UNIT 3 FINANCIAL MANAGEMENT

Structure

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3.1 INTRODUCTION

Finance is an important function is any business as money is required to support its various activities. It has given birth to "Financial Management" as a separate subject. Financial management is of recent origin and has not acquired a body of knowledge of its own. It draws heavily on "Economics" for its theoretical concepts. In the early half of the last century, the job of financial management was largely confined to the acquisition of funds. But, as business firms continued to expand, their markets and they became larger and more diversified, greater control of financial operation became highly important. Thus, now the scope of financial management is very wide and it should not be considered to be merely restricted for raising of capital. It also covers other aspects of financing such as assessing the needs of capital, raising sufficient amount of funds, cost of financing, budgeting, maintain liquidity, lending and borrowing policies, dividend policies and so on. Finance is considered as the life-blood of any business. It is defined as the provision of money at the time it is needed. All the plans of a businessman would remain mere dreams unless adequate money is available to convert them into reality. Financial management is very important to every type of organization. It refers to that part of managerial activity concerned with the procurement and utilization of funds for business purposes. Howard and Upton have defined the financial management as it involves the application of general management principles to financial operations.

Therefore, financial management is concerned with broadly four tasks. The first and foremost is estimation of the fixed and working capital requirements; secondly, formulation of capital structure; thirdly, procurement of fixed and working capital; and fourthly, management of earnings.

After studying this unit, you will be able to:

- describe financial management including its objectives, functions, significance, approaches and goals;
- define the concept, objectives, functions, basis and branches of accounting as well as make distinction between book-keeping and accounting;

- explain the objectives, principles, advantage and limitations of auditing; also classify the different types of auditor and state the qualities of an auditor; and
- discuss the concept of budgeting and explain the objectives, processes, advantages and limitations of budgeting.

3.2 FINANCIAL MANAGEMENT

Financial management is a managerial activity concerned with planning and controlling of the firm's financial resources to generate returns on its invested funds. The raising and using of capital for generating funds and paying returns to the suppliers of capital is the finance function of a firm. Thus, the funds raised by the company will be invested in the best investment opportunities, with an expectation of future benefits. Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise. Scope of financial management includes:

- **Investment decisions:** includes investment in fixed assets (called as capital budgeting). Investments in current assets are also a part of investment decisions called as working capital decisions.
- **Financial decisions:** relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.
- **Dividend decision:** The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two:
  a) Dividend for shareholders- dividend and the rate of it has to be decided.
  b) Retained profits- amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

3.2.1 Objectives of Financial Management

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be:

1. To ensure regular and adequate supply of funds to the concern.
2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
4. To ensure safety on investment, i.e., funds should be invested in safe ventures so that adequate rate of return can be achieved.
5. To plan a sound capital structure- there should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

3.2.2 Functions of Financial Management

1) **Estimation of capital requirements:** A finance manager has to make estimation with regards to capital requirements of the company. This will

depend upon expected costs and profits and future programmes and policies of a concern. Estimations have to be made in an adequate manner which increases earning capacity of enterprise.

2) **Determination of capital composition:** Once the estimation have been made, the capital structure have to be decided. This involves short- term and long- term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.

3) **Choice of sources of funds:** For additional funds to be procured, a company has many choices like-

   a) Issue of shares and debentures

   b) Loans to be taken from banks and financial institutions

   c) Public deposits to be drawn like in form of bonds.

   Choice of factor will depend on relative merits and demerits of each source and period of financing.

4) **Investment of funds:** The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.

5) **Disposal of surplus:** The net profit decision has to be made by the finance manager. This can be done in two ways:

   a) Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.

   b) Retained profits - The volume has to be decided which will depend upon expansion, innovational, diversification plans of the company.

6) **Management of cash:** Finance manager has to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintenance of enough stock, purchase of raw materials, etc.

7) **Financial controls:** The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.

3.2.3 Significance of Financial Management

Financial management occupies a significant place because it has an impact on all the activities of a firm. Its primary responsibility is to discharge the fiancé function successfully. No one can think of any business activity in isolation from its financial implications. The management may accept or reject a business proposition on the basis of its financial variabilities. In other words, the live executive who are directly involved in the decision-making process should give supreme importance for financial consideration. The finance function centres round the management of funds, raising of funds and the using them effectively.

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But the dimensions of financial management are much broader than mere procurement of funds. Planning is one of the primary activities of the financial manager. It helps him to obtain funds and the best time in relation to their cost of the conditions under which they can be obtained. However, Financial Management should not be taken as a profit extracting device. It implies a more comprehensive concept than the simple objective of profit-making. Its broader mission should be to protect the interest of the different sections of the community undisturbed and protected through maximizing the value of the firm.

The concepts of financial management are applicable to an organization, irrespective of its size, nature of ownership and control. They can be applied to any activity of an organization which has financial implication. In the words of Raymond Chambers:

"The term Corporate Financial Management is often used to emphasize the financial management of companies or corporations. Thus, it consists of the decisions relating to: (a) investment – concerned with capital budgeting and current assets management (b) financing-concerned with determining the best financing mix, and (c) dividend-concerned with the solution to the decision of dividend policy."

3.2.4 Approaches to Financial Management

Traditional Approach: Finance involves arrangement of funds required by the business enterprise from and through financial institutions ('from' signifies procurement of loan capital, and 'through' implies the selling of securities by financial institutions). Hence, the traditional approach of financial management focused on 'arrangement of finance' for meeting various financial needs of an enterprise.

Modern Approach: financial management encompasses wider applications, viz., assessment of funds required, effective procurement of those funds through most economical means, and efficient utilization of those funds through profitable investments, as well as cash and liquidity management. To put it in the words of Ezra Solomon, the key questions in financial management of a business enterprise happen to be: "(i) what is the total volume of funds, an enterprise should commit? (ii) What specific assets should an enterprise acquire? (iii) How should the funds required be financed?" These questions, if answered properly, lead to four broad decision areas of financial management, viz., funds requirement decision, financing decision, investment decision, and dividend decision.

3.2.5 Goals of Financial Management

The financial management has to take three important decisions viz. (i) Investment decision i.e., where to invest fund and in what amount, (ii) Financing decision i.e., from where to raise funds and in what amount, and (iii) Dividend i.e., how much to pay dividend and how much to retain for future expansion. In order to make these decisions the management must have a clear understanding of the objective sought to be achieved. It is generally agreed that the financial objective of the firm should be maximization of owner's economic welfare. There are two widely discussed approaches or criterion of maximizing owners' welfare -(i) Profit maximization, and (ii) Wealth maximization. It should be noted here that objective is used in the sense of goal or goals or decision criterion for the three decisions involved.

Profit Maximization: Maximization of profits is very often considered as the main objective of a business enterprise. The shareholders, the owners of the business invest their funds in the business with the hope of getting higher dividend on their investment. Moreover, the profitability of the business is an indicator of the sound health of the organization, because, it safeguards the economic interests of various social groups which are directly or indirectly connected with the company e.g. shareholders, creditors and employees. All these parties must get reasonable return for their contributions and it is possible only when company earns higher profits or sufficient profits to discharge the obligations to them.

Wealth Maximization: The wealth maximization (also known as value maximization or Net Present worth Maximization) is also universally accepted criterion for financial decision making. The value of an asset should be viewed in terms of benefits it can produce over the cost of capital investment. Era Solomon has defined the concept of wealth maximization as follows- "The gross present worth of a course of action is equal to the capitalized value of the flow of future expected benefits, discounted (or as capitalized) at a rate which reflects their certainty or uncertainty. Wealth or net amount of capital investment required to achieve the benefits being discussed. Any financial action which creates wealth or which has a net present worth above zero is a desirable one and should be undertaken. Any financial action which does not meet this test should be rejected. If two or more desirable courses of action are mutually exclusive (i.e., if only one can be undertaken) then the decision should be to do that which creates most wealth or shows the greatest amount of net present worth". In short, the operational objective of financial management is to maximize wealth or net present worth. Thus, the concept of wealth maximization is based on cash flows (inflows and outflows) generated by the decision. If inflows are greater than outflows, the decision is good because it maximizes the wealth of the owners. We have discussed above the two goals of financial management. Now the question is which one is the best or which goal should be followed in decision making. Certain objections have been raised against the profit maximization goal which strengthens the case for wealth maximization as the goal of financial decisions.

Profit Maximization Vs Wealth Maximization

The financial management has come a long way by shifting its focus from traditional approach to modern approach. The modern approach focuses on wealth maximization rather than profit maximization. This gives a longer term horizon for assessment, making way for sustainable performance by businesses.

A myopic person or business is mostly concerned about short term benefits. A short term horizon can fulfill objective of earning profit but may not help in creating wealth. It is because wealth creation needs a longer term horizon Therefore, financial management emphasizes on wealth maximization rather than profit maximization. For a business, it is not necessary that profit should be the only objective; it may concentrate on various other aspects like increasing sales, capturing more market share etc, which will take care of profitability. So, we can say that profit maximization is a subset of wealth and being a subset, it will facilitate wealth creation.

Giving priority to value creation, managers have now shifted from traditional approach to modern approach of financial management that focuses on wealth maximization. This leads to better and true evaluation of business. For e.g., under

wealth maximization, more importance is given to cash flows rather than profitability. As it is said that profit is a relative term, it can be a figure in some currency, it can be in percentage, etc. For example a profit of say Rs.10,00,000 cannot be judged as good or bad for a business, till it is compared with investment, sales, etc. Similarly, duration of earning the profit is also important i.e. whether it is earned in short term or long term.

In wealth maximization, major emphasis is on cash flows rather than profit. So, to evaluate various alternatives for decision making, cash flows are taken under consideration. For e.g. to measure the worth of a project, criteria like: "present value of its cash inflow – present value of cash outflows" (net present value) is taken. This approach considers cash flows rather than profits into consideration and also use discounting technique to find out worth of a project. Thus, maximization of wealth approach believes that money has time value.

An obvious question that arises now is that how can we measure wealth. Well, a basic principle is that ultimately wealth maximization should be discovered in increased net worth or value of business. So, to measure the same, value of business is said to be a function of two factors - earnings per share and capitalization rate. And it can be measured by adopting following relation:

Value of business = EPS / Capitalization rate

At times, wealth maximization may create conflict, known as agency problem. This describes conflict between the owners and managers of firm. As, managers are the agents appointed by owners, a strategic investor or the owner of the firm would be major concerned about the longer term performance of the business that can lead to maximization of shareholder's wealth. Whereas, a manager might focus on taking such decisions that can bring quick result, so that, he/she can get credit for good performance. However, in course of fulfilling the same, a manager might opt for risky decisions which can put the owner's objectives on stake.

Hence, a manager should align his/her objective to broad objective of organization and achieve a tradeoff between risk and return while making decision; keeping in mind the ultimate goal of financial management i.e. to maximize the wealth of its current shareholders.

Check Your Progress 1

Note: a) Write your answer in about 50 words.

b) Check your answer with possible answers given at the end of the unit.

1) What is Financial Management?

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2) What are the objectives of Financial Management?

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3.3 ACCOUNTING

3.3.1 Concept and Definition

You know there is a limit to human memory. You cannot remember everything you do. If you are given Rs. 6000 and asked to buy a number of items you will find it difficult to remember the detail of various items you purchased. Hence, it becomes necessary for you to write them on a piece of paper or a note book. It is still more difficult in case of business which usually involves a large number of transactions. In business, you have to buy and sell more frequently. You make payments and receive payments every now and then. It becomes almost impossible to remember all these transactions. So, unless you record them properly you cannot obtain any financial information you need. For example, you cannot easily ascertain the amounts to be received from various customers to whom the goods were sold on credit. You will not know the detail of how much you owe to your suppliers. You may also find it difficult to work out the profit earned or loss incurred during a particular period. It is, therefore, necessary to maintain a proper record of all the transactions which take place from time to time. The recording of business transactions in a systematic manner is the main function served by accounting.

The Concept

The traditional meaning of accounting was provided by the American Institute of Certified Public Accountants (AICPA) in 1961 when it defined accounting as:

"the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are, in part at least, of financial character and interpreting the results thereof":

American Accounting Association (AAA) has defined the Accounting as follow:

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"Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information".

3.3.2 Objectives of Accounting

The following are the main objectives of accounting:

1) **To keep systematic records:** Accounting is done to keep a systematic record of financial transactions, like purchase of goods, sale of goods, cash receipts and cash payments. In the absence of accounting there would have been terrific burden on human memory which in most cases would have been impossible to bear. Systematic record of various assets and liabilities of the business is also to be maintained.

2) **To ascertain the operational profit or loss.** Accounting helps in determining the net profit earned or loss suffered on account of running the business. This is done by keeping a proper record of revenues and expenses of a particular period. Profit and loss account prepared at the end of the year helps the management, suppliers, bankers and the government in knowing whether the business is earning profit or generating loss.

3) **To ascertain the financial position of the business:** The businessman is not only interested in knowing the operating result, but also interested in knowing the financial position of his business i.e., where it stands. In other words, he wants to know what the business owes to others and what it owns, and what happened to the capital – whether the capital has increased or decreased or remained constant. A scientific record of assets and liabilities facilitates the preparation of a "balance sheet" answers these questions.

4) **To facilitate rational decision making:** Apart from the owners, there are various other parties who are interested in knowing about the position of business, such as tax authorities, the management, the bank, the creditors, etc. From this viewpoint, the accounting system has to furnish the required information. In present scenario, accounting has taken up the task of analysis and reporting of information at the required point of time to the required level of authority to facilitate rational decision making.

3.3.3 Functions of Accounting

Following are the functions of accounting:

Record Keeping Function: The primary function of accounting is to keep a systematic record of financial transaction - journalisation, posting and preparation of final statements. The purpose of this function is to report regularly to the interested parties by means of financial statements.

Protect Business Property: The second function of accounting is to protect the property of business from unjustified and unwanted use. The accountant thus has to design such a system of accounting which protects its assets from an unjustified and unwanted use.

Legal Requirement Function: The third function of accounting is to devise such a system as will meet the legal requirements. Under the provision of law, a business man has to file various statements e.g., income tax returns, returns for

sales tax purpose, etc. Accounting system aims at fulfilling the requirements of law. Accounting is a base, with the help of which various returns, documents, statements etc., are prepared.

Communicating the Results*:* Accounting is the language of business. Various transactions are communicated through accounting. There are many parties - owners, creditors, government, and employees, etc, who are interested in knowing the results of the firm. The fourth function of accounting is to communicate the results to interested parties. The accounting shows a real and true position of the firm of the business.

3.3.4 Basis of Accounting

Cash Basis Accounting: According to this system, only actual cash receipts and payments are recorded in the books. The credit transactions are not recorded at all, till actual cash is received or paid. Thus, if purchases are made in the year 2010 on credit and payment for purchases is made in the year 2011, such purchases shall be considered to be an expense of the year 2011 and shall not be recorded in the year 2010. This system of accounting is mostly followed by non-trading organizations, professionals like lawyers, doctors, chartered accountants, etc.

Mercantile or Accrual System: According to this system, all the business transactions pertaining to the specific period, whether of cash or credit nature, are recorded in the books. This system of accounting is based on accrual concept, which states that revenue is recognized when it is earned and expense is recognized when obligation of payment arises. Actual movement of cash is irrelevant. Mercantile system of accounting is widely followed by the industrial and commercial undertakings because it takes into account the effects of all transactions already entered into.

3.3.5 Branches of Accounting

Accountants specialize in different types of accounting activities and this has resulted in the development of different branches of accounting. Some of these are:

Financial Accounting: It is the original form of accounting. It is mainly confined to the preparation of financial statements for the use of outsiders like debenture holders, creditors, suppliers, etc. The financial statements are the Income statement (or Profit and Loss Account), Statement of Retained Earnings (Profit and Loss Appropriation Account) and Balance Sheet. In this manner, the financial accounting is useful for ascertaining net profit or loss, the balance retained (undistributed profit, and the financial position).

Management Accounting: It is accounting for the management, which provides necessary information to the management for discharging its functions. It is concerned with the analysis and interpretation of accounting information to guide the management (or owners) for future planning of business activities. It makes the use of techniques such as ratio analysis and statement of cash flows.

Cost Accounting: It shows classification and analysis of costs on the basis of functions, processes, products, centers, etc.It also deals with cost computation, cost saving, cost reduction, etc. It helps in determining the selling price of products and services.

3.3.6 Book-keeping vs. Accounting

Book-keeping: It is a process of recording Company's day-to-day financial transaction into a journal. The journal entry included the date, the name of the accounts to be debited and credited, and the amounts. The bookkeeping process further requires that all transactions recorded in journal need to be classified into ledger accounts.

Accounting: It is the bigger picture. It is the system that keeps track of the data, including people, and records the transaction's history, as well as taking the information that is obtained through the bookkeeping process and using that information to analyze the results of the business. Accounting is the system that provides the reports and information needed for management to make decisions as to the direction of the business, as well as issues such as taxation, Sales Tax etc.

In this session you read about accounting, now answer the questions given in Check Your Progress 2

Check Your Progress 2

Note: a) Write your answer in about 50 words.

b) Check your answer with possible answers given at the end of the unit.

1) Define Accounting.

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2) What is the difference between Book-keeping and accounting?

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3.4 AUDITING

3.4.1 Meaning and Definition

Meaning: When the work of an accountant is finished, the duty of an auditor starts. Auditing involves verification of the entries passed by the accountant and the final accounts prepared by him. It is the scrutiny of the accounts of a business with help of vouchers, documents and the information given to him and also the explanations submitted to him. Unlike an accountant, the auditor has to satisfy himself after due verification and through scrutiny of accounts as to whether transactions entered into the books of accounts are bonafide. An auditor is required

to submit his report to the effect whether or not the Balance Sheet and Profit and Loss Account is a true and fair representation of the existing state of affairs of a business concern respectively.

Definition: "Auditing may be defined as the examination of the books, accounts and vouchers of a business with a view to ascertain whether or not the Balance Sheet is properly drawn up so as show a true and correct view of the state of affairs of the business."

"Auditing is a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report."

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3.4.2 Objectives of Auditing

For better understanding, objectives can be classified as:

Primary Objectives: To determine and judge the reliability of the financial statement and the supporting accounting records of a particular financial period is the main purpose of the audit. As per the Indian Companies Act, 1956 it is mandatory for the organizations to appoint a auditor who, after the examination

and verification of the books of account, disclose his opinion that whether the audited books of accounts, Profit and Loss Account and Balance Sheet are showing the true and fair view of the state of affairs of the company's business. To get a true and fair view of the companies' affairs and express his opinion, he has to thoroughly check all the transactions and relevant documents of the company made during the audited period. It helps the auditor to report the financial position of the organization. Audit also disclose whether the Accounting system adopted in the organization is adequate and appropriate in recording the various transactions as well as the setbacks of the system.

Secondary Objectives*:* In order to report the financial condition of the business, auditor has to examine the books of accounts and the relevant documents. In that process, he may come across some errors and frauds. We may classify these errors and frauds as below:

- **Detection and Prevention of Errors:** Following types of errors can be detected in the process of auditing.

  a) **Clerical Errors:** Due to wrong posting such errors may occur. Money received from Microsoft credited to the Semens's account is an example of clerical error. Even though the account was posted wrongly, the trial balance will agree.

  b) **Errors of Principle:** While recording a transaction, the fundamental principles of accounting is not properly observed, these types of errors could occur. Over valuation of closing stock or incorrect allocation of expenditure or receipt between capital and revenue are some of the examples of such errors. Such errors will not affect the trial balance but will affect the Profit and Loss account. It may occur due to lack of knowledge of sound principles of accounting or can be committed deliberately to falsify the accounts. To detect such errors, the auditor has to do a careful examination of the books of account.

- **Detection and Prevention of Frauds:** To get money illegally from the organization or from the proprietor frauds are committed intentionally and deliberately. If it remains undetected, it could affect the opinion of the auditor on the financial condition and the working results of the organization. Therefore, it is necessary for the auditor to exercise utmost care to detect such frauds. It can be committed by the top management or by the employees of the organization.

3.4.3 Principles of Auditing

The **Webster's New International Dictionary** defined the word 'Principle' as "a fundamental truth, primary law, a settled rule of action". Applied to auditing, principle is the fundamental truth necessary for the effective accomplishment of the objectives of auditing.

Though the principles of auditing are not as finally developed as the principles of accounting. The following fundamental principles of auditing have evolved over the years:

1) **Principle of Independence:** Independence is the basic veracity of auditing. Without it, objectives of auditing cannot be attained with all fairness. Since

independence is a mental situation, there must be independence to perform all the works. Only those audit report are accepted which have been made under Indian Companies Act, 1956 to give due place (importance) to independence.

2) **Principle of Objectivity:** Auditing must be conducted objectively. The auditor must be free from bias, emotions and whims while auditing. It demands verification of the transactions and the use of reasonable skill and diligence. According to this principle of auditing, those transactions which have been recorded in the books of accounts must be verified with true evidence.

3) **Principle of Full Disclosure:** According to this principle, the client should provide all possible evidence, explanations and records. The principle implies that the auditor should make full disclosure of his findings in respect of the audit work performed by him.

4) **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. The fact of materiality has to be in accordance with the situation.

5) **Confidentiality:** During the course of audit whatever information are supplied to the auditor, he should keep them confidentially. No information should be place before any third person without taking permission of the concerned authority. It should be provided only in case of legal duty of the auditor.

6) **Skills and Competence:** The work of audit should be performed by such persons who are trained, experienced and efficient. It is expected form the auditor that he is sincere to the declarations of the Indian Institute of Chartered Accountants.

7) **Report:** Preparation of audit report is the most important work of an auditor. Report should be provided in writing. He should provide a clean report which means that the auditor is satisfied with the books of accounts. On the other hand, if the auditor is not satisfied with the books of accounts, then he provides qualified report.

3.4.4 Advantages and Limitations of Auditing

It is compulsory for all the organizations registered under the companies act must be audited. There are advantages in auditing the accounts even when there is no legal obligation for doing so. Some of the advantages are listed below:

1) Audited accounts are readily accepted in Government authorities like, Income Tax Dept., Sales Tax dept., Land Revenue Departments, Banks etc.

2) By auditing the accounts errors and frauds can be detected and rectified in time.

3) Audited accounts carry greater authority than the accounts which have not been audited.

4) For obtaining loan from financial institutions like Banks, LIC, HUDCO, HDFC, IFCI etc., previous years audited accounts evaluated for determining the capability of returning the loan.

5) Regular audit of account create fear among the employees in the accounts department and exercise a great moral influence on clients staff thereby restraining them from commit frauds and errors.

6) Audited accounts facilitate settlement of claims on the retirement/death of a partner.

Auditing also suffers from certain **limitations** which are as follow:

1) **Only test check:** Since the number of transactions is very large, it is almost impossible for the auditor to check each and every transaction. Hence, only test checking is done by him. It is possible that frauds and errors may escape such test checking. In the absence of any suspicion, he is justified to do test checking only. Hence, there is no guarantee that audited accounts are free from errors and frauds as they exhibit a true and fair view of the financial position and the working results of the organization.

2) **Over emphasis on financial aspect:** Auditing is confined to checking, ticking, totalling, vouching etc of financial transactions recorded in the books. No attention is paid to other important aspects such as finances, efficiency and effectiveness of management and business ethics.

3) **Lack of independence:** In theory, the auditor is appointed by the shareholders. However, in practice, he is appointed by the management i.e. the shareholders having majority shares. As such, the auditor is hardly independent and cannot report fairly and friendly.

4) **Difficulty in verification and valuation of assets and liabilities:** It is almost impossible to certify and value the assets and liabilities and particularly the stock in trade. It is not possible to fix exactly the cost or market value of stock in trade. Again the stock may not even be marketable. Further, the book debts may be bad or doubtful. Hence, the balance sheet may not show a true and fair view of the financial position or its working results.

5) **Inefficient internal check and control:** Efficiency and effectiveness of auditing is largely dependent upon an efficient internal check and internal control systems. In case these are not efficient, the auditor cannot audit the accounts properly.

3.4.5 Types/Classification of Audit

Internal audit: An audit conducted in between two annual audits is called Interim Audit. Wherever a Company wants to declare an interim dividend, it becomes necessary to get interim audit of the accounts done up to the date at which the Company wants to declare the interim dividend. In other words, interim audit involves a complete audit of accounts for a part of the year i.e. from the date of the last Balance Sheet to the date of the interim accounting period.

External audit: External audit is that which is critical review of the representation of the published financial statements. It is compulsory for all company's which are listed in the stock exchange.

Continuous audit: An auditing process that examines accounting practices continuously throughout the year. Examination and verification of a firm's financial transactions and their supporting documents, carried out daily or on

fixed interval basis. Continuous-audit is performed usually by the firm's internal auditors to eliminate the year-end workload.

Procedural audit: It is an examination and appraisal of the procedures in maintaining the books of accounts of an organization. This can ensure the reliability for the preparation of Profit and Loss Account and Balance Sheet. It is not particular type of audit; rather it forms a part of the whole audit procedures.

Cost audit: Cost audit plays a dynamic role in the achievement of social objects of business, i.e., production of quality goods at a reduced price and the attainment of higher productivity in all factors of production. Cost audit is the audit process or verification of the cost of the manufacture or production of any article.Following is the main advantages of cost audit:

i) It brings to notice operational inefficiencies and enables corrective action.

ii) It suggests measure for productivity improvement.

iii) It helps the Government in controlling prices.

Management audit: Management audit is comparatively a recent modern thinking. It deals with the evaluation of the efficiency of the performance of management in an organization. "Management audit has been defined as a comprehensive critical review of all aspects of process of management."

Balance Sheet audit: Balance Sheet Audit does not simply mean an audit of the Balance Sheet only, it is more than this. In fact, Balance Sheet Audit is a system of audit where Balance Sheet is first taken up for examination and the audit works backward to the Profit and Loss Account and the books and records.

Suitability: Balance Sheet Audit is suitable where:

i) The size of the organization is big and transactions are numerous; and

ii) The internal control system of the organization is effective.

Complete audit: A complete audit is an unrestricted audit for the entire financial year and for the whole organization. In complete audit, the auditor is free to check all the books and records of the organization. A statutory audit is of this type. A partial audit is only an audit of part of the transactions or records.

Partial audit: A partial audit can be an audit covering the whole year or a part of the year. An audit to check inter-division transactions only or a cash audit or an audit of sales or purchases only is a partial audit. Thus, in partial audit, the field of audit is restricted and the nature of audit is specified to the auditor in the appointment letter. An audit which is conducted considering the particular area of accounting is known as partial audit. Under partial audit, audit of whole account is not conducted. Audit of particular area where the owner thinks essential to conduct audit will be conducted. Generally, transaction of business is related to cash, debtor, creditor, stock, etc. A business may conduct an audit of any of these transactions.

Internal audit: It involves a conduct of systematic examination of the records, procedures and operations of an organization. It is generally carried out by employees of the Company with a view to:

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i) confirming that the policies of management are being properly executed and drawing attention to those areas where policies appear to be inadequate; and

ii) to verify that the information used by management to control the undertaking is both adequate and accurate.

Cash audit: Cash audit is an audit of cash transactions and the cash book only. It is a limited or partial audit. Only the cash receipts and payments are checked in this audit with the help of documentary evidence to ensure that they have been properly entered in the cash book.

Propriety audit: Propriety audit refers that kind of audit wherein the various actions and decisions of the management of an enterprise are examined in the light of public interest and standard of conduct. The conduct of propriety audit by an auditor requires a rare quality of prudence, wisdom and skills, since he has to examine the regularity prudence and impact of the various actions and decisions of the management. In propriety audit, the auditor has to find out the justification of the transactions, the amount of the expenditure incurred and the prudence of the sanctioning authority.

Social Audit: Social audit is performed to know the corporate social responsibility.

3.4.6 Qualities of an Auditor

An auditor must have all the qualities of head and heart as he is required to perform a variety of functions. He must be a man of character and good behaviour. He must also be a hard task master so as to do the work himself and get the work done though his assistants. In particular, he must possess the following qualities:

1) **Knowledge of Book-keeping, Accountancy and Auditing:** An auditor must have thorough and up-to-date knowledge of accounting and auditing principles, practices, techniques and procedures. As accounting is a changing technique, he should be fully aware of the new changes and developments in the field of accounting. He should not pass any entry or account as correct unless he becomes sure of its correctness. Hence, the knowledge of the principles of accounting becomes very much necessary for him.

2) **Knowledge about Working of Business:** The auditor should know the technical details about the working of the business or the industry or trade carried on by his client, only then he would be able to judge whether the profit of the business and its financial position are truly reflected in the financial statements.

3) **Knowledge of Economics:** He should also the familiar with the principles of economics and the economic laws. It is essential because a business has to work within some specific social and economic conditions which have definite effect on the business.

4) **Knowledge of Audit Case Laws:** He should have good knowledge of the audit case laws and important decisions, both past and present, which have gone a long way in defining the duties and liabilities of an auditor under varying circumstances.

5) **Knowledge of Industrial Management:** He should have good knowledge of industrial management, financial administration and business organization.

6) **Technical Knowledge:** He must have thorough knowledge of the technical and other details of the business so that he can elicit necessary information from the employees of his client. This will also help him not to ask ridiculous questions from his client during the course of audit work.

7) **Knowledge of Latest Audit Techniques:** He should be well versed in latest auditing techniques, practices and procedures. He will do well if he participates in Seminars, Conferences and Convocations organized from time to time by the professional bodies in India and abroad.

8) **Knowledge of Tax Laws:** He should have up-to-date knowledge of Income-Tax Laws particularly when he is to conduct tax audit.

9) **Knowledge of Cost Accountancy:** He must have thorough and up-to-date knowledge of cost accounting principles, practices, techniques and procedures in order to be a cost auditor.

10) **Honesty:** An auditor must be honest person. He should not certify any transactions as correct unless he is sure that it is true. He must exercise reasonable care and skill before he believes what he certifies is true as was observed by Justice Lindley in the case London and General Bank (1895).

11) **Tactful:** An auditor must be tactful so as to effectively deal with client to get necessary explanations for his audit work.

12) **Secrecy:** He must not disclose the secrets of his client otherwise he will have to make good (compensate) the loss suffered by his client. He will also loose the confidence of his client and may not get audit work in future.

13) **Courteous and Well-behaved:** He should be courteous and well-behaved as he is to deal with senior officers of his client. He should try to win their confidence so as to get their whole heated co-operation to carry out his duties as auditor.

14) **Impartial:** He should be impartial. He must not be influenced in the discharge of his responsibilities directly or indirectly. In case he finds something suspicious, he should thoroughly examine the matter to find the truth.

15) **Common Sense:** He must possess good common sense to deal effectively with the employees who might be more experienced and clever than him. Well laid schemes of fraud cannot be discovered unless the auditor possesses a high level of common sense. In fact lack of common sense implies non-sense. Unfortunately, "the common sense is a thing which is uncommon to him".

16) **Cautious and Vigilance:** An auditor must be very cautious and vigilant. If he faces an awkward situation when his duty to his client is opposed to his own interests, he should be bold enough to discharge his duties faithfully and honestly. It will pay him in the long-run.

17) **Eliciting Information:** An auditor should be clever to be able to extract the necessary information in full. He should be capable of preparing a proper questionnaire having intelligent questions.

18) **Reasoning:** An auditor should always be prepared to hear arguments and must be reasonable.

19) **Methodical:** An auditor should be methodical, hard working and accurate.

20) **Prudence:** If the auditor is asked to give advice on matters relating to finance or to suggest improvements in the accounts, although not within his sphere, an auditor must be prudent and practical.

21) **Ability to prepare Report:** Last but not the least, an auditor should have the ability to write his report to the shareholders clearly, correctly, concisely and forcefully.

In this session you read about auditing, now answer the questions given in Check Your Progress 3.

Check Your Progress 3

Note: a) Write your answer in about 50 words.

b) Check your answer with possible answers given at the end of the unit.

1) What do you mean by audit?

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2) What is the main objective of audit?

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3.5 BUDGETING

It is well recognized that an enterprise should be managed effectively and efficiently. Managing, in fact, implies coordination and control of the total enterprise efforts to achieve the organizational objectives. The process of managing is facilitated when management charts its course of action in advance. The function of management also includes decision-making facilitated by various managerial techniques, procedures and by utilizing the individual and group efforts in a coordinated and rational way. In our daily life, we prepare budgets for matching the expenses with income and available funds can be invested in any project giving maximum return. Similarly in business, budgets are prepared on the basis of future estimated production and sales in order to find out the

profit in a specified period.Budgeting are a management process. It is defined as the process of preparing plans for future activities of a business enterprise after considering and involving the objectives of the said organization. It is a technique to formulate a budget, implement it and to evaluate it. The work of preparing a business budget is not a simple task and it is completed through budgeting. It has following characteristics:

1) Budgeting is a continuous managerial process.
2) Budgeting is related to a definite period of future time and usually a year.
3) Budgeting is based on certain objectives.
4) Budgeting is used for future forecasting of various business activities

3.5.1 Objectives of Budgeting

The determination of budget objectives and their achievement is the object of budgeting. Generally, following are the objectives of budgeting:

1) One of the objectives of budgeting is to prepare a budget on the basis of past, present and future conditions for pre-determined objectives covering all the activities of the business. Thus budgeting helps in planning.
2) Budgeting not only helps in planning but is also helps in co-coordinating the activities of various departments.
3) In budgeting, objectives and targets of all the departments are fixed and monitored. Thus it helps management in its controlling function.
4) Budgeting communicates the objectives, policies, physical and financial targets of all the departments.
5) Helps in performance evaluation.
6) Helps in comparing two or more firms or entities.
7) Helps in fixing standards.
8) Helps in cost control and cost reduction.
9) Helps in removing the complexities of delegation of powers.
10) Helps in raising competitive strength.
11) Helps in increasing managerial efficiency.

3.5.2 Process of Budgeting

The budgeting process can be described as follow**:**

1) **Formulation of Business Policies:** Before preparing a budget, it is very essential that business policies must be formulated because these policies work as pillars of guidance. Therefore, such policies are determined in advance and are formulated by the top management.

2) **Preparation of Budget Forecasts:** After formulation of budget policies, the budget organization gives order to all the heads to prepare budget estimates for a certain period of time for their departments. The heads prepare budget keeping in view the objectives, past data, information and present conditions.

3) **Comparison of Alternatives, Coordination and Review:** The budget committee considers the budgets prepared by the various departments with their alternates. By analyzing and reviewing, the budget committee selects the best one among the given alternatives considering the profitability and financial position of the Company. Budget committee tries to establish the coordination among various departmental budgets. If the Budget committee requires a change in the budget, the budget officer can issue a new circular to the head with necessary guidelines and points to be considered to revise the budget.

4) **Formation of Master Budget, Final Approval and Budget Execution:** After comprising and reviewing the budgets, the budget committee formulates the master budget coordinating all the departmental budgets. Then it is sent to the Boar of Directors for approval. A meeting of the shareholders may be called if necessary for the final approval of master budget. After the final approval with necessary amendments, it is handed over to the top management for execution at various levels in the organization.

3.5.3 Advantages of Budgeting

- **Helpful in managerial functions –** Budgeting helps in all managerial functions such as planning, organizing, co-coordinating, motivating and controlling.

- **Profitability analysis –** Revenue and expenditure are analyzed and predicted, therefore, future profitability can be projected.

- **Cost analysis –** All types of costs are estimated and analyzed therefore cost control and reduction is possible.

- **Helpful in comparison –** In budgeting actual are compared with budgeted standards and deviations are searched.

3.5.4 Limitation of Budgeting

1) Budgets are simply estimates of future activities and how much success will be achieved depends upon future situations. There are good chances of personal bias in budget formulation.

2) Budges can be ineffective if prepared on the basis of scanty information and knowledge.

3) If there is no full cooperation between various departments and employees budgets are bound to fail.

4) Budget expenses may prove highly burden some.

In this session you read about budget, now answer the questions given in Check Your Progress 4.

Check Your Progress 4

1) What is meant by budgeting?

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2) What are the different steps in budgeting?

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3.6 LET US SUM UP

Finance is an important function is any business as money is required to support its various activities. It has given birth to "Financial Management" as a separate subject. Financial management is a managerial activity concerned with planning and controlling of the firm's financial resources to generate returns on its invested funds. Thus now the scope of financial management is very wide and it should not be considered to be merely restricted for raising or capital. It also covers other aspects of financing such as assessing the needs of capital, raising sufficient amount of funds, cost of financing, budgeting, maintain liquidity, lending and borrowing policies, dividend policy and so on. Finance is considered as the life-blood or any business. Scope of financial management includes: Investment decisions, financing decisions and dividend decisions. The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. Its main objective is to maximize the profits and value of shareholder funds. Man functions of financial management are: Estimation of capital requirements, determination of capital's composition, investment of funds, and financial control. Approaches of financial management are: Traditional approach of financial management focuses on 'arrangement of finance' for meeting various financial needs of an enterprise whereas Modern approach encompasses wider applications, viz., assessment of funds required, effective

procurement of those funds through most economical means, and efficient utilization of those funds through profitable investments, as well as cash and liquidity management. Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are, in part at least, of financial character and interpreting the results thereof". Accounting has three branches such as Financial accounting, Management accounting, and Cost accounting. Basis of accounting are cash basis and accrual basis. Accounting is concerned with auditing. "Auditing may be defined as the examination of the books, accounts and vouchers of a business with a view to ascertain whether or not the Balance Sheet is properly drawn up so as show a true and correct view of the state of affairs of the business." There are two main objectives of Auditing. Primary objective is to determine and judge the reliability of the financial statement and the supporting accounting records of a particular financial period is the main purpose of the audit and the secondary objective is to examine the books of accounts and the relevant documents to locate errors and frauds and to suggest the way to prevent these frauds. In our daily life, we prepare budgets for matching the expenses with income and available funds can be invested in any project giving maximum return. Similarly in business, budgets are prepared on the basis of future estimated production and sales in order to find out the profit in a specified period. Budgeting are a management process. It is defined as the process of preparing plans for future activities of a business enterprise after considering and involving the objectives of the said organization. It is a technique to formulate a budget, implement it and to evaluate it.

3.7 KEYWORDS

Accounting : is a means of measuring and reporting the results of economic activities.

Management Accounting : The process of preparing management reports and accounts that provide accurate and timely financial and statistical information required by managers to make day-to-day and short-term decisions.

Cost Accounting : Cost accounting is the classifying, recording and appropriate allocation of expenditure for the determination of the costs of products/services, and for the presentation of suitably arranged data for purposes of control and guidance of management.

Financial Management : The planning, directing, monitoring, organizing, and controlling of the monetary resources of an organization.

Auditing : An examination and verification of a company's financial and accounting records and supporting documents by a professional, such as a Certified Public Accountant.

Budgeting : is defined as the process of preparing plans for future activities of a business enterprise after

considering and involving the objectives of the said organization.

Book-keeping : The systematic recording of a company's financial transactions.

Accrual basis of accounting: The most commonly used accounting method, which reports income when earned and expenses when incurred.

Cash basis of accounting : It is a method which reports income when received and expenses when paid.

Social audit : It is performed to know the corporate social responsibility.

3.8 REFERENCES AND SUGGESTED READINGS

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3.9 POSSIBLE ANSWERS: CHECK YOUR PROGRESS

Check Your Progress 1

1) What is Financial Management?

Ans. Financial management is a managerial activity concerned with lanning and controlling of the firm's financial resources to generate returns on its invested funds. The raising and using of capital for generating funds and paying returns to the suppliers of capital is the finance function of a firm. Thus the funds raised by the company will be invested in the best investment opportunities, with an expectation of future benefits.

2) What are the objectives of Financial Management?

Ans. The objectives of financial management are:

1) To ensure regular and adequate supply of funds to the concern.
2) Ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders?
3) To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.

Check Your Progress 2

1) Define Accounting.

Ans. Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.

2) What is the difference between Book-keeping and accounting?

Ans. Book-keeping: It is a process of recording Company's day-to-day financial transaction into a journal. The journal entry included the date, the name of the accounts to be debited and credited, and the amounts. The bookkeeping process further requires that all transactions recorded in journal need to be classified into ledger accounts.

Accounting: It is the bigger picture. It is the system that keeps track of the data, including people, and records the transaction's history, as well as taking the information that is obtained through the bookkeeping process and using that information to analyze the results of the business. .

Check Your Progress 3

1) What do you mean by audit?

Ans. Auditing is a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report.

2) What is the main objective of audit?

Ans. Objectives of Auditing are:

Primary Objectives: As per the Indian Companies Act, 1956 it is mandatory for the organizations to appoint a auditor who, after the examination and verification of the books of account, disclose his opinion that whether the audited books of accounts, Profit and Loss Account and Balance Sheet are showing the true and fair view of the state of affairs of the company's business.

Secondary Objectives*:* In order to report the financial condition of the business, auditor has to examine the books of accounts and the relevant documents. In that process he may come across some errors and frauds.

Check Your Progress 4

1) What is meant by budgeting?

Ans. Budgeting are a management process. It is defined as the process of preparing plans for future activities of a business enterprise after considering and involving the objectives of the said organization. It is a technique to formulate a budget, implement it and to evaluate it. The work of preparing a business budget is not a simple task and it is completed through budgeting.

2) What are the different steps in budgeting?

Ans. The different steps in budgeting are:

1) Formulation of Business Policies
2) Preparation of Budget forecasts
3) Comparison of Alternatives, Coordination and Review
4) Formation of Master Budget, Final approval and Budget Execution