capital Turnover

- **Working Capital Turnover Ratio** = Net Revenue from Operation ÷ Working Capital

## Profitability Ratios

Profitability ratios are calculated to analyze the earning capacity of the business, which is the outcome of utilization of resources employed in the business.

### Gross profit ratio

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

Where,

- Net Sales = Net Revenue from Operations

### Operating ratio

$$\text{Operating Ratio} = \frac{\text{Operating Cost}}{\text{Net Sales}} \times 100$$

### Operating profit ratio

- **Operating Profit Ratio** = 100 – Operating Ratio

Alternatively, it is calculated as under:

$$\text{Operating Profit Ratio} = \frac{\text{Operating Profit}}{\text{Net Sales}} \times 100$$

Where

- Operating Profit = Net Sales – Operating Cost

## Net profit ratio

$$\text{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$$

Generally,

- Net Profit = Profit after tax (PAT)

*Example: Understanding Above Terms*

| S. No | Particulars | Amount |
|---|---|---|
| 1 | Total Sales | 1,00,000 |
| 2 | Less Sales Return | (20,000) |
| 3 | Less Discount Allowed | (5,000) |
| 4 | Net Revenue from Operations or Net Sales (1 -2 -3) | 75,000 |
| 5 | Less Cost of Operations | 10,000 |
| 6 | Operating Profit (4-5) | 65,000 |
| | | |

## Return on Investment (ROI) or Return on Capital Employed (ROCE)

$$\text{ROI or ROCE} = \frac{\text{Profit before Interest and Tax}}{\text{Capital Employed}} \times 100$$

## Return on Net Worth (RONW)

Return on Shareholders' Funds is also called as Return on Net Worth.

$$\text{RONW} = \frac{\text{Profit After Tax}}{\text{Shareholders' Funds}} \times 100$$

## Earnings per share (EPS)

$$\text{Earnings per Share (EPS)} = \frac{\text{Net Income – Preferred Dividend}}{\text{Number of Equity Shares}}$$

Where,

- Net Income = Profit after Tax

## Book value per share

$$\text{Book Value per Share} = \frac{\text{Equity shareholders' funds}}{\text{Number of Equity Shares}}$$

Where,

- Equity shareholder fund = Shareholders' Funds – Preference Share Capital

## Dividend payout ratio

Dividend payout ratio refers to the proportion of earning that is distributed to the shareholders. This reflects company's dividend policy and growth in owner's equity. It is calculated as:

$$\text{Dividend Payout Ratio} = \frac{\text{Dividend per share}}{\text{Earning per Share}}$$

## Price / Earning ratio (P/E Ratio)

P/E Ratio reflects investor's expectation about the growth in the firm's earnings and reasonableness of the market price of its shares. P/E Ratio varies from industry to industry and company to company in the same industry depending upon investor's perception of their future. It is computed as:

$$\text{P/E Ratio} = \frac{\text{Market Price of Share}}{\text{Earning per Share}}$$

## Leverage Ratios:

Leverage or *capital structure* ratios are calculated to test the long-term financial position of a firm.

### Capital Gearing Ratio

The capital-gearing ratio is described as the relationship between equity share capital including reserves and surpluses to preference share capital and other fixed interest bearing loans.

$$\text{Capital Gearing Ratio} = \frac{\text{Equity share capital + Reserves and Surpluses}}{\text{Preference share capital + Long term debt bearing fixed interest}}$$

- Less than one means highly geared
- More than one means low geared
- Gearing should be kept in such a way that the company is able to maintain a steady rate of dividend.
- Borrowing is a cheap source of funds for many companies but a highly geared company is considered a risky investment by the potential investors because such a company has to pay more interest on loans and dividend on preferred stock.

## Advantages of Ratio Analysis

- Helps in Identification of problem areas.
- Simplifies complex figures and establish relationships.
- Helps to understand efficacy of decisions.

## Limitations of Ratio Analysis

- They can identify the problem but do not provide any solution.
- Lack of standardised definitions.
- Lack of universally accepted standard levels
- Ignores Qualitative or Non-monetary Aspects

- Forecasting is not feasible.
- This also suffers from reliability and limitations of Accounting Data
- Few ratios based on unrelated figures

# Working Capital Management

Every Company makes investment in fixed and current assets. Fixed assets like e.g., plant and machinery, land and building, vehicles, etc, remains in the business for more than one year. On the other hand, Current assets like inventories, debtors, bills receivables, etc. get converted into cash or cash equivalents within one year. Some part of these current assets, are usually financed through short-term sources, i.e., current liabilities. The rest is financed through long-term sources and is called Net Working Capital.

*Net Working Capital (NWC) = Current Assets (CA) - Current Liabilities (CL)*

Thus, net working capital may be defined as the excess of current assets over current liabilities.

Working Capital Management is a process of managing short-term assets and liabilities. It makes sure that a firm has sufficient liquidity to run its operations smoothly.

## Components of Working Capital:

As clear from above, WC includes both current assets & current liabilities:

**Current Assets**

- Current Assets are short-term assets either in form of cash or a cash equivalent which can be converted to cash within 12 months.
- Typical current assets include:
    - Cash and Cash equivalents,
    - Short-term investments (marketable securities),
    - Accounts receivable,
    - Stock inventory,
    - Supplies

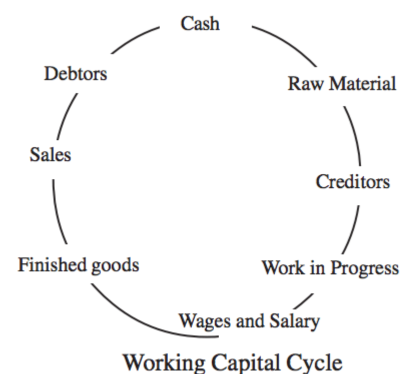
**Current Liabilities**

- Current Liabilities include payment obligations, which are due for payment within 1 year.
- Current Liabilities include:

- Creditors
- Bills Payable
- Bank Overdraft
- Unpaid Expenses
- Dividend Payable
- Income Tax Payable
- Short-term Credit

## Working Capital Cycle

Most of the amount invested in current assets is continuously recovered through realisations of debtors and cash sale of goods, and is re-invested in current assets. It keeps on revolving from cash to current assets and back again to cash. For this reason, it is also known as *circulating capital*.




Working Capital Cycle

## Factors Influencing Working Capital:

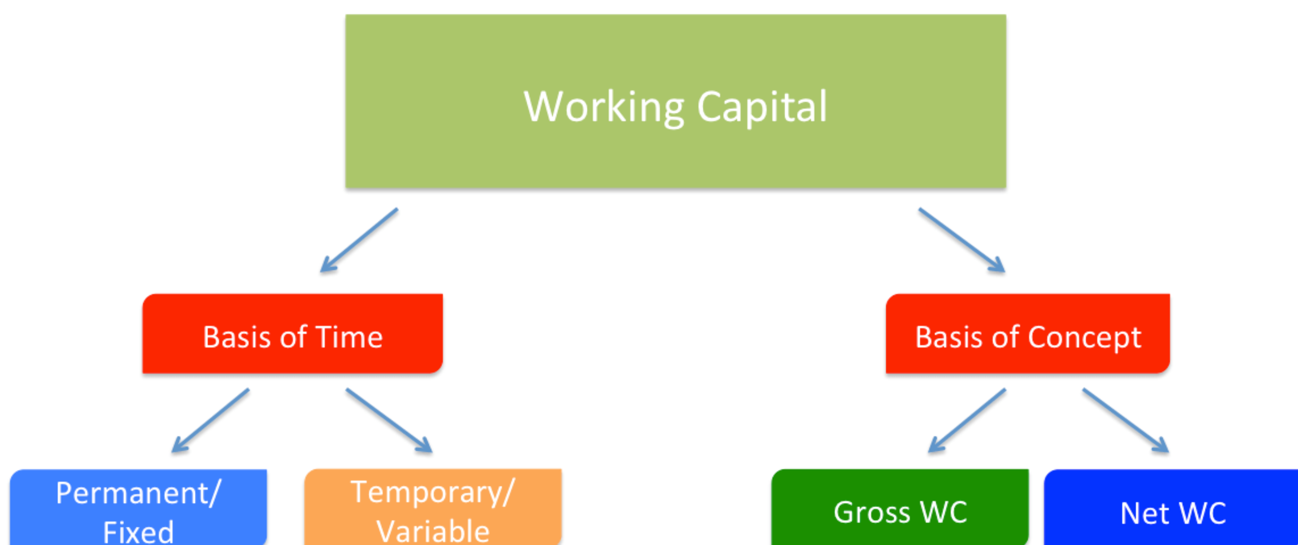
**Internal Factors:**

- Nature of Business
- Scale of Operations / Size of Business
- Production Cycle
- Credit Policy
- Availability of Credit
- Operating Efficiency
- Availability of raw materials
- Growth Prospects

**External Factors:**

- Business Cycle
- Changes in Technology
- Seasonal factors
- Inflation
- Taxation Policy
- Level of Competition

## Kinds of Working Capital:




## Gross Working Capital

- Gross WC is the sum of all of a company's current assets (assets that are convertible to cash within a year or less).
- It includes assets such as cash, accounts receivable, inventory, short-term investments and marketable securities.

### Net Working Capital

- Gross working capital or current assets, less current liabilities equate to Net Working Capital.

### Permanent Working Capital

- A part of WC is of a permanent nature because depending on the volume of business certain amount of cash, debtors and stock-in-trade shall always be maintained by every firm.
- This part is known as permanent or fixed Working Capital.
- It must always be financed through long-term sources.

### Variable Working Capital

- The remaining part of the WC requirement varies from period to period on account of fluctuations in the volume of business and is called fluctuating or variable WC.
- This part is usually financed through short-term sources like bank overdraft, trade creditors, bills payable, etc.

## Importance of Working Capital

Working capital is a prevalent metric for the efficiency, liquidity and overall health of a company.

- Sufficient WC enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.
- Adequate WC management helps a firm to survive through a crisis or ramp up production in case of an unexpectedly large order.
- It helps to operate the business smoothly by making payment of short-term liabilities. This allows purchase of raw materials and payment of salary, wages and overhead can be made without any delay, which in turn, improves solvency of the business by providing uninterrupted flow of production.
- Quick payment of credit purchase of raw materials ensures the regular supply of raw materials fro suppliers and improves the credit rating of the firm.

- Adequate WC, high solvency and good credit rating also helps to arrange loans from banks and financial institutions in easy and favourable terms.
- Optimal WC helps in improving operating efficiency of the firm.

# Responsibility Accounting

Responsibility accounting is a part of cost & management accounting and has emerged as a widely accepted practice within budgeting. In this system, the responsibility is delegated on a responsibility centre and accounting for the responsibility is on the basis of performance of the responsibility centre.

**Definition:**

According to Charles T. Horngren, "Responsibility accounting is a system of accounting that recognizes various decision centres throughout an organisation and traces costs to the individual managers who are primarily responsible for making decisions about the costs in question".

Alternatively, responsibility accounting is a system that involves identifying responsibility centers and their objectives, developing performance measurement schemes, and preparing and analyzing performance reports of the responsibility centers. It involves gathering & reporting, costs & revenues by areas of responsibility.

## Responsibility Centers

A responsibility center is a part or subunit of a company in which the manager has some degree of authority and responsibility.

### Cost or Expense Center

It is the subunit of the organization that has control over cost only. It has no control over revenues and investments and so are evaluated using variance analysis of costs. Examples include: production department, maintenance department, accounting department, legal department, HR department etc.

### Revenue Center:

Revenue center has control over revenue generation, but has no control over costs and investment, e.g. the sales and marketing department. Revenue centers are evaluated using variance analysis of revenues.

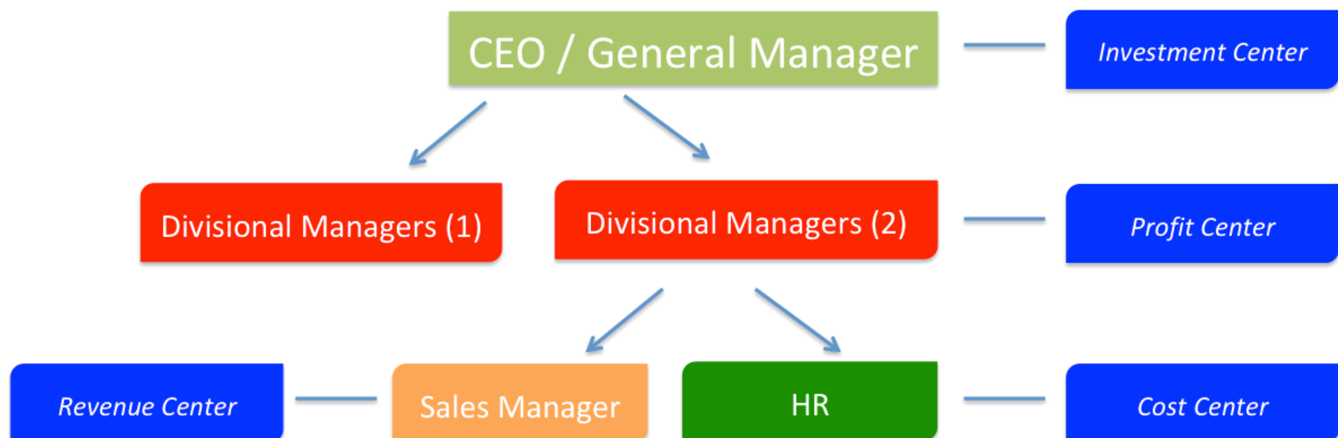
### Profit Center:

These centers have control over both revenues and costs. For example: a production department may be treated as a profit centre on the basis that it "sells" goods to the sales department. The accounting system can be so designed as to record revenues and profit on a notional basis immediately when the completed products are sent to the godown or sales department.

### Investment Center:

It is the subunit that has control over revenues, costs, and investments (assets such as receivables, inventory, fixed assets, etc.). Since investment centers are given authority to decide over its investments, it operates like a separate entity. Investment centers are evaluated using different profitability measures such as return on investment, residual income, economic value-added, and others.

#### Relationship between organization structure & responsibility centers:




### Stages of Responsibility Accounting

1. Fixing up standards or estimates based on responsibilities.
2. Evaluate the performance.
3. Analyze the variances and reporting them to top management.
4. Taking corrective action and communicating to the concerned persons.

## Uses of Responsibility Accounting

Responsibility accounting is an important aid in the management control process. Few of its advantages or uses are:

- **Performance Evaluation:** With responsibility localized, it is possible to evaluate individual managers on a cost basis through responsibility accounting.
- **Delegating Authority**: Responsible accounting allows for delegation & decentralization, which is necessary for large firms/corporations to function.
- **High Morale and Efficiency**: Responsibility accounting allows for rewards to be linked to the performance, this acts as a great morale booster.
- **Promotes Management by Objectives**: The heads of divisions and departments are assigned definite objectives before the commencement of the period. They are held answerable for the attainment of these targets. Such a system helps in establishing the principle of management by objectives (MBO).
- **Promotes Management by exception**: Responsibility accounting also promotes management by exception as here also attention is paid to matters that materially deviate from established standards.
- **Corrective Action**: Under responsibility accounting, as areas of authority are clearly laid down, such corrective action becomes easier.

# Social Accounting

Business is a socio-economic activity; it draws its inputs from the society and so owes certain degree of responsibility towards its welfare. Hence, there is need of an accounting method that focuses on the study of variables related with social results in respect of socio economic non-monetary outcome along with economic outcomes.

Social Accounting incorporates social and environmental impact into traditional financial accounting. It is a method by which a firm seeks to place a value on the impact on society of its operations. Social Accounting is the process of measuring, monitoring, and reporting to stakeholders the social and environmental effects of an organization's actions.

## Features of Social Accounting

- Social Accounting is an expression of a company's social responsibility.
- It is related to use of social and community resources.
- Lays emphasis on Social costs are resulting social benefits.
- Determines desirability of a firm in society.
- Application of accounting in Social Science.

## Need & Importance of Social Accounting

- Social Accounting helps management fulfill its social obligations and inform its members, government and general public.
- It provides management a feedback on its efforts and policies aimed at welfare of the society.
- Social accounting is also necessary from the viewpoint of public interest group, social organisation, investors and government bodies.
- Due to changing public need, social expectations of business have also changes. Social Accounting helps firm keep track of these expectations of society.
- Social accounting helps to determine whether company is properly utilizing their natural resources or not. It can identify and measure the net social contribution of an individual firm consisting of cost and benefits internalized to the firm and externalities affecting social system.

# Budgeting & Budgetary control

The efficiency of a management depends upon the attainment of the objectives of the enterprise. It is effective when it achieves the objectives with minimum effort and cost. One systematic approach for attaining effective management performance is *profit planning and control or budgeting*. Budgeting is an important control technique of cost control.

## Definitions:

Budgeting is a process, which includes two important functions: Budget and Budgetary control. Budget is a planning function and budgetary control is a controlling system or technique.

### Budget:

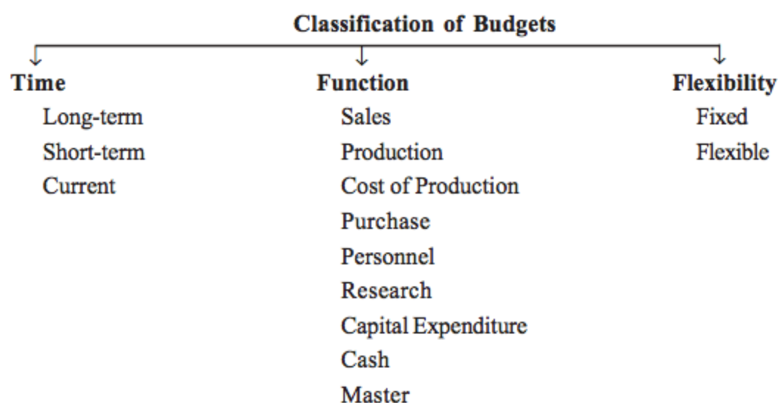
In simple terms, budget is a statement of plans expressed in quantitative, usually monetary terms, covering a specific period of time, usually one year. It can also be defined as, "Budget is financial and/or quantitative statement, prepared prior to a defined period of time for the purpose of attaining given objectives."

### Budgetary Control:

Budgetary control is a system and a technique, which uses budgets as a means of controlling all aspects of the business and is designed to assist management in the allocation of responsibility and authority, and to develop basis of measurement to evaluate performance and efficiency of the operations. It is the process of comparing actual output with the budgeted outputs to either secure objectives of the policy or to provide a basis for its revision.

## Classification of Budgets

Budgets can be classified into different categories on the basis of time, functions or flexibility. These are:




## Classification According to Time:

The budget, on the basis of time, may be classified as:

- Long-term budget,
- Short-term budget,
- Financial budget or Current budget.

### Long-Term Budget:

- A budget designed for a long period of time, generally is of 5 to 10 years.
- These budgets are concerned with planning of the operations of a firm over a considerably long period of time.

### Short-Term Budget:

- The budget prepared for a period of less than 5 years is a short-term budget. Generally short-term budgets are prepared for a period of one to two years.
- They are generally prepared in terms of physical as well as in monetary units.

### Current Budget:

- The budget prepared for a period of a week, a month, or a quarter is termed as a current budget.
- They are essentially short-term budgets adjusted to current conditions or prevailing circumstances.

## Classification According to Function:

Budgets can be classified on the basis of functions, they are meant to perform. Like:

### Sales Budget:

This is the most important budget on which all other budgets are based. The sales manager is responsible for preparation and execution of the budget. The budget forecasts total sales in terms of quantity, value, items, periods, areas etc.

### Production Budget:

The budget is basically based on sales budget. It forecasts quantity of production in terms of items, periods, areas, etc. The works manger is responsible for the preparation of overall production budget and departmental works manager is responsible for departmental production budgets.

### Cost of Production Budget:

It forecasts the cost of production. Separate budgets are prepared for different elements of costs such as direct materials budget, direct labour budget, factory overheads budget, office overheads budget, selling and distribution overhead budget, etc.

### Purchase Budget:

The budget forecasts the quantity and value of purchases required for production. It gives quantity-wise and period-wise information about the materials to be purchased. It correlates with sales forecast and production planning.

### Personnel Budget:

The budget anticipates the quantity of personnel required during a period for production activity. This may be further split up between direct and indirect personnel budgets.

### Research Budget:

The budget relates to the research work to be done for improvement in quality of the products or research for new products.

### Capital Expenditure Budget:

The budget provides a guidance regarding the amount of capital that may be required for procurement of capital assets during the budget period.

#### Cash Budgets:

The budget is a forecast of the cash position, for a specific duration of time for different time periods. It states the estimated amount of cash receipts and cash payments and the likely balance of cash in hand at the end of different periods.

#### Master Budget:

It is a summary budget incorporating all functional budgets in a capsule form. It interprets different functional budgets and covers within its range the preparation of projected income statement and projected balance sheet

#### Appropriation Budget

When budgets are prepared only for a particular activity/work, it is called Appropriation Budget. These budgets are related to only one activity/work and on completion of that particular activity the purpose of this budget end.

### Classification According to Flexibility

Budget can also be classified in the following categories:

#### Fixed Budget:

- A budget prepared on the basis of a standard or a fixed level of activity is called a fixed budget.
- It does not change with the change in the level of activity.
- If the output and sales do not fluctuate from year to year or if an accurate prediction of the same can be made, a fixed budget can be prepared.

#### Flexible Budget:

- A budget designed in a manner so as to give the budgeted cost of any level of activity is termed as a flexible budget.
- Such a budget is prepared after considering the fixed and variable elements of cost and the changes that may be expected for each item at various levels of operation.

**Difference between Fixed and Flexible Budget:**

| Fixed Budget | Flexible Budget |
|---|---|
| • Assumes that conditions would remain static. | • Designed to change according to a change in the level of activity. |
| • Costs are not classified according to fixed, variable and semi-variable. | • Costs are classified according to nature of their variability. |
| • Comparison of actual results difficult if production level changes. | • Comparisons are realistic since the changed plan figures are placed against actual ones. |
| • Cost cannot be ascertained if there is a change in the circumstances. | • Costs can easily be ascertained at different levels of activity |
| • Inflexible and remains the same irrespective of the volume of business activity. | • It can be suitably recast quickly to suit changed conditions. |

## Approaches to Budgeting

Various organizations use different approaches to budgeting. Few of the approaches include:

- Incremental Budgeting
- Formula Budgeting
- Program Budgeting
- Performance Budgeting
- Planning Programming Budgeting System (PPBS)
- Zero-Based Budgeting (ZBB)

### Incremental Budgeting

**Incremental budgeting** means making changes to the existing budget for arriving at the new budget. Hence, this approach is also called as historical budgeting. In this approach, a budget is prepared using a previous period's budget or actual performance as a basis with incremental amounts added for the new budget period. The budget is prepared with a small increase of say 5 or 10 per cent for each major item of expenditure of the previous year's allocation, assuming that all current programmes are as good and necessary.

The advantage of this method of budgeting is that it is relatively easy to prepare, present and understand. To some extent it also ensures that the funds provided are spent for the purpose stated. However, one primary disadvantage is that, this method does not go into the performance evaluation of activities and services and also does not suggest any future projections.

### Formula Budgeting

In **Formula Budgeting**, budgets are based on some pre-determined formula. The formulae are used for financial estimation as well as budget justification. This appears to be a broad and quick method and hence saves lot of time. But it does not account for finer variations in respect of each library and its customers and services.

### Program Budgeting

Program Budgeting approach seeks to more effectively manage fiscal resources by identifying and prioritizing institutional goals and providing funding toward those programs which best support the institution's goals and objectives.

### Performance Budgeting

Performance budgeting approach is similar to program budgeting but the emphasis shifts from programs to performance. In this approach, the expenditure is based on the performance of activities and it lays stress upon operational efficiency. This method requires careful accumulation of quantitative data on all the activities over a period of time. Management techniques such as cost-benefit analysis are used to measure the performance and establish norms.

### Planning Programming Budgeting System (PPBS)

PPBS is an extension of program budgeting and involves systems analysis, operation research and other cost-effectiveness processes to provide a more systematic and comprehensive comparison of costs and benefits of alterative approaches to a policy goal or program objective.

### Zero-Based Budgeting (ZBB)

As the name suggests, Zero based budgeting, assumes a budget of 'zero' for each program/activity until one convinces the appropriating authority that the program/activity is worthwhile and deserving support at a specified level.

This approach has similarity with PPBS and is quite opposite to incremental budgeting approach.

## Objectives of Budgeting

The objectives of the budgeting are:

- To control the cost and increase revenue and thereby maximise profit, so as to know profit at different level of production and best production level.
- To run production activities in efficient manner by lay behind the chances of interruption in production process due to lack of material, labour etc.
- To bring about coordination between different functions of an enterprise, which is essential for the success of any enterprise.
- To incorporate measures of calculation of deviations from budgeted results and analysis of the same, whereby responsibility can be fixed and controlling measures/action can be taken.
- To ensure that actions taken are in accordance with the targets and if required, to take suitable corrective action.
- To predict short-term and long-term financial positions for better financial position and management of working capital in better manner.

## Advantages of Budgeting

The following are the advantages of budgeting:

- Budgeting leads to maximum utilisation of resources with a view to ensuring maximum return.

- Budgeting increases the awareness about business enterprise at all levels of management in the process of fulfillment of targets.
- Budgeting is helpful in better co-ordination between different functions/activities of business/organization and hence, better understanding between different functions.
- Budgeting is a process of self-examination and self-criticism, which is essential for the success of any organization.
- Budgeting makes a path for active participation and support of top management
- Budgeting enables the organization to prefix its goals and push up the forces towards their achievements.
- Budgeting stimulates the effective use of resources and creates an attitude of cost consciousness throughout the organization.
- It creates the bases for measuring performances of different departments as well as different functions of the production activities.

## Limitations of Budgeting:

Budgeting has the following limitations:

- Forecasting, planning or budgeting is not an exact science and a certain amount of judgement is present in any budgeting plan.
- The basic requirement for the success of budgeting is the absolute support and enthusiasm provided by the top management. If it is lacking at any time, the whole system will collapse.
- Budgeting should be followed up by effective control action, this is often lacking in many organizations, which defeats the very purpose of budgeting.
- The installation of budgeting system is an elaborate process and it takes time.
- It is only a source and not a target and hence, cannot take the place of management, while it is only a tool of management. Thus, the budget should be regarded not as a master, but as a servant.
- It requires the experienced man-power, technical staff, analysis, control etc., hence, it is costly affair.

# Auditing

Definition | Objectives | Types | Advantages

The system of accounting and auditing of slate revenue and expenditure is believed to have existed in India under Maurya and Hindu Kings. Kautilya in his *Arthashastra* had given details regarding accounting and auditing of state finances. According to him, "all undertakings depend on finance. Hence, foremost attention shall be paid to the treasury." He had also mentioned various frauds and embezzlements and prescribed punishments for the same.

The word 'audit' is derived from the Latin word 'audire' which means 'to hear'. In the olden days whenever the proprietors of a business concern suspected fraud, they appointed a person to check the accounts and to hear the explanations given by the persons responsible for keeping the accounts.

In modern period, Auditing, has its origins in industrial revolution. The industrial revolution resulted increase of trading and industrial operations which required huge amounts of capital, which was not possible for small entrepreneurs due to their limited resources. This gave rise to new form of organisation, where, the shareholders contributed capital and had no control over the day-to-day working of the organisation. As such, the need arose for appointing an independent person who would check the accounts and report to the shareholders on the accuracy of the accounts and the safety of their investment. This gave rise to profession of Auditing.

## Definition of Auditing:

Auditing is the examination of accounting books & documentary evidences, through which an independent auditor finds out accuracy of figures & marks report on balance sheet and other financial statement. According to Montgomery, a celebrated author, "auditing is a systematic examination of .. the books and records of a business or the organisation in order to ascertain or verify and to report upon the facts regarding the financial operation and the result thereof."

## Principles of Auditing:

Auditing is characterized by reliance on a number of principles. These make the audit an effective and reliable tool in support of management policies and controls, providing information on which an organisation can act to improve its performance. Some of the underlining principles of auditing include:

- **Skills, Competence:** Such persons who are trained, experienced and efficient should perform the work of audit.
- **Ethical Conduct & Confidentiality:** Trust, integrity, confidentiality and discretion are essential to auditing.
- **Principle of Full Disclosure:** The principle implies that the auditor should make full disclosure of his findings in respect of the audit work performed by him. There is obligation to report truthfully and accurately audit findings, audit conclusions and audit reports.
- **Principle of Objectivity:** Auditing must be conducted objectively. The auditor must be free from bias, emotions: Due professional care needs to be taken for application of diligence and judgment in auditing.
- **Principle of Independence**: Independence is the basis for the impartiality of the audit and objectivity of the audit conclusions.
- **Principle of Materiality**: This principle indicates that more attention must be paid to those items, which are materially important, and in the area where the risk of error and fraud is relatively more.
- **Evidence-based approach**: The audit process should follow a rational method for reaching reliable and reproducible audit conclusions.

## Objectives of Auditing

The objectives of an audit may broadly be classified as Primary objectives and Secondary objectives.

**Primary Objective**

- The main purpose of audit is to determine the reliability and accuracy of the financial statements and the supporting accounting records for a particular financial period.

**Secondary Objectives**

- Detection and Prevention of Errors
- Detection and Prevention of Frauds

## Types of Errors:

**Errors of Principle:** Such errors are committed when some fundamental principle 1 '.. bf accounting is not properly observed in recording a transaction

**Clerical Errors:** Such an error arises on account of wrong posting.

- **Errors of Commission**: When amount of transaction or entry is incorrectly recorded in accounting books/ledger.
- **Errors of Omission**: When the transactions are not recorded in the books of original entry or posted to the ledger.
- **Compensating Errors**: When two or more errors are committed in such a way that the result df these errors on the debits and credits is nil.
- **Error of Duplication**: When a transaction is recorded more than once.

## Types of Frauds

**Misappropriation of Cash**: It is very common in big firms and can take place usually through:

- Suppressing receipts
- Recording less amount than the actual amount of receipt
- Fictitious payments
- Recording more amount than the actual amount of payment.

**Misappropriation of Goods:** This is common, especially, when goods are of high value but not bulky.

**Falsification or Manipulation of account**: Accounts may he manipulated by those responsible persons who are in top management of the organisation in order to achieve certain specific objectives.

**Window dressing:** When accounts are prepared in such a way that apparently on the face of it, they indicate a much better picture than actually what they are.

**Secret Reserves:** When accounts are prepared in such a way that apparently on the face of it, they disclose a worse picture than actually what they are.

## Differences between Errors & Frauds

| Errors | Frauds |
|---|---|
| Reason of occurrence is ignorance | It is made deliberately |
| Unplanned activity | Planned Activity |
| Generally, not considered an offence | Considered as Offence |
| Can cause undue profit, loss or even no impact | These always result in loss |
| Very easy to detect | Difficult to identify |

## Types of Audits

| Basis | Types |
|---|---|
| Scope | • **Specific Audit** – Performance Audit, Efficiency Audit, Cash Audit, Receipt Audit<br>• **General Audit** – It can be an internal or an independent Audit. |
| Activities | • Commercial<br>• Non-Commercial |
| Organization | • Government<br>• Private |
| Legal | • **Statutory/Required** – Banking Companies, Trust, Company, Corporations, Co-operative societies.<br>• **Non-statutory/ Voluntary** – Individual, Trader, etc. |

| | |
|---|---|
| Time period | • Periodical/ Interim<br>• Continuous |
| Who conducts | • Internal Audit<br>• Independent Audit |

## Advantages of Auditing:

- It safeguards the financial interests of persons who are not associated with the management of the organisation e.g. partners or shareholders.
- It acts as a moral check on employees from committing defalcations or embezzlement.
- Auditing statements of accounts are helpful in settling of taxes, negotiating loans etc.
- Auditing accounts facilitates settlement among partners.

# Internal Controls

Definition | Forms | Types | Objectives | Limitation

Internal Control system is one of the basic and essential factors for efficient and effective management. It covers both financial or non-financial aspects of management in an organisation.

## Definition of Internal Control in accounting & auditing:

Internal Controls are methods put in place by an organisation to ensure the integrity of financial and accounting information, meet operational and profitability target and transmit management policies throughout the organisation.

Internal controls are the process designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

a. Reliability of financial reporting,

b. Effectiveness and efficiency of operations, and

c. Compliance with applicable laws and regulations.

## Forms of Internal Controls

There are two forms of Internal Controls that help in ensuring correct and reliable records of transactions and operational efficiency. These are:

- **Accounting Control**
  - It ensures correct and reliable records of transactions in conformity with normally accepted accounting principles
- **Administrative Control**
  - These are wide in scope and comprise of the plan of organization that are concerned mainly with 'operational efficiencies'.

## Types of Internal Controls

1. **Detective:** Designed to detect errors or irregularities that may have occurred.
2. **Corrective:** Designed to correct errors or irregularities that have been detected.
3. **Preventive:** Designed to keep errors or irregularities from occurring.

## Internal Control Objectives

- **Authorisation**: To ensure that all transactions are authorized and approved by a responsible associate before that transaction is recorded
- **Completeness**: To ensure that records are not any missing entries
- **Accuracy**: To ensure that transactions have been entered correctly and in a timely manner
- **Validity**: To ensure that transactions are lawful in nature and do not contain any misrepresentations
- **Physical Safeguards & Security**: To ensure that that physical assets are safely guarded and only authorized personnel may access them.
- **Error Handling**: To ensure that when errors are discovered management is notified and the errors are corrected in a timely manner
- **Segregation of Duties**: To ensure that no one individual is reporting, collecting, and processing a single transaction.

## Components of Internal Control

Under the (Committee of Sponsoring Organizations of the Treadway Commission) COSO model a system of internal controls is a process that is made up of five interrelated components. These are:

- Control environment
- Risk Assessment
- Control Activities
- Information and communication
- Monitoring

## Difference Between Internal Control and Internal Audit

**Internal control** is a system that comprises of control environment and procedure, which help the organization in achieving business objectives.

On the other hand, **internal audit** is an activity performed by an agency or department created by the management of the organisation, to ensure that internal control system implemented in the organization are effective.

## Limitations of Internal Controls:

Some limitations inherent in all internal control systems include:

1. **Judgment:** The effectiveness of controls is limited by human judgment.
2. **Breakdowns:** Even well designed internal controls can break down at times. Sometimes due to new technology or due to complexity of computerized information systems.
3. **Management Override:** High level personnel may be able to override prescribed policies and procedures for personal gain or advantage.
4. **Collusion:** Control systems can be circumvented by employee collusion.

# Social Audit

Social audit as a term was used as far back as the 1950s. However, in the last decade, the term has acquired new relevance in India. It is generally believed today that it is the duty of the privately owned enterprise to ensure that it does not adversely affect the life of the community in which it operates. It is also expected that businesses should make positive contribution to the life of the community. The increasing demand for socially oriented programmes and disclosure of environmental effects of organisational behaviour has created pressure for adopting some kind of social auditing procedure.

## Background

*Kreps Theodore J* is regarded as the founding father of social audit concept. In India, TISCO was the first company to set up a Social Audit Committee for conducting social audit of its work under the chairmanship of Justice S.P. Kotwal, and Prof. Rajini Kothari and Prof. P.G. Mavalankar as members. This committee was entrusted with the task of "examining and reporting whether, and the extent to which, the TISCO has fulfilled the objectives contained in Clause 3A of its Articles of Association regarding its social and moral responsibilities to the consumers, employees, shareholders, and the local community".

## Concept of Social Audit

In general, Social Audit refers to a process for measuring, understanding, reporting and improving the social performance of an activity of an organization. Social Audit has been defined as a process of identification and examination of the activities of the firm in order to assess, evaluate, measure and report their impact on the immediate social environment.

## Salient Features of Social Audit

- Areas for social audit include any activity which has a significant social impact. Example: Social Audit of activities of an organisation affecting surrounding environmental quality.
- It can determine only what an organization is doing in social areas, not the amount of social good that results from these activities. It is a process audit rather than an audit for results.
- Social performance is difficult to audit because most of the results of social activities occur beyond the organisation's gate and it cannot get precise data from outside sources.

- Both the quantitative and qualitative data are used in the social audit. The qualitative data is often used to supplement the quantitative data.
- No professional standards and qualifications are prescribed for a social auditor.

## Key Principles of Social Audit

Eight specific key principles have been identified from Social Auditing practices around the world.

1. **Multi-Perspective/Polyvocal:** Aim to reflect the views (voices) of all those people (stakeholders) involved with or affected by the organization/department/ programme.
2. **Comprehensive:** Aims to (eventually) report on all aspects of the organisation's work and performance.
3. **Participatory:** Encourages participation of stakeholders and sharing of their values.
4. **Multidirectional:** Stakeholders share and give feedback on multiple aspects.
5. **Regular:** Aims to produce social accounts on a regular basis so that the concept and the practice become embedded in the culture of the organisation covering all the activities.
6. **Comparative:** Provides a means, whereby, the organisation can compare its own performance each year and against appropriate external norms or benchmarks; and provide for comparisons with organisations doing similar work and reporting in similar fashion.
7. **Verification:** Ensures that the social accounts are audited by a suitably experienced person or agency with no vested interest in the organisation.
8. **Disclosure:** Ensures that the audited accounts are disclosed to stakeholders and the wider community in the interests of accountability and transparency.

## Objectives of Social Audit

- Promote transparency and accountability in the implementation of the programme.
- Involve all stakeholders
- To monitor social and ethical impact and performance of the organization;
- To provide a basis for shaping management strategy in a socially responsible and accountable way and to design strategies;

- To facilitate organizational learning on how to improve social performance;
- To facilitate the strategic management of institutions (including concern for their influence and social impact on organizations and communities);
- To inform the community, public, other organizations and institutions about the allocation of their resources (time and money); this refers to issues of accountability, ethics (e.g., ethical investment) etc.

## Advantages of social audit

- Helps to assess achievement of social objectives of an organisation.
- Encourages greater concern for social performance throughout the organisation.
- Provides a recognized method for bringing the social point of view to the attention of management
- Provides data for comparing effectiveness of the different types of programmes.
- Develops human resources and social capital
- Helps the organization to build up the image and reputation in public domain.

## Limitations

- Complicated & time consuming
- No clear methodology
- Difficult define the scope
- Subjective
- Lack of qualified trainers
- Limited practical utility

# Performance & Efficiency Audit

## Performance Audit

A performance audit is used to examine how well a process or activity is performed. It can check factors such as the amount of time incurred to complete an activity, the cost-effectiveness of a process, the transaction error rate, the effectiveness of internal controls, the speed of the process, and how well it supports the objectives of the business.

Performance audit is usually an independent assessment that a scheme, program or an organization operates *economically, efficiently and effectively*. Performance Audit is invariably referred to as Value-for-money audit or Operational audit.

### Objectives of Performance Audit:

Three elements often referred to as the three E's are classified as main objectives of performance audits. These are:

#### Economy

- Performance audit assess that if measures have been taken to acquire resources of the right quality, in the right quantity, at the right time and place at the lowest possible cost.

#### Efficiency

- Performance audit makes sure that the organization/program/scheme is using their resources the best way possible.
- Efforts have been undertaken to achieve the optimal relationship between output of services or other results and the resources used to produce them

#### Effectiveness

- Checks whether the operation activities are meeting objectives, operational goals and producing other intended effects.

Besides these, performance audit provides management with information on adequate and inadequate management measures by means of a structured reporting process. It also contributes to accountability and transparency.

## Efficiency Audit

An economy and efficiency audit, or simply efficiency audit, focuses on analysis of the procurement, maintenance and implementation of resources. It is concerned with the utilization of resources in economic and most remunerative manner to achieve the objectives of the concern department/organization. It comprises of studying the plans of department/organization, comparing actual performance with plans and investigating the reasons for variances to take remedial action.

### Objectives & Purpose of Efficiency Audit

- To make sure that the organization has done optimum utilization of the investments in the organization.
- To identify the operational weaknesses by a review of the organization's environment.
- To check that the organization channels the investment in their most profitable ventures.

### Parameters of Efficiency Audit

The parameters for measuring efficiency include the following:

- Overall return on capital,
- Capacity utilization,
- Optimum utilization of men, machines and materials,
- Export performance and import substitution,
- Liquidity position
- Payback period