

**INTERMEDIATE COURSE  
(UNDER REVISED SCHEME OF  
EDUCATION AND TRAINING)**

**GROUP – II**

**REVISION TEST PAPERS  
NOVEMBER, 2019**



**BOARD OF STUDIES**  
**THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA**  
*(Set up by an Act of Parliament)*  
New Delhi

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## REVISION TEST PAPER, NOVEMBER 2019 – OBJECTIVE & APPROACH

*(Students are advised to go through the following paragraphs carefully to derive maximum benefit out of this RTP)*

### I Objective of Revision Test Paper

Revision Test Papers are one among the many educational inputs provided by the Board of Studies (BOS) to its students. Popularly referred to as RTP by the students, it is one of the very old publications of the BOS whose significance and relevance from the examination perspective has stood the test of time.

RTPs provide glimpses of not only the desirable ways in which examination questions are to be answered but also of the professional quality and standard of the answers expected of students in the examination. Further, aspirants can assess their level of preparation for the examination by answering various questions given in the RTP and can also update themselves with the latest developments in the various subjects relevant from the examination point of view.

The primary objectives of the RTP are:

- To help students get an insight of their preparedness for the forthcoming examination;
- To provide an opportunity for a student to find all the latest developments relevant for the forthcoming examination at one place;
- To supplement earlier studies;
- To enhance the confidence level of the students adequately; and
- To leverage the preparation of the students by giving guidance on how to approach the examinations.

RTPs contain the following:

- (i) Planning and preparing for examination
- (ii) Subject-wise guidance – An overview
- (iii) Updates applicable for a particular exam in the relevant subjects
- (iv) Topic-wise questions and detailed answers thereof in respect of each paper
- (v) Relevant announcement applicable for the particular examination

Students must bear in mind that the RTP contains a variety of questions based on different sections of the syllabi and thus a comprehensive study of the entire syllabus is a pre-requisite before answering the questions of the RTP. In other words, in order to

derive maximum benefit out of the RTPs, it is advised that before proceeding to solve the questions given in the RTP, students ought to have thoroughly read the Study Materials.

The topics on which the questions are set herein have been carefully selected and meticulous attention has been paid in framing different types of questions. Detailed answers are provided to enable the students to do a self-assessment and have a focused approach for effective preparation.

Students are welcome to send their suggestions for fine tuning the RTP to the Director, Board of Studies, The Institute of Chartered Accountants of India, A-29, Sector-62, Noida 201 309 (Uttar Pradesh). RTP is also available on the Institute's website [www.icaai.org](http://www.icaai.org) under the BOS knowledge portal in students section for downloading.

## II. Planning and preparing for examination

Ideally, when the RTP reaches your hand, you must have finished reading the relevant Study Materials of all the subjects. Make sure that you have read the Study Materials thoroughly as they cover the syllabus comprehensively. Get a good grasp of the concepts/ provisions discussed therein. Solve each and every question/illustration given therein to understand the application of the concepts and provisions.

After reading the Study Materials thoroughly, you should go through the Updates provided in the RTP and then proceed to solve the questions given in the RTP on your own. RTP is an effective tool to revise and refresh the concepts and provisions discussed in the Study Material. RTPs are provided to you to help you assess your level of preparation. Hence you must solve the questions given therein on your own and thereafter compare your answers with the answers given therein.

### Examination tips

How well a student fares in the examination depends upon the level and depth of his preparation. However, there are certain important points which can help a student better his performance in the examination. These useful tips are given below:

- Reach the examination hall well in time.
- As soon as you get the question paper, read it carefully and thoroughly. You are given separate 15 minutes for reading the question paper.
- Plan your time so that appropriate time is awarded for each question. Keep sometime for checking the answers as well.
- First impression is the last impression. The question which you can answer in the best manner should be attempted first.
- Always attempt to do all questions. Therefore, it is important that you must finish each question within allocated time.

- Read the question carefully more than once before starting the answer to understand very clearly as to what is required.
- Answer all parts of a question one after the other; do not answer different parts of the same question at different places.
- Write in a neat and legible hand-writing.
- Always be concise and write to the point and do not try to fill pages unnecessarily.
- There must be logical expression of the answer.
- In case a question is not clear, you may state your assumptions and then answer the question.
- Check your answers carefully and underline important points before leaving the examination hall.

### III. Subject-wise Guidance – An Overview

#### PAPER 5: ADVANCED ACCOUNTING

The Revisionary Test Paper (RTP) of Advanced Accounting is divided into two parts viz Part I - Relevant Announcements, Amendments and Notifications for November, 2019 examination and Part II –Questions and Answers.

It may be noted that the July, 2017\* edition of the Study Material is relevant for November, 2019 Examination.

**Part I of the Revisionary Test Paper** consists of the 'Relevant Amendments and Notifications - applicable and not applicable' for November, 2019 examination. The purpose of this information in the RTP is to apprise the students with the latest developments applicable for November, 2019 examination. The brief summary of the same has been given as under:

#### A. Applicable for November, 2019 examination:

- I. Amendments in Schedule III (Division I) to the Companies Act, 2013
- II. Maintenance of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR)
- III. Merging three categories of NBFCs viz. Asset Finance Companies (AFC), Loan Companies (LCs) and Investment Companies (ICs) into a new category called Investment and Credit Company (NBFC-ICC)

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\* Chapters No. 2, 12, 13 and 14 have been revised and the revised chapters have been web hosted at the BoS Knowledge Portal. It is advised to refer the revised chapters.

**B. Not applicable for November, 2019 examination:**

- I. Ind ASs issued by the Ministry of Corporate Affairs.
- II. The Guidance Note on 'Accounting for Depreciation in Companies in context of schedule II to the Companies Act, 2013' is not applicable for November, 2019 Examination.

**Part II of the Revisionary Test Paper** consists of twenty questions together with their answers. First fourteen questions are based on different topics discussed in the study material. Last 6 questions of this RTP are based on Guidance Notes and Accounting Standards. For easy reference, the topic / accounting standard number on which the question is based has been quoted at the top of each question. The details of topics, on which questions in the RTP are based, are as under:

Question No.	Topic
1	Employee Stock Option Plans
2	Buy Back of Securities
3	Equity Shares with differential Rights
4	Underwriting of Shares
5	Amalgamation of companies
6	Internal Reconstruction of a Company
7	Liquidation of a Company
8	Financial statements of Insurance Companies
9	Financial statements of Banking Companies
10	NBFCs
11	Mutual Funds
12	Valuation of Goodwill
13	Consolidated Financial Statements
14	Guidance Notes
15 to 20	Accounting Standards

Answers to the questions have been given in detail along with the working notes for easy understanding and comprehending the steps in solving the problems. The answers to the questions have been presented in the manner which is expected from the students in the examination. The students are expected to solve the questions under examination conditions and then compare their solutions with the solutions given in the Revisionary Test Paper and further strategize their preparation for scoring more marks in the examination.

**PAPER – 6: AUDITING AND ASSURANCE**

RTP is a tool to refresh your knowledge which you have acquired while doing your conceptual study from Study Material and other modes of knowledge like student journal, bare acts etc.

The Revisionary Test Paper (RTP) of Auditing and Assurance for November, 2019 carries twenty eight descriptive questions along with 10 MCQs. and their answers These questions have been taken from the entire syllabus which is divided into thirteen chapters along with engagement and quality control standards etc. discussed in the study material.

The various Chapters/topics as mentioned above are Standards on Auditing, Nature, Objective and Scope of Audit, Audit Strategy, Audit Planning and Audit Programme, Audit Documentation and Audit Evidence, Risk Assessment and Internal Control, Fraud and Responsibilities of Auditor in this Regard, Audit in an Automated Environment, Audit Sampling, Analytical Procedures, Audit of Items of Financial Statements, The Company Audit, Audit Report, Audit of Banks and Audit of Different Types of Entities. The chapter's name is also clearly indicated before each question. The questions in the RTP have been arranged in the same sequence as prescribed in the study material to facilitate easy revision by the students. An attempt has been made to cover the syllabus comprehensively.

This RTP of Auditing and Assurance has been divided into two parts viz Part I – Legislative Amendments / Notifications / Circulars / Rules / Guidelines issued by Regulating Authority relevant for November, 2019 examination and Part II – Questions and Answers.

The relevant notified sections of the Companies Act, 2013 and other legislative amendments including relevant Notifications / Circulars / Rules / Guidelines issued by Regulating Authorities up to 30<sup>th</sup> April, 2019 are applicable for November, 2019 Examination. The questions have been answered in this RTP keeping in view latest amendments as per above mentioned date.

**PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC MANAGEMENT****Section – A: Enterprise Information Systems**

The Revision Test Paper on Enterprise Information Systems is a supplementary tool that provides comprehensive view of the entire syllabus which is divided into five chapters. It is based on the study material that is already provided to the students. The chapter-wise questions and answers are provided so that students could test their preparation level for the examination. Full answer to each question is specified so that students would be benefited without searching the answers from various sources.

The RTP for November, 2019 contains total 15 questions out of which first 5 questions numbered 1 to 5 are Multiple Choice Questions (MCQ) based on different chapters. Each MCQ has four options out of which only one option is correct. Remaining 10 Descriptive



questions numbered 1 to 10 with 2 questions from each chapter are provided chapter-wise. These questions have been selected from various topics keeping in view the complete and uniform coverage of the whole syllabus to check the students' preparedness on answering the questions based on different skill levels "Comprehension & Knowledge" as well as "Analysis & Application". The questions provide an insight to the students on their understanding of the fundamental concepts of Information Systems and Business Process flows, Financial and Accounting systems, Core Banking Systems and e-Commerce/m-Commerce transactions.

### **Section – B: Strategic Management**

The Revision Test Paper in the subject of Strategic Management for the November, 2019 examination contains 17 questions. Broadly, the questions included are of two categories – multiple choice questions and other descriptive questions. Each question is further subdivided into different parts to extensively cover different chapters of the syllabus.

In the first question, multiple choice questions with four alternatives are included and the student has to opt the correct option. Subsequently, sixteen descriptive questions have been included that covers all the eight chapters of the syllabus. Chapter names have been mentioned before questions.

The students should take up this Revision Test Paper as a tool to check their preparedness in the subject. To properly self-assess the preparation in the subject, students must attempt the questions on their own. Mere reading will not be helpful. Compare your answers with the suggested answers and hints given to assess the present status of understanding and identify areas for improvement.

Work hard and perform well in the examination.

### **PAPER – 8: FINANCIAL MANAGEMENT AND ECONOMICS FOR FINANCE**

#### **PAPER – 8A: FINANCIAL MANAGEMENT**

The Revision Test Paper (RTP) of Financial Management comprises of ten questions for full coverage of the syllabus. Theoretical questions along with computational problems have also been incorporated so that you can give emphasis to the theoretical portion of the syllabus as well. Since this paper's inclination is more towards numerical-oriented questions which involve mathematical calculations, therefore, it is very important that you have thoroughly studied the theoretical aspects of the subject and are also clear about the concepts and logic behind the mathematical workings and formulae.

A summary of the questions both theoretical and computational has been given for your reference:

Qs. No.	Topic	About the Problem
1.	Ratio Analysis	Computation of various Ratios.
2.	Cost of Capital	Computation of the weighted average cost of capital using market value weights.
3.	Capital Structure	Computation of EBIT range among the plans for Indifference.
4.	Leverage	Calculation and Interpretation of leverages.
5.	Investment Decisions/Capital Budgeting	Evaluation of Project using the NPV method of investment appraisal.
6.	Risk Analysis in Capital Budgeting	Calculation of NPV based on Risk free and Risks adjusted discount rate (RADR).
7.	Dividend Decision	Computation of the market value per share and optimum dividend payout ratio as per Walter's model.
8.	Management of working Capital	Preparation of projected statement of Profit/Loss (Ignoring taxation and projected statement of working capital requirements.
9.	Receivable Management of working capital	Evaluation of credit Policies
10 (a).	Investment Decisions/Capital Budgeting	Meaning of Payback Reciprocal.
10 (b).	Management of working capital	Functions of treasury department.
10 (c).	Introduction to Financial Management	Inter relationship between investment, financing and dividend decisions.

### Section B: Economics for Finance

At the intermediate level, you are expected to not only require professional knowledge but also the ability to apply such knowledge in problem solving. Therefore, the questions have been framed in such a manner that not only your knowledge and understanding is tested but also how you apply this knowledge in solving problems.

Since this paper is knowledge and applications oriented, the first question relates to simple calculations like various components of National Income and what one needs to bear in mind while

calculating National Income. Second question relates to the circular flow in two sector economy model and marginal propensity to consume. Third question is about the allocation instruments by which governments can influence resource allocation in the economy. In the fourth question the government intervention to correct market failure through price intervention has been enquired. Fifth question relates to the impure public goods and demerit goods of the economy. Sixth question relates to the demand for money and empirical analysis of money supply. Seventh question is concerned about the calculation of narrow money as well as high powered money. In the eighth question, the theory of absolute advantage and custom duties have been asked. Ninth question relates to the non-tariff measures and last question relates to the foreign direct investment and real exchange rate.

Some answers have been given in detail so as to enable you to understand and comprehend the steps involved in answering/solving the problems; for others only hints have been provided. Students must attempt the questions themselves under examination conditions and then see the answers. This will help you in knowing your level of preparedness and further strategies your final preparation and presentation.



## PAPER – 5: ADVANCED ACCOUNTING

### PART – I: ANNOUNCEMENTS STATING APPLICABILITY & NON-APPLICABILITY FOR NOVEMBER, 2019 EXAMINATION

#### A. Applicable for November, 2019 Examination

##### I. Amendments in Schedule III (Division I) to the Companies Act, 2013

In exercise of the powers conferred by sub-section (1) of section 467 of the Companies Act, 2013), the Central Government made the following amendments in Division I of the Schedule III with effect from the date of publication of this notification in the Official Gazette:

(A) under the heading “II Assets”, under sub-heading “Non-current assets”, for the words “Fixed assets”, the words “Property, Plant and Equipment” shall be substituted;

(B) in the “Notes”, under the heading “General Instructions for preparation of Balance Sheet”, in paragraph 6,-

(I) under the heading “B. Reserves and Surplus”, in item (i), in sub- item (c), the word “Reserve” shall be omitted;

(II) in clause W., for the words “fixed assets”, the words “Property, Plant and Equipment” shall be substituted.

##### II. Maintenance of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR)

Statutory Liquidity Ratio (SLR)

In exercise of the powers conferred by sub-section (2A) of Section 24 read with Section 51 and Section 56 of the Banking Regulation Act, 1949 (10 of 1949) and in supersession of the notifications DBR.No.Ret.BC.14/12.02.001/2016-17 dated October 13, 2016 BR.NDBR.No.Ret.BC.91/12.02.001/2017-18 dated October 04, 2017, the Reserve Bank hereby specifies that with effect from the dates given below, every Scheduled Commercial Bank (including RRBs), Local Area Bank, Small Finance Bank, Payments Bank, Primary (urban) co-operative bank and State and central co-operative banks shall continue to maintain in India assets (referred to as ‘SLR assets’) the value of which shall not, at the close of business on any day, be less than:

- (i) 19.25 per cent from January 5, 2019
- (ii) 19.00 per cent from April 13, 2019
- (iii) 18.75 per cent from July 6, 2019
- (iv) 18.50 per cent from October 12, 2019
- (v) 18.25 per cent from January 4, 2020

(vi) 18.00 per cent from April 11, 2020

of their total net demand and time liabilities in India as on the last Friday of the second preceding fortnight, valued in accordance with the method of valuation specified by the Reserve Bank from time to time.

Cash Reserve Ratio (CRR)

The current Cash Reserve Ratio (CRR) is 4% of their Net Demand and Time Liabilities (NDTL) with effect from the fortnight beginning February 09, 2013 vide circular DBOD.No.Ret.BC.76 /12.01.001/2012-13 dated January 29, 2013. The Local Area Banks shall also maintain CRR at 4.00 per cent of its net demand and time liabilities from the fortnight beginning from February 09, 2013.

**III. Merging three categories of NBFCs viz. Asset Finance Companies (AFC), Loan Companies (LCs) and Investment Companies (ICs) into a new category called Investment and Credit Company (NBFC-ICC)**

As per circular RBI/2018-19/130 DNBR (PD) CC.No.097/03.10.001/2018-19 dated February 22, 2019, in order to provide NBFCs with greater operational flexibility, it has been decided that harmonisation of different categories of NBFCs into fewer ones shall be carried out based on the principle of regulation by activity rather than regulation by entity. Accordingly, it has been decided to merge the three categories of NBFCs viz. Asset Finance Companies (AFC), Loan Companies (LCs) and Investment Companies (ICs) into a new category called NBFC - Investment and Credit Company (NBFC-ICC). Investment and Credit Company (NBFC-ICC) means any company which is a financial institution carrying on as its principal business - asset finance, the providing of finance whether by making loans or advances or otherwise for any activity other than its own and the acquisition of securities; and is not any other category of NBFC as defined by the RBI in any of its Master Directions. (Circular DBR.BP.BC.No.25/21.06.001/2018-19 dated 22 February 2019)

Differential regulations relating to bank's exposure to the three categories of NBFCs viz, AFCs, LCs and ICs stand harmonised vide Bank's circular DBR.BP.BC.No.25/21.06.001/2018-19 dated February 22, 2019. Further, a deposit taking NBFC-ICC shall invest in unquoted shares of another company which is not a subsidiary company or a company in the same group of the NBFC, an amount not exceeding twenty per cent of its owned fund. All related Master Directions (Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016, Standalone Primary Dealers (Reserve Bank) Directions, 2016 and Residuary Non-Banking Companies (Reserve Bank) Directions, 2016) have also been updated accordingly.

**NOTE:** Chapters No. 2, 12, 13 and 14 have been revised and the revised chapters have been web hosted at the BoS Knowledge Portal. It is advised to refer the revised chapters.

**B. Not applicable for November, 2019 examination**

**I. Non-Applicability of Ind AS for November, 2019 Examination**

The Ministry of Corporate Affairs has notified Companies (Indian Accounting Standards) Rules, 2015 on 16<sup>th</sup> February, 2015, for compliance by certain class of companies. These Ind AS are not applicable for November, 2019 Examination.

**II The Guidance Note on 'Accounting for Depreciation in Companies in context of schedule II to the Companies Act, 2013' is not applicable for November, 2019 Examination.**

**PART – II : QUESTIONS AND ANSWERS**

**QUESTIONS**

**Employee Stock Option Plans**

1. The following particulars in respect of stock options granted by a company are available:

Grant date	April 1, 2016
Number of employees covered	50
Number of options granted per employee	1,000
Fair value of option per share on grant date (₹)	9

The options will vest to employees serving continuously for 3 years from vesting date, provided the share price is ₹ 65 or above at the end of 2018-19.

The estimates of number of employees satisfying the condition of continuous employment were 48 on 31/03/17, 47 on 31/03/18. The number of employees actually satisfying the condition of continuous employment was 45.

The share price at the end of 2018-19 was ₹ 68.

You are required to compute expenses to be recognised in each year in the books of the company.

**Buy Back of Securities**

2. Umesh Ltd. resolves to buy back 4 lakhs of its fully paid equity shares of ₹ 10 each at ₹ 22 per share. This buyback is in compliance with the provisions of the Companies Act and does not exceed 25% of Company's paid up capital in the financial year. For the purpose, it issues 1 lakh 11 % preference shares of ₹ 10 each at par, the entire amount being payable with applications. The company uses ₹ 16 lakhs of its balance in Securities

Premium Account apart from its adequate balance in General Reserve to fulfill the legal requirements regarding buy-back. Give necessary journal entries to record the above transactions.

### Equity Shares with Differential Rights

3. (a) What is meant by "equity shares with differential rights". Can preference shares be also issued with differential rights?
- (b) L, M, N and O hold Equity capital in the proportion of 30:30:20:20 in AB Ltd. X, Y, Z and K hold preference share capital in the proportion of 40:30:20:10.

You are required to identify the voting rights of shareholders in case of resolution of winding up of the company if the paid-up capital of the company is ₹ 80 Lakh and Preference share capital is ₹ 40 Lakh.

### Underwriting of Shares

4. A company made a public issue of 2,00,000 equity shares of ₹ 10 each at a premium of ₹ 2 per share. The entire issue was underwritten by the underwriters L, M, N and O in the ratio of 4:3:2:1 respectively with the provision of firm underwriting of 5,000, 4,000, 2,000 and 2,000 shares respectively.

The company received application for 1,50,000 shares (excluding firm underwriting) from public, out of which applications for 55,000, 40,000, 42,000 and 8,000 shares were marked in favour of L, M, N and O respectively.

Calculate the liability of each underwriter as regards the number of shares to be taken up assuming that the benefit of underwriting is not given to the individual underwriter.

### Amalgamation of Companies

5. The following is the summarized Balance Sheet of A Ltd. as at 31<sup>st</sup> March, 2019:

<i>Liabilities</i>	₹	<i>Assets</i>	₹
8,000 Equity shares of ₹ 100 each	8,00,000	Building	3,40,000
10% Debentures	4,00,000	Machinery	6,40,000
Loans	1,60,000	Inventory	2,20,000
Trade payables	3,20,000	Trade receivables	2,60,000
General Reserve	80,000	Bank	1,36,000
		Patent	1,30,000
		Share issue Expenses	34,000
	17,60,000		17,60,000

B Ltd. agreed to absorb A Ltd. on the following terms and conditions:

- (1) B Ltd. would take over all assets, except bank balance and Patent at their book values less 10%. Goodwill is to be valued at 4 year's purchase of super profits, assuming



that the normal rate of return be 8% on the combined amount of share capital and general reserve.

- (2) B Ltd. is to take over trade payables at book value.
- (3) The purchase consideration is to be paid in cash to the extent of ₹ 6,00,000 and the balance in fully paid equity shares of ₹ 100 each at ₹ 125 per share.

The average profit is ₹ 1,24,400. The liquidation expenses amounted to ₹ 16,000. B Ltd. sold prior to 31<sup>st</sup> March, 2018 goods costing ₹ 1,20,000 to A Ltd. for ₹ 1,60,000. ₹ 1,00,000 worth of goods are still in Inventory of A Ltd. on 31<sup>st</sup> March, 2018. Trade payables of A Ltd. include ₹ 40,000 still due to B Ltd.

Show the necessary Ledger Accounts to close the books of A Ltd. and prepare the Balance Sheet of B Ltd. as at 1<sup>st</sup> April, 2019 after the takeover.

**Internal Reconstruction of a Company**

- 6. Platinum Limited has decided to reconstruct the Balance Sheet since it has accumulated huge losses. The following is the draft Balance Sheet of the company as on 31<sup>st</sup> March, 2019 before reconstruction:

Liabilities	Amount (₹)	Assets	Amount (₹)
Share Capital			
50,000 shares of ₹ 50 each fully paid up	25,00,000	Goodwill	22,00,000
1,00,000 shares of ₹ 50 each ₹ 40 paid up	40,00,000	Land & Building	42,70,000
Capital Reserve	5,00,000	Machinery	8,50,000
8% Debentures of ₹ 100 each	4,00,000	Computers	5,20,000
12% Debentures of ₹ 100 each	6,00,000	Inventories	3,20,000
Trade payables	12,40,000	Trade receivables	10,90,000
Outstanding Expenses	10,60,000	Cash at Bank	2,68,000
Total	<u>1,03,00,000</u>	Profit & Loss Account	7,82,000
		Total	<u>1,03,00,000</u>

Following is the interest of Mr. Shiv and Mr. Ganesh in Platinum Limited:

	Mr. Shiv	Mr. Ganesh
8% Debentures	3,00,000	1,00,000
12% Debentures	<u>4,00,000</u>	<u>2,00,000</u>
Total	<u>7,00,000</u>	<u>3,00,000</u>

The following scheme of internal reconstruction was framed and implemented, as approved by the court and concerned parties:

- (1) Uncalled capital is to be called up in full and then all the shares to be converted into Equity Shares of ₹ 40 each.
- (2) The existing shareholders agree to subscribe in cash, fully paid up equity shares of 40 each for ₹ 12,50,000.
- (3) Trade payables are given option of either to accept fully paid equity shares of ₹ 40 each for the amount due to them or to accept 70% of the amount due to them in cash in full settlement of their claim. Trade payables for ₹ 7,50,000 accept equity shares and rest of them opted for cash towards full and final settlement of their claim.
- (4) Mr. Shiv agrees to cancel debentures amounting to ₹ 2,00,000 out of total debentures due to him and agree to accept 15% Debentures for the balance amount due. He also agrees to subscribe further 15% Debentures in cash amounting to ₹ 1,00,000.
- (5) Mr. Ganesh agrees to cancel debentures amounting to ₹ 50,000 out of total debentures due to him and agree to accept 15% Debentures for the balance amount due.
- (6) Land & Building to be revalued at ₹ 51,84,000, Machinery at ₹ 7,20,000, Computers at ₹ 4,00,000, Inventories at ₹ 3,50,000 and Trade receivables at 10% less to as they are appearing in Balance Sheet as above.
- (7) Outstanding Expenses are fully paid in cash.
- (8) Goodwill and Profit & Loss A/c will be written off and balance, if any, of Capital Reduction A/c will be adjusted against Capital Reserve.

You are required to pass necessary Journal Entries for all the above transactions and draft the company's Balance Sheet immediately after the reconstruction.

### Liquidation of a Company

7. Given below is the Balance Sheet of OM Limited as on 31.3.2019:

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Share Capital:		Fixed Assets:	
14%, 1,60,000 cumulative preference shares of ₹100 each fully paid up	16,00,000	Land	1,60,000
32,000 equity shares of ₹100 each, ₹ 60 per share paid up	19,20,000	Buildings	6,40,000
Reserves and Surplus	NIL	Plant and Machinery	21,60,000
Secured Loans:		Patents	1,60,000
14% debentures	9,20,000	Investments	NIL
		Current Assets:	
		Inventory at cost	4,00,000

(Having a floating charge on all assets)		Trade receivables	9,20,000
Interest accrued on above debentures	1,28,800	Cash at bank	2,40,000
(Also having a floating charge as above)		Profit and Loss A/c	9,60,000
Loan on mortgage of land and building	6,00,000		
Unsecured Loan	NIL		
Current liabilities			
Trade payables	4,71,200		
	56,40,000		56,40,000

On 31.3.2019 the company went into voluntary liquidation. The dividend on 14% preference shares was in arrears for one year. Trade payables include preferential creditors amounting to ₹ 1,20,000.

The assets realized the following sums:

Land ₹ 3,20,000; Buildings ₹ 8,00,000; Plant and machinery ₹ 20,00,000; Patent ₹ 2,00,000; Inventory ₹ 6,40,000; Trade receivables ₹ 8,00,000.

The expenses of liquidation amounted to ₹ 1,17,736. The liquidator is entitled to a commission of 2% on all assets realized (except cash at bank) and 2% on amounts among unsecured creditors other than preferential creditors. All payments were made on 30th June, 2019. Interest on mortgage loan shall be ignored at the time of payment.

Prepare the liquidator's final statement of account.

### Financial Statements of Insurance Companies

8. From the following information as on 31<sup>st</sup> March, 2019 of Xeta Insurance Co. Ltd. engaged in fire insurance business, prepare the Revenue Account, reserving 50% of the net premiums for unexpired risks and an additional reserve of ₹ 7,00,000:

Particulars	Amount ₹
Reserve for unexpired risk on 31st March, 2018	15,00,000
Additional reserve on 31st March, 2018	3,00,000
Claims paid	19,20,000
Estimated liability in respect of outstanding claims on 31st March, 2018	1,95,000
Estimated liability in respect of outstanding claims on 31st March, 2019	2,70,000
Expenses of management (including ₹ 90,000 in connection with claims)	8,40,000
Re-insurance premium paid	2,25,000

Re-insurance recoveries	60,000
Premiums	33,60,000
Interest and dividend (gross before TDS)	1,50,000
Profit on sale of investments	30,000
Commission	3,50,000

### Financial Statements of Banking Companies

9. The following is an extract from the Trial Balance of Jeevan Bank Ltd. as at 31<sup>st</sup> March, 2019:

Rebate on bills discounted as on 1-4- 2018	1,36,518 (Cr.)
Discount received	3,40,312 (Cr.)

Analysis of the bills discounted reveals as follows:

Amount (₹)	Due date
5,60,000	June 1, 2019
17,44,000	June 8, 2019
11,28,000	June 21, 2019
16,24,000	July 1, 2019
12,00,000	July 5, 2019

You are required to find out the amount of discount to be credited to Profit and Loss account for the year ending 31<sup>st</sup> March, 2019 and pass Journal Entries. The rate of discount may be taken at 10% per annum.

### NBFCs

10. While closing its books of account on 31<sup>st</sup> March, 2018 a Non-Banking Finance Company has its advances classified as follows:

	₹ in lakhs
Standard assets	13,400
Sub-standard assets	670
Secured portions of doubtful debts:	
– Up to one year	160
– one year to three years	45
– more than three years	20
Unsecured portions of doubtful debts	48
Loss assets	24

You are required to Calculate the amount of provision, which must be made against the Advances as per the Non-Banking Financial Company –Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016.

**Mutual Funds**

11. Surakshit Mutual Fund is registered with SEBI and is in the process of finalizing the annual statement of accounts of one of its open ended mutual fund schemes. From the information furnished below, you are required to prepare a statement showing the movement of unit holders' funds for the financial year ended 31<sup>st</sup> March, 2018.

	₹ '000
Opening Balance of net assets	54,00,000
Net Income for the year (Audited)	3,82,500
38,25,900 units issued during 2017-2018	4,34,250
33,85,350 units redeemed during 2017-2018	3,20,940
The par value per unit is ₹ 100	

**Valuation of Goodwill**

12. The following is the summarized Balance Sheet of Mansa Ltd. as at 31<sup>st</sup> March, 2019:

<i>Liabilities</i>	<i>(₹ in lakhs)</i>	<i>Assets</i>	<i>(₹ in lakhs)</i>
Share Capital:		Fixed Assets:	
Equity shares of ₹ 10 each	1,200.00	Land and buildings	600.00
9% Preference share fully paid up	240.00	Plant and machinery	1,926.00
Reserve and Surplus:		Furniture and fixture	132.00
General reserve	288.00	Vehicles	120.00
Profit and Loss	729.60	Investments	240.00
Secured loans:		Inventory	162.00
10% Debentures	120.00	Trade Receivables	117.60
12% Term loan	432.00	Cash and bank	249.60
Trade Payables	384.00		
Provision for taxation	<u>153.60</u>		
	<u>3547.20</u>		<u>3547.20</u>

Non-trade investments were 15% of the total investments.

Balances as on 1.4.2018 to the following accounts were as: Profit and Loss account ₹ 259.20 lakhs, General reserve ₹ 276 lakhs. The company requires you to calculate the value of average capital employed.

**Consolidated Financial Statements**

13. The following summarised Balance Sheets of H Ltd. and its subsidiary S Ltd. were prepared as on 31<sup>st</sup> March, 2019:

	H Ltd. (₹)	S Ltd. (₹)
<b><u>Equity and Liabilities</u></b>		
<b>Shareholders' Funds</b>		
Equity Share Capital (fully paid up shares of ₹ 10 each)	12,00,000	2,00,000
<b>Reserves and Surplus</b>		
General Reserve	4,35,000	1,55,000
Profit and Loss Account	2,80,000	65,000
<b>Current Liabilities</b>		
Trade Payables	<u>3,25,000</u>	<u>1,25,000</u>
Total	<u>22,40,000</u>	<u>5,45,000</u>
	H Ltd. (₹)	S Ltd. (₹)
<b><u>Assets</u></b>		
<b>Non-Current Assets</b>		
Property, Plant and Equipment		
Machinery	6,40,000	1,80,000
Furniture	3,75,000	34,000
<b>Non-Current Investments</b>		
Shares in S Ltd. - 16,000 shares @ ₹ 20 each	3,20,000	-
<b>Current Assets</b>		
Inventories	2,68,000	62,000
Trade Receivables	4,73,000	2,37,000
Cash and Bank	<u>1,64,000</u>	<u>32,000</u>
Total	<u>22,40,000</u>	<u>5,45,000</u>

H Ltd. acquired the 80% shares of S Ltd. on 1<sup>st</sup> April, 2018. On the date of acquisition, General Reserve and Profit Loss Account of S Ltd. stood at ₹ 50,000 and ₹ 30,000 respectively.

Machinery (book value ₹ 2,00,000) and Furniture (book value ₹ 40,000) of S Ltd. were revalued at ₹ 3,00,000 and ₹ 30,000 respectively on 1<sup>st</sup> April, 2018 for the purpose of fixing the price of its shares (rates of depreciation computed on the basis of useful lives: Machinery 10% and Furniture 15%). Trade Payables of H Ltd. include ₹ 40,000 due to S Ltd. for goods supplied since the acquisition of the shares. These goods are charged at

10% above cost. The inventories of H Ltd. includes goods costing ₹ 55,000 (cost to H Ltd.) purchased from S Ltd.

You are required to prepare the Consolidated Balance Sheet of H Ltd. with its subsidiary S Ltd. as at 31<sup>st</sup> March, 2019.

### Guidance Notes

14. (i) How will a company classify its investment in preference shares, which are convertible into equity shares within one year from the balance sheet date? Will it classify the investment as a current asset or a non-current asset? Explain.

### Accounting Standards

#### AS 7 Construction Contracts

- (ii) On 1<sup>st</sup> December, 2018, "Sampath" Construction Company Limited undertook a contract to construct a building for ₹ 108 lakhs. On 31<sup>st</sup> March, 2019 the company found that it had already spent ₹ 83.99 lakhs on the construction. A prudent estimate of additional cost for completion was ₹ 36.01 lakhs.

You are required to compute the amount of provision for foreseeable loss, which must be made in the Final Accounts for the year ended 31<sup>st</sup> March, 2019 based on AS 7 "Accounting for Construction Contracts."

#### AS 9 Revenue Recognition

15. The Board of Directors decided on 31.3.2019 to increase the sale price of certain items retrospectively from 1st January, 2019. In view of this price revision with effect from 1st January 2019, the company has to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2019 to 31st March, 2019. Accountant cannot make up his mind whether to include ₹ 15 lakhs in the sales for 2018-2019. Advise.

#### AS 18 Related Party Transactions

16. SP hotels Limited enters into an agreement with Mr. A for running its hotel for a fixed return payable to the later every year. The contract involves the day-to-day management of the hotel, while all financial and operating policy decisions are taken by the Board of Directors of the company. Mr. A does not own any voting power in SP Hotels Limited. Would he be considered as a related party of SP Hotels Limited?"

#### AS 19 Leases

17. Sun Limited wishes to obtain a machine costing ₹ 30 lakhs by way of lease. The effective life of the machine is 14 years, but the company requires it only for the first 3 years. It enters into an agreement with Star Ltd., for a lease rental for ₹ 3 lakhs p.a. payable in arrears and the implicit rate of interest is 15%. The chief accountant of Suraj Limited is not sure about the treatment of these lease rentals and seeks your advice. (use annuity factor at @ 15% for 3 years as 3.36)

**AS 20 Earnings Per Share**

18. The following information relates to M/s. XYZ Limited for the year ended 31<sup>st</sup> March, 2019:

Net Profit for the year after tax: ₹ 37,50,000

Number of Equity Shares of ₹ 10 each outstanding: ₹ 5,00,000

Convertible Debentures Issued by the Company (at the beginning of the year)

Particulars	Nos.
8% Convertible Debentures of ₹ 100 each	50,000
Equity Shares to be issued on conversion	55,000

The Rate of Income Tax: 30%.

You are required to calculate Basic and Diluted Earnings Per Share (EPS).

**AS 26 Intangible Assets**

19. K Ltd. launched a project for producing product X in October, 2018. The Company incurred ₹ 40 lakhs towards Research and Development expenses upto 31<sup>st</sup> March, 2019. Due to prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years.

Advise the Company as per the applicable Accounting Standard.

**AS 29 Provisions, Contingent Liabilities and Contingent Assets**

20. XYZ Ltd. has not made provision for warranty in respect of certain goods due to the fact that the company can claim the warranty cost from the original supplier. Hence the accountant of the company says that the company is not having any liability for warranties on a particular date as the amount gets reimbursed. You are required to comment on the accounting treatment done by the XYZ Ltd. in line with the provisions of AS 29.

**SUGGESTED ANSWERS/HINTS**

1. The vesting of options is subject to satisfaction of two conditions viz. service condition of continuous employment for 3 years and market condition that the share price at the end of 2018-19 is not less than ₹ 65. The company should recognise value of option over 3-year vesting period from 2016-17 to 2018-19.

**Year 2016-17**

Fair value of option per share = ₹ 9

Number of shares expected to vest under the scheme =  $48 \times 1,000 = 48,000$

Fair value =  $48,000 \times ₹ 9 = ₹ 4,32,000$



Expected vesting period = 3 years

Value of option recognised as expense in 2016-17 = ₹ 4,32,000 /3 = ₹ 1,44,000

**Year 2017-18**

Fair value of option per share = ₹ 9

Number of shares expected to vest under the scheme = 47 × 1,000 = 47,000

Fair value = 47,000 × ₹ 9 = ₹ 4,23,000

Expected vesting period = 3 years

Cumulative value of option to recognise as expense in 2016-17 and 2017-18

= (₹ 4,23,000/ 3) × 2 = ₹ 2,82,000

Value of option recognised as expense in 2016-17 = ₹ 1,44,000

Value of option recognised as expense in 2017-18

= ₹ 2,82,000 – ₹ 1,44,000 = ₹ 1,38,000

**Year 2018-19**

Fair value of option per share = ₹ 9

Number of shares actually vested under the scheme = 45 × 1,000 = 45,000

Fair value = 45,000 × ₹ 9 = ₹ 4,05,000

Vesting period = 3 years

Cumulative value of option to recognise as expense in 2016-17, 2017-18 and 2018-19 = ₹ 4,05,000

Value of option recognised as expense in 2016-17 and 2017-18 = ₹ 2,82,000

Value of option recognised as expense in 2018-19 = ₹ 4,05,000 – ₹ 2,82,000 = ₹ 1,23,000

2.

**Journal Entries in the books of Umesh Ltd.**

			₹	₹
1.	Bank A/c To 11% Preference share application & allotment A/c (Being receipt of application money on preference shares)	Dr.	10,00,000	10,00,000
2.	11% Preference share application & allotment A/c To 11% Preference share capital A/c	Dr.	10,00,000	10,00,000

	(Being allotment of 1 lakh preference shares)			
3.	General reserve A/c To Capital redemption reserve A/c (Being creation of capital redemption reserve for buy back of shares)	Dr.	30,00,000	30,00,000
4.	Equity share capital A/c Premium payable on buyback A/c To Equity shareholders/Equity shares buy back A/c (Amount payable to equity shareholder on buy back)	Dr. Dr.	40,00,000 48,00,000	88,00,000
5.	Equity shareholders/ Equity shares buy back A/c To Bank A/c (Being payment made for buy back of shares)	Dr.	88,00,000	88,00,000
6.	Securities Premium A/c General reserve A/c To Premium payable on buyback A/c (Being premium on buyback charged from securities premium and general reserve)	Dr.	16,00,000 32,00,000	48,00,000

**Working Notes:****1. Calculation of amount used from General Reserve Account**

	₹
Amount paid for buy back of shares (4,00,000 shares x ₹ 22)	88,00,000
Less: Proceeds from issue of Preference Shares (1,00,000 shares x ₹10)	(10,00,000)
Less: Utilization of Securities Premium Account	(16,00,000)
Balance used from General Reserve Account	<u>62,00,000</u>
* Used under Section 68 for buy back	32,00,000
Used under Section 69 for transfer to CRR (W.N 2)	<u>30,00,000</u>
	<u>62,00,000</u>

**2. Amount to be transferred to Capital Redemption Reserve account**

	₹
Nominal value of shares bought back (4,00,000 shares x ₹10)	40,00,000

Less: Nominal value of Preference Shares issued for such buy back (1,00,000 shares x ₹10)	<u>(10,00,000)</u>
Amount transferred to Capital Redemption Reserve Account	<u>30,00,000</u>

3. (a) Equity shares with Differential Rights means the share with dissimilar rights as to dividend, voting or otherwise. Preference shares cannot be issued with differential rights. It is only the equity shares, which are issued.
- (b) L, M, N and O hold Equity capital in the proportion of 30:30:20:20 and X, Y, Z and K hold preference share capital in the proportion of 40:30:20:10. As the paid-up equity share capital of the company is ₹ 80 Lakhs and Preference share capital is ₹ 40 Lakh (2:1), then relative weights in the voting right of equity shareholders and preference shareholders will be 2/3 and 1/3. The respective voting right of various shareholders will be

$$\begin{aligned}
 L &= \frac{2}{3} \times \frac{30}{100} = \frac{3}{15} \\
 M &= \frac{2}{3} \times \frac{30}{100} = \frac{3}{15} \\
 N &= \frac{2}{3} \times \frac{20}{100} = \frac{2}{15} \\
 O &= \frac{2}{3} \times \frac{20}{100} = \frac{2}{15} \\
 X &= \frac{1}{3} \times \frac{40}{100} = \frac{2}{15} \\
 Y &= \frac{1}{3} \times \frac{30}{100} = \frac{1}{10} \\
 Z &= \frac{1}{3} \times \frac{20}{100} = \frac{1}{15} \\
 K &= \frac{1}{3} \times \frac{10}{100} = \frac{1}{30}
 \end{aligned}$$

4. Calculation of liability of each underwriter assuming that the benefit of firm underwriting is not given to individual underwriter

Particulars	No. of shares				
	L	M	N	O	Total
Gross liability	80,000	60,000	40,000	20,000	2,00,000
Less: Marked Applications (excluding firm underwriting)	(55,000)	(40,000)	(42,000)	(8,000)	(1,45,000)
Balance	25,000	20,000	(2,000)	12,000	55,000
Less: Surplus of N allotted to L, M & O in the ratio of 4:3:1	(1,000)	(750)	2,000	(250)	-
Balance	24,000	19,250	-	11,750	55,000
Less: Unmarked application including firm underwriting (WN)	(7,200)	(5,400)	(3,600)	(1,800)	(18,000)

Net Liability	16,800	13,850	(3,600)	9,950	37,000
Less: Surplus of N allotted to L, M & O in the ratio of 4:3:1	(1,800)	(1,350)	3,600	(450)	-
Balance	15,000	12,500	-	9,500	37,000
Add: Firm Underwriting	5,000	4,000	2,000	2,000	13,000
Total Liability	20,000	16,500	2,000	11,500	50,000

**Working Note:**

Particulars	No. of shares
Applications received from public	1,50,000
Add: Firm underwriting	<u>13,000</u>
Total Applications	1,63,000
Less: Marked application	<u>(1,45,000)</u>
Unmarked application including firm underwriting	18,000

5.

**Books of A Limited****Realization Account**

	₹		₹
To Building	3,40,000	By Trade payables	3,20,000
To Machinery	6,40,000	By B Ltd.	12,10,000
To Inventory	2,20,000	By Equity Shareholders (Loss)	76,000
To Trade receivables	2,60,000		
To Patent	1,30,000		
To Bank (Exp.)	<u>16,000</u>		
	<u>16,06,000</u>		<u>16,06,000</u>

**Bank Account**

To Balance b/d	1,36,000	By Realization (Exp.)	16,000
To B Ltd.	6,00,000	By 10% Debentures	4,00,000
		By Loan	1,60,000
		By Equity shareholders	<u>1,60,000</u>
	<u>7,36,000</u>		<u>7,36,000</u>

**10% Debentures Account**

To Bank	<u>4,00,000</u>	By Balance b/d	<u>4,00,000</u>
	<u>4,00,000</u>		<u>4,00,000</u>

<b>Loan Account</b>			
To Bank	<u>1,60,000</u>	By Balance b/d	<u>1,60,000</u>
	<u>1,60,000</u>		<u>1,60,000</u>
<b>Share Issue Expenses Account</b>			
To Balance b/d	<u>34,000</u>	By Equity shareholders	<u>34,000</u>
	<u>34,000</u>		<u>34,000</u>
<b>General Reserve Account</b>			
To Equity shareholders	<u>80,000</u>	By Balance b/d	<u>80,000</u>
	<u>80,000</u>		<u>80,000</u>
<b>B Ltd. Account</b>			
To Realisation A/c	12,10,000	By Bank	6,00,000
		By Equity share in B Ltd. (4,880 shares at ₹ 125 each)	<u>6,10,000</u>
	<u>12,10,000</u>		<u>12,10,000</u>
<b>Equity Shares in B Ltd. Account</b>			
To B Ltd.	<u>6,10,000</u>	By Equity shareholders	<u>6,10,000</u>
	<u>6,10,000</u>		<u>6,10,000</u>
<b>Equity Share Holders Account</b>			
To Realization Account	76,000	By Equity share capital	8,00,000
To Share issue Expenses	34,000	By General reserve	80,000
To Equity shares in B Ltd.	6,10,000		
To Bank	<u>1,60,000</u>		
	<u>8,80,000</u>		<u>8,80,000</u>

**B Ltd**  
**Balance Sheet as on 1<sup>st</sup> April, 2019 (An extract)\***

	<i>Particulars</i>	<i>Notes</i>	<i>₹</i>
	<b>Equity and Liabilities</b>		
<b>1</b>	<b>Shareholders' funds</b>		
a	Share capital	1	4,88,000
b	Reserves and Surplus	2	1,07,000
<b>2</b>	<b>Current liabilities</b>		
a	Trade Payables	3	2,80,000

\* In the absence of the particulars of assets and liabilities (other than those of A Ltd.), the complete Balance Sheet of B Ltd. after takeover cannot be prepared.

b	Bank overdraft		6,00,000
	<b>Total</b>		14,75,000
	<b>Assets</b>		
<b>1</b>	<b>Non-current assets</b>		
a	Property, Plant and Equipment		
	Tangible assets	4	8,82,000
	Intangible assets	5	2,16,000
<b>2</b>	<b>Current assets</b>		
a	Inventories	6	1,83,000
b	Trade receivables	7	1,94,000
			14,75,000

**Notes to Accounts**

			₹
<b>1</b>	<b>Share Capital</b>		
	Equity share capital		
	4,880 Equity shares of ₹ 100 each (Shares have been issued for consideration other than cash)		4,88,000
	<b>Total</b>		<u>4,88,000</u>
<b>2</b>	<b>Reserves and Surplus (an extract)</b>		
	Securities Premium		1,22,000
	Profit and loss account	.....	
	Less: Unrealized profit	(15,000)	<u>(15,000)</u>
	<b>Total</b>		<u>1,07,000</u>
<b>3</b>	<b>Trade payables</b>		
	Opening balance	3,20,000	
	Less: Inter-company transaction cancelled upon amalgamation	(40,000)	2,80,000
<b>4</b>	<b>Tangible assets</b>		
	Buildings		3,06,000
	Machinery		5,76,000
	<b>Total</b>		<u>8,82,000</u>
<b>5</b>	<b>Intangible assets</b>		
	Goodwill		2,16,000

<b>6</b>	<b>Inventories</b>		
	Opening balance	1,98,000	
	Less: Cancellation of profit upon amalgamation	(15,000)	1,83,000
<b>7</b>	<b>Trade receivables</b>		
	Opening balance	2,34,000	
	Less: Intercompany transaction cancelled upon amalgamation	(40,000)	1,94,000

**Working Notes:**

<b>1. Valuation of Goodwill</b>	₹
Average profit	1,24,400
Less: 8% of ₹ 8,80,000	<u>(70,400)</u>
Super profit	<u>54,000</u>
Value of Goodwill = 54,000 x 4	<u>2,16,000</u>
<b>2. Net Assets for purchase consideration</b>	
Goodwill as valued in W.N.1	2,16,000
Building	3,06,000
Machinery	5,76,000
Inventory	1,98,000
Trade receivables (2,60,000-26,000)	<u>2,34,000</u>
Total Assets	15,30,000
Less: Trade payables	<u>(3,20,000)</u>
Net Assets	<u>12,10,000</u>

Out of this ₹ 6,00,000 is to be paid in cash and remaining i.e., (12,10,000 – 6,00,000) ₹ 6,10,000 in shares of ₹ 125. Thus, the number of shares to be allotted  $6,10,000/125 = 4,880$  shares.

<b>3. Unrealized Profit on Inventory</b>	₹
The Inventory of A Ltd. includes goods worth ₹ 1,00,000 which was sold by B Ltd. on profit. Unrealized profit on this Inventory will be	
$\frac{40,000}{1,60,000} \times 1,00,000$	25,000
As B Ltd purchased assets of A Ltd. at a price 10% less than the book value, 10% need to be adjusted from the Inventory i.e., 10% of ₹ 1,00,000.	<u>(10,000)</u>
Amount of unrealized profit	<u>15,000</u>

## 6. Journal Entries in the books of Platinum Ltd.

		₹	₹
Bank A/c (1,00,000 x ₹ 10)	Dr.	10,00,000	
To Equity share capital A/c			10,00,000
(Being money on final call received)			
Equity share capital (₹ 50) A/c	Dr.	75,00,000	
To Equity share capital (₹ 40) A/c			60,00,000
To Capital Reduction A/c			15,00,000
(Being conversion of equity share capital of ₹ 50 each into ₹ 40 each as per reconstruction scheme)			
Bank A/c	Dr.	12,50,000	
To Equity Share Capital A/c			12,50,000
(Being new shares allotted at ₹ 40 each)			
Trade payables A/c	Dr.	12,40,000	
To Equity share capital A/c			7,50,000
To Bank A/c (4,90,000 x 70%)			3,43,000
To Capital Reduction A/c			1,47,000
(Being payment made to trade payables in shares or cash to the extent of 70% as per reconstruction scheme)			
8% Debentures A/c	Dr.	3,00,000	
12% Debentures A/c	Dr.	4,00,000	
To Shiv A/c			7,00,000
(Being cancellation of 8% and 12% debentures of Shiv)			
Bank A/c	Dr.	1,00,000	
To Shiv A/c			1,00,000
(Being new debentures subscribed by Shiv)			
Shiv A/c	Dr.	8,00,000	
To 15% Debentures A/c			6,00,000
To Capital Reduction A/c			2,00,000
(Being issuance of new 15% debentures and balance transferred to capital reduction account as per reconstruction scheme)			
8% Debentures A/c	Dr.	1,00,000	
12% Debentures A/c	Dr.	2,00,000	
To Ganesh A/c			3,00,000
(Being cancellation of 8% and 12% debentures of Ganesh)			



Ganesh A/c	Dr.	3,00,000	
To 15% Debentures A/c			2,50,000
To Capital Reduction A/c			50,000
(Being issuance of new 15% debentures and balance transferred to capital reduction account as per reconstruction scheme)			
Land and Building	Dr.	9,14,000	
(51,84,000 – 42,70,000)			
Inventories	Dr.	30,000	
To Capital Reduction A/c			9,44,000
(Being value of assets appreciated)			
Outstanding expenses A/c	Dr.	10,60,000	
To Bank A/c			10,60,000
(Being outstanding expenses paid in cash)			
Capital Reduction A/c	Dr.	33,41,000	
To Machinery A/c			1,30,000
To Computers A/c			1,20,000
To Trade receivables A/c			1,09,000
To Goodwill A/c			22,00,000
To Profit and Loss A/c			7,82,000
(Being amount of Capital Reduction utilized in writing off P & L A/c (Dr.) balance, goodwill and downfall in value of other assets)			
Capital Reserve A/c	Dr.	5,00,000	
To Capital Reduction A/c			5,00,000
(Being debit balance of capital reduction account adjusted against capital reserve)			

**Balance Sheet (as reduced) as on 31.3.2019**

<i>Particulars</i>		<i>Notes</i>	<i>₹</i>
<b>Equity and Liabilities</b>			
<b>1</b>	<b>Shareholders' funds</b>		
a	Share capital	1	80,00,000
<b>2</b>	<b>Non-current liabilities</b>		
a	Long-term borrowings	2	<u>8,50,000</u>
	<b>Total</b>		<b><u>88,50,000</u></b>

<b>Assets</b>			
<b>1</b>	<b>Non-current assets</b>		
a	Property, Plant and Equipment		
	Tangible assets	3	63,04,000
<b>2</b>	<b>Current assets</b>		
a	Inventories		3,50,000
b	Trade receivables		9,81,000
c	Cash and cash equivalents		<u>12,15,000</u>
	<b>Total</b>		<b><u>88,50,000</u></b>

**Notes to accounts**

			₹
<b>1.</b>	<b>Share Capital</b>		
	2,00,000 Equity shares of ₹ 40		80,00,000
<b>2.</b>	<b>Long-term borrowings</b>		
	Secured		
	15% Debentures (assumed to be secured)		8,50,000
<b>3.</b>	<b>Tangible assets</b>		
	Land & Building	51,84,000	
	Machinery	7,20,000	
	Computers	<u>4,00,000</u>	63,04,000

**Working Notes:**1. **Cash at Bank Account**

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance b/d	2,68,000	By Trade Creditors A/c	3,43,000
To Equity Share capital A/c	10,00,000	By Outstanding expenses A/c	10,60,000
To Equity Share Capital A/c	12,50,000	By Balance c/d (bal. fig.)	12,15,000
To Shiv A/c	<u>1,00,000</u>		
	<u>26,18,000</u>		<u>26,18,000</u>

2. **Capital Reduction Account**

Particulars		₹	Particulars		₹
To	Machinery A/c	1,30,000	By	Equity Share Capital A/c	15,00,000
To	Computers A/c	1,20,000	By	Trade Creditors A/c	1,47,000
To	Trade receivables A/c	1,09,000	By	Shiv A/c	2,00,000
To	Goodwill A/c	22,00,000	By	Ganesh A/c	50,000
To	Profit and Loss A/c	7,82,000	By	Land & Building	9,14,000
			By	Inventories	30,000
			By	Capital Reserve A/c	<u>5,00,000</u>
		<u>33,41,000</u>			<u>33,41,000</u>

7. **OM Ltd.**

**Liquidator's Final Statement of Account**

Receipts	Value Realised		Payments ₹	Payments ₹
<i>Assets Realised:</i>				
Cash at Bank	2,40,000	Liquidator's Remuneration (W.N. 1)		1,02,224
Trade receivables	8,00,000	Liquidation Expenses		1,17,736
Inventory	6,40,000	Debentureholders:		
Plant and Machinery	20,00,000	14% Debentures	9,20,000	
Patent	2,00,000	Interest Accrued (W.N. 2)	<u>1,61,000</u>	10,81,000
Surplus from Securities (W.N. 3)	5,20,000	Creditors:		
		Preferential	1,20,000	
		Unsecured	<u>3,51,200</u>	4,71,200
		Preference Shareholders:		
		Preference Share Capital	16,00,000	
		Arrears of Dividend	<u>2,24,000</u>	18,24,000
		Equity Shareholders (W.N.4)		
		₹ 25.12 per share on 32,000 shares		<u>8,03,840</u>
	<u>44,00,000</u>			<u>44,00,000</u>

**Working Notes:**

		₹
1	Liquidator's remuneration:	
	2% on assets realised (2% of ₹47,60,000)	95,200
	2% on payments to unsecured creditors (2% on ₹3,51,200)	<u>7,024</u>
		<u>1,02,224</u>
2	Interest accrued on 14% Debentures:	
	Interest accrued as on 31.3.2019	1,28,800
	Interest accrued upto the date of payment i.e. 30.6.2019	<u>32,200</u>
		<u>1,61,000</u>
3	Surplus from Securities:	
	Amount realised from Land and Buildings (₹3,20,000 + ₹8,00,000)	11,20,000
	Less: Mortgage Loan	<u>(6,00,000)</u>
		<u>5,20,000</u>
4	Amount payable to Equity Shareholders:	
	Equity share capital (paid up)	19,20,000
	Less: Amount available for equity shareholders	<u>(8,03,840)</u>
	Loss to be borne by equity shareholders	<u>11,16,160</u>
	Loss per equity share (₹11,16,160/32,000)	34.88
	Amount payable to equity shareholders for each equity share (60-34.88)	25.12

8.

**FORM B- RA****Name of the Insurer: Xeta Insurance Company Limited****Registration No. and Date of registration with IRDA: .....****Revenue Account for the year ended 31<sup>st</sup> March, 2019**

Particulars	Schedule	Amount (₹)
Premium earned (net)	1	26,67,500
Profit on sale of investment		30,000
Others		-
Interest and dividend (gross)		1,50,000

Total (A)		28,47,500
Claims incurred (Net)	2	20,25,000
Commission	3	3,50,000
Operating expenses related to insurance	4	7,50,000
Total (B)		31,25,000
Operating loss from insurance business (A) – (B)		2,77,500

**Schedule –1 Premium earned (net)**

	₹
Premium received	33,60,000
Less: Premium on reinsurance ceded	(2,25,000)
Net Premium	31,35,000
Less: Adjustment for change in Reserve for Unexpired risk (as per W.N.)	(4,67,500)
Total premium earned	26,67,500

**Schedule -2 Claims incurred (net)**

	₹
Claims paid	19,20,000
Add: Expenses regarding claims	90,000
	20,10,000
Less: Re-insurance recoveries	(60,000)
	19,50,000
Add: Claims outstanding as on 31 <sup>st</sup> March, 2019	2,70,000
	22,20,000
Less: Claims outstanding as on 31 <sup>st</sup> March, 2018	(1,95,000)
	20,25,000

**Schedule -3 Commission**

	₹
Commission paid	3,50,000

**Schedule-4 Operating expenses related to Insurance Business**

	₹
Expenses of management (8,40,000 - 90,000)	7,50,000

**Working Note:****Calculation for change in Reserve for Unexpired risk:**

		₹
Reserve for Unexpired Risk as on 31 <sup>st</sup> March, 2019 (50% of 31,35,000)	15,67,500	
Additional Reserve as on 31 <sup>st</sup> March, 2019	<u>7,00,000</u>	22,67,500
Less: Reserve for Unexpired Risk as on 31 <sup>st</sup> March, 2018	15,00,000	
Additional Reserve as on 31 <sup>st</sup> March, 2018	<u>3,00,000</u>	<u>(18,00,000)</u>
		4,67,500

9. The amount of rebate on bills discounted as on 31<sup>st</sup> March, 2019 the period which has not been expired upto that day will be calculated as follows:

Discount on ₹5,60,000 for 62 days @ 10%	9,512
Discount on ₹17,44,000 for 69 days @ 10%	32,969
Discount on ₹11,28,000 for 82 days @ 10%	25,341
Discount on ₹16,24,000 for 92 days @ 10%	40,934
Discount on ₹12,00,000 for 96 days @ 10%	<u>31,562</u>
Total	<u>1,40,318</u>

**Note:** The due date of the bills discounted is included in the number of days above.

**The amount of discount to be credited to the profit and loss account will be:**

	₹
Transfer from rebate on bills discounted as on 31.03. 2018	1,36,518
Add: Discount received during the year	<u>3,40,312</u>
	4,76,830
Less: Rebate on bills discounted as on 31.03. 2019 (as above)	<u>(1,40,318)</u>
	<u>3,36,512</u>

**Journal Entries**

		₹	₹
Rebate on bills discounted A/c	Dr.	1,36,518	
To Discount on bills A/c			1,36,518
(Transfer of opening unexpired discount on 31.03. 2018)			
Discount on bills A/c	Dr.	1,40,318	
To Rebate on bills discounted A/c			1,40,318
(Unexpired discount on 31.03. 2019 taken into account)			

Discount on Bills A/c To P & L A/c (Discount earned in the year, transferred to P&L A/c)	Dr.	3,36,512	3,36,512
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**10. Calculation of provision required on advances as on 31<sup>st</sup> March, 2018:**

	<i>Amount ₹ in lakhs</i>	<i>Percentage of provision</i>	<i>Provision ₹ in lakhs</i>
Standard assets	13,400	.40	53.60
Sub-standard assets	670	10	670
Secured portions of doubtful debts			
–up to one year	160	20	32
–one year to three years	45	30	13.5
–more than three years	20	50	10
Unsecured portions of doubtful debts	48	100	48
Loss assets	24	100	<u>24</u>
			<u>851.10</u>

**11. Statement showing the Movement of Unit Holders' Funds  
for the year ended 31<sup>st</sup> March, 2018**

	(₹ '000)
Opening balance of net assets	54,00,000
Add: Par value of units issued (38,25,900 × ₹ 100)	3,82,590
Net Income for the year	3,82,500
Transfer from Reserve/Equalisation fund (Refer working note)	<u>69,255</u>
	62,34,345
Less: Par value of units redeemed (33,85,350 × ₹ 100)	<u>(3,38,535)</u>
Closing balance of net assets (as on 31 <sup>st</sup> March, 2018)	<u>58,95,810</u>

**Working Note:**

<i>Particulars</i>	<i>Issued</i>	<i>Redeemed</i>
Units	38,25,900	33,85,350
	₹ 000	₹ 000
Par value	3,82,590	3,38,535
Sale proceeds / Redemption value	4,34,250	3,20,940

Profit transferred to Reserve / Equalization Fund	51,660	17,595
Balance in Reserve / Equalization Fund (Issued & Redeemed)	69,255	

12.

**Computation of Average Capital employed**

	(₹ in lakhs)	
Total Assets as per Balance Sheet		3,547.20
Less: Non-trade investments (15% of ₹240 lakhs)		<u>(36.00)</u>
		3,511.20
Outside Liabilities:		
10% Debentures	120.00	
12% Term Loan	432.00	
Trade Payables	384.00	
Provision for Taxation	<u>153.60</u>	<u>(1,089.60)</u>
Capital Employed as on 31.03.2019		2,421.60
Less: ½ of profit earned during the year:		
Increase in General Reserve balance	12.00	
Increase in Profit & Loss A/c	<u>470.40</u>	
	<u>482.40</u>	<u>241.20</u>
Average capital employed		<u>2,180.40</u>

13

**Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd.****as at 31st March, 2019**

Particulars	Note No.	(₹)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		12,00,000
(1,20,000 equity shares of ₹ 10 each)		
(b) Reserves and Surplus	1	8,16,200
(2) Minority Interest (W.N.4)		99,300
(3) Current Liabilities		
(a) Trade Payables	2	4,10,000
Total		<u>25,25,500</u>



II. Assets		
(1) Non-current assets		
(a) Property, Plant and Equipment		
(i) Tangible assets	3	13,10,500
(ii) Intangible assets	4	24,000
(b) Current assets		
(i) Inventories	5	3,25,000
(ii) Trade Receivables	6	6,70,000
(iii) Cash at Bank	7	1,96,000
Total		25,25,500

**Notes to Accounts**

		₹	
1.	Reserves and Surplus		
	General Reserves	4,35,000	
	Add: 80% share of S Ltd.'s post-acquisition reserves (W.N.3)	<u>84,000</u>	5,19,000
	Profit and Loss Account	2,80,000	
	Add: 80% share of S Ltd.'s post-acquisition profits (W.N.3)	21,200	
	Less: Unrealised gain	<u>(4,000)</u>	<u>2,97,200</u>
			<u>8,16,200</u>
2.	Trade Payables		
	H Ltd.	3,25,000	
	S Ltd.	1,25,000	
	Less: Mutual transaction	<u>(40,000)</u>	4,10,000
3.	Tangible Assets		
	Machinery		
	H Ltd.	6,40,000	
	S Ltd.	2,00,000	
	Add: Appreciation	<u>1,00,000</u>	
		3,00,000	
	Less: Depreciation	<u>(30,000)</u>	<u>2,70,000</u>
	Furniture		
	H. Ltd.	3,75,000	
	S Ltd.	40,000	

	Less: Decrease in value	(10,000)		
		30,000		
	Less: Depreciation	(4,500)	25,500	4,00,500
				<u>13,10,500</u>
4.	Intangible assets			
	Goodwill [WN 5]			24,000
5.	Inventories			
	H Ltd.		2,68,000	
	S Ltd.		<u>62,000</u>	3,30,000
	Less: Inventory reserve			<u>(5,000)</u>
				<u>3,25,000</u>
6.	Trade Receivables			
	H Ltd.		4,73,000	
	S Ltd.		<u>2,37,000</u>	
				7,10,000
	Less: Mutual transaction			<u>(40,000)</u>
				<u>6,70,000</u>
7.	Cash and Bank			
	H Ltd.		1,64,000	
	S Ltd.		<u>32,000</u>	1,96,000

**Working Notes:**

1. Profit or loss on revaluation of assets in the books of S Ltd. and their book values as on 1.4.2018

	₹
<b>Machinery</b>	
Revaluation as on 1.4.2018	3,00,000
Less: Book value as on 1.4.2018	<u>(2,00,000)</u>
Profit on revaluation	<u>1,00,000</u>
<b>Furniture</b>	
Revaluation as on 1.4.2018	30,000
Less: Book value as on 1.4.2018	<u>(40,000)</u>
Loss on revaluation	<u>(10,000)</u>

2. Calculation of short/excess depreciation

	Machinery	Furniture
Upward/ (Downward) Revaluation (W.N. 4)	1,00,000	(10,000)

Rate of depreciation	10% p.a.	15% p.a.
Difference [(short)/excess]	(10,000)	1,500

### 3. Analysis of reserves and profits of S Ltd. as on 31.03.2019

	Pre-acquisition profit upto 1.4.2018	Post-acquisition profits (1.4.2018 – 31.3.2019)	
	(Capital profits)	General Reserve	Profit and loss account
General reserve as on 31.3.2019	50,000	1,05,000	
Profit and loss account as on 31.3.2019	30,000		35,000
Upward Revaluation of machinery as on 1.4.2018	1,00,000		
Downward Revaluation of Furniture as on 1.4.2018	(10,000)		
Short depreciation on machinery (W.N. 5)			(10,000)
Excess depreciation on furniture (W.N. 5)			1,500
Total	<u>1,70,000</u>	<u>1,05,000</u>	<u>26,500</u>

### 4. Minority Interest

	₹
Paid-up value of (2,00,000 x 20%)	40,000
Add: 20% share of pre-acquisition profits and reserves [(20% of (50,000 + 30,000))]	16,000
20% share of profit on revaluation	18,000
20% share of post-acquisition reserves	21,000
20% share of post-acquisition profit	5,300
	<u>1,00,300</u>
Less: Unrealised Profit on Inventory (55,000 x 10/110) x 20%	(1,000)
	<u>99,300</u>

### 5. Cost of Control or Goodwill

Cost of Investment		3,20,000
Less: Paid-up value of 80% shares	1,60,000	
80% share of pre-acquisition profits and reserves		

(₹ 64,000 + ₹72,000)	1,36,000	(2,96,000)
Cost of control or Goodwill		<u>24,000</u>

14. (i) In accordance with the Schedule III, an investment realizable within 12 months from the reporting date is classified as a current asset. Such realization should be in the form of cash or cash equivalents, rather than through conversion of one asset into another non-current asset. Hence, company must classify such an investment as a non-current asset, unless it expects to sell the preference shares or the equity shares on conversion and realise cash within 12 months.

- (ii) **Calculation of foreseeable loss for the year ended 31<sup>st</sup> March, 2019**  
(as per AS 7 “Construction Contracts”)

	(₹ in lakhs)
Cost incurred till 31 <sup>st</sup> March, 2019	83.99
Prudent estimate of additional cost for completion	<u>36.01</u>
Total cost of construction	120.00
Less: Contract price	<u>(108.00)</u>
Foreseeable loss	<u>12.00</u>

According to para 35 of AS 7 (Revised 2002) “Construction Contracts”, when it is probable that total contract costs will exceed total contract revenue; the expected loss should be recognized as an expense immediately. Therefore, amount of ₹12 lakhs is required to be provided for in the books of Sampath Construction Company for the year ended 31<sup>st</sup> March, 2019.

15. Price revision was effected during the current accounting period 2018-2019. As a result, the company stands to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2019 to 31st March, 2019. If the company is able to assess the ultimate collection with reasonable certainty, then additional revenue arising out of the said price revision may be recognised in 2018-2019 vide para 10 of AS 9.
16. Mr. A will not be considered as a related party of SP Hotels Limited in view of paragraph 3(c) of AS 18 which states, “individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual”. In the given case, in the absence of share ownership, Mr. A would not be considered to exercise significant influence on SP Hotels Limited, even though there is an agreement giving him the power to manage the company. Further, the fact that Mr. A does not have the ability to direct or instruct the board of directors does not qualify him as a key management personnel.

17. As per AS 19 'leases', a lease will be classified as finance lease if at the inception of the lease, the present value of minimum lease payment\* amounts to at least substantially all of the fair value of leased asset. In the given case, the implicit rate of interest is given at 15%. The present value of minimum lease payments at 15% using PV- Annuity Factor can be computed as:

Annuity Factor (Year 1 to Year 3)	3.36
Present Value of minimum lease payments (₹ 3 lakhs each year)	₹ 10.08 lakhs (approx.)

Thus present value of minimum lease payments is ₹10.08 lakhs and the fair value of the machine is ₹ 30 lakhs. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred. However, in the given case, the effective useful life of the machine is 14 years while the lease is only for three years. Therefore, lease agreement is an operating lease. Lease payments under an operating lease should be recognized as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

**18. Computation of basic earnings per share**

Net profit for the current year / Weighted average number of equity shares outstanding during the year

$$₹ 37,50,000 / 5,00,000 = ₹ 7.50 \text{ per share}$$

**Computation of diluted earnings per share**  $\frac{\text{Adjusted net profit for the current year}}{\text{Weighted average number of equity shares}}$

**Adjusted net profit for the current year**

	₹
Net profit for the current year	37,50,000
Add: Interest expense for the current year	4,00,000
Less: Tax relating to interest expense (30% of ₹ 4,00,000)	<u>(1,20,000)</u>
Adjusted net profit for the current year	<u>40,30,000</u>

**Number of equity shares resulting from conversion of debentures**

= 55,000 Equity shares (given in the question)

---

\* In calculating the present value of the of minimum lease payments, the discount rate is the interest rate implicit in the lease.

**Weighted average number of equity shares used to compute diluted earnings per share**

= 5,55,000 shares (5,00,000 + 55,000)

**Diluted earnings per share**

= 40,30,000 / 5,55,000 = ₹ 7.26 per share

**Note:** Conversion of convertible debentures into Equity Share will be dilutive potential equity shares. Hence, to compute the adjusted profit the interest paid on such debentures will be added back as the same would not be payable in case these are converted into equity shares.

19. As per para 41 of AS 26 "Intangible Assets", expenditure on research should be recognized as an expense when it is incurred. An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the conditions specified in para 44 of the standard. An intangible asset (arising from development) should be derecognised when no future economic benefits are expected from its use according to para 87 of the standard. Thus, the manager cannot defer the expenditure write off to future years in the given case.

Hence, the expenses amounting ₹ 40 lakhs incurred on the research and development project has to be written off in the current year ending 31<sup>st</sup> March, 2019.

20. As per para 46 of AS 29 "Provisions, Contingent Liabilities and Contingent Assets", where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

It is apparent from the question that the company had not made provision for warranty in respect of certain goods considering that the company can claim the warranty cost from the original supplier. However, the provision for warranty should have been made as per AS 29 and the amount claimable as reimbursement should be treated as a separate asset in the financial statements of the company rather than omitting the disclosure of such liability. Accordingly, it is viewed that the accounting treatment adopted by the company with respect to warranty is not correct.

## PAPER – 6: AUDITING AND ASSURANCE

### PART – I : ACADEMIC UPDATE

(Legislative Amendments / Notifications / Circulars / Rules / Guidelines issued by  
Regulating Authority)

#### Chapter 10-Company Audit

(1) **Casual Vacancy by Resignation:** As per **section 140(2) of the Act**, the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed **Form ADT-3** (as per Rule 8 of CAAR) with the company and the Registrar.

In case of the companies referred to in **section 139(5)** i.e. Government company, the auditor shall also file such statement with the CAG along with the company and the Registrar.

The auditor shall indicate the reasons and other facts as may be relevant with regard to his resignation.

***In case of failure, the auditor shall be liable to a penalty of fifty thousand rupees or the remuneration of the auditor, whichever is less, and in case of continuing failure, with further penalty of five hundred rupees for each day after the first during which such failure continues, subject to a maximum of five lakh rupees as per section 140(3) of Companies (Amendment) Second Ordinance 2019.***

{Note: Amendment in section 140(3) of (Companies (Amendment) Second Ordinance 2019 dated 21 February 2019 has been inserted above in Bold and italic part. The Relevant page no 10.12 of the Company Audit Chapter under the heading no 2.3.1}

(2) **Submission of Cost Audit Report to the Central Government-** The company shall within 30 days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein in Form CRA-4 in Extensible Business Reporting Language (XBRL) format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

***Provided that the companies which have got extension of time of holding Annual General Meeting under section 96 (1) of the Companies Act, 2013, may file form CRA-4 within resultant extended period of filing financial statements under section 137 of the Companies Act, 2013.***

If, after considering the cost audit report and the, information and explanation furnished by the company as above, the Central Government is of the opinion, that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

**{Note: As per MCA notification dated 3 December 2018 vide Companies (cost records and audit) Amendment Rules, 2018, a Proviso has been inserted above in Bold and italic Relevant page no 10.44 of the Company Audit Chapter under the heading no 14 sub heading namely Submission of Cost Audit Report}**

## PART – II: QUESTIONS AND ANSWERS

### QUESTIONS

#### PART – II A: Multiple Choice Questions

1. Judging the significance of a matter requires \_\_\_\_\_ of the facts and circumstances.
  - (a) objective analysis
  - (b) subjective analysis
  - (c) Both subjective and objective analysis
  - (d) qualitative analysis
2. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of \_\_\_\_\_ exercised in performing the work and evaluating the results.
  - (a) professional skepticism
  - (b) professional integrity
  - (c) professional judgment
  - (d) Professional sincerity
3. Audit evidence is necessary to support the auditor's opinion and report. It is \_\_\_\_\_ in nature and is primarily obtained from audit procedures performed during the course of the audit.
  - (a) cumulative
  - (b) regressive
  - (c) selective
  - (d) objective



4. \_\_\_\_\_ refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
  - (a) Audit assessment procedures
  - (b) substantive procedures
  - (c) test of control
  - (d) Risk assessment procedures
5. When more persuasive audit evidence is needed regarding the effectiveness of a control,
  - (a) it may be appropriate to increase the extent of testing of the control and reduce the extent of the degree of reliance on controls.
  - (b) it may be appropriate to decrease the extent of testing of the control as well as the degree of reliance on controls.
  - (c) it may be appropriate to decrease the extent of testing of the control and increase the extent of the degree of reliance on controls.
  - (d) it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls.
6. When deviations from controls upon which the auditor intends to rely are detected,
  - (a) the auditor shall not make any inquiries to understand these matters and their potential consequences
  - (b) the auditor shall make specific inquiries to understand these matters and their potential consequences
  - (c) the auditor shall make general inquiries to understand these matters and their potential consequences
  - (d) the auditor shall make both general as well as specific inquiries to understand these matters and their potential consequences
7. Which of the following statement is correct :
  - (a) Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time
  - (b) Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time
  - (c) Substantive analytical procedures are generally more applicable to small volumes of transactions that tend to be predictable over time
  - (d) None of the above

8. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express:
- (a) a disclaimer opinion
  - (b) a qualified opinion
  - (c) a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.
  - (d) unmodified opinion
9. A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered is called-
- (a) Negative confirmation request
  - (b) Non-response
  - (c) Exception
  - (d) Positive confirmation request
10. In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, \_\_\_\_\_, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.
- (a) the board
  - (b) any director
  - (c) Managing Director
  - (d) Whole time director

#### **PART II B – DESCRIPTIVE QUESTIONS**

1. State with reason (in short) whether the following statements are true or false:
- (i) As per Section 139(6), the first auditor of a company, including a Government company, shall be appointed by the Board of Directors within 60 days from the date of registration of the company.
  - (ii) As per section 140(2) of the Act, the auditor who has resigned from the company need not inform the Registrar of Companies.
  - (iii) Preconditions for an audit have not been defined in SA 210 "Agreeing the Terms of Audit Engagements."
  - (iv) The auditor need not discuss elements of planning with the entity's management in any case.

- (v) Planning is a discrete phase of an audit.
- (vi) Subjective examination connotes critical examination and scrutiny of the accounting statements.
- (vii) Inquiry alone provides sufficient audit evidence of the absence of a material misstatement at the assertion level and of the operating effectiveness of controls.
- (viii) The assessment of risks is a matter capable of precise measurement.
- (ix) According to Section 53 of the Companies Act, 2013, a company can issue shares at a discount.
- (x) An intangible asset is an identifiable monetary asset.

### Chapter 1- Nature, Objective and Scope of Audit

2. (a) An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so. Explain stating the factors based on which client can request the auditor to change the engagement.  
(b) The firm should **establish policies and procedures** designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements. Explain in the above context the purpose of monitoring compliance with quality control policies and procedures.
3. (a) The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.  
In the above context, explain the guiding principles.  
(b) Write a note on "Self-review threats"

### Chapter 2- Audit Strategy, Audit Planning and Audit Programme

4. (a) Plans should be made to cover acquiring knowledge of the client's accounting systems, policies and internal control procedures. Explain.  
(b) As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan. Explain.
5. (a) Engagement partner of Audit Firm MKC AND COMPANY thinks that Planning an audit would involve establishing the overall audit strategy for the engagement and developing an audit plan. Also, Adequate planning would benefit the audit of financial statements in several ways. Analyse explaining the benefits of adequate planning.

- (b) Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after the completion of the previous audit and continues until the completion of the current audit engagement. Analyse and Explain.

### Chapter 3- Audit Documentation and Audit Evidence

6. (a) Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively. He needs evidence to obtain information for arriving at his judgment. Discuss explaining clearly the detailed meaning of audit evidence.
- (b) Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Explain
7. (a) SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files. Explain
- (b) When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. Explain stating also the objective of the auditor regarding going concern.
8. (a) Discuss the meaning and nature of Audit Documentation.
- (b) Explain clearly objective of the auditor regarding written representation.

### Chapter 4- Risk Assessment and Internal Control

9. (a) Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. Analyse and Explain.
- (b) The extent and the nature of the audit programme is substantially influenced by the internal control system in operation. Analyse and explain.
10. (a) The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". Explain.
- (b) The auditor of FAST CARS Ltd obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether management has created and maintained a culture of honesty and ethical behaviour and the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.
- Advise what is included in control environment. Also explain the elements of control environment.

**Chapter 5- Fraud and Responsibilities of the Auditor in this Regard.**

11. The scope of auditor's inquiry under **clause (x)** of paragraph 3 of Companies (Auditor's Report) Order, 2016 is restricted to frauds 'noticed or reported' during the year. Explain.
12. Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence. Explain stating clearly how this type of fraud is generally committed.

**Chapter 6- Audit in an Automated Environment**

13. Give some of the points that an auditor should consider to obtain an understanding of the company's automated environment:
14. Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should understand the risks that arise from the use of IT systems. Explain those risks.

**Chapter 7- Audit Sampling**

15. There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. Explain
16. The extent of the checking to be undertaken is primarily a matter of judgment of the auditor. It is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed Explain

**Chapter 8 - Analytical Procedures**

17. Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis. Analyse and Explain stating clearly the meaning of analytical procedures.
18. Give examples of Analytical Procedures having consideration of comparisons of the entity's financial information

**Chapter 9 - Audit of Items of Financial Statements**

19. The auditor A of ABC & Co.- firm of auditors is conducting the audit of XYZ Ltd and while performing testing of additions wanted to verify that all PPE (Property Plant and Equipment) purchase invoices are in the name of the entity he is auditing. For all additions to land, building in particular, the auditor desires to have concrete evidence about ownership. The auditor is worried about whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Advise the auditor.
20. Explain with examples the audit procedure to establish the existence of intangible fixed assets as at the period- end.

**Chapter 10 - The Company Audit**

21. The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Explain stating the advantages of the joint audit.
22. According to Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report in accordance with the relevant provisions of the Act. Explain clearly the relevant provisions relating to signing of report.
23. The auditor shall make a report to the members of the company on the accounts examined by him. Explain with reference to relevant provisions of the Companies Act, 2013.

**Chapter 11 - Audit Report**

24. Communicating Key Audit Matter is not a substitute for disclosure in the Financial Statements rather Communicating key audit matters in the auditor's report is in the context of the Auditor having formed an opinion on the financial statements as a whole. Analyse.
25. The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section.

**Chapter 12- Bank Audit**

26. (a) Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors. In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about, among other points, the amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet. Explain
- (b) The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances. Explain in the context of Audit of Banks.

**Chapter 13- Audit of Different Types of Entities**

27. (a) Audit of government expenditure is one of the major components of government audit conducted by the office of C&AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Explain those standards.
- (b) Explain in detail the duties of Comptroller and Auditor General of India.
28. What are the special steps involved in conducting the audit of an Educational Institution?

## SUGGESTED ANSWERS / HINTS

## ANSWERS - MULTIPLE CHOICE QUESTIONS

1. (a)
2. (c)
3. (a)
4. (d)
5. (d)
6. (b)
7. (a)
8. (c)
9. (b)
10. (a)

## DESCRIPTIVE ANSWERS

1. (i) **Incorrect:** As per **Section 139(6)**, the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.
- (ii) **Incorrect:** As per section 140(2) of the Act, the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT-3 (as per Rule 8 of CAAR) with the company and the Registrar.
- (iii) **Incorrect:** As per SA 210 "Agreeing the Terms of Audit Engagements", preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.
- (iv) **Incorrect:** The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement.
- (v) **Incorrect:** According to SA-300, "Planning an Audit of Financial Statements", planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

- (vi) **Incorrect:** Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs.
- (vii) **Incorrect:** Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.
- (viii) **Incorrect:** The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.
- (ix) **Incorrect:** According to Section 53 of the Companies Act, 2013, a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54 of the Companies Act, 2013.
- (x) **Incorrect:** An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.
2. (a) An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.
- A request from the client for the auditor to change the engagement may result from -
1. a **change in circumstances** affecting the need for the service,
  2. a **misunderstanding** as to the nature of an audit or related service originally requested.
  3. a **restriction on the scope of the engagement**, whether imposed by management or caused by circumstances.
- (b) The firm should **establish policies and procedures** designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.
- The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:
- (a) Adherence to professional standards and regulatory and legal requirements;
  - (b) Whether the quality control system has been appropriately designed and



effectively implemented; and

- (c) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

3. (a) The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

The following are the guiding principles in this regard: -

1. For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
2. In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.
3. Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
4. When such threats exist, the auditor should either desist from the task or put in place safeguards that eliminate them.
5. If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

- (b) **Self-review threats**, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement (Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.), or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.

4. (a) **The auditor should plan his work to enable him to conduct an effective audit** in an efficient and timely manner. Plans should be based on knowledge of the client's business.

**Plans should be made to cover, among other things:**

- (a) acquiring knowledge of the client's accounting systems, policies and internal control procedures;

- (b) establishing the expected degree of reliance to be placed on internal control;
- (c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and
- (d) coordinating the work to be performed.

From the above, it is clear that statement given in the question is partly correct.

- (b) **The auditor shall update and change the overall audit strategy** and the audit plan as necessary during the course of the audit. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. **For example**, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.
5. (a) Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:
1. Helping the auditor to devote appropriate attention to important areas of the audit.
  2. Helping the auditor identify and resolve potential problems on a timely basis.
  3. Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
  4. Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
  5. Facilitating the direction and supervision of engagement team members and the review of their work.
  6. Assisting, where applicable, in coordination of work done by auditors of components and experts.
- (b) Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

1. The analytical procedures to be applied as risk assessment procedures.
  2. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
  3. The determination of materiality.
  4. The involvement of experts.
  5. The performance of other risk assessment procedures.
6. (a) Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgment.

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

**Explaining this further, audit evidence includes:-**

- (1) **Information contained in the accounting records:** Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
- (2) **Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements:** Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

- (b) **Audit evidence is necessary to support the auditor's opinion and report.** It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated.

7. (a) **The auditor shall assemble the audit documentation in an audit file** and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

- ◆ Deleting or discarding superseded documentation.
- ◆ Sorting, collating and cross referencing working papers.
- ◆ Signing off on completion checklists relating to the file assembly process.
- ◆ Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

- (b) Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Objectives of the auditor regarding going concern

The objectives of the auditor are:

- (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
  - (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and
  - (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.
8. (a) **Audit documentation:** SA 230 on "Audit Documentation", audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as "working papers" or "work papers" are also sometimes used.)

**Nature of Audit Documentation****Audit documentation provides:**

- (a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and
- (b) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

**(b) The objectives of the auditor regarding written representation**

The objectives of the auditor are:

**(a) To obtain written representations**

To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

**(b) To support other evidence**

To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and

**(c) To respond appropriately**

To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

9. (a) **While obtaining audit evidence about the effective operation of internal controls**, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether

the assessment of control risk is confirmed. In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures.

It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorisation, recording and documentation of transaction at each stage through which it flows.

- (b) **The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation.** If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers. It is also important for him to know whether the system is actually in operation. Often, after installation of a system, no proper follow up is there by the management to ensure compliance. The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially. This state of affairs is probably the worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.

It would be better if the auditor can undertake the review of the internal control system of client. This will give him enough time to assimilate the controls and implications and will enable him to be more objective in the framing of the audit programme. He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed.

From the foregoing, it can be concluded that the extent and the nature of the audit programme is substantially influenced by the internal control system in operation. In deciding upon a plan of test checking, the existence and operation of internal control system is of great significance.

A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme.

In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be

required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction.

10. (a) The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

It can be concluded from the above that-

**Risk of Material Misstatement= Inherent Risk x Control Risk**

- (b) **Control Environment – Component of Internal Control:** The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
- (i) Management has created and maintained a culture of honesty and ethical behavior; and
  - (ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

**What is included in Control Environment?**

The control environment includes:

- (i) the governance and management functions and
- (ii) the attitudes, awareness, and actions of those charged with governance and management.
- (iii) The control environment sets the tone of an organization, influencing the control consciousness of its people.

**Elements of the Control Environment:** Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- (a) **Communication and enforcement of integrity and ethical values** – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
- (b) **Commitment to competence** – Matters such as management’s consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.



- (c) **Participation by those charged with governance** – Attributes of those charged with governance such as:
- ◆ Their independence from management.
  - ◆ Their experience and stature.
  - ◆ The extent of their involvement and the information they receive, and the scrutiny of activities.
  - ◆ The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
- (d) **Management's philosophy and operating style – Characteristics such as management's:**
- ◆ Approach to taking and managing business risks.
  - ◆ Attitudes and actions toward financial reporting.
  - ◆ Attitudes toward information processing and accounting functions and personnel.
- (e) **Organisational structure** – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
- (f) **Assignment of authority and responsibility** - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.
- (g) **Human resource policies and practices** – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.
- 11. Reporting under Companies (Auditor's Report) Order, 2016 [CARO, 2016]:** The auditor is also required to report under **clause (x)** of paragraph 3 of Companies (Auditor's Report) Order, 2016, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

The scope of auditor's inquiry under **clause (x)** of paragraph 3 of Companies (Auditor's Report) Order, 2016 is restricted to frauds 'noticed or reported' during the year. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of SA 240, "The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements".

**Audit Procedures and Reporting under CARO:**

- (1) While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.
- (2) The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon.

The auditor should enquire from the management about any frauds on the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees including officers of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.

- (3) The auditor should obtain written representations from management that:
  - (i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;
  - (ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;
  - (iii) it has
    - (a) disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and
    - (b) disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- (4) Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their

written representation words such as, "We do not agree that items constitute misstatements because [description of reasons]."

The auditor should consider if any fraud has been reported by them during the year under section 143(12) of the Act and if so whether that same would be reported under this Clause. It may be mentioned here that section 143(12) of the Act requires the auditor has reasons to believe that a fraud is being committed or has been committed by an employee or officer. In such a case the auditor needs to report to the Central Government or the Audit Committee. However, this Clause will include only the reported frauds and not suspected fraud.

- (5) Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:
- (i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered.
  - (ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.
  - (iii) While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.

**12. Manipulation of Accounts:** Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed:

- (a) to avoid incidence of income-tax or other taxes;
- (b) for declaring a dividend when there are insufficient profits;
- (c) to withhold declaration of dividend even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and
- (d) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

13. Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment:
- ◆ Information systems being used (one or more application systems and what they are).
  - ◆ Their purpose (financial and non-financial).
  - ◆ Location of IT systems - local vs global.
  - ◆ Architecture (desktop based, client-server, web application, cloudbased).
  - ◆ Version (functions and risks could vary in different versions of same application).
  - ◆ Interfaces within systems (in case multiple systems exist).
  - ◆ In-house vs Packaged.
  - ◆ Outsourced activities (IT maintenance and support).
  - ◆ Key persons (CIO, CISO, Administrators).
14. Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems.
- Given below are some such risks that should be considered:
- ◆ Inaccurate processing of data, processing inaccurate data, or both.
  - ◆ Unauthorized access to data.
  - ◆ Direct data changes (backend changes).
  - ◆ Excessive access / Privileged access (super users).
  - ◆ Lack of adequate segregation of duties.
  - ◆ Unauthorized changes to systems or programs.
  - ◆ Failure to make necessary changes to systems or programs.
  - ◆ Loss of data.
15. No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished and auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment

of non-consequential routine checking. By routine checking we traditionally think of extensive checking and vouching of all entries.

16. The extent of the checking to be undertaken is primarily a matter of judgment of the auditor, there is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do is to express his opinion and become bound by that. To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On a consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed and which have a recognised basis. Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability.

17. Since routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests. These collectively are known as overall tests. With the passage of tests, analytical procedures have acquired lot of significance as substantive audit procedure. SA-520 on Analytical Procedures discusses the application of analytical procedures during an audit.



**Meaning of Analytical Procedures.** As per the Standard on Auditing (SA) 520 “Analytical Procedures”, the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

18. **Examples of Analytical Procedures having consideration of comparisons of the entity’s financial information with are:**
- ◆ Comparable information for prior periods.
  - ◆ Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
  - ◆ Similar industry information, such as a comparison of the entity’s ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry
19. In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity. For all additions to land, building in particular, the

auditor should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

The auditor should insist and verify the original title deeds for all immovable properties held as at the balance sheet date. In case the entity has given such immovable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immovable property as security. In addition, the auditor should also verify the register of charges, available with the entity to assess the PPE that has been given as security to any third parties

- 20. Since an Intangible Asset is an identifiable non-monetary asset**, without physical substance, for establishing the existence of such assets, the auditor should verify whether such intangible asset is in active use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Example- for verifying the existence of software, the auditor should verify whether such software is in active use by the entity and for the purpose, the auditor should verify the sale of related services/ goods during the period under audit, in which such software has been used.

Example- For verifying the existence of design/ drawings, the auditor should verify the production data to establish if such products for which the design/ drawings were purchased, are being produced and sold by the entity.

In case any intangible asset is not in active use, deletion should have been recorded in the books of account post approvals by the entity's management and amortization charge should have ceased to be charged beyond the date of deletion Chapter 10 - The Company Audit

- 21. Joint Audit:** The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the **advantages** that flow may be the following:

- (i) Sharing of expertise.
- (ii) Advantage of mutual consultation.
- (iii) Lower workload.
- (iv) Better quality of performance.
- (v) Improved service to the client.
- (vi) Displacement of the auditor of the company taken over in a takeover often obviated.

- (vi) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- (vii) Lower staff development costs.
- (ix) Lower costs to carry out the work.
- (x) A sense of healthy competition towards a better performance

**22. Duty to Sign the Audit Report:** As per **section 145** of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company, in accordance with the provisions of **section 141(2)**.

**Section 141(2)** of the Companies Act, 2013 states that where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

The qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting.

**23. Right to report to the members of the company on the accounts examined by him –**

The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under this section and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

**24. Communicating key audit matters in the auditor's report is not:**

- (i) A substitute for disclosures in the financial statements that the applicable Financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
- (ii) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);
- (iii) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
- (iv) A separate opinion on individual matters

25. **Basis for Opinion:** The auditor's report shall include a section, directly following the Opinion section, with the heading "**Basis for Opinion**", that:
- (a) States that the audit was conducted in accordance with Standards on Auditing;
  - (b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
  - (c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.
  - (d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.
26. (a) **Audit of Advances:** Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.
- In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:
- (a) Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
  - (b) Advances represent amount due to the bank.
  - (c) Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
  - (d) There are no unrecorded advances.
  - (e) The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
  - (f) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
  - (g) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.
- (b) The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:
- ◆ examining the validity of the recorded amounts;
  - ◆ examining loan documentation;
  - ◆ reviewing the operation of the accounts;
  - ◆ examining the existence, enforceability and valuation of the security;



- ◆ checking compliance with RBI norms including appropriate classification and provisioning; and
- ◆ carrying out appropriate analytical procedures.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts however need to be examined in detail unless the amount involved is insignificant.

Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.

- 27 (a) **Government Expenditure Audit:** Audit of government expenditure is one of the major components of government audit conducted by the office of C&AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. **Briefly, these standards are explained below:**
- (i) **Audit against Rules & Orders:** The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority.
  - (ii) **Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorising such expenditure.
  - (iii) **Audit against Provision of Funds:** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made.
  - (iv) **Propriety Audit:** It is required to be seen that the expenditure is incurred with due regard to broad and general principles of financial propriety. The auditor aims to bring out cases of improper, avoidable, or in fructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Audit aims to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions.
  - (v) **Performance Audit:** This involves that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

- (b) **Duties of C&AG: The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under-**
- (i) **Compile and submit Accounts of Union and States** - The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.
  - (ii) **General Provisions Relating to Audit - It shall be the duty of the C&AG –**
    - (a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;
    - (b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;
    - (c) to audit and report on all trading, manufacturing profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.
  - (iii) **Audit of Receipts and Expenditure** - Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.
  - (iv) **Audit of Grants or Loans** - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.
  - (v) **Audit of Receipts of Union or States** - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated

Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.

- (vi) **Audit of Accounts of Stores and Inventory** - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.
- (vii) **Audit of Government Companies and Corporations** - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

**28. The Special Steps Involved in the Audit of an Educational Institution are the following:**

- (i) Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.
- (ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.
- (iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.
- (iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

- (v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
- (vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.
- (vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.
- (viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.
- (ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.
- (x) Verify rental income from landed property with the rent rolls, etc.
- (xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
- (xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.
- (xiii) Report any old heavy arrears on account of fees, dormitory rents, etc, to the Managing Committee.
- (xiv) Confirm that caution money and other deposits paid by students on admission have been shown as liability in the balance sheet and not transferred to revenue.
- (xv) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.
- (xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.
- (xvii) Vouch donations, if any, with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.
- (xviii) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

- (xix) Vouch in the usual manner all establishment expenses and enquire into any unduly heavy expenditure under any head.
- (xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.
- (xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
- (xxii) Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. These should be checked by reference to Inventory Register and values applied to various items should be test checked.
- (xxiii) Confirm that the refund of taxes deducted from the income from investment (interest on securities, etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.
- (xxiv) Verify the annual statements of accounts and while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of Staff, etc.

**PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC  
MANAGEMENT**

**SECTION – A: ENTERPRISE INFORMATION SYSTEMS  
QUESTIONS**

**Multiple Choice Questions**

1. In an organization, there are certain risks that would prevent an organization from accomplishing its objectives and meeting its goals. These are referred as \_\_\_\_\_ risks.
  - (a) Operational
  - (b) Strategic
  - (c) Financial
  - (d) Reputational
  
2. Mr. A visited an e-commerce website and placed an order for a pair of shoes. He made his payment of ₹ 2,000 through credit card and received a confirmation mail on his registered email-id. With respect to e-commerce architecture, which layer of the software is he working on?
  - (a) Database Layer
  - (b) Application Layer
  - (c) Presentation Layer
  - (d) Client Layer
  
3. Which of the following statement is incorrect?
  - (a) A Proxy Server is a computer that offers a computer network service to allow clients to make indirect network connections to other network services.
  - (b) The term Information Security refers to ensure Confidentiality, Integrity and Availability of information.
  - (c) Any Application Software has primarily four gateways through which enterprise can control functioning, access and use the various menus and functions of the software - Configuration, Masters, Transactions and Reports.
  - (d) Section 66-C of Information Technology Act, 2000 provides for the punishment for cheating by personation by using computer resource.

4. An amount of ₹100/- is to be written off as same is not recovered from customer since last three years. Which voucher is best suited for the transaction?
  - (a) Journal
  - (b) Sales
  - (c) Purchase
  - (d) Contra
  
5. While doing a concurrent audit in a bank, Mr. X noticed that some changes have been made to advance master data files of the database. He uses an audit technique to identify such suspicious transactions. This technique shall be defined as \_\_\_\_\_.
  - (a) Continuous and Intermittent Simulation (CIS)
  - (b) System Control Audit Review File (SCARF)
  - (c) Audit Hook
  - (d) Integrated Test Facility (ITF)

**Descriptive Questions**

**Chapter 1: Automated Business Processes**

1. A book publisher offered discount to customers based on their mode of purchase and the number of copies ordered as shown below:

Mode of Purchase	Number of copies ordered	Discount %
Online	More than 5	20
	Less than or equal to 5	15
Offline	More than 10	10
	Less than or equal to 10	5

If Customer name, Customer type, Date of order placed, Number of copies ordered and unit price are input; draw a flowchart to calculate the net amount of the bill and date of purchase for each customer and print it. The above is to be carried out for 50 customers.

2. Discuss all the stages of Human Resource (HR) Life Cycle.

**Chapter 2: Financial and Accounting Systems**

3. Sales and Distribution Process that is used by organizations to support sales and distribution activities of products and services, starting from enquiry to order and then ending with delivery is one of the most important module in ERP. Determine the various activities that are involved in Sales and Distribution Process.

4. Describe the term "Business Reporting" and why do you think there is a need of it in today's world?

### **Chapter 3: Information Systems and Its Components**

5. Many organizations now recognize that data is a critical resource that must be managed properly and therefore, accordingly, centralized planning and control are implemented. Identify the various control activities involved in maintaining the integrity of the database.
6. An Internet connection exposes an organization to the harmful elements of the outside world. Prepare a list of various Network Access Controls by means of which the protection can be achieved against these harmful elements.

### **Chapter 4: E- Commerce, M-Commerce and Emerging Technologies**

7. Discuss various Commercial Laws that govern e-Commerce/m-Commerce transactions in India.
8. The Prime Minister Office of a country X plans to establish specific infrastructure setup with its access shared amongst members of the group constituting of some selected high-profiled dignitaries and officers from different ministries. The objective of the group is to carry out certain assignments related to nation's security and integrity. Which is the most suitable choice of the cloud under Cloud Computing? Discuss its advantages and limitations as well.

### **Chapter 5: Core Banking Systems**

9. "The deployment and implementation of Core Banking Systems (CBS) should be controlled at various stages to ensure that the banks automation objectives are achieved". Analyse the statement.
10. Differentiate between Internet Banking Channel Server (IBCS) and Internet Banking Application Server (IBAS) used in Core Banking Systems (CBS).

## **SUGGESTED ANSWERS/HINTS**

### **Multiple Choice Answers**

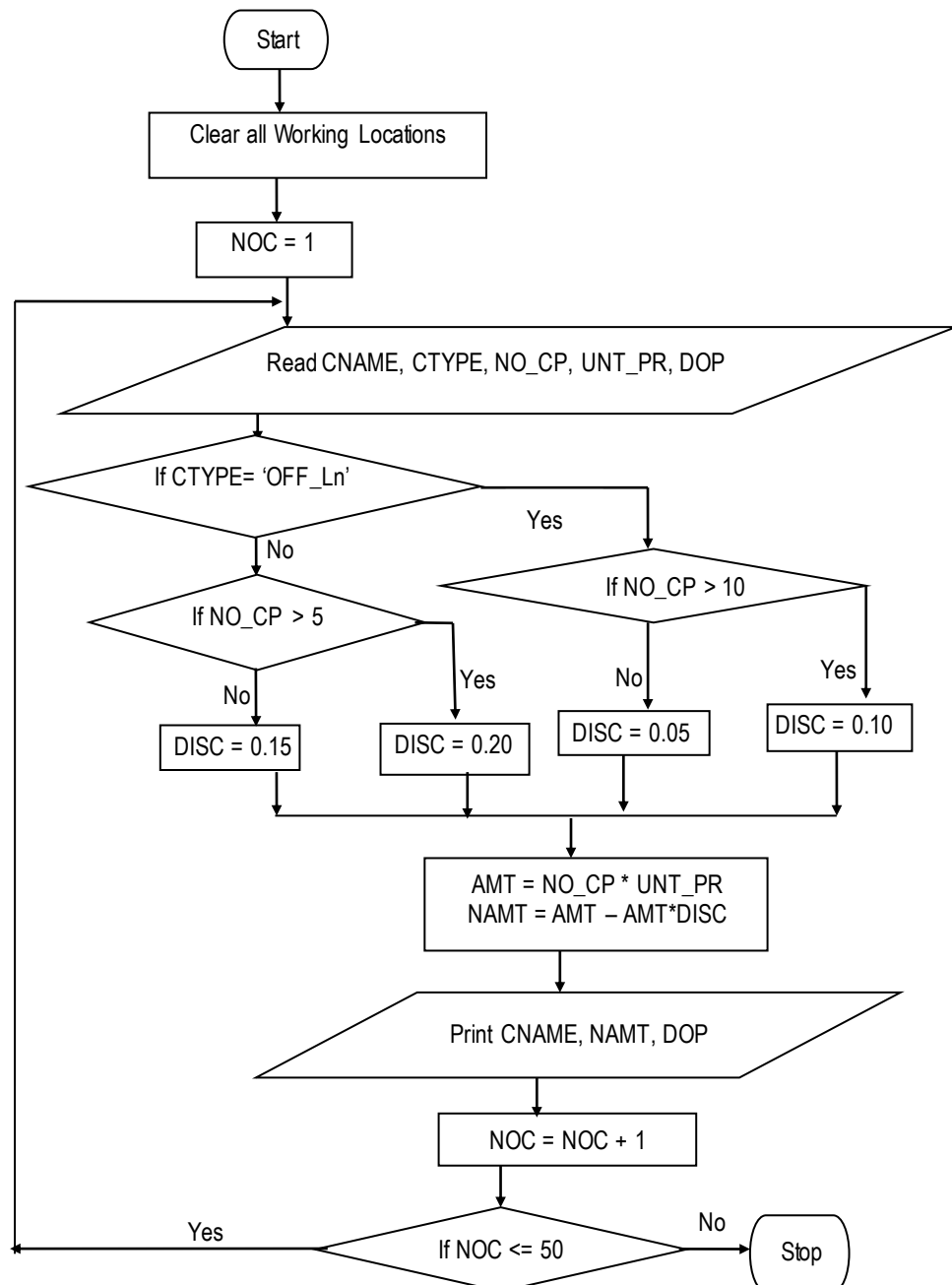
1. (b) Strategic
2. (b) Application Layer
3. (d) Section 66-C of Information Technology Act, 2000 provides for the punishment for cheating by personation by using computer resource.
4. (a) Journal



5. (c) Audit Hook

**Descriptive Answers**

1. The required flowchart is given below:



Abbreviations used in the flowchart are as follows:

DOP	-	Date of order placed	CNAME	-	Customer Name
NO_CP	-	Number of Copies	UNT_PR	-	Unit Price
DISC	-	Discount	AMT	-	Total Amount
NAMT	-	Net Amount	NOC	-	Number of Customers
CTYPE	-	Type of the Customer (Can either be Online or Offline[OFF_LN])			

2. The Human Resources (HR) Life Cycle refers to human resources management and covers all the stages of an employee's time within a specific enterprise and the role the human resources department plays at each stage. Typical stage of HR cycle includes the following:
- Recruiting and On-boarding: Recruiting** is the process of hiring a new employee. The role of the human resources department in this stage is to assist in hiring. This might include placing the job ads, selecting candidates whose resumes look promising, conducting employment interviews and administering assessments such as personality profiles to choose the best applicant for the position. **On boarding** is the process of getting the successful applicant set up in the system as a new employee.
  - Orientation and Career Planning: Orientation** is the process by which the employee becomes a member of the company's work force through learning her new job duties, establishing relationships with co-workers and supervisors and developing a niche. **Career planning** is the stage at which the employee and her supervisors work out her long-term career goals with the company. The human resources department may make additional use of personality profile testing at this stage to help the employee determine her best career options with the company.
  - Career Development: Career development** opportunities are essential to keep an employee engaged with the company over time. After an employee, has established himself at the company and determined his long-term career objectives, the human resources department should try to help him meet his goals, if they're realistic. This can include professional growth and training to prepare the employee for more responsible positions with the company. The company also assesses the employee's work history and performance at this stage to determine whether he has been a successful hire.
  - Termination or Transition:** Some employees will leave a company through retirement after a long and successful career. Others will choose to move on to other opportunities or be laid off. Whatever the reason, all employees will eventually leave the company. The role of HR in this process is to manage the transition by ensuring that all policies and procedures are followed, carrying out an exit interview

if that is company policy and removing the employee from the system. These stages can be handled internally or with the help of enterprises that provide services to manage the employee life cycle.

3. The various activities that are involved in a Sales and Distribution Process are as follows:
- **Pre-Sales Activities:** This include prospecting of customers, identifying prospective customers, gathering data, contacting them and fixing appointments, showing demo, discussion, submission of quotations, etc.
  - **Sales Order:** Sales order is recorded in our books after getting a confirmed purchased order from our customer. Sales order shall contain details just like purchase order. E.g. Stock Item Details, Quantity, Rate, Due Date of Delivery, Place of Delivery, etc.
  - **Inventory Sourcing:** It includes making arrangements before delivery of goods, ensuring goods are ready and available for delivery.
  - **Material Delivery:** Material is delivered to the customer as per sales order. All inventory details are copied from Sales Order to Material Delivery for saving user's time and efforts. This transaction shall have a linking with Sales Order. Stock balance shall be reduced on recording of this transaction.
  - **Billing:** This is a transaction of raising an invoice against the delivery of material to customer. This transaction shall have a linking with Material Delivery and all the details shall be copied from it. Stock balance shall not affect again.
  - **Receipt from Customer:** This is a transaction of receiving amount from customer against sales invoice and shall have a linking with sales invoice.
4. **Business Reporting** is defined as the public reporting of operating and financial data by a business enterprise, or the regular provision of information to decision-makers within an organization to support them in their work. This reporting process involves querying data sources with different logical models to produce a human readable report - for example, a computer user must query the Human Resources databases and the Capital Improvements databases to show how efficiently space is being used across an entire corporation.

Through reporting, organizations communicate with their stakeholders about:

- mission, vision, objectives, and strategy;
- governance arrangements and risk management;
- trade-offs between the shorter- and longer-term strategies; and
- financial, social, and environmental performance (how they have fared against their objectives in practice).

The need of Business Reporting is for following reasons:

- Effective and transparent business reporting allows organizations to present a cohesive explanation of their business and helps them engage with internal and external stakeholders, including customers, employees, shareholders, creditors, and regulators.
  - High-quality business reporting is at the heart of strong and sustainable organizations, financial markets, and economies, as this information is crucial for stakeholders to assess organizational performance and make informed decisions with respect to an organization's capacity to create and preserve value.
  - Many organizations are increasingly complex, and have larger economic, environmental, and social footprints. Thus, various stakeholder groups require ESG (Environmental, Social and Governance) information, as well as greater insight into how these factors affect financial performance and valuations.
  - High-quality reports also promote better internal decision-making. High-quality information is integral to the successful management of the business, and is one of the major drivers of sustainable organizational success.
5. Many organizations now recognize that data is a critical resource that must be managed properly and therefore, accordingly, centralized planning and control are implemented. For data to be managed better; users must be able to share data, data must be available to users when it is needed, in the location where it is needed, and in the form in which it is needed. Careful control should be exercised over the roles by appointing senior, trustworthy persons, separating duties to the extent possible and maintaining and monitoring logs of the data administrator's and database administrator's activities.

The control activities involved in maintaining the integrity of the database is as under:

- (a) **Definition Controls:** These controls are placed to ensure that the database always corresponds and comply with its definition standards.
- (b) **Existence/Backup Controls:** These ensure the existence of the database by establishing backup and recovery procedures. Backup refers to making copies of the data so that these additional copies may be used to restore the original data after a data loss. Backup controls ensure the availability of system in the event of data loss due to unauthorized access, equipment failure or physical disaster; the organization can retrieve its files and databases. Various backup strategies like dual recording of data; periodic dumping of data; logging input transactions and changes to the data are used.
- (c) **Access Controls:** Access controls are designed to prevent unauthorized individual from viewing, retrieving, computing or destroying the entity's data. These controls are User Access Controls through passwords, tokens and biometric Controls; and Data Encryption controls that keep the data in database in encrypted form.

- (d) **Update Controls:** These controls restrict update of the database to authorized users by either permitting only addition of data to the database or allowing users to change or delete existing data.
  - (e) **Concurrency Controls:** These controls provide solutions, agreed-upon schedules and strategies to overcome the data integrity problems that may arise when two update processes access the same data item at the same time.
  - (f) **Quality Controls:** These controls ensure the accuracy, completeness, and consistency of data maintained in the database. This may include traditional measures such as program validation of input data and batch controls over data in transit through the organization.
6. Various Network Access Controls by means of which the protection can be achieved against harmful elements in an organization are as follows:
- **Policy on use of network services:** An enterprise wide policy applicable to internet service requirements aligned with the business need for using the Internet services is the first step. Selection of appropriate services and approval to access them should be part of this policy.
  - **Enforced path:** Based on risk assessment, it is necessary to specify the exact path or route connecting the networks; e.g., internet access by employees will be routed through a firewall and proxy.
  - **Segregation of networks:** Based on the sensitive information handling function; say a Virtual Private Network (VPN) connection between a branch office and the head-office, this network is to be isolated from the internet usage service
  - **Network connection and routing control:** The traffic between networks should be restricted, based on identification of source and authentication access policies implemented across the enterprise network facility.
  - **Security of network services:** The techniques of authentication and authorization policy should be implemented across the organization's network.
  - **Firewall:** A Firewall is a system that enforces access control between two networks. To accomplish this, all traffic between the external network and the organization's Intranet must pass through the firewall that will allow only authorized traffic between the organization and the outside to pass through it. The firewall must be immune to penetrate from both outside and inside the organization.
  - **Encryption:** Encryption is the conversion of data into a secret code for storage in databases and transmission over networks. The sender uses an encryption algorithm with a key to convert the original message called the Clear text into Cipher text. This is decrypted at the receiving end.
  - **Call Back Devices:** It is based on the principle that the key to network security is to keep the intruder off the Intranet rather than imposing security measure after the

criminal has connected to the intranet. The call-back device requires the user to enter a password and then the system breaks the connection. If the caller is authorized, the call back device dials the caller's number to establish a new connection. This limits access only from authorized terminals or telephone numbers and prevents an intruder masquerading as a legitimate user.

7. Following commercial laws are applicable to e-commerce and m-commerce transactions in India.

- **Income Tax Act, 1961:** Income Tax Act, has detailed provisions regarding taxation of income in India. In respect of e-commerce / m-commerce transactions; the issue of deciding place of origin transaction for tax purpose is critical.
- **Companies Act, 2013:** Companies Act, 2013, regulates the corporate sector. The law defines all regulatory aspects for companies in India. Most of the merchants in e-commerce / m-commerce business are companies, both private and public.
- **Foreign Trade (Development and Regulation) Act, 1992:** This is an act to provide for the development and regulation of foreign trade by facilitating imports into, augmenting exports from India and for matters connected therewith or incidental thereto.
- **The Factories Act, 1948:** This is an act to regulate working conditions of workers and extends to the place of storage as well as transportation. Most of the merchants in e-commerce/m-commerce business need to comply with provisions of the act.
- **The Custom Act, 1962:** This act defines import/export of goods/services from India and provides for levy of appropriate customs duty.
- **The Goods and Services Tax Act, 2017 (GST):** This Act requires each applicable business, including e-commerce/m-commerce, to upload each sales and purchase invoice on one central IT infrastructure, mandating reconciliations of transactions between business, triggering of tax credits on payments of GST, facilitating filling of e-returns, etc.
- **Indian Contract Act, 1872:** This act defines constituents of a valid contract. In case of e-commerce/m-commerce business, it becomes important to define these constituents.
- **The Competition Act, 2002:** This is a law to regulate practices that may have adverse effect on competition in India. Competition Commission have been vigilant to ensure that e-commerce/m-commerce merchants do not engage in predatory practices.
- **Foreign Exchange Management Act (FEMA 1999):** This law regulates foreign direct investments, flow of foreign exchange in India and has important implications

for e-commerce/m-commerce business.

- **Consumer Protection Act, 1986:** The law to protect consumer rights has been source of most of litigations for transaction done through e-commerce and m-commerce.

All laws above have same nature of applicability as in a normal commercial transaction. The fact that transactions are done electronically gives rise to issues which are unique in nature. Few of issues have been put to rest by court decisions but new issues crop up every day.

8. The most suitable choice is **Community Cloud** which is the cloud infrastructure provisioned for exclusive use by a specific community of consumers from organizations that have shared concerns (eg. mission security requirements, policy, and compliance considerations). It may be owned, managed, and operated by one or more of the organizations in the community, a third party or some combination of them, and it may exist on or off premises. In this, a private cloud is shared between several organizations. This model is suitable for organizations that cannot afford a private cloud and cannot rely on the public cloud either.

Advantages of Community Cloud are as follows:

- It allows establishing a low-cost private cloud.
- It allows collaborative work on the cloud.
- It allows sharing of responsibilities among the organizations.
- It has better security than the public cloud.

The **limitation of the Community Cloud** is that the autonomy of the organization is lost and some of the security features are not as good as the private cloud. It is not suitable in the cases where there is no collaboration.

9. The deployment and implementation of Core Banking Systems (CBS) should be controlled at various stages to ensure that banks automation objectives are achieved:
  - **Planning:** Planning for implementing the CBS should be done as per strategic and business objectives of bank.
  - **Approval:** The decision to implement CBS requires high investment and recurring costs and will impact how banking services are provided by the bank. Hence, the decision must be approved by the Board of directors.
  - **Selection:** Although there are multiple vendors of CBS, each solution has key differentiators. Hence, bank should select the right solution considering various parameters as defined by the bank to meet their specific requirements and business objectives.
  - **Design and develop or procured:** CBS solutions used to be earlier developed in-house by the bank. Currently, most of the CBS deployment are procured. There

should be appropriate controls covering the design or development or procurement of CBS for the bank.

- **Testing:** Extensive testing must be done before the CBS is live. The testing is to be done at different phases at procurement stage to test suitability to data migration to ensure all existing data is correctly migrated and testing to confirm processing of various types of transactions of all modules produces the correct results.
- **Implementation:** CBS must be implemented as per pre-defined and agreed plan with specific project milestones to ensure successful implementation.
- **Maintenance:** CBS must be maintained as required. E.g. program bugs fixed, version changes implemented, etc.
- **Support:** CBS must be supported to ensure that it is working effectively.
- **Updation:** CBS modules must be updated based on requirements of business processes, technology updates and regulatory requirements.;
- **Audit:** Audit of CBS must be done internally and externally as required to ensure that controls are working as envisaged.

Fundamentally, in a CBS, all the bank's branches access applications from centralized data-centers. All transactions are routed through core systems, which are available 24x7 and accessible from anywhere, anytime and through multiple devices such as desktops, laptops, ATM, Internet, mobile phone, tablets, etc.

10. **Internet Banking Channel Server (IBCS):** IBCS (Internet Banking Channel Server) software stores the name and password of the entire internet banking customers. IBCS server also contains the details about the branch to which the customer belongs. The Internet Banking customer would first have to log into the bank's website with the user name and password.

**Internet Banking Application Server (IBAS):** The Internet Banking Software which is stored in the IBAS (Internet Banking Application Server) authenticates the customer with the login details stored in the IBCS. Authentication process is the method by which the details provided by the customer are compared with the data already stored in the data server to make sure that the customer is genuine and has been provided with internet banking facilities.



**SECTION – B: STRATEGIC MANAGEMENT**

**Multiple Choice Questions**

1. In the questions given below select the best answer out of options (A), (B), (C), or (D):
  - (a) Which of the following statements correctly explain strategic management?
    - (i) Strategic management provides framework for major decisions.
    - (ii) Strategic management helps to enhance the longevity of the business.
    - (iii) Strategic management is an inexpensive process.
    - (iv) Strategic management helps organisation to be more reactive than proactive.

(A) (i) and (ii)  
(B) (i), (ii) and (iii)  
(C) (i), (ii) and (iv)  
(D) (i), (iii) and (iv)
  - (b) Which of the following is not true for core competency:
    - A. It distinguishes a company competitively.
    - B. It is a source of competitive advantage.
    - C. It is an individual skill and separate technique.
    - D. It is often visible in the form of organizational functions.
  - (c) Statement that is typically focused on present business scope and broadly describes an organizations present capabilities, customer focus, activities, and business makeup is:
    - A. Vision
    - B. Mission
    - C. Strategy
    - D. Goals
  - (d) Arrange divestment, liquidation, stability and turnaround strategies in order of preference for adoption by a typical organisation.
    - A. Turnaround, stability, liquidation and divestment.
    - B. Divestment, liquidation, stability and turnaround.
    - C. Stability, turnaround, liquidation and divestment.
    - D. Stability, turnaround, divestment and liquidation.
  - (e) Best-cost provider strategy is related to providing customers more value for money by:
    - A. Highlighting low cost and low quality difference.

- B. Emphasizing low cost and better quality difference.
  - C. Producing high cost and low quality difference.
  - D. Managing high cost and low quality difference.
- (f) Supply chain refers to the linkages between:
- A. Suppliers
  - B. Logistics
  - C. Customers
  - D. All the above
- (g) Which of the following is not true for SBUs
- A. It is relevant for multi-product, multi-business enterprises.
  - B. It provides for more control at enterprise level with centralised strategic planning.
  - C. A SBU has its own set of competitors.
  - D. SBUs can be created for units at distant geographical locations.
- (h) Strategy evaluation is difficult on account of following trends, except:
- A. There is dramatic increase in the environment's complexity.
  - B. It is difficult to predict future.
  - C. Firms have unlimited resources.
  - D. Obsolescence is rapid.
- (i) Acquisition of another organisation that was using your product in their manufacturing is:
- A. Horizontal integrated diversification
  - B. Forward integrated diversification
  - C. Backward integrated diversification
  - D. conglomerate diversification
- (j) Porter' cost leadership is a \_\_\_\_\_ strategy
- A. Functional level
  - B. Business level
  - C. Corporate level
  - D. Implementation

**Descriptive answers**

**Chapter 1-Introduction to Strategic Management**

2. Ramesh Sharma has fifteen stores selling consumer durables in Delhi Region. Four of these stores were opened in last three years. He believes in managing strategically and enjoyed significant sales of refrigerator, televisions, washing machines, air conditioners and like till four years back. With shift to the purchases to online stores, the sales of his stores came down to about seventy per cent in last four years.

Analyse the position of Ramesh Sharma in light of limitations of strategic management.

3. Strategic management helps an organization to work through changes in environment to gain competitive advantage. In light of statement discuss its benefits.

**Chapter 2-Dynamics of Competitive Strategy**

4. Shridhar who is running a medium size cloth manufacturing business in Panipat wishes to understand the driving forces that trigger change. He has sought advice from you and wishes to know common driving forces.
5. Major core competencies are identified in three areas - competitor differentiation, customer value and application to other markets. Discuss.

**Chapter 3-Strategic Management Process**

6. Mr Raj has been hired as a CEO by XYZ Ltd a FMCG company that has diversified into affordable cosmetics. The company intends to launch *Feelgood* brand of cosmetics. XYZ wishes to enrich the lives of people with its products that are good for skin and are produced in ecologically beneficial manner using herbal ingredients. Draft vision and mission statement that may be formulated by Raj.
7. With the help of a model explain strategic management process.

**Chapter 4-Corporate Level Strategies**

8. Pizza Galleria was India's first pizza delivery chain enjoying monopoly for several years. However, after entry of Modino and Uncle Jack it is struggling to compete. Both Modino and Uncle Jack have opened several eateries and priced the product aggressively. In last four years the chain has suffered significant losses. The chain wishes to know whether they should go for turnaround strategy. List out components of action plan for turnaround strategy.
9. What is stability strategy? What are the reasons to pursue stability strategy?

**Chapter 5-Business Level Strategies**

10. A century-old footwear company "Mota Shoes" had an image of being the footwear choice for formal occasions. In an attempt to reinvent its brand, it tied up with a foreign footwear giant "Buffrine" to manufacture and sell its HideseeK brand in the country. Putting its best foot forward, it launched extra soft, casual and relaxed footwear for young. Aiming at a brand and image makeover the "Mota Shoes" decided to price the Hide Seek products at premium.

What kind of Michael Porter business level strategy is being used by "Mota Shoe company"? State its advantages.

11. Buyers can exert considerable pressure on business. Do you agree? Discuss.

**Chapter 6-Functional Level Strategies**

12. A web company initially started as an online marketplace for books. From "biggest E - Bookstore," its owners wants to expand into an e commerce platform selling electronic goods. Implementation of this needs additional funds.

What are the different sources of raising funds and their impact on the financial strategy which you as a financial manager will consider?

13. Implementing supply chain management in a business organization has several steps. Discuss.

**Chapter 7-Organisation and Strategic Leadership**

14. Jupiter Electronics Ltd. is known for its ability to come out with path-breaking products. Though the work environment at Jupiters is relaxed and casual, yet, there is a very strong commitment to deadlines. The employees believe in "work hard play hard" ethic. The organisation has moved away from formal and hierarchical set up to a more results-driven approach. Employees are committed to strategies and work towards achieving them. They guard innovations, maintain confidentiality and secrecy in their working. They are closely related to values, practices, and norms of organisations

What aspects of an organization that are being discussed? Explain.

15. Discuss the concept of Hourglass Structure

**Chapter 8-Strategy Implementation and Control**

16. India's luxurious domestic airline *Indijet* in an attempt to retain its leadership in aviation sector has hired J S Dutta as its Chief Executive. Mr Dutta wishes to reorient company to make it a domestic discount carrier. He desires to introduce no frills business model by offering extremely low fares and improve margins by cutting down traditional amenities such as reclining seats and complimentary meals. At the same time setting the stage for a new air revolution, he wishes to brand itself as on-time airlines having proper systems in place and removing additional and wasteful activities and processes.

What steps will you advise to Mr Dutta?

17. What is implementation control? Discuss its basic forms.

**SUGGESTED ANSWERS/HINTS**

1.

(a) A	(b) C	(c) B	(d) D	(e) B
(f) D	(g) B	(h) C	(i) B	(j) B

2. Ramesh Sharma is facing declining sales on account of large scale shift of customers to online stores. While he is using the tools of strategic management, they cannot counter all hindrances and always achieve success. There are limitations attached to strategic management as follows:
- ◆ Environment under which strategies are made is highly complex and turbulent. Entry of online stores, a new kind of competitor brought a different dimension to selling consumer durables. Online stores with their size power could control the market and offer stiff competition to traditional stores.
  - ◆ Another limitation of strategic management is that it is difficult to predict how things will shape-up in future. Ramesh Sharma, although managing strategically failed to see how online stores will impact the sales.
  - ◆ Although, strategic management is a time-consuming process, he should continue to manage strategically. The challenging times require more efforts on his part.
  - ◆ Strategic management is costly. Ramesh Sharma may consider engaging experts to find out preferences of the customers and attune his strategies to better serve them in a customized manner. Such customized offerings may be difficult to match by the online stores.
  - ◆ The stores owned by Ramesh Sharma are much smaller than online stores. It is very difficult for him to visualize how online stores will be moving strategically.
3. Strategic management involves developing the company's vision, environmental scanning, strategy formulation, implementation, evaluation and control. It emphasises the monitoring and evaluation of external opportunities and threats in the light of a company's strengths and weaknesses and designing strategies for the survival and growth. It helps in creation of competitive advantage to outperform the competitors and also guide the company successfully through all changes in the environment.

The major benefits of strategic management are:

- ◆ Strategic management gives a direction to the company to move ahead. It defines the goals and mission.
- ◆ It helps organisations to be proactive instead of reactive in shaping its future.
- ◆ It provides framework for all major decisions of an enterprise such as decisions on businesses, products, markets, manufacturing facilities, investments and organisational structure. It provides better guidance to entire organisation on the crucial point - what it is trying to do.
- ◆ It helps organisations to identify the available opportunities and identify ways and means to achieve them.
- ◆ It serves as a corporate defence mechanism against mistakes and pitfalls.

- ◆ It helps to enhance the longevity of the business.
  - ◆ It helps the organisation to develop certain core competencies and competitive advantages that would facilitate survival and growth.
4. Industry and competitive conditions of organisation change as environmental forces are in motion. The most dominant forces are called driving forces because they have the biggest influence on what kinds of changes will take place in the industry's structure and competitive environment. Analyzing driving forces has two steps: identifying what the driving forces are and assessing the impact they will have on the industry.

Many events can affect an industry powerfully enough to qualify as driving forces. Some are unique and specific to a particular industry situation, but many drivers of change fall into general category affecting different industries simultaneously. Some of the categories/examples of drivers are:

- ◆ The internet and the new e-commerce opportunities and threats it breeds in the industry.
  - ◆ Increasing globalization.
  - ◆ Changes in the long-term industry growth rate.
  - ◆ Product innovation.
  - ◆ Marketing innovation.
  - ◆ Entry or exit of major forms.
  - ◆ Diffusion of technical know-how across more companies and more countries.
  - ◆ Changes in cost and efficiency.
5. According to C.K. Prahalad and Gary Hamel, major core competencies are identified in three areas - competitor differentiation, customer value, and application to other markets.
- ◆ **Competitor differentiation:** The company can consider having a core competence if the competence is unique and it is difficult for competitors to imitate. This can provide a company an edge compared to competitors. It allows the company to provide better products or services to market with no fear that competitors can copy it.
  - ◆ **Customer value:** When purchasing a product or service it has to deliver a fundamental benefit for the end customer in order to be a core competence. It will include all the skills needed to provide fundamental benefits. The service or the product has to have real impact on the customer as the reason to choose to purchase

them. If customer has chosen the company without this impact, then competence is not a core competence.

- ◆ **Application of competencies to other markets:** Core competence must be applicable to the whole organization; it cannot be only one particular skill or specified area of expertise. Therefore, although some special capability would be essential or crucial for the success of business activity, it will not be considered as core competence, if it is not fundamental from the whole organization's point of view. Thus, a core competence is a unique set of skills and expertise, which will be used throughout the organisation to open up potential markets to be exploited.

6. Feelgood brand of cosmetics may have following vision and mission:

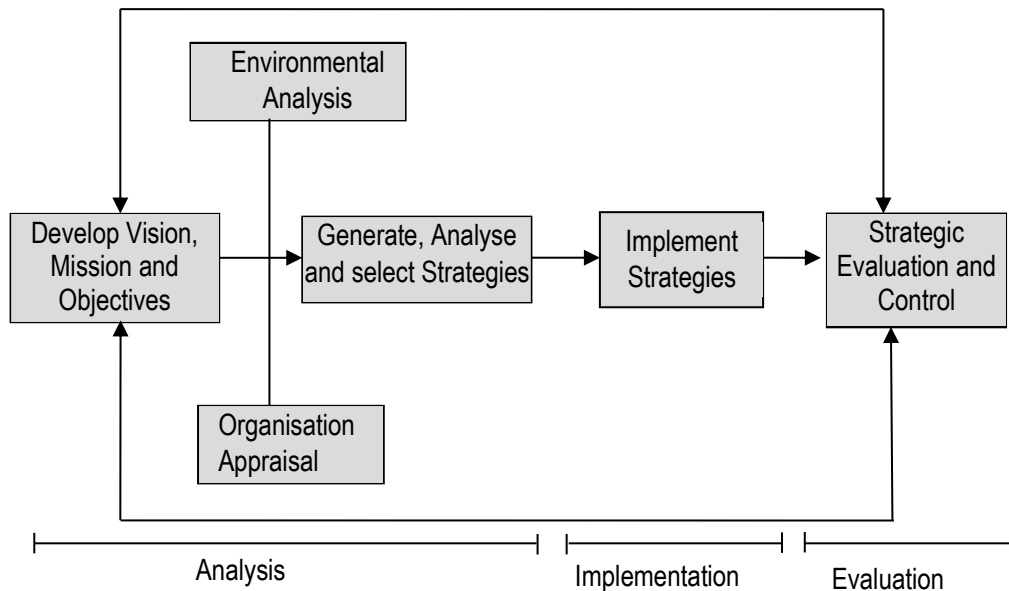
**Vision:** Vision implies the blueprint of the company's future position. It describes where the organisation wants to land. Mr Raj should aim to position "Feelgood cosmetics" as India's beauty care company. It may have vision to be India's largest beauty care company that improves looks, give extraordinary feeling and bring happiness to people.

**Mission:** Mission delineates the firm's business, its goals and ways to reach the goals. It explains the reason for the existence of the firm in the society. It is designed to help potential shareholders and investors understand the purpose of the company:

Mr Raj may identify mission in the following lines:

- ◆ To be in the business of cosmetics to enhance the lives of people, give them confidence to lead.
  - ◆ To protect skin from harmful elements in environment and sun rays.
  - ◆ To produce herbal cosmetics using natural ingredients.
7. The strategic management process can best be studied and applied using a model. Identifying an organization's vision, mission, goals and objectives, is the starting point for strategic management process. The strategic management process is dynamic and continuous. A change in any one of the major components in the model can necessitate a change in any or all of the other components. Therefore, strategy formulation, implementation, and evaluation activities should be performed on a continual basis, not just at the end of the year or semi-annually.

Formulating, implementing, and evaluating strategies are the major components of the strategic management that are represented in the following model:



**Figure: Strategic Management Model**

The strategic management process is not as cleanly divided and neatly performed in practice. Strategists do not go through the process in lockstep fashion. Generally, there is give-and-take among hierarchical levels of an organization. Many organizations conduct formal meetings semi-annually to discuss and update the firm's vision/mission, opportunities/threats, strengths/weaknesses, strategies, objectives, policies, and performance. Creativity from participants is encouraged in meeting. Good communication and feedback are needed throughout the strategic management process.

8. Pizza Chain may choose to have turnaround strategy if there are:
- ◆ Persistent negative cash flow from business.
  - ◆ Uncompetitive products or services.
  - ◆ Declining market share.
  - ◆ Deterioration in physical facilities.
  - ◆ Over-staffing, high turnover of employees, and low morale.
  - ◆ Mismanagement.

For turnaround strategies to be successful, it is imperative to focus on the short and long-term financing needs as well as on strategic issues. The chain may attempt to leverage the potential Indian market by engaging a new logistics partner. It may bring innovation in food items, as well as quality and improvements in the overall dine-in and delivery experience. During the turnaround, the “product mix” may be changed, requiring the organization to do some repositioning.



A workable action plan for turnaround would involve:

**Stage One – Assessment of current problems:** The first step is to assess the current problems and get to the root causes and the extent of damage the problem has caused.

**Stage Two – Analyze the situation and develop a strategic plan:** Before making any major changes; determine the chances of the business's survival. Identify appropriate strategies and develop a preliminary action plan.

**Stage Three – Implementing an emergency action plan:** If the organization is in a critical stage, an appropriate action plan must be developed to stop the bleeding and enable the organization to survive. A positive operating cash flow must be established as quickly as possible and enough funds to implement the turnaround strategies must be raised.

**Stage Four – Restructuring the business:** The financial state of the organization's core business is particularly important. If the core business is irreparably damaged, then the outlook for the entire organization may be bleak. Efforts to be made to position the organization for rapid improvement.

**Stage Five – Returning to normal:** In the final stage of turnaround strategy process, the organization should begin to show signs of profitability, return on investments and enhancing economic value-added. Emphasis is placed on a number of strategic efforts such as carefully adding new products and improving customer service, creating alliances with other organizations, increasing the market share, etc.

9. One of the important goals of a business enterprise is stability - to safeguard its existing interests and strengths, to pursue well established and tested objectives, to continue in the chosen business path, to maintain operational efficiency on a sustained basis, to consolidate the commanding position already reached, and to optimise returns on the resources committed in the business. A stability strategy is pursued by a firm when:
- ◆ It continues to serve in the same or similar markets and deals in same or similar products and services.
  - ◆ The strategic decisions focus on incremental improvement of functional performance.

Major reasons for stability strategy are as follows:

- ◆ A product has reached the maturity stage of the product life cycle.
  - ◆ It is less risky as it involves less changes and the staff feels comfortable with things as they are.
  - ◆ The environment faced is relatively stable.
  - ◆ Expansion may be perceived as being threatening.
  - ◆ Consolidation is sought through stabilizing after a period of rapid expansion.
10. Mota shoes is trying to use differentiation. This strategy is aimed at broad mass market and involves the creation of a product or service that is perceived by the customers as unique. The uniqueness can be associated with product design, brand image, features,

technology, dealer network or customer service. Because of differentiation, the business can charge a premium for its product.

A differentiation strategy has definite advantages as it may help to remain profitable even with rivalry, new entrants, suppliers' power, substitute products, and buyers' power.

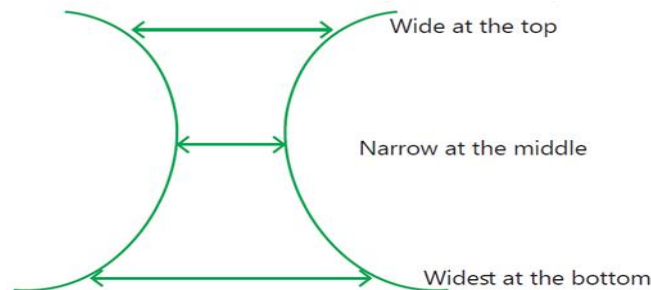
- i. **Rivalry:** Brand loyalty acts as a safeguard against competitors. It means that customers will be less sensitive to price increases, as long as the firm can satisfy the needs of its customers.
  - ii. **Buyers:** They do not negotiate for price as they get special features and also they have fewer options in the market.
  - iii. **Suppliers:** Because differentiators charge a premium price, they can afford to absorb higher costs of supplies and customers are willing to pay extra too.
  - iv. **New entrants:** Innovative features are expensive to copy. So, new entrants generally avoid these features because it is tough for them to provide the same product with special features at a comparable price.
  - v. **Substitutes:** Substitute products can't replace differentiated products which have high brand value and enjoy customer loyalty.
11. Buyers of an industry's products or services can exert considerable pressure on existing firms to secure lower prices or better services. This is evident in situations where buyers enjoy superior position than the seller of product. This leverage is particularly evident when:
- (i) Buyers have full knowledge of the sources of products and their substitutes.
  - (ii) They spend a lot of money on the industry's products, i.e., they are big buyers.
  - (iii) The industry's product is not perceived as critical to the buyer's needs and buyers are more concentrated than firms supplying the product. They can easily switch to the substitutes available.
12. Successful strategy implementation often requires additional capital. Besides net profit from operations and the sale of assets, two basic sources of capital for an organization are debt and equity. Being a financial manager to determine an appropriate mix of debt and equity in a firm's capital structure can be vital to successful strategy implementation. Fixed debt obligations generally must be met, regardless of circumstances. This does not mean that stock issuances are always better than debt for raising capital. If ordinary stock is issued to finance strategy implementation; ownership and control of the enterprise are diluted. This can be a serious concern in today's business environment of hostile takeovers, mergers, and acquisitions.

The major factors regarding which strategies have to be made by a financial manager are: capital structure; procurement of capital and working capital borrowings; reserves and surplus as sources of funds; and relationship with lenders, banks and financial institutions. Strategies related to the sources of funds are important since they determine how financial resources will be made available for the implementation of strategies. Organizations have

a range of alternatives regarding the sources of funds. While one company may rely on external borrowings, another may follow a policy of internal financing.

13. Successful implementing supply management systems requires a change from managing individual functions to integrating activities into key supply chain processes. It involves collaborative work between buyers and suppliers, joint product development, common systems and shared information. A key requirement for successfully implementing supply chain will be network of information sharing and management. Implementing and successfully running supply chain management system will involve:
- (i) **Product development:** Customers and suppliers must work together in the product development process. Right from the start the partners will have knowledge of all. Involving all partners will help in shortening the life cycles.
  - (ii) **Procurement:** Procurement requires careful resource planning, quality issues, identifying sources, negotiation, order placement, inbound transportation and storage. Organizations have to coordinate with suppliers in scheduling without interruptions.
  - (iii) **Manufacturing:** Flexible manufacturing processes must be in place to respond to market changes. They should be adaptive to accommodate customization and changes in the taste and preferences.
  - (iv) **Physical distribution:** Delivery of final products to customers is the last position in a marketing channel. Availability of the products at the right place at right time is important for each channel participant.
  - (v) **Outsourcing:** Outsourcing is not limited to the procurement of materials and components, but also include outsourcing of services so that the company is able to focus on those activities where it has competency.
  - (vi) **Customer services:** Organizations, through interfaces with the company's production and distribution operations, develop customer relationships so as to satisfy them.
  - (vii) **Performance measurement:** Supplier capabilities and customer relationships can be correlated with a firm performance. Performance is measured in different parameters such as costs, customer service, productivity and quality.
14. The scenario being referred to is culture in Jupiter Electronics. Strong culture promotes good strategy execution when there's fit and impels execution when there's negligible fit. A culture grounded in values, practices, and behavioral norms that match what is needed for good strategy execution helps energize people throughout the organization to do their jobs in a strategy-supportive manner. A culture built around such business principles as listening to customers, encouraging employees to take pride in their work, and giving employees a high degree of decision-making responsibility. This is very conducive to successful execution of a strategy of delivering superior customer service.
- A strong strategy-supportive culture makes employees feel genuinely better about their jobs and work environment and the merits of what the company is trying to accomplish. Employees are stimulated to take on the challenge of realizing the organizational vision, do their jobs competently and with enthusiasm, and collaborate with others.

15. Information technology and communications have significantly altered the functioning of organizations. The role played by middle management is diminishing as the tasks performed by them are increasingly being replaced by the technological tools. Hourglass organization structure consists of three layers with constricted middle layer. The structure has a short and narrow middle-management level. Information technology links the top and bottom levels in the organization taking away many tasks that are performed by the middle level managers. A shrunken middle layer coordinates diverse lower level activities. Contrary to traditional middle level managers who are often specialist, the managers in the hourglass structure are generalists and perform wide variety of tasks. They would be handling cross-functional issues emanating such as those from marketing, finance or production.



Hourglass structure has obvious benefit of reduced costs. It also helps in enhancing responsiveness by simplifying decision making. Decision making authority is shifted close to the source of information so that it is faster.

16. Mr Dutta should adopt business process reengineering (BPR). It is an approach to unusual improvement in operating effectiveness through the redesigning of critical business processes and supporting business systems. It is revolutionary redesign of key business processes that involves examination of the basic process itself. BPR refers to the analysis and redesign of workflows and processes both within the organization and between the organization and the external entities like suppliers, distributors, and service providers.

The orientation of redesigning efforts involves total deconstruction and rethinking of business process BPR involves the following steps:

- i. **Determining objectives:** Objectives are the desired end results of the redesign process. They will provide the required focus, direction, and motivation for the redesign process and help in building a comprehensive foundation for the reengineering process.
- ii. **Identify customers and determine their needs:** The process designers have to understand customers. The purpose is to redesign business process that clearly provides value addition to the customer.
- iii. **Study the existing processes:** The study of existing processes will provide an important base for the process designers. The purpose is to gain an understanding of the 'what', and 'why' of the targeted process.

- iv. **Formulate a redesign process plan:** Formulation of redesign plan is the real crux of the reengineering efforts. Customer focussed redesign concepts are identified and formulated. In this step alternative processes are considered and the best is selected.
  - v. **Implement the redesigned process:** It is easier to formulate new process than to implement them. Implementation of the redesigned process and application of other knowledge gained from the previous steps is key to achieve dramatic improvements.
17. Managers implement strategy by converting major plans into concrete, sequential actions that form incremental steps. Implementation control is directed towards assessing the need for changes in the overall strategy in light of unfolding events and results associated with incremental steps and actions.

Strategic implementation control is not a replacement to operational control. Strategic implementation control, unlike operational controls continuously monitors the basic direction of the strategy. The two basic forms of implementation control are:

- (i) **Monitoring strategic thrusts:** Monitoring strategic thrusts help managers to determine whether the overall strategy is progressing as desired or whether there is need for readjustments.
- (ii) **Milestone Reviews.** All key activities necessary to implement strategy are segregated in terms of time, events or major resource allocation. It normally involves a complete reassessment of the strategy. It also assesses the need to continue or refocus the direction of an organization.

**PAPER – 8: FINANCIAL MANAGEMENT AND ECONOMICS FOR FINANCE**

**SECTION A: FINANCIAL MANAGEMENT**

**QUESTIONS**

**Ratio Analysis**

1. The following is the Profit and loss account and Balance sheet of KLM LLP.

**Trading and Profit & Loss Account**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening stock	12,46,000	By Sales	1,96,56,000
To Purchases	1,56,20,000	By Closing stock	14,28,000
To Gross profit c/d	42,18,000		
	2,10,84,000		2,10,84,000
		By Gross profit b/d	42,18,000
To Administrative expenses	18,40,000	By Interest on investment	24,600
To Selling & distribution expenses	7,56,000	By Dividend received	22,000
To Interest on loan	2,60,000		
To Net profit	14,08,600		
	42,64,600		42,64,600

**Balance Sheet as on.....**

Capital & Liabilities	Amount (₹)	Assets	Amount (₹)
Capital	20,00,000	Plant & machinery	24,00,000
Retained earnings	42,00,000	Building	42,00,000
General reserve	12,00,000	Furniture	12,00,000
Term loan from bank	26,00,000	Sundry receivables	13,50,000
Sundry Payables	7,20,000	Inventory	14,28,000
Other liabilities	2,80,000	Cash & Bank balance	4,22,000
	1,10,00,000		1,10,00,000

You are required to COMPUTE:

- (i) Gross profit ratio      (ii) Net profit ratio      (iii) Operating cost ratio  
(iv) Operating profit ratio      (v) Inventory turnover ratio      (vi) Current ratio  
(vii) Quick ratio      (viii) Interest coverage ratio      (ix) Return on capital employed

- (x) Debt to assets ratio.

### Cost of Capital

2. KM Ltd. has the following capital structure on September 30, 2019:

Sources of capital	(₹)
Equity Share Capital (40,00,000 Shares of ₹ 10 each)	4,00,00,000
Reserves & Surplus	4,00,00,000
12% Preference Shares	2,00,00,000
9% Debentures	6,00,00,000
	16,00,00,000

The market price of equity share is ₹60. It is expected that the company will pay next year a dividend of ₹6 per share, which will grow at 10% forever. Assume 40% income tax rate. You are required to COMPUTE weighted average cost of capital using market value weights.

### Capital Structure

3. The management of RT Ltd. wants to raise its funds from market to meet out the financial demands of its long-term projects. The company has various combinations of proposals to raise its funds. You are given the following proposals of the company:

Proposal	Equity shares (%)	Debts (%)	Preference shares (%)
P	100	-	-
Q	50	50	-
R	50	-	50

- (i) Cost of debt and preference shares is 12% each.  
(ii) Tax rate –40%  
(iii) Equity shares of the face value of ₹10 each will be issued at a premium of ₹10 per share.  
(iv) Total investment to be raised ₹8,00,00,000.  
(v) Expected earnings before interest and tax ₹3,60,00,000.

From the above proposals the management wants to take advice from you for appropriate plan after computing the following:

- Earnings per share
- Financial break-even-point

COMPUTE the EBIT range among the plans for indifference.

**Leverage**

4. The following summarises the percentage changes in operating income, percentage changes in revenues, and betas for four listed firms.

Firm	Change in revenue	Change in operating income	Beta
A Ltd.	35%	22%	1.00
B Ltd.	24%	35%	1.65
C Ltd.	29%	26%	1.15
D Ltd.	32%	30%	1.20

Required:

- CALCULATE the degree of operating leverage for each of these firms. Comment also.
- Use the operating leverage to EXPLAIN why these firms have different beta.

**Capital Budgeting**

5. MTR Limited is considering buying a new machine which would have a useful economic life of five years, at a cost of ₹25,00,000 and a scrap value of ₹3,00,000, with 80 per cent of the cost being payable at the start of the project and 20 per cent at the end of the first year. The machine would produce 75,000 units per annum of a new product with an estimated selling price of ₹300 per unit. Direct costs would be ₹285 per unit and annual fixed costs, including depreciation calculated on a straight-line basis, would be ₹8,40,000 per annum.

In the first year and the second year, special sales promotion expenditure, not included in the above costs, would be incurred, amounting to ₹1,00,000 and ₹1,50,000 respectively.

EVALUATE the project using the NPV method of investment appraisal, assuming the company's cost of capital to be 15 percent.

**Risk Analysis in Capital Budgeting**

6. SL Ltd. has invested ₹1,000 lakhs in a project. The risk-free rate of return is 5%. Risk premium expected by the Management is 10%. The life of the project is 5 years. Following are the cash flows that are estimated over the life of the project.

Year	Cash flows (₹ in lakhs)
1	125
2	300
3	375
4	400
5	325



CALCULATE Net Present Value of the project based on Risk free rate and also on the basis of Risks adjusted discount rate.

**Dividend Decision**

7. The following information pertains to SD Ltd.

Earnings of the Company	₹ 50,00,000
Dividend Payout ratio	60%
No. of shares outstanding	10,00,000
Equity capitalization rate	12%
Rate of return on investment	15%

- (i) COMPUTE the market value per share as per Walter’s model?
- (ii) COMPUTE the optimum dividend payout ratio according to Walter’s model and the market value of Company’s share at that payout ratio?

**Management of Working Capital**

8. Following are cost information of KG Ltd., which has commenced a new project for an annual production of 24,000 units which is the full capacity:

	Costs per unit (₹)
Materials	80.00
Direct labour and variable expenses	40.00
Fixed manufacturing expenses	12.00
Depreciation	20.00
Fixed administration expenses	8.00
	160.00

The selling price per unit is expected to be ₹192 and the selling expenses ₹10 per unit, 80% of which is variable.

In the first two years of operations, production and sales are expected to be as follows:

Year	Production (No. of units)	Sales (No. of units)
1	12,000	10,000
2	18,000	17,000

To assess the working capital requirements, the following additional information is available:

- (a) Stock of materials                      2 months’ average consumption

- (b) Work-in-process Nil
- (c) Debtors 2 month's average sales.
- (d) Cash balance ₹ 1,00,000
- (e) Creditors for supply of materials 1 month's average purchase during the year.
- (f) Creditors for expenses 1 month's average of all expenses during the year.

PREPARE, for the two years:

- (i) A projected statement of Profit/Loss (Ignoring taxation); and
- (ii) A projected statement of working capital requirements

### Management of Working Capital

9. A regular customer of your company has approached to you for extension of credit facility for purchasing of goods. On analysis of past performance and on the basis of information supplied, the following pattern of payment schedule emerges:

Pattern of Payment Schedule	
At the end of 30 days	20% of the bill
At the end of 60 days	30% of the bill.
At the end of 90 days	30% of the bill.
At the end of 100 days	18% of the bill.
Non-recovery	2% of the bill.

The customer wants to enter into a firm commitment for purchase of goods of ₹30 lakhs in 2019, deliveries to be made in equal quantities on the first day of each quarter in the calendar year. The price per unit of commodity is ₹300 on which a profit of ₹10 per unit is expected to be made. It is anticipated that taking up of this contract would mean an extra recurring expenditure of ₹10,000 per annum. If the opportunity cost is 18% per annum, would you as the finance manager of the company RECOMMEND the grant of credit to the customer? Assume 1 year = 360 days.

### Miscellaneous

10. Write short notes on the following:
- (a) STATE the meaning of Payback Reciprocal.
- (b) STATE the functions of treasury department.
- (c) DESCRIBE the Inter relationship between investment, financing and dividend decisions.

**SUGGESTED HINTS/ANSWERS**

$$1. \quad (i) \quad \text{Gross profit ratio} = \frac{\text{Gross profit}}{\text{Sales}} \times 100 = \frac{₹42,18,000}{₹1,96,56,000} \times 100 = 21.46\%$$

$$(ii) \quad \text{Net profit ratio} = \frac{\text{Net profit}}{\text{Sales}} \times 100 = \frac{₹14,08,600}{₹1,96,56,000} \times 100 = 7.17\%$$

$$(iii) \quad \text{Operating ratio} = \frac{\text{Operating cost}}{\text{Sales}} \times 100$$

Operating cost = Cost of goods sold + Operating expenses

Cost of goods sold = Sales – Gross profit

$$= 1,96,56,000 - 42,18,000 = 1,54,38,000$$

Operating expenses = Administrative expenses + Selling & distribution expenses

$$= 18,40,000 + 7,56,000 = 25,96,000$$

$$\text{Therefore, Operating ratio} = \frac{1,54,38,000 + 25,96,000}{1,96,56,000} \times 100$$

$$= \frac{1,80,34,000}{1,96,56,000} \times 100 = 91.75\%$$

$$(iv) \quad \text{Operating profit ratio} = 100 - \text{Operating cost ratio} \\ = 100 - 91.75\% = 8.25\%$$

$$(v) \quad \text{Inventory turnover ratio} = \frac{\text{Cost of goods sold}}{\text{Average stock}} \\ = \frac{1,54,38,000}{(14,28,000 + 12,46,000) / 2} \\ = \frac{1,54,38,000}{13,37,000} = 11.55 \text{ times}$$

$$(vi) \quad \text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Current assets = Sundry receivables + Inventory + Cash & Bank balance

$$= 13,50,000 + 14,28,000 + 4,22,000 = 32,00,000$$

$$\begin{aligned}\text{Current liabilities} &= \text{Sundry Payables} + \text{Other liabilities} \\ &= 7,20,000 + 2,80,000 = 10,00,000\end{aligned}$$

$$\text{Current ratio} = \frac{32,00,000}{10,00,000} = 3.2 \text{ times}$$

$$\begin{aligned}\text{(vi) Quick Ratio} &= \frac{\text{Current assets} - \text{Inventories}}{\text{Current liabilities}} \\ &= \frac{32,00,000 - 14,28,000}{10,00,000} = 1.77 \text{ times}\end{aligned}$$

$$\begin{aligned}\text{(vii) Interest coverage ratio} &= \frac{\text{EBIDT}}{\text{Interest}} = \frac{\text{Net profit} + \text{Interest}}{\text{Interest}} \\ &= \frac{14,08,600 + 2,60,000}{2,60,000} = 6.42 \text{ times}\end{aligned}$$

$$\text{(ix) Return on capital employed (ROCE)} = \frac{\text{EBIT}}{\text{Capital employed}} \times 100$$

$$\begin{aligned}\text{Capital employed} &= \text{Capital} + \text{Retained earnings} + \text{General reserve} + \text{Term loan} \\ &= 20,00,000 + 42,00,000 + 12,00,000 + 26,00,000 \\ &= 1,00,00,000\end{aligned}$$

$$\text{Therefore, ROCE} = \frac{16,68,600}{1,00,00,000} \times 100 = 16.69\%$$

$$\text{(x) Debt to assets ratio} = \frac{\text{Debts}}{\text{Total assets}} \times 100 = \frac{26,00,000}{1,10,00,000} \times 100 = 23.64\%$$

## 2. Workings:

$$\text{(i) Cost of Equity (K}_e\text{)} = \frac{D_1}{P_0} + g = \frac{\text{₹}6}{\text{₹}60} + 0.10 = 0.20 = 20\%$$

$$\text{(ii) Cost of Debentures (K}_d\text{)} = I(1 - t) = 0.09(1 - 0.4) = 0.054 \text{ or } 5.4\%$$

### Computation of Weighted Average Cost of Capital (WACC using market value weights)

Source of capital	Market Value of capital (₹)	Weight	Cost of capital (%)	WACC (%)
9% Debentures	6,00,00,000	0.1875	5.40	1.01
12% Preference Shares	2,00,00,000	0.0625	12.00	0.75

Equity Share Capital (₹60 × 40,00,000 shares)	24,00,00,000	0.7500	20.00	15.00
Total	32,00,00,000	1.00		16.76

3. (i) **Computation of Earnings per Share (EPS)**

Plans	P (₹)	Q (₹)	R (₹)
Earnings before interest & tax (EBIT)	3,60,00,000	3,60,00,000	3,60,00,000
Less: Interest charges	--	(48,00,000)	--
Earnings before tax (EBT)	3,60,00,000	3,12,00,000	3,60,00,000
Less: Tax @ 40%	(1,44,00,000)	(1,24,80,000)	(1,44,00,000)
Earnings after tax (EAT)	2,16,00,000	1,87,20,000	2,16,00,000
Less: Preference share dividend	--	--	(48,00,000)
Earnings available for equity shareholders	2,16,00,000	1,87,20,000	1,68,00,000
No. of equity shares	40,00,000	20,00,000	20,00,000
E.P.S	5.40	9.36	8.40

(ii) **Computation of Financial Break-even Points**

Proposal 'P' = 0

Proposal 'Q' = ₹48,00,000 (Interest charges)

Proposal 'R' = Earnings required for payment of preference share dividend  
i.e. ₹48,00,000 ÷ 0.6 = ₹80,00,000

(iii) **Computation of Indifference Point between the Proposals**

Combination of Proposals

(a) Indifference point where EBIT of proposal "P" and proposal 'Q' is equal

$$\frac{\text{EBIT}(1-0.4)}{40,00,000 \text{ shares}} = \frac{(\text{EBIT} - ₹48,00,000)(1-0.4)}{20,00,000 \text{ shares}}$$

$$0.6 \text{ EBIT} = 1.2 \text{ EBIT} - ₹57,60,000$$

$$\text{EBIT} = ₹96,00,000$$

(b) Indifference point where EBIT of proposal 'P' and proposal 'R' is equal:

$$\frac{\text{EBIT}(1-0.40)}{40,00,000 \text{ shares}} = \frac{\text{EBIT}(1-0.40) - ₹48,00,000}{20,00,000 \text{ shares}}$$

$$\frac{0.6\text{EBIT}}{40,00,000 \text{ shares}} = \frac{0.6\text{EBIT} - ₹48,00,000}{20,00,000 \text{ shares}}$$

$$0.30 \text{ EBIT} = 0.6 \text{ EBIT} - ₹48,00,000$$

$$\text{EBIT} = \frac{₹48,00,000}{0.30} = ₹1,60,00,000$$

(c) Indifference point where EBIT of proposal 'Q' and proposal 'R' are equal

$$\frac{(\text{EBIT} - ₹48,00,000)(1-0.4)}{20,00,000 \text{ shares}} = \frac{\text{EBIT}(1-0.4) - ₹48,00,000}{20,00,000 \text{ shares}}$$

There is no indifference point between proposal 'Q' and proposal 'R'

4. (i) Degree of operating leverage =  $\frac{\% \text{ Change in Operating income}}{\% \text{ Change in Revenues}}$

A Ltd.	=	0.22 / 0.35	=	0.63
B Ltd.	=	0.35 / 0.24	=	1.46
C Ltd.	=	0.26 / 0.29	=	0.90
D Ltd.	=	0.30 / 0.32	=	0.94

It is level specific.

(ii) High operating leverage leads to high beta. So when operating leverage is lowest i.e. 0.63, Beta is minimum (1) and when operating leverage is maximum i.e. 1.46, beta is highest i.e. 1.65

#### 5. Calculation of Net Cash flows

$$\text{Contribution} = (300 - 285) \times 75,000 = ₹11,25,000$$

$$\text{Fixed costs} = 8,40,000 - [(25,00,000 - 3,00,000)/5] = ₹4,00,000$$

Year	Capital (₹)	Contribution (₹)	Fixed costs (₹)	Adverts (₹)	Net cash flow (₹)
0	(20,00,000)				(20,00,000)
1	(5,00,000)	11,25,000	(4,00,000)	(1,00,000)	1,25,000
2		11,25,000	(4,00,000)	(1,50,000)	5,75,000
3		11,25,000	(4,00,000)		7,25,000
4		11,25,000	(4,00,000)		7,25,000
5	3,00,000	11,25,000	(4,00,000)		10,25,000

**Calculation of Net Present Value**

Year	Net cash flow (₹)	12% discount factor	Present value (₹)
0	(20,00,000)	1.000	(20,00,000)
1	1,25,000	0.892	1,11,500
2	5,75,000	0.797	4,58,275
3	7,25,000	0.711	5,15,475
4	7,25,000	0.635	4,60,375
5	10,25,000	0.567	5,81,175
			1,26,800

The net present value of the project is ₹1,26,800.

6. The Present Value of the Cash Flows for all the years by discounting the cash flow at 5% is calculated as below:

Year	Cash flows ₹ in lakhs	Discounting Factor @5%	Present value of Cash Flows ₹ In Lakhs
1	125	0.952	119.00
2	300	0.907	272.10
3	375	0.863	323.62
4	400	0.822	328.80
5	325	0.783	254.47
Total of present value of Cash flow			1,297.99
Less: Initial investment			1,000.00
Net Present Value (NPV)			297.99

Now when the risk-free rate is 5% and the risk premium expected by the Management is 10%. So the risk adjusted discount rate is  $5\% + 10\% = 15\%$ .

Discounting the above cash flows using the Risk Adjusted Discount Rate would be as below:

Year	Cash flows ₹ in Lakhs	Discounting Factor@15%	Present Value of Cash Flows ₹ in lakhs
1	125	0.869	108.62
2	300	0.756	226.80

3	375	0.657	246.37
4	400	0.571	228.40
5	325	0.497	161.52
Total of present value of Cash flow			971.71
Initial investment			1,000.00
Net present value (NPV)			(28.29)

7. (i) Walter's model is given by

$$P = \frac{D + \frac{r}{K_e}(E - D)}{K_e}$$

Where

P = Market price per share.

E = Earnings per share = ₹ 5

D = Dividend per share = ₹ 3

R = Return earned on investment = 15%

$K_e$  = Cost of equity capital = 12%

$$P = \frac{3 + \frac{0.15}{0.12}(5 - 3)}{0.12} = ₹ 45.83$$

- (ii) According to Walter's model when the return on investment is more than the cost of equity capital, the price per share increases as the dividend pay-out ratio decreases. Hence, the optimum dividend pay-out ratio in this case is nil.

So, at a pay-out ratio of zero, the market value of the company's share will be:

$$P = \frac{0 + \frac{0.15}{0.12}(5 - 0)}{0.12} = ₹ 52.08$$

8. (i) **Projected Statement of Profit / Loss**  
(Ignoring Taxation)

	Year 1	Year 2
Production (Units)	12,000	18,000
Sales (Units)	10,000	17,000



	(₹)	(₹)
Sales revenue (A) (Sales unit × ₹192)	19,20,000	32,64,000
<b>Cost of production:</b>		
Materials cost (Units produced × ₹80)	9,60,000	14,40,000
Direct labour and variable expenses (Units produced × ₹40)	4,80,000	7,20,000
Fixed manufacturing expenses (Production Capacity: 24,000 units × ₹12)	2,88,000	2,88,000
Depreciation (Production Capacity : 24,000 units × ₹20)	4,80,000	4,80,000
Fixed administration expenses (Production Capacity : 24,000 units × ₹8)	1,92,000	1,92,000
Total Costs of Production	24,00,000	31,20,000
Add: Opening stock of finished goods (Year 1 : Nil; Year 2 : 2,000 units)	---	4,00,000
Cost of Goods available for sale (Year 1: 12,000 units; Year 2: 20,000 units)	24,00,000	35,20,000
Less: Closing stock of finished goods at average cost (year 1: 2000 units, year 2 : 3000 units) (Cost of Production × Closing stock/ units produced)	(4,00,000)	(5,28,000)
Cost of Goods Sold	20,00,000	29,92,000
Add: Selling expenses – Variable (Sales unit × ₹8)	80,000	1,36,000
Add: Selling expenses -Fixed (24,000 units × ₹2)	48,000	48,000
Cost of Sales : (B)	21,28,000	31,76,000
Profit (+) / Loss (-): (A - B)	(-) 2,08,000	(+) 88,000

**Working Notes:**

**1. Calculation of creditors for supply of materials:**

	Year 1 (₹)	Year 2 (₹)
Materials consumed during the year	9,60,000	14,40,000

Add: Closing stock (2 month's average consumption)	1,60,000	2,40,000
	11,20,000	16,80,000
Less: Opening Stock	---	1,60,000
Purchases during the year	11,20,000	15,20,000
Average purchases per month (Creditors)	93,333	1,26,667

## 2. Creditors for expenses:

	Year 1 (₹)	Year 2 (₹)
Direct labour and variable expenses	4,80,000	7,20,000
Fixed manufacturing expenses	2,88,000	2,88,000
Fixed administration expenses	1,92,000	1,92,000
Selling expenses (variable + fixed)	1,28,000	1,84,000
Total	10,88,000	13,84,000
Average per month	90,667	1,15,333

## (ii) Projected Statement of Working Capital requirements

	Year 1 (₹)	Year 2 (₹)
<b>Current Assets:</b>		
Inventories:		
- Stock of materials (2 month's average consumption)	1,60,000	2,40,000
- Finished goods	4,00,000	5,28,000
Debtors (2 month's average sales) (including profit)	3,20,000	5,44,000
Cash	1,00,000	1,00,000
Total Current Assets/ Gross working capital (A)	9,80,000	14,12,000
<b>Current Liabilities:</b>		
Creditors for supply of materials (Refer to working note 1)	93,333	1,26,667
Creditors for expenses (Refer to working note 2)	90,667	1,15,333
Total Current Liabilities: (B)	1,84,000	2,42,000
Estimated Working Capital Requirements: (A-B)	7,96,000	11,70,000

9. Statement showing the Evaluation of credit Policies

Particulars	Proposed Policy ₹
<b>A. Expected Profit:</b>	
(a) Credit Sales	30,00,000
(b) Total Cost	
(i) Variable Costs	29,00,000
(ii) Recurring Costs	10,000
	29,10,000
(c) Bad Debts	60,000
(d) Expected Profit [(a) – (b) – (c)]	30,000
<b>B. Opportunity Cost of Investments in Receivables</b>	1,00,395
<b>C. Net Benefits (A – B)</b>	(70,395)

**Recommendation:** The Proposed Policy should not be adopted since the net benefits under this policy are negative

**Working Note: Calculation of Opportunity Cost of Average Investments**

$$\text{Opportunity Cost} = \text{Total Cost} \times \frac{\text{Collection period}}{360} \times \frac{\text{Rate of Return}}{100}$$

Particulars	20%	30%	30%	18%	Total
A. Total Cost	5,82,000	8,73,000	8,73,000	5,23,800	28,51,800
B. Collection period	30/360	60/360	90/360	100/360	
C. Required Rate of Return	18%	18%	18%	18%	
D. Opportunity Cost (A × B × C)	8,730	26,190	39,285	26,190	1,00,395

10. (a) As the name indicates it is the reciprocal of payback period. A major drawback of the payback period method of capital budgeting is that it does not indicate any cut off period for the purpose of investment decision. It is, however, argued that the reciprocal of the payback would be a close approximation of the Internal Rate of Return (later discussed in detail) if the life of the project is at least twice the payback period and the project generates equal amount of the annual cash inflows. In practice, the payback reciprocal is a helpful tool for quick estimation of rate of return of a project provided its life is at least twice the payback period.

The payback reciprocal can be calculated as follows:

$$\text{Payback Reciprocal} = \frac{\text{Average annual cash in flow}}{\text{Initial investment}}$$

- (b) 1. **Cash Management:** It involves efficient cash collection process and managing payment of cash both inside the organisation and to third parties.
- There may be complete centralization within a group treasury or the treasury may simply advise subsidiaries and divisions on policy matter viz., collection/payment periods, discounts, etc.
- Treasury will also manage surplus funds in an investment portfolio. Investment policy will consider future needs for liquid funds and acceptable levels of risk as determined by company policy.
2. **Currency Management:** The treasury department manages the foreign currency risk exposure of the company. In a large multinational company (MNC) the first step will usually be to set off intra-group indebtedness. The use of matching receipts and payments in the same currency will save transaction costs. Treasury might advise on the currency to be used when invoicing overseas sales.
- The treasury will manage any net exchange exposures in accordance with company policy. If risks are to be minimized then forward contracts can be used either to buy or sell currency forward.
3. **Fund Management:** Treasury department is responsible for planning and sourcing the company's short, medium and long-term cash needs. Treasury department will also participate in the decision on capital structure and forecast future interest and foreign currency rates.
4. **Banking:** It is important that a company maintains a good relationship with its bankers. Treasury department carry out negotiations with bankers and act as the initial point of contact with them. Short-term finance can come in the form of bank loans or through the sale of commercial paper in the money market.
5. **Corporate Finance:** Treasury department is involved with both acquisition and divestment activities within the group. In addition, it will often have responsibility for investor relations. The latter activity has assumed increased importance in markets where share-price performance is regarded as crucial and may affect the company's ability to undertake acquisition activity or, if the price falls drastically, render it vulnerable to a hostile bid.
- (c) **Inter-relationship between Investment, Financing and Dividend Decisions:** The finance functions are divided into three major decisions, viz., investment, financing and dividend decisions. It is correct to say that these decisions are inter-related because the underlying objective of these three decisions is the same, i.e. maximisation of shareholders' wealth. Since investment, financing and dividend decisions are all interrelated, one has to consider the joint impact of these decisions

on the market price of the company's shares and these decisions should also be solved jointly. The decision to invest in a new project needs the finance for the investment. The financing decision, in turn, is influenced by and influences dividend decision because retained earnings used in internal financing deprive shareholders of their dividends. An efficient financial management can ensure optimal joint decisions. This is possible by evaluating each decision in relation to its effect on the shareholders' wealth.

The above three decisions are briefly examined below in the light of their inter-relationship and to see how they can help in maximising the shareholders' wealth i.e. market price of the company's shares.

**Investment decision:** The investment of long term funds is made after a careful assessment of the various projects through capital budgeting and uncertainty analysis. However, only that investment proposal is to be accepted which is expected to yield at least so much return as is adequate to meet its cost of financing. This has an influence on the profitability of the company and ultimately on its wealth.

**Financing decision:** Funds can be raised from various sources. Each source of funds involves different issues. The finance manager has to maintain a proper balance between long-term and short-term funds. With the total volume of long-term funds, he has to ensure a proper mix of loan funds and owner's funds. The optimum financing mix will increase return to equity shareholders and thus maximise their wealth.

**Dividend decision:** The finance manager is also concerned with the decision to pay or declare dividend. He assists the top management in deciding as to what portion of the profit should be paid to the shareholders by way of dividends and what portion should be retained in the business. An optimal dividend pay-out ratio maximises shareholders' wealth.

The above discussion makes it clear that investment, financing and dividend decisions are interrelated and are to be taken jointly keeping in view their joint effect on the shareholders' wealth

## PAPER – 8: FINANCIAL MANAGEMENT AND ECONOMICS FOR FINANCE

## SECTION: B: ECONOMICS FOR FINANCE

## QUESTIONS

1. (a) Explain few important points which one needs to bear in mind while calculating National Income.

- (b) Calculate Net Domestic Product at Factor Cost from the following data:

Particulars	In Crore
Wages	7142
Mixed income	450
Rent	541
Salaries	8912
Interest	1013
Profit	714

- (c) Calculate Personal Income from the following data:

Particulars	In Crore
Undistributed profits of corporation	50
Net domestic product accruing to private sector	700
Corporation tax	65
Net factor income from abroad	10
Net current transfer from rest of the world	20
Net current transfer from the government	25
Interest on national debt	40

2. (a) Explain the concept of circular flow in two sector economy model?
- (b) i. Find out the MPC, when in an economy total income increases by ₹ 7500 crore due to increase in investment by ₹ 2500 crore?
- ii. Assume that the consumption function in an economy is specified by the equation  $C = 200 + 0.9Y$
- With the help of an example show that in this economy as income increases MPC remains constant.
3. How can the government influence the resource allocation in an economy?
4. When price of certain essential goods rises excessively, how does the government intervene to control the price? Explain with the help of an example and with suitable diagram.

5. (a) Is cable television an example of impure public good? Verify your answer.  
 (b) Is production of steel a demerit good? Give reason.
6. (a) Explain the classical version of quantity theory of demand for money.  
 (b) Why empirical analysis of money supply is important?
7. (a) Calculate the narrow money from the following information.
- |   |                |
|---|----------------|
| Components                                    | in Million (₹) |
| Currency with the public                      | 15473.2        |
| Demand deposits of banks                      | 6943.1         |
| Saving deposits with post office saving banks | 978.1          |
| Other deposits of the RBI                     | 501.2          |
- (b) What is high powered money? Calculate it from the following data:
- |   |                |
|---|----------------|
| Components                                      | in Million (₹) |
| Net RBI Credit to the Government                | 41561.2        |
| RBI credit to the Commercial sector             | 18459.3        |
| RBI's net non-monetary liabilities              | 24981.2        |
| RBI's claims on banks                           | 31456.2        |
| RBI's Net foreign assets                        | 10456.1        |
| Government's currency liabilities to the public | 21417.1        |
8. (a) The table below shows the output of Wheat and Rice by using one hour of labour time in country A and country B -
- |                       |           |           |
|-----------------------|-----------|-----------|
| Goods                 | Country A | Country B |
| Wheat (Quintal /hour) | 10        | 5         |
| Rice (Quintal/hour)   | 5         | 10        |
- Which country has an absolute advantage over other country in production of wheat and rice and which good they obtain through international trade?
- (b) Define custom duties? What are their main goals?
9. (a) Is prohibition of import of poultry from countries affected by avian flu, meat and poultry processing standards to reduce pathogens, residue limits for pesticides in foods etc. an example of Sanitary and Phytosanitary (SPS) measure? How?  
 (b) Food Laws, Quality Standards and Industrial Standards are examples of which type of non-tariff measures? Give Comments.
10. (a) Distinguish between horizontal and vertical Foreign Direct Investment.

- (b) Assume that ₹ 70 is needed to buy one US dollar in foreign exchange market (i.e. the nominal exchange rate is ₹ 70/ US \$). Suppose that a price index of standardized basket of goods and services is ₹ 200 in India and US \$ 100 in United States, find out the real exchange rate? (Treat India as a domestic country and United States as a foreign country)

### SUGGESTIONS ANSWERS/ HINTS

1. (a) Few important points which one needs to bear in mind while calculating National Income are -
- (i) The value of only final goods and services or only the value added by the production process would be included in GDP. By 'value added' we mean the difference between value of output and purchase of intermediate goods.
  - (ii) Intermediate consumption consists of the value of the goods and services consumed as inputs by a process of production, excluding fixed assets whose consumption is recorded as consumption of fixed capital. Intermediate goods used to produce other goods rather than being sold to final purchasers are not counted as it would involve double counting.
  - (iii) Gross Domestic Product (GDP) is a measure of production activity which covers all production activities recognized by SNA called the 'production boundary'.
  - (iv) Economic activities include all human activities which create goods and services that are exchanged in a market and valued at market price. On the other hand, Non-economic activities are those which produce goods and services, but since these are not exchanged in a market transaction they do not command any market value; for e.g. hobbies, housekeeping and child rearing services of home makers and services of family members that are done out of love and affection.
  - (v) National income is a 'flow' measure of output per time period—for example, per year—and includes only those goods and services produced in the current period i.e. produced during the time interval under consideration. The value of market transactions such as exchange of goods which already exist or are previously produced, do not enter into the calculation of national income. Therefore, the value of assets such as stocks and bonds which are exchanged during the pertinent period are not included in national income as these do not directly involve current production of goods and services.
  - (vi) Two types of goods used in the production process are counted in GDP namely, capital goods (business plant and equipment purchases) and inventory investment—the net change in inventories of final goods awaiting sale or of materials used in the production which may be positive or negative.



(b) Net Domestic Product at Factor Cost = Compensation of Employees (wages and salaries) + operating surplus (rent, interest and profit) + mixed income  
 = 7142+8912+541+1013+714+450  
 = 18772 crores.

(c) Personal Income = Net domestic product accruing to private sector + Net factor income from abroad + Net current transfers from government + Net current transfers from rest of the world + interest on National debt – Corporation tax – Undistributed profits of corporations  
 = 700+10+25+20+40-65-50  
 = 680 Crores

2. (a) The two sector economy model assumes that there are only two sectors in the economy viz, households and firms, with only consumption and investment outlays. Households own all factors of production and they sell their factor services to earn factor incomes which are entirely spent to consume all final goods and services produced by business firms. The business firms are assumed to hire factors of production from the households; they produce and sell goods and services to the households and they do not save. There are no corporations, corporate savings or retained earnings. The total income produced, Y, accrues to the households and equals their disposable personal income  $Y_d$  i.e.,  $Y = Y_d$ . All prices (including factor prices), supply of capital and technology remain constant. The government sector does not exist and therefore, there are no taxes, government expenditure or transfer payments. The economy is a closed economy, i.e., foreign trade does not exist; there are no exports and imports and external inflows and outflows. All investment outlay is autonomous (not determined either by the level of income or the rate of interest); all investment is net and, therefore, national income equals the net national product. The circular flow of income and expenditure which presents the working of the two-sector economy should be illustrated diagrammatically. There are no injections into or leakages from the system. Since the whole of household income is spent on goods and services produced by firms, household expenditures equal the total receipts of firms which equal value of output.

(b) i. Given,  
 Increase in income= 7500 crore  
 Increase in investment= 2500 crore  
 Therefore,  
 Investment multiplier (k)=  $\Delta Y/\Delta I$  or  
 $\Delta Y/\Delta I=1/1-mpc$   
 $7500/2500=1/1-mpc$

$$mpc=0.66$$

- ii. Suppose assume that income is 1000, 2000 and 3000

$$\text{Then consumption is } C= 200+0.9(1000) =1100$$

$$C= 200+0.9(2000) = 2000$$

$$C= 200+0.9(3000) = 2900$$

Thus:

Y	C	MPC ( $\Delta C/\Delta Y$ )
1000	1100	-
2000	2000	900/1000=0.9
3000	2900	900/1000=0.9

So we see as income increases from ₹ 1000 to ₹ 2000 and from ₹ 2000 to ₹ 3000, marginal propensity to consume remains constant i.e., 0.9.

3. A variety of allocation instruments are available by which governments can influence resource allocation in the economy. They are -
- government may directly produce the economic good (for example, electricity and public transportation services)
  - government may influence private allocation through incentives and disincentives (for example, tax concessions and subsidies may be given for the production of goods that promote social welfare and higher taxes may be imposed on goods such as cigarettes and alcohol)
  - government may influence allocation through its competition policies, merger policies etc. which will affect the structure of industry and commerce (for example, the Competition Act in India promotes competition and prevents anti-competitive activities).
  - governments' regulatory activities such as licensing, controls, minimum wages, and directives on location of industry influence resource allocation.
  - government sets legal and administrative frameworks, and
  - any of a mixture of intermediate techniques may be adopted by governments.
4. When prices of certain essential commodities rise excessively, government may resort to control in the form of price ceilings (also called maximum price) for making a resource or commodity available to all at reasonable prices. For example: maximum prices of food grains and essential items are set by government during times of scarcity. A price ceiling which is set below the prevailing market clearing price will generate excess demand over supply. (The students should draw the diagram in support of their answers)

With the objective of ensuring stability in prices and distribution, governments often intervene in grain markets through building and maintenance of buffer stocks. It involves purchases from the market during good harvest and releasing stocks during periods when production is below average.

5. (a) Yes, cable television is an example of impure public good. Impure public goods only partially satisfy two characteristics of public goods namely, non-rivalry in consumption and non-excludability.

Cable television is non-rivalrous because the use of cable television by other individuals will in no way reduce your enjoyment of it. The good is excludable since the cable TV service providers can refuse connection if you do not pay for set top box and recharge it regularly.

- (b) Demerits goods are those goods which are believed to be socially undesirable. The consumption of these goods imposes significant negative externalities on the society as a whole.

No. The production of steel is not essentially a demerit good. Though it causes pollution and have negative externalities, it is not a socially undesirable good.

6. (a) According to Fisher, quantity theory of money demonstrate that there is strong relationship between money and price level and the quantity of money is the main determinant of the price level or the value of money. In other words, changes in the general level of commodity prices or changes in the value or purchasing power of money are determined first and foremost by changes in the quantity of money in circulation. Fisher's version, also termed as 'equation of exchange' or 'transaction approach' is formally stated as follows:

$$MV = PT$$

Where, M= the total amount of money in circulation (on an average) in an economy  
 V = transactions velocity of circulation i.e. the average number of times across all transactions a unit of money (say Rupee) is spent in purchasing goods and services  
 P = average price level ( $P = MV/T$ ) T = the total number of transactions.

Later, Fisher extended the equation of exchange to include demand (bank) deposits (M') and their velocity (V') in the total supply of money. Thus, the expanded form of the equation of exchange becomes:

$$MV + M'V' = PT$$

Where M' = the total quantity of credit money V' = velocity of circulation of credit money The total supply of money in the community consists of the quantity of actual money (M) and its velocity of circulation (V). Velocity of money in circulation (V) and the velocity of credit money (V') remain constant. T is a function of national income.

Since full employment prevails, the volume of transactions T is fixed in the short run. Briefly put, the total volume of transactions (T) multiplied by the price level (P)

represents the demand for money. The demand for money (PT) is equal to the supply of money (MV + M'V). In any given period, the total value of transactions made is equal to PT and the value of money flow is equal to MV+ M'V.

Fisher did not specifically mention anything about the demand for money; but the same is embedded in his theory as dependent on the total value of transactions undertaken in the economy. Thus, there is an aggregate demand for money for transactions purpose and more the number of transactions people want, greater will be the demand for money. The total volume of transactions multiplied by the price level (PT) represents the demand for money.

- (b) Empirical analysis of money supply is important for two reasons:
1. It facilitates analysis of monetary developments in order to provide a deeper understanding of the causes of money growth.
  2. It is essential from a monetary policy perspective as it provides a framework to evaluate whether the stock of money in the economy is consistent with the standards for price stability and to understand the nature of deviations from this standard. The central banks all over the world adopt monetary policy to stabilise price level and GDP growth by directly controlling the supply of money. This is achieved mainly by managing the quantity of monetary base. The success of monetary policy depends to a large extent on the controllability of money supply and the monetary base.
7. (a)  $M_1 = \text{Currency with the public} + \text{demand deposits of banks} + \text{other deposits of the RBI}$   
 $= 15473.2 + 6943.1 + 501.2 = 22917.5$  million
- (b) High powered money is also known as reserve money which determines the level of liquidity and price level in the economy.
- Reserve Money = Net RBI Credit to the Government + RBI credit to the Commercial sector+ RBI's claims on banks+ RBI's Net foreign assets+ Government's currency liabilities to the public- RBI's net non-monetary liabilities
- $$= 41561.2 + 18459.3 + 31456.2 + 10456.1 + 21417.1 - 24981.2 = 98368.7$$
- million
8. (a) As can be seen from the table, one hour of labour time produces 10 quintal and 5 quintal of wheat respectively in country A and country B. On the other hand, one hour of labour time produces 5 quintal of rice in country A and 10 quintal of rice in country B. Country A is more efficient than country B, or has an absolute advantage over country B in production of wheat. Similarly, country B is more efficient than country A, or has an absolute advantage over country A in the production of rice. If both nations can engage in trade with each other, each nation will specialize in the production of the good it has an absolute advantage in and obtain the other commodity through international trade. Therefore, country A would specialise completely in production of wheat and country B in rice.

- (b) Customs duties are basically taxes or duties imposed on goods and services which are imported or exported. It is defined as a financial charge in the form of a tax, imposed at the border on goods going from one customs territory to another. They are the most visible and universally used trade measures that determine market access for goods. Import duties being pervasive than export duties, custom duties are often identified with import duties. Custom duties are aimed at altering the relative prices of goods and services imported, so as to contract the domestic demand and thus regulate the volume of their imports. Custom duties leave the world market price of the goods unaffected; while raising their prices in the domestic market. The main goals of custom duties are to raise revenue for the government, and more importantly to protect the domestic import-competing industries.
9. (a) Yes, prohibition of import of poultry from countries affected by avian flu, meat and poultry processing standards to reduce pathogens, residue limits for pesticides in foods etc. are the examples of Sanitary and Phytosanitary (SPS) measures. These measures are applied to protect human, animal or plant life from risks arising from additives, pests, contaminants, toxins or disease-causing organisms and to protect biodiversity. These include ban or prohibition of import of certain goods, all measures governing quality and hygienic requirements, production processes, and associated compliance assessments.
- (b) Food laws, quality standards, industrial standards are some of the examples of Technical Barriers to Trade (TBT), which cover both food and non-food traded products. Technical Barriers to Trade refer to mandatory 'Standards and Technical Regulations' that define the specific characteristics that a product should have, such as its size, shape, design, labelling/marketing/packaging, functionality or performance and production methods, excluding measures covered by the SPS Agreement.
10. (a) A horizontal direct investment is one under which the investor establishes the same type of business operation in a foreign country as it operates in its home country, for example, a cell phone service provider based in the United States moving to India to provide the same service. On the other hand, vertical investment is one under which the investor establishes or acquires a business activity in a foreign country which is different from the investor's main business activity yet in some way supplements its major activity. For example; an automobile manufacturing company may acquire an interest in a foreign company that supplies parts or raw materials required for the company.
- (b) Real Exchange Rate = Nominal exchange rate \* Domestic price index / Foreign price index  
 =  $70 * 200 / 100$   
 = 140

**Applicability of Standards/Guidance Notes/Legislative Amendments etc.  
for November, 2019 Examination  
Intermediate (New Course)**

**Paper 5: Advanced Accounting**

**List of Applicable Accounting Standards**

- AS 7: Construction Contracts
- AS 9: Revenue Recognition
- AS 14: Accounting for Amalgamations
- AS 18: Related Party Disclosures
- AS 19: Leases
- AS 20: Earnings Per Share
- AS 24: Discontinuing Operations
- AS 26: Intangible Assets
- AS 29: Provisions, Contingent Liabilities and Contingent Assets.

**List of Applicable Guidance Notes issued by ICAI on specified accounting aspects**

The Study Guidelines containing the List of applicable Guidance Notes is given as **Annexure**.

**Applicability of the Companies Act, 2013 and other Legislative Amendments for November, 2019 Examination**

The relevant notified Sections of the Companies Act, 2013 and legislative amendments including relevant Notifications / Circulars / Rules / Guidelines issued by Regulating Authorities up to 30<sup>th</sup> April, 2019 will be applicable for November, 2019 Examination.

**Non-Applicability of Ind AS :**

The Ministry of Corporate Affairs has notified Companies (Indian Accounting Standards) Rules, 2015 on 16<sup>th</sup> February, 2015, for compliance by certain class of companies. These Ind AS do not form part of the syllabus and hence are not applicable.

**ANNEXURE: STUDY GUIDELINES**

**List of applicable Guidance Notes issued by ICAI on specified accounting aspects**

1. Guidance Note on Terms Used in Financial Statements.
2. Guidance Note on Accrual Basis of Accounting.
3. Guidance Note on Accounting for Corporate Dividend Tax.
4. Guidance Note on Accounting for Employee Share-based Payments.
5. Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax

under the Income-tax Act, 1961.

6. Guidance Note on Accounting for Real Estate Transactions (revised 2012)
7. Guidance Note on Turnover in case of Contractors.
8. Guidance Note on Schedule III to the Companies Act, 2013.

### Paper 6: Auditing and Assurance

#### List of topic-wise inclusion in the syllabus

#### I. List of applicable Engagements and Quality Control Standards on Auditing for November, 2019 Examination

S.No	SA	<i>Title of Standard on Auditing</i>
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
3	SA 210	Agreeing the Terms of Audit Engagements
4	SA 220	Quality Control for Audit of Financial Statements
5	SA 230	Audit Documentation
6	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements
7	SA 250	Consideration of Laws and Regulations in An Audit of Financial Statements
8	SA 299	Joint Audit of Financial Statements(Revised)
9	SA 300	Planning an Audit of Financial Statements
10	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
11	SA 320	Materiality in Planning and Performing an Audit
12	SA 500	Audit Evidence
13	SA 501	Audit Evidence - Specific Considerations for Selected Items
14	SA 505	External Confirmations
15	SA 510	Initial Audit Engagements-Opening Balances
16	SA 520	Analytical Procedures
17	SA 530	Audit Sampling
18	SA 550	Related Parties

19	SA 560	Subsequent Events
20	SA 570	Going Concern (Revised)
21	SA 580	Written Representations
22	SA 610	Using the Work of Internal Auditors (Revised)
23	SA 700	Forming an Opinion and Reporting on Financial Statements(Revised)
24	SA 701	Communicating Key Audit Matters in the Independent Auditor's Report (New)
25	SA 705	Modifications to the Opinion in the Independent Auditor's Report (Revised)
26	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report (Revised)
27	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements

## II. Applicability of the Companies Act, 2013 and other Legislative Amendments for November, 2019 Examination

- (i) The **January 2019 Edition of the Study Material** on Intermediate Paper 6: Auditing and Assurance [comprising of 2 Modules – Modules 1 – 2]. is relevant for November, 2019 Examinations. **This is an integrated Study Material cum Practice Manual.**

Students are expected to be updated with the notifications, circulars and other legislative amendments made upto 6 months prior to the examination. **For instance, for November, 2019 examination, significant notifications and circulars issued upto 30<sup>th</sup> April, 2019 would be relevant.**

The relevant notified Sections of the Companies Act, 2013 and legislative amendments including relevant Notifications / Circulars / Rules / Guidelines issued by Regulating Authority up to 30<sup>th</sup> April, 2019 will be applicable for November, 2019 Examination. **It may be noted that the significant notifications and circulars issued up to 30<sup>th</sup> April, 2019, which are not covered in the January 2019 Edition of the Study Material, would be given as Academic Update in the Revision Test Paper for November, 2019 Examination.**

- (ii) Companies (Auditor's Report) Order, 2016 issued by Ministry of Corporate Affairs on 29<sup>th</sup> March, 2016 is applicable for November, 2019 Examination.

### List of topic-wise exclusion in the syllabus

- I. Statement on Reporting under Section 227(1A) of the Companies Act, 1956 (Section 143(1) of the Companies Act, 2013) **excluded**.
- II. **Following Engagements and Quality Control Standards on Auditing excluded:**



(1)	(2)	(3)
S. No	SA	Exclusions
1	SA 260	Communication with Those Charged with Governance (Revised)
2	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
3	SA 330	The Auditor's Responses to Assessed Risks
4	SA 402	Audit Considerations Relating to an Entity Using a Service Organization
5	SA 450	Evaluation of Misstatements Identified during the Audits
6	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
7	SA 600	Using the Work of Another Auditor
8	SA 620	Using the Work of an Auditor's Expert
9	SA 720	The Auditor's Responsibilities Relating to Other Information

**III. Following Guidance Notes are excluded:**

1. Guidance Note on Audit of Inventories.
2. Guidance Note on Audit of Debtors, Loans and Advances.
3. Guidance Note on Audit of Investments.
4. Guidance Note on Audit of Cash and Bank Balances.
5. Guidance Note on Audit of Liabilities.
6. Guidance Note on Audit of Revenue.
7. Guidance Note on Audit of Expenses.
8. Guidance Note on Reporting under section 143(3)(f) and (h) of the Companies Act, 2013