PAPER – 5: ADVANCED ACCOUNTING

PART – I: ANNOUNCEMENTS STATING APPLICABILITY & NON-APPLICABILITY FOR MAY, 2020 EXAMINATION

A. <u>Applicable for May, 2020 Examination</u>

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

© The Institute of Chartered Accountants of India

(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. Sale of Securities held in Held to Maturity (HTM) Category

Accounting treatment

Investments by Primary (Urban) Co-operative Banks (UCBs) if securities acquired by banks with the intention to hold them up to maturity will be classified under HTM category. As per Circular no. RBI/2018-19/205 DCBR.BPD. (PCB) Cir.No.10/16.20.000/2018-19 dated 10th June, 2019, it is reiterated that UCBs are not expected to resort to sale of securities held in HTM category. However, if due to liquidity stress, UCBs are required to sell securities from HTM portfolio, they may do so with the permission of their Board of Directors and rationale for such sale may be clearly recorded. Profit on sale of investments from HTM category shall first be taken to the Profit and Loss account and, thereafter, the amount of such profit shall be appropriated to 'Capital Reserve' from the net profit for the year after statutory appropriations. Loss on sale shall be recognized in the Profit and Loss account in the year of sale.

Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks

As per Circular no. RBI/2018-19/204 DBR.No.BP.BC.46/21.04.141/2018-19 dated 10th June, 2019 (referring to RBI circular DBR No BP.BC.6/21.04.141/2015-16 dated July 1, 2015 advising banks that if the value of sales and transfer of securities to / from HTM category exceeds 5 per cent of the book value of investments held in HTM category at the beginning of the year) banks should disclose the market value of the investments held in the HTM category and indicate the excess of book value over market value for which provision is not made. Apart from transactions that are already exempted from inclusion in the 5 per cent cap, it has been decided that repurchase of State Development Loans (SDLs) by the concerned state government shall also be exempted.

© The Institute of Chartered Accountants of India

IV. 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 harmonized 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.

B. <u>Not applicable for May, 2020 examination</u>

Non-Applicability of Ind AS for May, 2020 Examination

The Ministry of Corporate Affairs has notified Companies (Indian Accounting Standards) Rules, 2015 on 16th February, 2015, for compliance by certain class of companies. These Ind AS are not applicable for May, 2020 Examination.

Change in in the curriculum of Advanced Accounting at Intermediate level w.e.f. May, 2020 Examination

<u>Accounting Standards/topics newly included in the curriculum</u>

- Application of Accounting Standards: AS 4; AS 5; AS 17 and AS 22

© The Institute of Chartered Accountants of India

- Dissolution of partnership firms including piecemeal distribution of assets; Amalgamation of partnership firms; Conversion of partnership firm into a company and Sale to a company; Issues related to accounting in Limited Liability Partnership.

Exclusion of topics from the curriculum

- Application of Guidance Notes issued by the ICAI on specific accounting aspects
- Underwriting of Shares and Debentures
- Valuation of Goodwill
- Financial Reporting of Insurance Companies and Mutual Funds and regulatory requirements thereof

NOTE: July 2019 Edition of Study Material is applicable for May, 2020 Examination.

PART – II : QUESTIONS AND ANSWERS

QUESTIONS

Dissolution of partnership firm

1. Ram, Wazir and Adil give you the following Balance Sheet as on 31st March, 2019:

Liabilities		₹	Assets		₹
Ram's Loan		15,000	Plant and Machinery at cost		30,000
Capital Accounts:			Fixtures and Fittings		2,000
Ram	30,000		Stock		10,400
Wazir	10,000		Debtors	18,400	
Adil	2,000	42,000	Less: Provision	(400)	18,000
Sundry Creditors		17,800	Joint Life Policy		15,000
Loan on Hypothecation of			Patents and Trademarks		10,000
Stock		6,200	Cash at Bank		8,000
Joint Life Policy Reserve		12,400			
		93,400			93,400

The partners shared profits and losses in the ratio of Ram 4/9, Wazir 2/9 and Adil 1/3. Firm was dissolved on 31st March, 2019 and you are given the following information:

(a) Adil had taken a loan from insurers for ₹ 5,000 on the security of Joint Life Policy.

The policy was surrendered and Insurers paid a sum of ₹ 10,200 after deducting ₹ 5,000 for Adil's loan and ₹ 300 as interest thereon.

(b) One of the creditors took some of the patents whose book value was ₹ 6,000 at a valuation of ₹ 4,500. The balance to that creditor was paid in cash.

(c) The firm had previously purchased some shares in a joint stock company and had written them off on finding them useless. The shares were now found to be worth ₹ 3,000 and the loan creditor agreed to accept the shares at this value.

(d) The remaining assets realized the following amount:

	₹
Plant and Machinery	17,000
Fixtures and Fittings	1,000
Stock	9,000
Debtors	16,500
Patents	at 50% of their book value.

(e) The liabilities were paid and a total discount of ₹ 500 was allowed by the creditors.

(f) The expenses of realization amounted to ₹ 2,300.

You are required to prepare the Realization Account, Bank Account and Partners' Capital Accounts in columnar form. Also provide necessary working notes in your answer.

Conversion of Partnership firms into a company

2. The following is the Balance Sheet of M/s. Pratham and Kaushal as on 31st March, 2019:

Liabilities	₹	Assets	₹
Capital Accounts:		Machinery	54,000
Pratham	50,000	Furniture	5,000
Kaushal	30,000	Investments (non-trading)	50,000
Reserves	20,000	Stock	20,000
Loan Account of Kaushal	15,000	Debtors	21,000
Creditors	40,000	Cash	5,000
	1,55,000		1,55,000

It was agreed that Mr. Rohan is to be admitted for a fourth share in the future profits from 1st April, 2019. He is required to contribute cash towards goodwill and ₹ 15,000 towards capital.

The following further information is furnished:

(a) Pratham & Kaushal share the profits in the ratio 3 : 2.

(b) Pratham was receiving salary of ₹ 750 p.m. from the very inception of the firm in 2012 in addition to share of profit.

© The Institute of Chartered Accountants of India

(c) The future profit ratio between Pratham, Kaushal & Rohan will be 2:1:1. Pratham will not get any salary after the admission of Rohan.

(d) It was agreed that the value of goodwill of the firm shall be determined on the basis of 3 years' purchase of the average profits from business of the last 5 years. The particulars of the profits are as under:

Year ended	Profit/(Loss)
31st March, 2015	25,000
31st March, 2016	12,500
31st March, 2017	(2,500)
31st March, 2018	35,000
31st March, 2019	30,000

The above Profits and Losses are after charging the Salary of Pratham. The Profit of the year ended 31st March, 2015 included an extraneous profit of ₹ 40,000 and the loss for the year ended 31st March, 2017 was on account of loss by strike to the extent of ₹ 20,000.

(e) The cash trading profit for the year ended 31st March, 2020 was ₹ 50,000 before depreciation.

(f) The partners had drawn each ₹ 1,000 p.m. as drawings.

(g) The value of other assets and liabilities as on 31st March, 2020 were as under:

	₹
Machinery (before depreciation)	60,000
Furniture (before depreciation)	10,000
Investment	50,000
Stock	15,000
Debtors	30,000
Creditors	20,000

(h) Provide depreciation @ 10% on Machinery and @ 5% on Furniture on the Closing Balance and interest is accumulated @ 6% on Kaushal's loan. The loan along with interest would be repaid within next 12 months.

(i) Investments (non -trading) are held from inception of the firm and interest is received @ 10% p.a.

(j) The partners applied for conversion of the firm into Karma Ltd., a Private Limited Company. Certificate was received on 1st April, 2020. They decided to convert Capital Accounts of the partners into share capital in the ratio of 2:1:1 on the basis of

© The Institute of Chartered Accountants of India

a total Capital as on 31st March, 2020. If necessary, partners have to subscribe to fresh capital or withdraw.

Prepare the Profit and Loss Account of the firm for the year ended 31st March, 2020 and the Balance Sheet of the Company on 1st April, 2020.

Sale of Partnership firm to a Company

3. Mohit, Neel and Om were Partners sharing Profits and Losses in the ratio of 5:3:2 respectively. The Trial Balance of the Firm on 31st March, 2019 was the following:

Particulars	₹	₹
Machinery at Cost	2,00,000	
Inventory	1,37,400	
Trade receivables	1,24,000	
Trade payables		1,69,400
Capital A/cs:		
Mohit		1,36,000
Neel		90,000
Om		46,000
Drawing A/cs:		
Mohit	50,000	
Neel	46,000	
Om	34,000	
Depreciation on Machinery		80,000
Profit for the year ended 31st March		2,48,600
Cash at Bank	1,78,600	
	7,70,000	7,70,000

Interest on Capital Accounts at 10% p.a. on the amount standing to the credit of Partners' Capital Account at the beginning of the year, was not provided before preparing the above Trial Balance. On the above date, they formed a MNO Private Limited Company with an Authorized Share Capital of 2,00,000 shares of ₹ 10 each to be divided in different classes to take over the business of Partnership firm.

You are provided the following information:

1. Machinery is to be transferred at ₹ 1,40,000.
2. Shares in the Company are to be issued to the partners, at par, in such numbers, and in such classes as will give the partners, by reason of their shareholdings alone, the

© The Institute of Chartered Accountants of India

same rights as regards interest on capital and the sharing of profit and losses as they had in the partnership.

3. Before transferring the business, the partners wish to draw from the partnership profits to such an extent that the bank balance is reduced to ₹ 1,00,000. For this purpose, sufficient profits of the year are to be retained in profit-sharing ratio.

4. Assets and liabilities except Machinery and Bank, are to be transferred at their book value as on the above date.

You are required to prepare:

(a) Statement showing the workings of the Number of Shares of each class to be issued by the company, to each partner.

(b) Capital Accounts showing all adjustments required to dissolve the Partnership.

(c) Balance Sheet of the Company immediately after acquiring the business of the Partnership and Issuing of Shares.

Limited Liability Partnerships

4. Differentiate on ordinary partnership firm with an LLP (Limited Liability Partnership) in respect of the following:

(1) Applicable Law

(2) Number of Partners

(3) Ownership of Assets

(4) Liability of Partners/Members

Accounting for ESOPs

5. On 1st April, 2019, a company offered 100 shares to each of its 400 employees at ₹ 25 per share. The employees are given a month to accept the shares. The shares issued under the plan shall be subject to lock-in to transfer for three years from the grant date i.e. 30th, April 2019. The market price of shares of the company on the grant date is ₹ 30 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at ₹ 28 per share.

Up to 30th April, 2019, 50% of employees accepted the offer and paid ₹ 25 per share purchased. Nominal value of each share is ₹ 10. You are required to record the issue of shares in the books of the company under the aforesaid plan.

Buy Back of Securities

6. The following was the Balance Sheet of C Ltd. as on 31st March ,2019:

Equity & Liabilities	₹ Lakhs	Assets	₹ Lakhs
Share Capital:		Fixed Assets	14,000

© The Institute of Chartered Accountants of India

Equity shares of ₹ 10 each Fully Paid Up	8,000	Investments	2,350
10% Redeemable Pref. Shares of ₹ 10 each Fully Paid Up	2,500	Cash at Bank	2,300
Reserves & Surplus		Other Current Assets	8,250
Capital Redemption Reserve	1,000		
Securities Premium	800		
General Reserve	6,000		
Profit & Loss Account	300		
Secured Loans:			
9% Debentures	5,000		
Current Liabilities:			
Trade payables	2,300		
Sundry Provisions	1,000		
	26,900		26,900

On 1st April, 2019 the Company redeemed all its Preference Shares at a Premium of 10% and bought back 10% of its Equity Shares at ₹ 20 per Share. In order to make cash available, the Company sold all the Investments for ₹ 2,500 lakhs.

You are required to pass journal entries for the above and prepare the Company's Balance sheet immediately after buyback of equity shares and redemption of preference shares.

Equity Shares with Differential Rights

7. (a) Can preference shares be also issued with differential rights? Explain in brief.

   (b) Explain the conditions under Companies (Share Capital and Debentures) Rules, 2014, to deal with equity shares with differential rights.

Amalgamation of Companies

8. P Ltd. and Q Ltd. agreed to amalgamate and form a new company called PQ Ltd. The summarized balance sheets of both the companies on the date of amalgamation stood as below:

Liabilities	P Ltd. ₹	Q Ltd. ₹	Assets	P Ltd. ₹	Q Ltd. ₹
Equity Shares (₹ 100 each)	8,20,000	3,20,000	Land & Building	4,50,000	3,40,000
9% Pref. Shares (₹ 100 each)	3,80,000	2,80,000	Furniture & Fittings	1,00,000	50,000

© The Institute of Chartered Accountants of India

8% Debentures	2,00,000	1,00,000	Plant & Machinery	6,20,000	4,50,000
General Reserve	1,50,000	50,000	Trade receivables	3,25,000	1,50,000
Profit & Loss A/c	3,52,000	2,05,000	Inventory	2,33,000	1,05,000
Unsecured Loan	-	1,75,000	Cash at bank	2,08,000	1,75,000
Trade payables	88,000	1,60,000	Cash in hand	54,000	20,000
	19,90,000	12,90,000		19,90,000	12,90,000

PQ Ltd. took over the assets and liabilities of both the companies at book value after creating provision @ 5% on inventory and trade receivables respectively and depreciating Furniture & Fittings by @ 10%, Plant and Machinery by @ 10%. The trade receivables of P Ltd. include ₹ 25,000 due from Q Ltd.

PQ Ltd. will issue:

(i) 5 Preference shares of ₹ 20 each @ ₹ 18 paid up at a premium of ₹ 4 per share for each pref. share held in both the companies.

(ii) 6 Equity shares of ₹ 20 each @ ₹ 18 paid up a premium of ₹ 4 per share for each equity share held in both the companies.

(iii) 6% Debentures to discharge the 8% debentures of both the companies.

(iv) 20,000 new equity shares of ₹ 20 each for cash @ ₹ 18 paid up at a premium of ₹ 4 per share.

PQ Ltd. will pay cash to equity shareholders of both the companies in order to adjust their rights as per the intrinsic value of the shares of both the companies.

You are required to prepare ledger accounts in the books of P Ltd. and Q Ltd. to close their books.

Internal Reconstruction of a Company

9. The following is the Balance Sheet of Star Ltd. as on 31st March, 2019:

	₹
A. Equity & Liabilities	
1. Shareholders' Fund:	
(a) Share Capital:	
9,000 7% Preference Shares of ₹ 100 each fully paid	9,00,000
10,000 Equity Shares of ₹ 100 each fully paid	10,00,000
(b) Reserve & Surplus:	
Profit & Loss Account	(2,00,000)
2. Non-current liabilities:	

		"A" 6% Debentures (Secured on Bombay Works)	3,00,000
		"B" 6% Debentures (Secured on Chennai Works)	3,50,000
	3.	**Current Liabilities and Provisions:**	
		(a) Workmen's Compensation Fund:	
		Bombay Works	10,000
		Chennai Works	5,000
		(b) Trade Payables	1,25,000
		Total	24,90,000
B.	**Assets:**		
	Non- current Assets:		
	1.	**PPE**:	
		Bombay Works	9,50,000
		Chennai Works	7,75,000
	2.	**Investment:**	
		Investments for Workman's Compensation Fund	15,000
	3.	**Current Assets:**	
		(a) Inventories	4,50,000
		(b) Trade Receivables	2,50,000
		(c) Cash at Bank	50,000
			24,90,000

A reconstruction scheme was prepared and duly approved. The salient features of the scheme were as follows:

(i) Paid up value of 7% Preference Share to be reduced to ₹ 80, but the rate of dividend being raised to 9%.

(ii) Paid up value of Equity Shares to be reduced to ₹ 10.

(iii) The directors to refund ₹ 50,000 of the fees previously received by them.

(iv) Debenture holders forego their interest of ₹ 26,000 which is included among the trade payables.

(v) The preference shareholders agreed to waive their claims for preference share dividend, which is in arrears for the last three years.

(vi) "B" 6% Debenture holders agreed to take over the Chennai Works at ₹ 4,25,000 and to accept an allotment of 1,500 equity shares of ₹ 10 each at par, and upon their forming a company called Zia Ltd. (to take over the Chennai Works) they allotted 9,000 equity shares of ₹ 10 each fully paid at par to Star Ltd.

© The Institute of Chartered Accountants of India

(vii) The Chennai Worksmen's compensation fund disclosed that there were actual liabilities of ₹ 1,000 only. As a consequence, the investments of the fund were realized to the extent of the balance. Entire investments were sold at a profit of 10% on book value and the proceeds were utilized for part payment of the creditors.

(viii) Inventory was to be written off by ₹ 1,90,000 and a provision for doubtful debts is to be made to the extent of ₹ 20,000.

(ix) Chennai works completely written off.

(x) Any balance of the Capital Reduction Account is to be applied as two-third to write off the value of Bombay Works and one-third to Capital Reserve.

Pass necessary Journal Entries in the books of Star Ltd. after the scheme has been carried into effect.

Liquidation of Company

10. Alpha Ltd. is under the process of liquidation. Liquidator is entitled to receive remuneration at 2% on the assets realized, 3% on the amount distributed to Preferential Creditors and 3% on the payment made to Unsecured Creditors. The assets were realized for ₹ 37,50,000 against which payment was made as follows:

Liquidation Expenses	₹ 37,500
Secured Creditors	₹ 15,00,000
Preferential Creditors	₹ 1,12,500

The amount due to Unsecured Creditors was ₹ 22,50,000. You are asked to calculate the total Remuneration payable to Liquidator.

Calculation shall be made to the nearest multiple of a rupee.

Banking Companies

11. Anmol Bank Ltd. has a balance of ₹ 40 crores in "Rebate on bills discounted" account as on 31st March, 2018. The Bank provides you the following information:

(i) During the financial year ending 31st March, 2019 Anmol Bank Ltd. discounted bills of exchange of ₹ 5,000 crores charging interest @ 14% and the average period of discount being 146 days.

(ii) Bills of exchange of ₹ 500 crores were due for realization from the acceptors/customers after 31st March, 2019. The average period of outstanding after 31st March, 2019 being 73 days. These bills of exchange of ₹ 500 crores were discounted charging interest @ 14% p.a.

You are requested to give the necessary Journal Entries in the books of Anmol Bank Ltd. for the above transactions.

© The Institute of Chartered Accountants of India

NBFCs

12. LK Finance Ltd. is a non-banking financial company. It provides you with the following information regarding its outstanding amount, ₹ 400 lakhs of which installments are overdue on 400 accounts for last two months (amount overdue ₹ 80 lakhs), on 24 accounts for three months (amount overdue ₹ 48 lakhs), on 10 accounts for more than 30 months (amount overdue ₹ 40 lakhs) and on 4 accounts for more than three years (amount over due ₹ 40 lakhs-already identified as sub-standard assets) and one account of ₹ 20 lakhs which has been identified as non-recoverable by the management. Out of 10 accounts overdue for more than 30 months, 6 accounts are already identified as sub-standard (amount ₹ 12 lakhs) for more than fourteen months and other are identified as sub-standard asset for a period of less than fourteen months.

    Classify the assets of the company in line with Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Consolidated Financial Statements

13. From the following summarized balance sheets of Kedar Ltd. and its subsidiary Vijay Ltd. drawn up at 31st March, 2019, prepare a consolidated balance sheet as at that date, having regard to the following:

    (i) Reserves and Profit and Loss Account of Vijay Ltd. stood at ₹ 62,500 and ₹ 37,500 respectively on the date of acquisition of its 80% shares by Kedar Ltd. on 1st April, 2018.

    (ii) Machinery (Book-value ₹ 2,50,000) and Furniture (Book value ₹ 50,000) of Vijay Ltd. were revalued at ₹ 3,75,000 and ₹ 37,500 respectively on 1st April, 2018 for the purpose of fixing the price of its shares. [Rates of depreciation computed on the basis of useful lives: Machinery 10%, Furniture 15%.]

Summarised Balance Sheet of Kedar Ltd. and Vijay Ltd. as on 31st March, 2019

Liabilities	Kedar Ltd.	Vijay Ltd.	Assets	Kedar Ltd.	Vijay Ltd.
	₹	₹		₹	₹
Equity and Liabilities			Non-current assets		
Shareholders' funds			Fixed assets		
Share Capital			Machinery	7,50,000	2,25,000
Shares of ₹ 100 each	15,00,000	2,50,000	Furniture	3,75,000	42,500

© The Institute of Chartered Accountants of India

Reserves	5,00,000	1,87,500	Other non-current assets	11,00,000	3,75,000
Profit and Loss			Non-current Investments		
Account	2,50,000	62,500	Shares in Vijay Ltd.:		
Trade Payables	3,75,000	1,42,500	2,000 shares at ₹ 200 each	4,00,000	—
	26,25,000	6,42,500		26,25,000	6,42,500

Accounting Standards

AS 4 Contingencies and Events occurring after the Balance Sheet Date

14. (a) With reference to AS 4 "Contingencies and events occurring after the balance sheet date", state whether the following events will be treated as contingencies, adjusting events or non-adjusting events occurring after balance sheet date in case of a company which follows April to March as its financial year.

(i) A major fire has damaged the assets in a factory on 5th April, 5 days after the year end. However, the assets are fully insured and the books have not been approved by the Directors.

(ii) A suit against the company's advertisement was filed by a party on 10th April, 10 days after the year end claiming damages of ₹ 20 lakhs.

AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

(b) Explain whether the following will constitute a change in accounting policy or not as per AS 5.

(i) Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.

(ii) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organization. Such employees will get pension of ₹ 20,000 per month. Earlier there was no such scheme of pension in the organization.

AS 7 Construction Contracts

15. (a) A construction contractor has a fixed price contract for ₹ 9,000 lacs to build a bridge in 3 years time frame. A summary of some of the financial data is as under:

© The Institute of Chartered Accountants of India

	(Amount ₹ in lacs)		
	Year 1	Year 2	Year 3
Initial Amount for revenue agreed in contract	9,000	9,000	9,000
Variation in Revenue (+)	-	200	200
Contracts costs incurred up to the reporting date	2,093	6,168*	8,100**
Estimated profit for whole contract	950	1,000	1,000

*Includes ₹ 100 lacs for standard materials stored at the site to be used in year 3 to complete the work.

**Excludes ₹ 100 lacs for standard material brought forward from year 2.

The variation in cost and revenue in year 2 has been approved by customer.

Compute year wise amount of revenue, expenses, contract cost to complete and profit or loss to be recognized in the Statement of Profit and Loss as per AS-7 (revised).

AS 9 Revenue Recognition

(b) The following information of Meghna Ltd. is provided:

(i) Goods of ₹ 60,000 were sold on 20-3-2019 but at the request of the buyer these were delivered on 10-4-2019.

(ii) On 15-1-2019 goods of ₹ 1,50,000 were sent on consignment basis of which 20% of the goods unsold are lying with the consignee as on 31-3-2019.

(iii) ₹ 1,20,000 worth of goods were sold on approval basis on 1-12-2018. The period of approval was 3 months after which they were considered sold. Buyer sent approval for 75% goods up to 31-1-2019 and no approval or disapproval received for the remaining goods till 31-3-2019.

(iv) Apart from the above, the company has made cash sales of ₹ 7,80,000 (gross). Trade discount of 5% was allowed on the cash sales.

You are required to advise the accountant of Meghna Ltd., with valid reasons, the amount to be recognized as revenue in above cases in the context of AS-9.

AS 17 Segment Reporting

16. (a) The Chief Accountant of Cotton Garments Limited gives the following data regarding its five segments: (₹ in Crore)

Particulars	A	B	C	D	E	Total
Segment Assets	40	15	10	10	5	80
Segment Results	(95)	5	5	(5)	15	(75)
Segment Revenue	310	40	30	40	30	450

© The Institute of Chartered Accountants of India

The Chief Accountant is of the opinion that segment "A" alone should be reported. Is he justified in his view? Examine his opinion in the light of provisions of AS 17 'Segment Reporting'.

AS 18 Related Party Transactions

(b) Arohi Ltd. sold goods for ₹ 90 lakhs to Anya Ltd. during financial year ended 31-3-2019. The Managing Director of Arohi Ltd. own 100% of Anya Ltd. The sales were made to Anya Ltd. at normal selling prices followed by Arohi Ltd. The Chief accountant of Arohi Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant correct? Comment in accordance with AS 18.

AS 19 Leases

17. (a) ABC Ltd. took a machine on lease from XYZ Ltd., the fair value being ₹ 10,00,000. The economic life of the machine as well as the lease term is 4 years. At the end of each year, ABC Ltd. pays ₹ 3,50,000. The lessee has guaranteed a residual value of ₹ 50,000 on expiry of the lease to the lessor. However, XYZ Ltd. estimates that the residential value of the machinery will be ₹ 35,000 only. The implicit rate of return is 16% and PV factors at 16% for year 1, year 2, year 3 and year 4 are 0.8621, 0.7432, 0.6407 and 0.5523 respectively. You are required to calculate the value of machinery to be considered by ABC Ltd. and the finance charges for each year.

AS 20 Earnings Per Share

(b) From the following information, you are required to compute Basic and Diluted Earnings Per Share (EPS) of M/s. XYZ Limited for the year ended 31st March, 2019 :

Net Profit for the year after tax:	₹ 75,00,000
Number of Equity Shares of ₹ 10 each outstanding:	₹ 10,00,000

1,00,000, 8% Convertible Debentures of ₹ 100 each were issued by the Company at the beginning of the year. 1,10,000 Equity Shares were supposed to be issued on conversion. Consider rate of Income Tax as 30%.

AS 22 Accounting for Taxes on Income

18. (a) The following particulars are stated in the Balance Sheet of PQR Ltd. as on 31.03.2018:

	(₹ in lakh)
Deferred Tax Liability (Cr.)	30.00
Deferred Tax Assets (Dr.)	15.00

© The Institute of Chartered Accountants of India

The following transactions were reported during the year 2018-2019:

i.	Tax Rate	30%
		(₹ in lakh)
ii.	Depreciation as per books	80.00
	Depreciation for tax purposes	70.00
iii.	Items disallowed in 2017-2018 and allowed for tax purposes in 2018-2019.	10.00
iv.	Donations to Private Trust made in 2018-2019.	10.00

There were no additions to Fixed Assets during the year.

You are required to show the impact of various items on Deferred Tax Assets and Deferred Tax Liability as on 31.03.2019.

AS 24 Discontinuing Operations

(b) (i) What are the disclosure and presentation requirements of AS 24 for discontinuing operations?

(ii) Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of AS 24, but that might do so in combination with other circumstances.

AS 26 Intangible Assets

19. A company acquired patent right for ₹ 1200 lakhs. The product life cycle has been estimated to be 5 years and the amortization was decided in the ratio of estimated future cash flows which are as under:

Year	1	2	3	4	5
Estimated future cash flows (₹ in lakhs)	600	600	600	300	300

After 3rd year, it was ascertained that the patent would have an estimated balance future life of 3 years and the estimated cash flow after 5th year is expected to be ₹ 150 lakhs. You are required to determine the amortization pattern under Accounting Standard 26.

AS 29 Provisions, Contingent Liabilities and Contingent Assets

20. With reference to AS 29, how would you deal with the following in the annual accounts of the company at the Balance Sheet dates:

(i) An organization operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety percent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten percent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

© The Institute of Chartered Accountants of India

(ii) During 2018-19 Ace Ltd. gives a guarantee of certain borrowings of Brew Ltd., whose financial condition at that time is sound. During 2019-20, the financial condition of Brew Ltd. deteriorates and on 31st Dec. 2019, it goes into liquidation. (Balance Sheet date 31-3-19).

SUGGESTED ANSWERS/HINTS

1. **Realization Account**

	₹			₹
To Plant and machinery	30,000	By Provision for doubtful debts		400
To Fixtures and fittings	2,000	By Loan on hypothecation of stock (W.N.3)		3,000
To Stock	10,400	By Creditors (W.N.2)		500
To Debtors	18,400	By Joint Life Policy A/c (W.N.4)		12,900
To Patents and Trademarks (W.N.5)	5,500	By Bank		
		Plant and machinery	17,000	
To Bank	2,300	Fixtures and fittings	1,000	
		Stock	9,000	
		Debtors	16,500	
		Patents and Trademarks	2,000	45,500
		By Partners' Capital Accounts		
		Ram	2,800	
		Wazir	1,400	
		Adil	2,100	6,300
	68,600			68,600

Bank Account

	₹		₹
To Balance b/d	8,000	By Adil's Capital A/c- drawings	5,300
To Joint Life Policy	15,500	By Loan on hypothecation of stock	3,200
To Realisation A/c	45,500		
To Adil's Capital A/c	5,400	By Creditors	12,800
		By Realisation A/c (expenses)	2,300
		By Ram's Loan A/c	15,000
		By Ram's Capital A/c	27,200
		By Wazir's Capital A/c	8,600
	74,400		74,400

© The Institute of Chartered Accountants of India

Partners' Capital Accounts

	Ram	*Wazir*	*Adil*		*Ram*	*Wazir*	*Adil*
	₹	₹	₹		₹	₹	₹
To Bank			5,300	By Balance b/d	30,000	10,000	2,000
To Realisation A/c	2,800	1,400	2,100	By Bank A/c (bal.fig.)			5,400
To Bank (Bal. Fig.)	27,200	8,600					
	30,000	10,000	7,400		30,000	10,000	7,400

Working Notes:

1. **Ram's Loan Account**

	₹		₹
To Bank A/c	15,000	By Balance b/d	15,000
	15,000		15,000

2. **Sundry Creditors Account**

	₹		₹
To Patents and Trademarks A/c	4,500	By Balance b/d	17,800
To Realisation A/c	500		
To Bank A/c	12,800		
	17,800		17,800

3. **Loan on Hypothecation of Stock Account**

	₹		₹
To Realisation A/c	3,000	By Balance b/d	6,200
To Bank A/c	3,200		
	6,200		6,200

4. **Joint Life Policy Account**

	₹		₹
To Balance b/d	15,000	By Joint Life Policy Reserve A/c	12,400
To Realisation A/c	12,900	By Bank A/c (10,200 + 5,300)	15,500
	27,900		27,900

© The Institute of Chartered Accountants of India

5. **Patents and Trademarks Account**

	₹		₹
To Balance b/d	10,000	By Creditors A/c	4,500
		By Realisation A/c	1,500
		By Realisation A/c (bal.fig.)	4,000*
	10,000		10,000

2. M/s Pratham, Kaushal and Rohan

Profit and Loss Account for the year ending on 31st March, 2020

	₹		₹
To Depreciation on Machinery	6,000	By Trading Profit	50,000
To Depreciation on furniture	500	By Interest on Investment	5,000
To Interest on Kaushal's loan	900		
To Net Profit to :			
Pratham's Capital A/c	23,800		
Kaushal's Capital A/c	11,900		
Rohan's Capital A/c	11,900		
	55,000		55,000

Balance Sheet of the Karma Pvt. Ltd. as on 1st April, 2020

	Notes No.	₹
I Equity and Liabilities		
Shareholders' funds		
Share capital		1,41,600
Current liabilities		
Short term borrowings	1	15,900
Trade payables		20,000
Total		1,77,500
II Assets		
Non-current assets		
Property, plant & Equipment	2	63,500
Non-current investments		50,000

© The Institute of Chartered Accountants of India

Current assets		
Inventories		15,000
Trade receivables		30,000
Cash and cash equivalents		19,000
Total		1,77,500

Notes to Accounts

		₹
1. Short term borrowings		
Loan from Kaushal		15,900
2. PPE		
Machinery	54,000	
Furniture	9,500	63,500

Working Notes:

1. **Calculation of goodwill**

	2014-15 ₹	*2015-16* ₹	*2016-17* ₹	*2017-18* ₹	*2018-19* ₹
Profits/(Loss)	25,000	12,500	(2,500)	35,000	30,000
Adjustment for extraneous profit of 2014-15 and abnormal loss of 2016-17	(40,000)	-	20,000	—	—
	(15,000)	12,500	17,500	35,000	30,000
Add: Salary of Pratham (750 x12)	9,000	9,000	9,000	9,000	9,000
	(6,000)	21,500	26,500	44,000	39,000
Less: Interest on non-trading investment	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
	(11,000)	16,500	21,500	39,000	34,000
Total Profit from 2015-16 to 2018-19					1,11,000
Less: Loss for 2014-15					(11,000)
					1,00,000
Average Profit					20,000

© The Institute of Chartered Accountants of India

Goodwill equal to 3 years' purchase					60,000
Contribution from Rohan for ¼ share					15,000

2. **Calculation of sacrificing ratio of Partners Pratham and Kaushal on admission of Rohan**

	Old share	New share	Sacrificing share	Gaining share
Pratham	3/5	1/2	$\frac{3}{5}-\frac{1}{2}=\frac{6-5}{10}=\frac{1}{10}$	
Kaushal	2/5	1/4	$\frac{2}{5}-\frac{1}{4}=\frac{8-5}{20}=\frac{3}{20}$	
Rohan		1/4		1/4

3. **Goodwill adjustment entry through Partners' capital accounts (in their sacrificing ratio of 2:3)**

	₹	₹
Rohan' s capital A/c Dr.	15,000	
To Pratham's capital A/c		6,000
To Kaushal' s capital A/c		9,000
(Rohan's share in goodwill adjusted through Pratham and Kaushal)		

4. **Partners' Capital Accounts**

	Pratham ₹	*Kaushal* ₹	*Rohan* ₹		*Pratham* ₹	*Kaushal* ₹	*Rohan* ₹
To Drawings (1,000 x 12)	12,000	12,000	12,000	By Balance b/d	50,000	30,000	—
To Pratham			6,000	By General Reserve	12,000	8,000	—
To Kaushal			9,000	By *Rohan*	6,000	9,000	—
To Balance c/d	79,800	46,900	14,900	By Bank (15,000 + 15,000)	—	—	30,000
				By Profit & Loss A/c	23,800	11,900	11,900
	91,800	58,900	41,900		91,800	58,900	41,900

© The Institute of Chartered Accountants of India

5. **Balance Sheet of the firm as on 31st March, 2020**

Liabilities	₹	₹	*Assets*	₹	₹
Pratham's Capital	79,800		Machinery	60,000	
Kaushal's Capital	46,900		*Less*: Depreciation	(6,000)	54,000
Rohan's Capital	14,900	1,41,600	Furniture	10,000	
			Less: Depreciation	(500)	9,500
Kaushal's Loan	15,000		Investments		50,000
Add: Interest due	900	15,900	Stock-in-trade		15,000
Creditors		20,000	Debtors		30,000
			Cash (W.N.6)		19,000
		1,77,500			1,77,500

6. **Cash balance as on 31.3.2020**

	₹	₹
Cash trading profit		50,000
Add: Investment Interest		5,000
Add: Decrease in Stock Balance		5,000
		60,000
Less: Increase in Debtors	9,000	
Less: Decrease in Creditors	20,000	(29,000)
		31,000
Add: Opening cash balance	5,000	
Add: Cash brought in by *Rohan*	30,000	35,000
		66,000
Less: Drawings (12,000 +12,000 +12,000)	36,000	
Less: Additions to Machine (60,000 - 54,000)	6,000	
Furniture (10,000 - 5,000)	5,000	(47,000)
Closing cash balance		19,000

7. **Distribution of shares – Conversion into Company**

		₹
Capital:	Pratham	79,800
	Kaushal	46,900
	Rohan	14,900

© The Institute of Chartered Accountants of India

Share Capital		1,41,600
Distribution of shares:	Pratham (1/2)	70,800
	Kaushal (1/4)	35,400
	Rohan (1/4)	35,400

Pratham and Kaushal should withdraw capital of ₹ 9,000 (₹ 79,800 – ₹ 70,800) and ₹11,500 (₹ 46,900 – ₹ 35,400) respectively and Rohan should subscribe shares of ₹ 20,500 (₹35,400 – ₹ 14,900).

3. (a) Number of Shares to be issued to Partners

	₹
Assets: Machinery ₹ 1,40,000 + Inventory ₹ 1,37,400 +Trade Receivable ₹1,24,000 + Bank ₹ 1,00,000	5,01,400
Less: Liabilities taken over	(1,69,400)
Net Assets taken over (Purchase Consideration)	3,32,000

Classes of Shares to be issued :	Mohit	Neel	Om	Total
10% Preference Shares of ₹ 10 each (to retain rights as to Interest on Capital)	1,36,000	90,000	46,000	2,72,000
Balance in Equity Shares of ₹ 10 each	30,000	18,000	12,000	60,000
(3,32,000 -2,72,000) (issued in profit sharing ratio)				
	1,66,000	1,08,000	58,000	3,32,000

(b) Partners' Capital Accounts

Particulars	Mohit	Neel	Om	Particulars	Mohit	Neel	Om
To Drawings	50,000	46,000	34,000	By balance b/d	1,36,000	90,000	46,000
To 10% Preference share capital	1,36,000	90,000	46,000	By Interest on Capital	13,600	9,000	4,600
To Equity Shares	30,000	18,000	12,000	By profit for the year 5:3:2 (W.N. 1)	1,10,700	66,420	44,280
To Bank – Additional	54,300	17,420	6,880	By Machinery* A/c	10,000	6,000	4,000
drawings (W.N. 2)							
Total	2,70,300	1,71,420	98,880		2,70,300	1,71,420	98,880

© The Institute of Chartered Accountants of India

* Gain on Transfer of Machinery = ₹ 1,40,000 – (₹ 2,00,000-₹ 80,000) = ₹ 20,000 in 5:3:2 ratio.

(c) Balance sheet of MNO Ltd. as on 31st March, 2019 (after Takeover of Firm)

		Note no.	₹
I	Equity and Liabilities:		
	(1) Shareholders Funds		
	Share Capital	1	3,32,000
	(2) Current Liabilities		
	Trade Payables		1,69,400
	Total		5,01,400
II	Assets		
	(1) Non-Current Assets		
	Property, plant & equipment		1,40,000
	(2) Current Assets:		
	(a) Inventories		1,37,400
	(b) Trade Receivables		1,24,000
	(c) Cash and Cash Equivalents		1,00,000
	Total		5,01,400

Notes to Accounts

	Particulars	₹
1.	Shares capital	
	Authorized shares capital	20,00,000
	Issued, Subscribed & paid up	
	6,000 Equity Shares of ₹ 10 each	60,000
	27,200 10% Preference Shares capital of ₹ 10 each	2,72,000
	(All above shares issued for consideration other than cash, in takeover of partnership firm)	3,32,000

Working Note:

1. **Profit & Loss Appropriation Account for the year ended 31st March, 2019**

Particulars	₹	₹	Particulars	₹
To Interest on Capital:			By Net Profit	2,48,600

Mohit [₹ 1,36,000 x 10%]	13,600		(given)	
Neel [₹ 90,000 x 10%]	9,000			
Om [₹ 46,000 x 10%]	4,600	27,200		
To Profits transferred to Capital in profit sharing ratio 5:3:2				
Mohit	1,10,700			
Neel	66,420			
Om	44,280	2,21,400		
Total		2,48,600		2,48,600

2. **Statement showing Additional Drawings in Cash**

(a) Funds available for Drawings

	Total Drawing of Partners (given)	1,30,000
Add:	Further Funds available for Drawings (1,78,600-1,00,000)	78,600
		2,08,600
Less:	Interest on Capital	(27,200)
	Amount available for Additional Drawings	1,81,400

(b) Ascertainment of Additional Drawings

Particulars	Mohit	Neel	Om
As per above statement ₹ 1,81,400 (in profit sharing ratio)	90,700	54,420	36,280
Add: Interest	13,600	9,000	4,600
	1,04,300	63,420	40,880
Less: Already drawn	(50,000)	(46,000)	(34,000)
Additional Drawings	54,300	17,420	6,880

4. Distinction between an ordinary partnership firm and an LLP

Key Elements	Partnerships	LLPs
Applicable Law	Indian Partnership Act 1932	The Limited Liability Partnerships Act, 2008
Number of Partners	Minimum 2 and Maximum 20 (subject to 10 for banks)	Minimum 2 but no maximum limit

© The Institute of Chartered Accountants of India

Ownership of Assets	Firm cannot own any assets. The partners own the assets of the firm.	The LLP as an independent entity can own assets
Liability of Partners/ Members	Unlimited: Partners are severally and jointly liable for actions of other partners and the firm and their liability extends to personal assets.	Limited to the extent of their contribution towards LLP except in case of intentional fraud or wrongful act of omission or commission by a partner.

5. Fair value of an option = ₹ 28

Difference between Fair value and Issue Price =₹ 28 – ₹ 25 = 3.

Number of employees accepting the offer = 400 employees x 50% = 200 employees

Number of shares issued = 200 employees x 100 shares/employee = 20,000 shares

Employee Compensation Expenses recognized in 2019-20 =20,000 shares x ₹ 3 = ₹ 60,000

Securities Premium A/c = ₹ 28 – 10 = ₹ 18 per share = 20,000 x 18 = ₹ 3,60,000

Journal Entry

Date	*Particulars*		*₹*	*₹*
30.04.2019	Bank (20,000 shares x ₹ 25)	Dr.	5,00,000	
	Employees compensation expense A/c	Dr.	60,000	
	To Share Capital			2,00,000
	To Securities Premium			3,60,000
	(Being stock purchase option accepted by 200 employees for 100 shares each at ₹ 25 per share on a Fair Value of ₹ 28 per share)			

Note: Employees compensation expenses amounting ₹ 60,000 will ultimately be charged to profit & loss account.

6. (i) Journal Entries in the books of C Ltd. (₹ in lakhs)

	Particulars			
1	Bank A/c	Dr.	2,500	
	To Investments A/c			2,350
	To Profit and Loss A/c			150
	(Being investment sold on profit for the purpose of buy-back)			
2	10% Redeemable Preference Share Capital A/c	Dr.	2,500	

	Premium on Redemption of Preference Shares A/c	Dr.	250	
	To Preference Shareholders A/c			2,750
	(Being redemption of preference share capital at premium of 10%)			
3	Securities Premium A/c	Dr.	250	
	To Premium on Redemption of Preference Shares A/c			250
	(Being premium on redemption of preference shares adjusted through securities premium)			
4	Equity Share Capital A/c	Dr.	800	
	Premium on buyback	Dr.	800	
	To Equity buy-back A/c			1,600
	(Being Equity Share bought back, Share Capital cancelled, and Premium on Buyback accounted for)			
5	Securities Premium A/c (800-250)	Dr.	550	
	General Reserve A/c		250	
	To Premium on Buyback A/c			800
	(Being premium on buyback provided first out of securities premium and the balance out of general reserves.)			
6	Preference Shareholders A/c		2,750	
	Equity buy-back A/c		1,600	
	To Bank A/c			4,350
	(Being payment made to preference shareholders and equity shareholders)			
7	General Reserve Account		3,300	
	To Capital Redemption Reserve Account			3,300
	(Being amount transferred to capital redemption reserve account towards face value of preference shares redeemed and equity shares bought back)			

(ii) Balance Sheet of C Ltd. (after Redemption and Buyback)

(₹ Lakhs)

	Particulars	Note No	Amount
	EQUITY AND LIABILITIES		₹
(I)	Shareholders' Funds:		
	(a) Share Capital	1	7,200

© The Institute of Chartered Accountants of India

	(b) Reserves and Surplus	2	7,200
(2)	Non-Current Liabilities:		
	(a) Long Term Borrowings	3	5,000
(3)	Current Liabilities:		
	(a) Trade payables		2,300
	(b) Short Term Provisions		1,000
	Total		22,700
(II)	ASSETS		
(1)	Non-Current Assets		
	PPE		14,000
	Current Assets:		
	(a) Cash and Cash equivalents (W N)		450
	(b) Other Current Assets		8,250
			22,700

Notes to Accounts

				₹ in Lakhs
1.	**Share Capital**			
	720 lakh Equity Shares of ₹ 10 each Fully Paid up (80 lakh Equity Shares bought back)			7,200
2.	**Reserves and Surplus**			
	General Reserve	6,000		
	Less: Adjustment for premium paid on buy back	(250)		
	Less: Transfer to CRR	(3,300)	2,450	
	Capital Redemption Reserve	1,000		
	Add: Transfer due to buy-back of shares from Gen. res.	3,300	4,300	
	Securities premium	800		
	Less: Adjustment for premium paid on redemption of preference shares	(250)		
	Less: Adjustment for premium paid on buy back	(550)	-	
	Profit & Loss A/c	300		

© The Institute of Chartered Accountants of India

	Add: Profit on sale of investment	150	450	7,200
3.	**Long-term borrowings**			
	Secured			
	9 % Debentures			5,000

Working Note:

Bank Account

Receipts	Amount	Payments	Amount
	(₹ Lakhs)		(₹ Lakhs)
To balance b/d	2,300	By Preference Shareholders A/c	2,750
To Investment A/c (sale Proceeds)	2,500	By Equity Shareholders A/c	1,600
		By Balance c/d (Balancing figure)	450
	4,800		4,800

7. (a) No. Preference shares cannot be issued with differential rights. It is only the equity shares, which are issued with differential rights.

(b) In exercise of the power conferred under Section 43(a)(ii), the central government announced Rule 4 under Companies (Share Capital and Debentures) Rules, 2014, to deal with equity shares with differential rights.

The rules lay down the following conditions to be compulsorily complied with:

(a) The articles of association of the company authorizes the issue of shares with differential rights;

(b) The issue of shares is authorized by an ordinary resolution passed at a general meeting of the shareholders: Provided that where the equity shares of a company are listed on a recognized stock exchange, the issue of such shares shall be approved by the shareholders through postal ballot;

(c) The shares with differential rights shall not exceed twenty-six percent of the total post-issue paid up equity share capital including equity shares with differential rights issued at any point of time;

(d) The company having consistent track record of distributable profits for the last three years;

(e) The company has not defaulted in filing financial statements and annual returns for three financial years immediately preceding the financial year in which it is decided to issue such shares;

© The Institute of Chartered Accountants of India

(f) The company has no subsisting default in the payment of a declared dividend to its shareholders or repayment of its matured deposits or redemption of its preference shares or debentures that have become due for redemption or payment of interest on such deposits or debentures or payment of dividend;

(g) The company has not defaulted in payment of the dividend on preference shares or repayment of any term loan from a public financial institution or State level financial institution or scheduled Bank that has become repayable or interest payable thereon or dues with respect to statutory payments relating to its employees to any authority or default in crediting the amount in Investor Education and Protection Fund to the Central Government;

(h) The company has not been penalized by Court or Tribunal during the last three years of any offence under the Reserve Bank of India Act, 1934, the Securities and Exchange Board of India Act, 1992, the Securities Contracts Regulation Act, 1956, the Foreign Exchange Management Act, 1999 or any other special Act, under which such companies being regulated by sectoral regulators.

8. **In the Books of P Ltd.**

Realization Account

		₹			₹
To	Land & Building	4,50,000	By	8% Debentures	2,00,000
To	Plant & Machinery	6,20,000	By	Trade Payables	88,000
To	Furniture & Fitting	1,00,000	By	PQ Ltd.	16,02,100
To	Trade receivables	3,25,000		(Purchase consideration)	
To	Inventory/Stock	2,33,000	By	Equity Shareholders A/c	1,37,900
To	Cash at Bank	2,08,000		(loss)	
To	Cash in Hand	54,000			
To	Preference shareholders	38,000			
	(excess payment)				
		20,28,000			20,28,000

Equity Shareholders Account

		₹			₹
To	Realization A/c (loss)	1,37,900	By	Share capital	8,20,000
To	Equity Shares in PQ Ltd.	10,82,400	By	Profit & Loss A/c	3,52,000
To	Cash	1,01,700	By	General Reserve	1,50,000
		13,22,000			13,22,000

© The Institute of Chartered Accountants of India

9% Preference Shareholders Account

To	Preference Shares in PQ Ltd.	4,18,000	By	Pref. Share capital	3,80,000
			By	Realization A/c	38,000
		4,18,000			4,18,000

PQ Ltd. Account

To	Realization A/c	16,02,100	By Shares in PQ Ltd.		
			For Equity	10,82,400	15,00,400
			For Pref.	4,18,000	
			By Cash		1,01,700
		16,02,100			16,02,100

8% Debentures holders Account

	₹		₹
To 6% Debentures	2,00,000	By 8% Debentures	2,00,000

Books of Q Ltd.

Realization Account

		₹			₹
To	Land & Building	3,40,000	By	8% Debentures	1,00,000
To	Plant & Machinery	4,50,000	By	Trade payables	1,60,000
To	Furniture & Fittings	50,000	By	Unsecured loan	1,75,000
To	Trade receivables	1,50,000	By	PQ Ltd. (Purchase consideration)	7,92,250
To	Inventory	1,05,000			
To	Cash at bank	1,75,000	By	Equity Shareholders A/c Loss	90,750
To	Cash in hand	20,000			
To	Pref. shareholders	28,000			
		13,18,000			13,18,000

Equity Shareholders Account

		₹			₹
To	Equity shares in PQ Ltd.	4,22,400	By	Share Capital	3,20,000
To	Realization	90,750	By	Profit & Loss A/c	2,05,000

© The Institute of Chartered Accountants of India

To	Cash	61,850	By General Reserve	50,000
		5,75,000		5,75,000

9% Preference Shareholders Account

		₹		₹
To	Preference Shares in PQ Ltd.	3,08,000	By Share capital	2,80,000
			By Realization A/c	28,000
		3,08,000		3,08,000

PQ Ltd. Account

		₹			₹
To	Realization A/c	7,92,250	By Equity shares in PQ Ltd.		
			For Equity	4,22,400	
			Preference	3,08,000	7,30,400
			By Cash		61,850
		7,92,250			7,92,250

8% Debentures holders Account

	₹		₹
To 6% Debentures	1,00,000	By 8% Debentures	1,00,000

Working Notes:

(i) Purchase consideration

	P Ltd. ₹	*Q Ltd.* ₹
Payable to preference shareholders:		
Preference shares at ₹ 22 per share	4,18,000	3,08,000
Equity Shares at ₹ 22 per share	10,82,400	4,22,400
Cash [See W.N. (ii)]	1,01,700	61,850
	16,02,100	7,92,250

(ii) Value of Net Assets

	P Ltd. ₹	*Q Ltd.* ₹
Land & Building	4,50,000	3,40,000
Plant & Machinery less 10% Depreciation	5,58,000	4,05,000

© The Institute of Chartered Accountants of India

Furniture & Fittings less 10% Depreciation		90,000		45,000
Trade receivables less 5%		3,08,750		1,42,500
Inventory less 5%		2,21,350		99,750
Cash at Bank		2,08,000		1,75,000
Cash in hand		54,000		20,000
		18,90,100		12,27,250
Less: Debentures	2,00,000		1,00,000	
Trade payables	88,000		1,60,000	
Secured Loans	–	(2,88,000)	1,75,000	(4,35,000)
		16,02,100		7,92,250
Payable in shares		15,00,400		7,30,400
Payable in cash*		1,01,700		(61,850)

(iii)

	P	Q
Plant &Machinery	6,20,000	4,50,000
Less: Depreciation 10%	62,000	45,000
	5,58,000	4,05,000
Furniture & Fixtures	1,00,000	50,000
Less: Depreciation 10%	10,000	5,000
	90,000	45,000

**This cash is paid to equity shareholders of both the companies for adjustment of their rights as per intrinsic value of both companies.*

9. In the books of Star Ltd.

Journal Entries

Particulars			*Amount* ₹	*Amount* ₹
(i)	7% Preference share capital (₹ 100)	Dr.	9,00,000	
	To 9% Preference share capital (₹ 80)			7,20,000
	To Capital reduction A/c			1,80,000
	(Being preference shares reduced to ₹ 80 and also rate of dividend raised from 7% to 9%)			

(ii)	Equity share capital A/c (₹ 100 each)	Dr.	10,00,000	
	To Equity share capital A/c (₹ 10 each)			1,00,000
	To Capital reduction A/c			9,00,000
	(Being reduction of nominal value of one share of ₹ 100 each to ₹ 10 each)			
(iii)	Bank A/c	Dr.	50,000	
	To Capital reduction A/c			50,000
	(Being directors refunded the fee amount)			
(iv)	Trade payables A/c (Interest on debentures)	Dr.	26,000	
	To Capital reduction A/c			26,000
	(Being interest forgone by the debenture holders)			
(v)	No entry required			
(vi) a	'B' 6% Debentures A/c	Dr.	3,50,000	
	To Debentures holders A/c			3,50,000
	(Being amount due to Debentures holders)			
b	Debentures holders A/c	Dr.	4,40,000	
	To Chennai Works A/c			4,25,000
	To Equity share capital A/c			15,000
	(Being Chennai works taken over and equity shares issued to 'B' 6% Debenture holders)			
c	Equity share of Zia ltd. A/c	Dr.	90,000	
	To Debentures holders A/c			90,000
	(Being 9,000 equity shares of Zia Ltd. issued by Debentures holders)			
(vii) a	Chennai Works – Workmen Compensation Fund	Dr.	4,000	
	To Capital reduction A/c			4,000
	(Being difference due to reduced amount of actual liability transferred to capital reduction account)			
b	Bank A/c	Dr.	15,400	
	To Investment for Workmen Compensation Fund			14,000

© The Institute of Chartered Accountants of India

	To Capital reduction A/c			1,400
	(Being investment for Workmen Compensation Fund sold @ 10% profit)			
c	Trade Payables A/c	Dr.	15,400	
	To Bank A/c			15,400
	(Being part payment made to trade payables)			
(viii)	Capital reduction A/c	Dr.	2,10,000	
	To Provision for Doubtful Debts A/c			20,000
	To Inventory A/c			1,90,000
	(Being assets revalued)			
(ix)	Capital reduction A/c	Dr.	5,50,000	
	To Profit & Loss A/c			2,00,000
	To PPE – Chennai Works			3,50,000*
	(Being assets revalued and losses written off)			
(x)	Capital reduction A/c	Dr.	4,01,400	
	To PPE – Bombay Works			2,67,600
	To Capital reserve A/c			1,33,800
	(Being assets revalued and remaining amount transferred to capital reserve account)			

10. Calculation of Total Remuneration payable to Liquidator

		Amount in ₹
2% on Assets realised	37,50,000 x 2%	75,000
3% on payment made to Preferential creditors	1,12,500 x 3%	3,375
3% on payment made to Unsecured creditors (Refer W.N)		58,882
Total Remuneration payable to Liquidator		1,37,257

Working Note:

Liquidator's remuneration on payment to unsecured creditors

Cash available for unsecured creditors after all payments including liquidation expenses, payment to secured creditors, preferential creditors & liquidator's remuneration

* ₹ 7,75,000 less ₹ 4,25,000

= ₹ 37,50,000 – ₹ 37,500 – ₹ 15,00,000 – ₹ 1,12,500 – ₹ 75,000 – ₹ 3,375 = ₹ 20,21,625.

Liquidator's remuneration

= 3/103 x ₹ 20,21,625= ₹ 58,882

11. **In the books of Anmol bank Ltd.**

Journal Entries *₹ in crores*

Particulars		*Debit*	*Credit*
Rebate on bills discounted A/c	Dr.	40	
To Discount on bills A/c			40
(Being the transfer of opening balance in 'Rebate on bills discounted A/c' to 'Discount on bills A/c')			
Bills purchased and discounted A/c	Dr.	5,000	
To Discount on bills A/c			280
To Clients A/c			4,720
(Being the discounting of bills of exchange during the year)			
Discount on bills A/c	Dr.	14	
To Rebate on bills discounted A/c			14
(Being the unexpired portion of discount in respect of the discounted bills of exchange carried forward)			
Discount on bills A/c	Dr.	306	
To Profit and Loss A/c			306
(Being the amount of income for the year from discounting of bills of exchange transferred to Profit and loss A/c)			

Working Notes:

1. **Discount received on the bills discounted during the year**

   ₹ 5,000 crores x 14/100 x 146/365 = ₹ 280 crores

2. **Calculation of rebate on bill discounted**

   ₹ 500 crores x 14/100 x 73/365 = ₹14 crores

3. Income from bills discounted transferred to Profit and Loss A/c would be calculated by preparing Discount on bills A/c.

© The Institute of Chartered Accountants of India

Discount on bills A/c

₹ in crores

Date	*Particulars*	*Amount*	*Date*	*Particulars*	*Amount*
31.3.2019	To Rebate on bills discounted	14	1.4.2018	By Rebate on bills discounted b/d	40
”	To Profit and Loss A/c (Bal. Fig.)	306	2018-19	By Bills purchased and discounted	280
		320			320

12. Statement showing classification as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016

		(₹ in lakhs)
Standard Assets		
Accounts (Balancing figure)	172.00	
400 accounts overdue for a period for 2 months	80.00	
24 accounts overdue for a period by 3 months	48.00	300.00
Sub-Standard Assets		
4 accounts identified as sub-standard asset for a period less than 14 months		28.00
Doubtful Debts		
6 accounts identified as sub-standard for a period more than 14 months		12.00
4 accounts identified as sub-standard for a period more than 3 years		40.00
Loss Assets		
1 account identified by management as loss asset		20.00
Total overdue		400.00

13. Consolidated Balance Sheet of Kedar Ltd. and its Subsidiary Vijay Ltd. as at 31st March, 2019

Particulars	**Note No.**	**(₹)**
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		15,00,000

	(b) Reserves and Surplus	1	8,61,500
	(2) Minority Interest (W.N.5)		1,20,375
	(3) Current Liabilities		
	(a) Trade Payables	2	5,17,500
	Total		29,99,375
II.	**Assets**		
	(1) Non-current assets		
	(a) (i) Property, Plant & Equipment	3	14,94,375
	(ii) Intangible assets	4	30,000
	(b) Other non- current assets	5	14,75,000
	Total		29,99,375

Notes to Accounts

				₹
1.	**Reserves and Surplus**			
	Reserves		5,00,000	
	Add: 4/5th share of Vijay Ltd.'s post-acquisition reserves (W.N.3)		1,00,000	6,00,000
	Profit and Loss Account		2,50,000	
	Add: 4/5th share of Vijay Ltd.'s post-acquisition profits (W.N.4)		11,500	2,61,500
				8,61,500
2.	**Trade Payables**			
	Kedar Ltd.		3,75,000	
	Vijay Ltd.		1,42,500	5,17,500
3.	**Property, Plant & Equipment**			
	Machinery			
	Kedar Ltd.		7,50,000	
	Vijay Ltd.	2,50,000		
	Add: Appreciation	1,25,000		
		3,75,000		
	Less: Depreciation	(37,500)	3,37,500	
	Furniture	-		

© The Institute of Chartered Accountants of India

	Kedar Ltd.	-	3,75,000	
	Vijay Ltd.	50,000		
	Less: Decrease in value	(12,500)		
		37,500		
	Less: Depreciation	(5,625)	31,875	14,94,375
4.	**Intangible assets**			
	Goodwill [WN 6]			30,000
5.	**Other non-current assets**			
	Kedar Ltd.		11,00,000	
	Vijay Ltd.		3,75,000	14,75,000

Working Notes:

		₹
1.	**Pre-acquisition profits and reserves of Vijay Ltd.**	₹
	Reserves	62,500
	Profit and Loss Account	37,500
		1,00,000
	Kedar Ltd.'s = 4/5 × 1,00,000	80,000
	Minority Interest = 1/5 × 1,00,000	20,000
2.	**Profit on revaluation of assets of Vijay Ltd.**	-
	Profit on Machinery ₹ (3,75,000 – 2,50,000)	1,25,000
	Less: Loss on Furniture ₹ (50,000 – 37,500)	12,500
	Net Profit on revaluation	1,12,500
	Kedar Ltd.'s share 4/5 × 1,12,500	90,000
	Minority Interest 1/5 × 1,12,500	22,500
3.	**Post-acquisition reserves of Vijay Ltd.**	-
	Post-acquisition reserves (Total reserves less pre-acquisition reserves = ₹ 1,87,500 – 62,500)	1,25,000
	Kedar Ltd.'s share 4/5 × 1,25,000	1,00,000
	Minority interest 1/5 × 25,000	25,000
4.	**Post -acquisition profits of Vijay Ltd.**	-
	Post-acquisition profits (Profit & loss account balance less pre-acquisition profits = ₹ 62,500 – 37,500)	25,000
	Add: Excess depreciation charged on furniture @ 15%	-
	on ₹ 12,500 i.e. (50,000 – 37,500)	1,875
		26,875

	Less: Under depreciation on machinery @ 10%	-
	on ₹ 1,25,000 i.e. (3,75,000 – 2,50,000)	(12,500)
	Adjusted post-acquisition profits	14,375
	Kedar Ltd.'s share 4/5 × 14,375	11,500
	Minority Interest 1/5 × 14,375	2,875
5.	**Minority Interest**	-
	Paid-up value of (2,500 – 2,000) = 500 shares	-
	held by outsiders i.e. 500 × ₹ 100	50,000
	Add: 1/5th share of pre-acquisition profits and reserves	20,000
	1/5th share of profit on revaluation	22,500
	1/5th share of post-acquisition reserves	25,000
	1/5th share of post-acquisition profit	2,875
		1,20,375
6.	**Cost of Control or Goodwill**	
	Paid-up value of 2,000 shares held by Kedar Ltd. i.e. 2,000 × ₹ 100	2,00,000
	Add: 4/5th share of pre-acquisition profits and reserves	80,000
	4/5th share of profit on the revaluation	90,000
	Intrinsic value of shares on the date of acquisition	3,70,000
	Price paid by Kedar Ltd. for 2,000 shares	4,00,000
	Less: Intrinsic value of the shares	(3,70,000)
	Cost of control or Goodwill	30,000

14. (a) According to AS 4 on 'Contingencies and Events Occurring after the Balance Sheet Date', adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. However, adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. "Contingencies" used in the Standard is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.

(i) Fire has occurred after the balance sheet date and also the loss is totally insured. Therefore, the event becomes immaterial and the event is non-adjusting in nature.

(ii) The contingency is restricted to conditions existing at the balance sheet date. However, in the given case, suit was filed against the company's advertisement by a party on 10th April for amount of ₹ 20 lakhs. Therefore, it does not fit into the definition of a contingency and hence is a non-adjusting event.

© The Institute of Chartered Accountants of India

(b) As per AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy.

(i) Accordingly, introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is not a change in an accounting policy.

(ii) Similarly, the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial will not be treated as a change in an accounting policy

15. (a) The amounts of revenue, expenses and profit recognized in the statement of profit and loss in three years are computed below:

(Amount in ₹ lakhs)

	Up to the reporting date	*Recognized in previous years*	*Recognized in current year*
Year 1			
Revenue (9,000 x 26%)	2,340	-	2,340
Expenses (8,050 x 26%)	2,093	-	2,093
Profit	247	-	247
Year 2			
Revenue (9,200 x 74%)	6,808	2,340	4,468
Expenses (8,200 x 74%)	6,068	2,093	3,975
Profit	740	247	493
Year 3			
Revenue (9,200 x 100%)	9,200	6,808	2,392
Expenses (8,200 x 100%)	8,200	6,068	2,132
Profit	1,000	740	260

Working Note:

	Year 1	*Year 2*	*Year 3*
Revenue after considering variations	9,000	9,200	9,200
Less: Estimated profit for whole contract	950	1,000	1,000
Estimated total cost of the contract (A)	8,050	8,200	8,200
Actual cost incurred upto the reporting date (B)	2,093	6,068 (6,168-100)	8,200 (8,100+100)
Degree of completion (B/A)	26%	74%	100%

© The Institute of Chartered Accountants of India

(b) As per AS 9 "Revenue Recognition", in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

Case (i) The sale is complete but delivery has been postponed at buyer's request. M/s Paper Products Ltd. should recognize the entire sale of ₹ 60,000 for the year ended 31st March, 2019.

Case (ii) 20% goods lying unsold with consignee should be treated as closing inventory and sales should be recognized for ₹ 1,20,000 (80% of ₹ 1,50,000). In case of consignment sale revenue should not be recognized until the goods are sold to a **third party.**

Case (iii) In case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed. Therefore, revenue should be recognized for the total sales amounting ₹ 1,20,000 as the time period for rejecting the goods had expired.

Case (iv) Trade discounts given should be deducted in determining revenue. Thus ₹ 39,000 should be deducted from the amount of turnover of ₹ 7,80,000 for the purpose of recognition of revenue. Thus, revenue should be ₹ 7,41,000.

16. (a) As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

(i) Its **revenue** from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or

(ii) Its segment **result** whether profit or loss is 10% or more of:

(1) The combined result of all segments in profit; or

(2) The combined result of all segments in loss,

whichever is greater in absolute amount; or

© The Institute of Chartered Accountants of India

(iii) Its segment **assets** are 10% or more of the total assets of all segments.

Further, if the total external revenue attributable to reportable segments constitutes less than 75% of total enterprise revenue, additional segments should be identified as reportable segments even if they do not meet the 10% thresholds until at least 75% of total enterprise revenue is included in reportable segments.

Accordingly,

(a) On the basis of **revenue from sales** criteria, segment A is a reportable segment.

(b) On the basis of the **result** criteria, segments A & E are reportable segments (since their results in absolute amount is 10% or more of ₹ 100 crore).

(c) On the basis of **asset** criteria, all segments except E are reportable segments.

Since all the segments are covered in atleast one of the above criteria, all segments have to be reported upon in accordance with AS 17.

Hence, the opinion of chief accountant that only segment 'A' is reportable is wrong.

(b) As per AS 18 'Related Party Disclosures', Enterprises over which the key management personnel is able to exercise significant influence are related parties. This includes enterprises owned by directors or major shareholders of the reporting enterprise that have a member of key management in common with the reporting enterprise. In the given case, Arohi Ltd. and Anya Ltd. are related parties and hence disclosure of transaction between them is required irrespective of whether the transaction was done at normal selling price. Hence the contention of Chief Accountant of Arohi Ltd. is wrong.

17. (a) As per AS 19 "Leases", the lessee should recognize the lease as an asset and a liability at the inception of a finance lease. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payment from the standpoint of the lessee, the amount recorded as an asset and liability should be the present value of minimum lease payments from the standpoint of the lessee.

Value of machinery

In the given case, fair value of the machinery is ₹ 10, 00,000 and the net present value of minimum lease payments is ₹ 10, 07,020 (Refer working Note). As the present value of the machine is more than the fair value of the machine, the machine and the corresponding liability will be recorded at value of ₹10,00,000.

© The Institute of Chartered Accountants of India

Calculation of finance charges for each year

Year	*Finance charge (₹)*	*Payment (₹)*	*Reduction in outstanding liability (₹)*	*Outstanding liability (₹)*
1st year beginning	-	-	-	10,00,000
End of 1st year	1,60,000	3,50,000	1,90,000	8,10,000
End of 2nd year	1,29,600	3,50,000	2,20,400	5,89,600
End of 3rd year	94,336	3,50,000	2,55,664	3,33,936
End of 4th year	53,430	3,50,000	2,96,570	37,366

Working Note:

Present value of minimum lease payments

Annual lease rental x PV factor ₹ 3,50,000 x (0.8621 + 0.7432 + 0.6407+ 0.5523)	₹ 9,79 ,405
Present value of guaranteed residual value ₹ 50,000 x (0.5523)	₹ 27,615
	₹ 10,07,020

(b) Computation of basic earnings per share

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

₹ 75,00,000 / 10,00,000 = ₹ 7.50 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	75,00,000
Add: Interest expense for the current year	8,00,000
Less: Tax relating to interest expense (30% of ₹ 8,00,000)	(2,40,000)
Adjusted net profit for the current year	80,60,000

Number of equity shares resulting from conversion of debentures

= 1,10,000 Equity shares (given in the question)

© The Institute of Chartered Accountants of India

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

= 11,10,000 shares (10,00,000 + 1,10,000)

Diluted earnings per share

= ₹ 80,60,000/ 11,10,000

= ₹ 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.

18. (a) Impact of various items in terms of AS 22 deferred tax liability/deferred tax asset

Transactions	*Analysis*	*Nature of difference*	*Effect*	*Amount*
Difference in depreciation	Generally, written down value method of depreciation is adopted under IT Act which leads to higher depreciation in earlier years of useful life of the asset in comparison to later years.	Responding timing difference	Reversal of DTL	₹ (80-70) lakh × 30% = ₹ 3 lakh
Disallowances, as per IT Act, of earlier years	Tax payable for the earlier year was higher on this account.	Responding timing difference	Reversal of DTA	₹ 10 lakh × 30% = ₹ 3 lakh
Donation to private trusts	Not an allowable expenditure under IT Act.	Permanent difference	Not applicable	Not applicable

(b) (i) An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15) occurs:

(a) a description of the discontinuing operation(s);

(b) the business or geographical segment(s) in which it is reported as per

© The Institute of Chartered Accountants of India

AS 17, Segment Reporting;

(c) the date and nature of the initial disclosure event;

(d) the date or period in which the discontinuance is expected to be completed if known or determinable;

(e) the carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;

(f) the amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period;

(g) the amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto; and

(h) the amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.

(ii) Para 3 of AS 24 "Discontinuing Operations" explains the criteria for determination of discontinuing operations. According to Paragraph 9 of AS 24, examples of activities that do not necessarily satisfy criterion (a) of paragraph 3, but that might do so in combination with other circumstances, include:

(i) Gradual or evolutionary phasing out of a product line or class of service;

(ii) Discontinuing, even if relatively abruptly, several products within an ongoing line of business;

(iii) Shifting of some production or marketing activities for a particular line of business from one location to another; and

(iv) Closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

19. Amortization of cost of patent as per AS 26

Year	*Estimated future cash flow (₹ in lakhs)*	*Amortization Ratio*	*Amortized Amount (₹ in lakhs)*
1	600	.25	300
2	600	.25	300
3	600	.25	300

© The Institute of Chartered Accountants of India

4	300	.40 (Revised)	120
5	300	.40 (Revised)	120
6	150	.20 (Revised)	60
			1,200

In the first three years, the patent cost will be amortized in the ratio of estimated future cash flows i.e. (600: 600: 600: 300: 300).

The unamortized amount of the patent after third year will be ₹ 300 lakh (1,200-900) which will be amortized in the ratio of revised estimated future cash flows (300:300:150) in the fourth, fifth and sixth year.

20. (i) The construction of the oil rig creates an obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil. An outflow of resources embodying economic benefits in settlement is probable. Thus, a provision is recognized for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig. However, there is no obligation to rectify the damage that will be caused by extraction of oil, as no oil has been extracted at the balance sheet date. So, no provision is required for the cost of extraction of oil at balance sheet date.

Ten per cent of costs that arise through the extraction of oil are recognized as a liability when the oil is extracted.

(ii) As per AS 29, for a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation.

The obligating event is the giving of the guarantee by Ace Ltd. for certain borrowings of Brew Ltd., which gives rise to an obligation. No outflow of benefits is probable at 31 March 2019.Thus no provision is recognized. The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

During 2019-20, the financial condition of Brew Ltd. deteriorates and finally goes into liquidation. The obligating event is the giving of the guarantee, which gives rise to a legal obligation. At 31 March 2020, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation. Thus, provision is recognized for the best estimate of the obligation.

© The Institute of Chartered Accountants of India

PAPER – 6: AUDITING AND ASSURANCE

PART – I : ACADEMIC UPDATE

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

Chapter 9-Audit of Items of Financial Statements

In section 53 of the principal Act, for subsection (3), the following sub-section shall be substituted, namely:— "(3) Where any company fails to comply with the provisions of this section, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of twelve per cent. per annum from the date of issue of such shares to the persons to whom such shares have been issued."

Penalty has been linked with amount raised through the issue of shares at a discount or a penalty of ₹ 5 lakhs whichever is less. Further, in case of default, the company is required to refund the amount alongwith 12% interest per annum.

(Reference to page no. is 9.8 and 9.9 of the study module 2)

PART – II: QUESTIONS AND ANSWERS

PART – II A: Multiple Choice Questions based on Integrated Case Scenarios

Integrated Case Scenario-1

M/s NSG & Associates have been appointed as auditors of Viaan Ltd. for the financial year 2019-20. The processes, operations, accounting and decisions are carried out by using computers in Viaan Ltd. The auditors understand that there are several aspects that they should consider to determine the level of automation and complexity in the business environment of Viaan Ltd. While planning the audit work, the engagement partners discussed with the audit staff about the various types of controls in the automated environment.

The different types of audit tests that can be used in audit of an automated business environment were also discussed within the engagement team. The responsibility regarding the Internal Financial Controls was also discussed in detail. Further the tools and techniques that can be used to deal with the enormous data and information of Viaan Ltd. were briefed to the audit staff by the engagement partners.

Based on the above facts, answer the following:-

1. ………. are the manual controls that make use of some form of data or information or report produced from the IT systems and applications.

   (a) Application Controls

© The Institute of Chartered Accountants of India

(b) IT dependent Controls

(c) Automated Controls

(d) General IT Controls

2. Statement 1: Application controls include both manual and automated controls that operate at a business process level.

   Statement 2: General IT Controls apply to mainframe, miniframe as well as end user environment.

   (a) Only Statement 1 is correct

   (b) Only Statement 2 is correct

   (c) Both Statements 1 & 2 are correct

   (d) Both Statements 1 & 2 are incorrect

3. ………….. are also known as pervasive or indirect controls :-

   (a) General IT Controls

   (b) Application Controls

   (c) IT dependent Controls

   (d) None of the above

4. Which of the following are not the types of audit tests that can be used in the audit in an automated environment?

   (a) Observation

   (b) Inspection

   (c) Re performance

   (d) None of the above

5. ………….. is the combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information:-

   (a) Computer Assisted Audit Techniques

   (b) Automated Controls

   (c) Data Analytics

   (d) None of the above

Integrated Case Scenario-2

M/s JK & Associates have been appointed as auditors of Venus Ltd. for the financial year 2019-20. The team consist of Mr. J & Mr. K both Chartered Accountants as also the engagement partners and the audit staff consisting of 2 article assistants. While starting the audit work of

Venus Ltd, the engagement partners briefed the audit staff about the audit work, areas to be covered and the various auditing concepts and their application in the audit of Venus Ltd along with applicable Standard on Auditing.

Various topics like audit planning, overall audit strategy, audit programme were discussed in detail. The team was told about the purpose and implication of various statements and guidance notes issued by the Institute of Chartered Accountants of India (ICAI) from time to time. Mr. K also briefed the team about the concept of materiality to be applied while planning and performing audit. The team was also explained in detail about the area where benchmark materiality can be applied in case of Venus Ltd.

Based on the above facts, answer the following:-

1. ………. sets the scope, timing & direction of the audit and guides the development of the more detailed plan.
   (a) Audit Programme
   (b) Overall Audit Strategy
   (c) Completion Memorandum
   (d) Audit Plan
2. Statement 1: The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential process but are closely inter-related.

   Statement 2: The auditor shall establish an overall audit strategy that guides the development of audit plan.
   (a) Only Statement 1 is correct
   (b) Only Statement 2 is correct
   (c) Both Statements 1 & 2 are correct
   (d) Both Statements 1 & 2 are incorrect
3. ………….. means the amount set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatement exceeds materiality for the financial statements as a whole :-
   (a) Benchmark Materiality
   (b) Materiality in Planning
   (c) Performance Materiality
   (d) Materiality.

© The Institute of Chartered Accountants of India

4. Which of the following is not an example of benchmark that can be used in determining the materiality in the case of financial statements:-
   (a) Total Revenue
   (b) Profit before tax
   (c) Net Asset Value
   (d) None of the above
5. (i) Guidance notes issued by ICAI provide guidance to members on matters which may arise in the course of their professional work.
   (ii) Statements are issued by ICAI with a view to secure compliance by members on some matters.
   (iii) Guidance notes are recommendatory in nature.
   (iv) Statements are mandatory in nature.
   (a) All the above statements are correct.
   (b) Statements 1 & 2 are correct
   (c) Statements 1, 2 & 3 are correct
   (d) Statements 1,2 & 4 are correct

MCQ's not based on Case Scenario

1. Statement 1: Audit procedures consist of Risk Assessments Procedures and other procedures.

   Statement 2: Substantive procedures consist of test of details and analytical procedures.
   (a) Only Statement 1 is correct
   (b) Only Statement 2 is correct
   (c) Both 1 & 2 are correct
   (d) Both 1 & 2 are incorrect
2. With respect to the forms specified by companies (Cost Records & Audit) Rule 2014, which of the following is incorrect combination:
   (a) Form CRA 1- Maintenance of cost records by the Company.
   (b) Form CRA 2- Intimation of appointment of another cost auditor to Central Government.
   (c) Form CRA 3- Submission of Cost Audit Report to the Board of Directors of the company.
   (d) Form CRA 4- Submission of Cost Audit Report by the company to the Registrar.

© The Institute of Chartered Accountants of India

3. Statement I 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 financial data.

   Statement II 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.

   (a) Only Statement I is correct

   (b) Only Statement II is correct

   (c) Both statements are correct

   (d) Both Statements are incorrect

4. Which of the following is not an example of Analytical Procedures having consideration of comparisons of the entity's financial information:

   (a) Comparable information for prior periods.

   (b) Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.

   (c) 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.

   (d) Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.

5. Statement I : A firm whereof majority of partners practising in India are qualified for appointment may be appointed by its firm name to be auditor of a company.

   Statement II : Where a firm including a limited liability partnership is appointed as an auditor of a company, all the partners shall be authorised to act and sign on behalf of the firm.

   (a) Only Statement I is correct

   (b) Only Statement II is correct

   (c) Both statements are correct

   (d) Both Statements are incorrect

PART II B – DESCRIPTIVE QUESTIONS

1. State with reason (in short) whether the following statements are true or false:

   (i) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding hundred crore rupees or more shall constitute an Audit Committee.

© The Institute of Chartered Accountants of India

(ii) According to Section 140(1), the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a general resolution of the company.

(iii) As per sub-section (5) of the section 140, the Tribunal cannot direct the company to change its auditors.

(iv) SA 210 does not require the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.

(v) Government audit does not serve as a mechanism or process for public accounting of government funds.

(vi) An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 180 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

(vii) An Audit report is an opinion drawn on the entity's financial statements to make sure that the records are true and correct representation of the transactions they claim to represent.

(viii) In the planning stage, analytical procedures would not in any way assist the auditor.

(ix) Statistical sampling has narrower application where a population to be tested consists of a large number of similar items.

(x) Risk assessment procedures are not performed to obtain an understanding of the entity and its environment.

Chapter 1- Nature, Objective and Scope of Audit

2. (a) The person conducting audit should take care to ensure that financial statements would not mislead anybody. Explain stating clearly the meaning of Auditing.

   (b) Explain the objectives of an Audit as per SA 200.

3. (a) There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain with examples.

   (b) In case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Explain such assertions or subject matters.

Chapter 2- Audit Strategy, Audit Planning and Audit Programme

4. (a) Plans should be further developed and revised as necessary during the course of the audit. Explain.

   (b) Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. The process of establishing the overall

© The Institute of Chartered Accountants of India

audit strategy assists the auditor to determine such matters as for example - the resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters. Explain the other three such matters.

5. (a) Knowledge of the Client's business is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of client's business, a proper audit is not possible. As per SA-315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment", the auditor shall obtain an understanding of the relevant industry, regulatory and other external factors including the applicable financial reporting framework. Substantiate with the help of examples.

   (b) Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques.

   Analyse and explain with the help of example of evidence in respect of Sales.

Chapter 3- Audit Documentation and Audit Evidence

6. (a) Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Explain stating clearly objectives of the auditor regarding written representation.

   (b) The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report. Explain the auditor's obligation in the above situation.

7. (a) The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Explain with the help of at least three examples.

   (b) When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests.

8. (a) Define the following :

   (i) Positive confirmation request

© The Institute of Chartered Accountants of India

(ii) Negative confirmation request

(iii) Non-response

(iv) Exception

(b) Explain clearly the examples of matters relevant in planning attendance at physical inventory counting.

Chapter 4- Risk Assessment and Internal Control

9. (a) When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements. Explain

(b) Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. Analyse and explain giving examples.

10. (a) Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control.

(b) It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Explain with the help of example in respect of the procedure for sales.

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

11. Auditor of A Ltd while conducting audit in the course of the performance of his duties as auditor, believes with reasons that "an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed". Analyse and also explain the manner of reporting the matter to the Central Government.

12. Discrepancies in the accounting records, including transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy is one of the example of circumstances that indicate the possibility of fraud. Explain at least four other such examples relating to discrepancies in the accounting records.

Chapter 6- Audit in an Automated Environment

13. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform check completeness of data and population that is used in either test of controls or substantive audit tests. Explain in detail stating all the relevant points.

14. Explain some of the commonly used methods for testing in an automated environment.

© The Institute of Chartered Accountants of India

Chapter 7- Audit Sampling

15. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded. Explain

16. Explain the sampling method which involves selection of a block(s) of contiguous items from within the population. Also give example.

Chapter 8 - Analytical Procedures

17. Explain the commonly used technique in the comparison of current data with the prior period balance or with a trend in two or more prior period balances.

18. When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions. Explain the other relevant points in this context.

Chapter 9 - Audit of Items of Financial Statements

19. Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP), also commonly referred to as accounting standards (AS). In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable accounting standards. Explain with example stating the relevant assertions involved in this regard. Also explain financial statement audit.

20. What does the Valuation assertion mean in respect of Assets, liabilities and equity balances? Explain with the help of example in respect of Inventory.

Chapter 10 - The Company Audit

21. ABC Ltd is a company incorporated in India. It has branches within and outside India. Explain who can be appointed as an auditor of these branches within and outside India. Also explain to whom branch auditor is required to report.

22. Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard.

23. The head accountant of a company entered fake invoices of credit purchases in the books of account aggregate of ₹ 50 lakh and cleared all the payments to such bogus creditor. How will you deal as an auditor ?

© The Institute of Chartered Accountants of India

Chapter 11 - Audit Report

24. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required.

25. The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also Identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section.

Chapter 12- Bank Audit

26. In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense. Analyse and explain stating the audit approach and procedure in regard to interest expense.

27. In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also. Analyse and Explain.

Chapter 13- Audit of Different Types of Entities

28. (a) As per Multi-state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account. Explain

    (b) Explain the powers and duties of auditors under the Multi-State Co-operative Societies Act, 2002.

SUGGESTED ANSWERS / HINTS

ANSWERS - MULTIPLE CHOICE QUESTIONS- Integrated Case Scenario-1

1. (b)

2. (c)

3. (a)

4. (d)

© The Institute of Chartered Accountants of India

5. (c)

ANSWERS - MULTIPLE CHOICE QUESTIONS- Integrated Case Scenario-2

1. (b)

2. (c)

3. (c)

4. (d)

5. (a)

General MCQ's

1 (c)

2 (d)

3 (b)

4 (d)

5 (a)

DESCRIPTIVE ANSWERS

1. (i) Incorrect: all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more shall constitute an Audit Committee.

(ii) Incorrect: According to Section 140(1)**,** the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per Rule 7 of CAAR, 2014.

(iii) Incorrect: As per sub-section (5) of the section 140, the Tribunal either *suo motu* or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

(iv) Incorrect: SA 210 requires the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.

(v) Incorrect: Government audit serves as a mechanism or process for public accounting of government funds. It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.

(vi) Incorrect: An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where

© The Institute of Chartered Accountants of India

the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

(vii) **Incorrect:** The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements. The aforesaid purpose is achieved by the expression of an independent reporting by the auditor as to whether the financial statements exhibit a true and fair view of the affairs of the entity.

Thus, an Audit report is an opinion drawn on the entity's financial statements to make sure that the records are true and fair representation of the transactions they claim to represent.

(viii) **Incorrect:** In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

(ix) **Incorrect:** Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

(x) **Incorrect:** Risk assessment procedures 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.

2. **(a)** "An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

Analysis of the Definition

1. Audit is Independent examination of Financial information.
2. of any entity – that entity may be profit oriented or not and irrespective of its size or legal form. For example – Profit oriented – Audit of Listed company engaged in business. On the other hand, Audit of NGO – not profit oriented.
3. The objective of the audit is to express an opinion on the financial statements.

The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:

© The Institute of Chartered Accountants of India

(i) the accounts have been drawn up with reference to entries in the books of account;

(ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;

(iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;

(iv) the information conveyed by the statements is clear and unambiguous;

(v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and

(vi) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.

(b) As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement; and

(b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

3. (a) The Nature of Audit Procedures: There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.

2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

(b) Other Matters that Affect the Limitations of an Audit: In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.

© The Institute of Chartered Accountants of India

- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

4. (a) **Plans should be further developed and revised as necessary during the course of the audit.**

SA-300, "Planning an Audit of Financial Statements" further expounds this principle. According to it, **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.

(b) **Overall audit strategy** sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

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.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

1. The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
2. The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
3. When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
4. How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place **(for example, on-site or off-site)**, and whether to complete engagement quality control reviews.

5. (a) **Examples are :**

- ♦ The competitive environment, including demand, capacity, product and price competition as well as cyclical or seasonal activity.

© The Institute of Chartered Accountants of India

- Supplier and customer relationships, such as types of suppliers and customers (e.g., related parties, unified buying groups) and the related contracts with those entities.
- Technological developments, such as those related to the entity's products, energy supply and cost.
- The effect of regulation on entity operations.

(b) Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit programme. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.

Example

Sales are evidenced by:

(i) invoices raised by the client;

(ii) price list;

(iii) forwarding notes to client;

(iv) inventory-issue records;

(v) sales managers' advice to the inventory section;

(vi) acknowledgements of the receipt of goods by the customers; and

(vii) collection of money against sales by the client.

6. (a) Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

Written representations are requested from those responsible for the preparation and presentation of the financial statements.

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

© The Institute of Chartered Accountants of India

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.

(b) The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment and, if so,

(c) Inquire how management intends to address the matter in the financial statements.

7. (a) Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

Example

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.

© The Institute of Chartered Accountants of India

- ♦ Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

(b) When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

(a) Determining the information to be confirmed or requested;

(b) Selecting the appropriate confirming party;

(c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and

(d) Sending the requests, including follow-up requests when applicable, to the confirming party.

8. (a) Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

(b) Matters relevant in planning attendance at physical inventory counting include, for example:

(a) Nature of inventory.

(b) Stages of completion of work in progress.

(c) The risks of material misstatement related to inventory.

(d) The nature of the internal control related to inventory.

(e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.

(f) The timing of physical inventory counting.

(g) Whether the entity maintains a perpetual inventory system.

(h) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which

© The Institute of Chartered Accountants of India

locations attendance is appropriate

(i) Whether the assistance of an auditor's expert is needed.

9. (a) **Control risk assessment when control deficiencies are identified:** When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements.

When control deficiencies are identified and auditor identifies and tests more than one control for each relevant assertion, he evaluates control risk considering all of the controls he has tested. If auditor determines that they support a 'rely on controls' risk assessment, or if compensating controls are identified, tested and evaluated to be effective, he may conclude that the 'rely on controls' is still appropriate. Otherwise we change our control risk assessment to 'not rely on controls.'

When a deficiency relates to an ineffective control that is the only control identified for an assertion, he revises risk assessment to 'not rely on controls' for associated assertions, as no other controls have been identified that mitigate the risk related to the assertion. If the deficiency relates to one WCGW (what can go wrong) out of several WCGW's, he can 'rely on controls' but performs additional substantive procedures to adequately address the risks related to the deficiency.

(b) Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the financial statements;
- Determining materiality in accordance with SA 320;
- Considering the appropriateness of the selection and application of accounting policies;
- Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

© The Institute of Chartered Accountants of India

10. (a) Objectives of Internal Control

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

Objectives of Internal Control are :

(i) transactions are executed in accordance with managements general or specific authorization;

(ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;

(iii) assets are safeguarded from unauthorised access, use or disposition; and

(iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

(b) 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.

For example, the procedure for sales requires the following:

1. Before acceptance of any order the position of inventory of the relevant article should be known to ascertain whether the order can be executed in time.
2. An advice under the authorisation of the sales manager should be sent to the party placing the order, internal reference number, and the acceptance of the order. This advice should be prepared on a standardised form and copy thereof should be forwarded to inventory section to enable it to prepare for the execution of the order in time.
3. The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.

© The Institute of Chartered Accountants of India

4. The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.

5. Before deciding upon the credit period, a reference should be made to the credit section to know the creditworthiness of the party and particularly whether the party has honoured its commitments in the past.

11. **Reporting to the Central Government:** As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

In this regard, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been prescribed. Sub-rule (1) of the said rule states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ **1 crore or above**, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

The manner of reporting the matter to the Central Government is as follows:

(a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;

(b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;

(c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

(d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

(e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and

(f) the report shall be in the form of a statement as specified in Form ADT-4.

© The Institute of Chartered Accountants of India

12. Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

13. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

- ♦ Check completeness of data and population that is used in either test of controls or substantive audit tests.
- ♦ Selection of audit samples – random sampling, systematic sampling.
- ♦ Re-computation of balances – reconstruction of trial balance from transaction data.
- ♦ Reperformance of mathematical calculations – depreciation, bank interest calculation.
- ♦ Analysis of journal entries as required by SA 240.
- ♦ Fraud investigation.
- ♦ Evaluating impact of control deficiencies.

14. When testing in an automated environment, some of the more common methods are as follows:

- ♦ Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
- ♦ Observe how a user processes transactions under different scenarios.
- ♦ Inspect the configuration defined in an application.

15. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

© The Institute of Chartered Accountants of India

For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

16. **Block Sampling:** This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

    Example

    Take the first 200 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.

17. **Trend analysis** – A commonly used technique is the comparison of current data with the prior period **balance** or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

18. When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall:

    (i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;

    (ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

    (iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

    (iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

© The Institute of Chartered Accountants of India

19. Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP), also commonly referred to as accounting standards (AS).

A financial statement audit comprises the examination of an entity's financial statements and accompanying disclosures by an independent auditor. The result of this examination is a report by the auditor, attesting to the truth and fairness of presentation of the financial statements and related disclosures.

In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding:

- completeness;
- cut-off;
- existence/ occurrence;
- valuation/ measurement;
- rights and obligations; and
- presentation and disclosure

of assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable accounting standards.

Example

If Company X's balance sheet shows building with carrying amount of ₹ 50 lakh, the auditor shall assume that the management has claimed/ asserted that:

- The building recognized in the balance sheet exists as at the period- end (existence assertion);
- Company X owns and controls such building (Rights and obligations assertion);
- The building has been valued accurately in accordance with the measurement principles (Valuation assertion);
- All buildings owned and controlled by Company X are included within the carrying amount of ₹ 50 lakh (Completeness assertion).

20. **Meaning of Valuation Assertion–** Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Example of Inventory explaining the valuation assertion is given hereunder: Inventory has been recognized at the lower of cost and net realizable value in accordance with AS 2 - Inventories. Any costs that could not be reasonably allocated to the cost of production (e.g. general and administrative costs) and any abnormal wastage have been excluded from the cost of inventory. An acceptable valuation basis (eg. FIFO, Weighted

© The Institute of Chartered Accountants of India

average etc.) has been used to value inventory as at the period-end.

21. Sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company' s auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per rule 12 of the Companies (Audit and Auditors) Rules, 2014, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

22. **Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan.** In developing the joint audit plan, the joint auditors should:

(a) identify division of audit areas and common audit areas;

(b) ascertain the reporting objectives of the engagement;

(c) consider and communicate among all joint auditors the factors that are significant

(d) in directing the engagement team's efforts;

(e) consider the results of preliminary engagement activities, or similar engagements performed earlier.

(f) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

23. Here, the auditor of the company is required to report the fraudulent activity to the Board or Audit Committee (as the case may be) within 2 days of his knowledge of fraud. Further, the company is also required to disclose the same in Board's Report. It may be noted that the auditor need not to report the central government as the amount of fraud involved is less than ₹ 1 crore, however, reporting under CARO, 2016 is required.

24. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial

© The Institute of Chartered Accountants of India

statements to be materially misstated. Indicators of a lack of neutrality include the following:

(i) The selective correction of misstatements brought to management's attention during the audit.

Example

- Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
- The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives.

(ii) Possible management bias in the making of accounting estimates.

25. The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

(a) Identify the entity whose financial statements have been audited;

(b) State that the financial statements have been audited;

(c) Identify the title of each statement comprising the financial statements;

(d) Refer to the notes, including the summary of significant accounting policies; and

(e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

26. In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. In modern day banking, the entries for interest expenses are automatically generated through a batch process in the CBS system.

- The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.
- The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences. The auditor should obtain general ledger break-up for the interest expense incurred on deposits (savings and term deposits) and borrowing

© The Institute of Chartered Accountants of India

each month/quarter. The auditor should analyse month on month (or quarter on quarter) cost analysis and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger. The auditor should understand the process of computation of the average balance and re-compute the same on sample basis.

- The auditor should, on a test check basis, verify the calculation of interest and ensure that:

  (a) Interest has been provided on all deposits upto the date of the balance sheet;

  (b) Interest rates are in accordance with the bank's internal regulations, the RBI directives and agreements with the respective deposit holder;

  (c) Interest on savings accounts are in accordance with the rules framed by the bank/RBI in this behalf.

  (d) Interest on inter–branch balances has been provided at the rates prescribed by the head office/RBI.

  The auditor should ascertain whether there are any changes in interest rate on saving accounts and term deposits during the period. The auditor should obtain the interest rate card for various types of deposits and analyse the interest cost for the period accordingly. The auditor should examine the completeness that interest has been accrued on the entire borrowing portfolio and the same should agree with the general ledgers. The auditor should re-compute the interest accrual i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc from the term sheet, deal ticket, agreements, etc and ensure that the recomputed amount is tallying with the amount as per books of accounts without any significant difference.

27. Reversal of Income:

If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any

© The Institute of Chartered Accountants of India

communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

28. (a) As per sub-section (3) & (4) of section 73 of Multi- state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co-operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

(a) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and

(b) In the case of the profit and loss account, of the profit or loss for its financial year. The auditor's report shall also state:

(i) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.

(ii) Whether, in his opinion, proper books of account have been kept by the Multi- State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State co-operative society not visited by him.

(iii) Whether the report on the accounts of any branch office audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.

(iv) Whether the Multi-State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.

Where any of the matters referred to in sub-section (3) or (4) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

(b) Section 73 of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors. According to this, every auditor of a Multi-State co-operative society shall have a right of access at all times to the books accounts and vouchers of the Multi-State co-operative society, whether kept at the head office of the Multi-State co-operative society or elsewhere, and shall be entitled to require from the officers or other employees of the Multi- State co-operative society such information

© The Institute of Chartered Accountants of India

and explanation as the auditor may think necessary for the performance of his duties as an auditor.

As per section 73(2), the auditor shall make following inquiries:

(a) Whether loans and advances made by the Multi-State co-operative society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State co-operative society or its members,

(b) Whether transactions of the Multi-State co-operative society which are represented merely by book entries are not prejudicial to the interests of the Multi-State co-operative society,

(c) Whether personal expenses have been charged to revenue account, and

(d) Where it is Stated in the books and papers of the Multi-State co-operative society that any shares have been allotted for cash, whether cash has actually, been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet as correct regular and not misleading.

© The Institute of Chartered Accountants of India

PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC MANAGEMENT

SECTION – A: ENTERPRISE INFORMATION SYSTEMS

QUESTIONS

Multiple Choice Questions

Q. No (s) 1 to 5 are based on the Case Scenario

A Cooperative society in Ghaziabad decides to open a bank named ABC Bank with its two branches located in Noida, Uttar Pradesh. The branches of banks are proposed to be connected to each other and all the processing and transactions being computerized with a centralized database. Further, to avoid manual working and proceed with advance technology, and at the same time to enhance functionality within branch; all the computer systems within all the departments in each branch would have connection-oriented network. The bank proposes to abide by all the regulations and compliance prevailing in India with respect to banking sector.

Mr. A is appointed as an IT - Head to carry out the Feasibility study of the proposed system and submit the report to top management of the Cooperative Society. After the report is submitted to the Top Management, following issues are raised by the management:

- There may be a conflict for some common resources in the network.
- Since the data is centrally located, it may create a possibility of access to non-relevant data by other departments.
- What would happen, if any employee intentionally destroys or alters the information residing in any of computer of any branch?
- Network security related issues between both branches of bank.

Based on the above case scenario, answer the following questions:

1. In purview of above case, under which legal provision of IT Act, 2000; the management can prove an employee guilty if (s)he intentionally destroys or alters the information residing in a computer resource of a branch?
   (a) Section 43
   (b) Section 65
   (c) Section 66 E
   (d) Section 66 C
2. Which of the following control shall be implemented in both the branches of ABC bank to suppress the risk of possibility of access to non-relevant data by other departments?
   (a) Proper training of the users with well documented manuals.

© The Institute of Chartered Accountants of India

(b) Clear defining of change control procedures and holding everyone to them.

(c) Back up arrangement needs to be very strong.

(d) Access rights need to be defined very carefully and to be given on "Need to know" and "Need to do" basis only.

3. The feature of Internet banking through ABC Banks' website allows ease and convenience to its customers. Which of the following is not the limitation of Internet banking?

(a) Difficult for a non-technical person

(b) Risk of data theft

(c) Written Record not to be maintained

(d) Overspending

4. The Top management of cooperative society raised its concern over an issue related to conflict of sharing of common resources in network between its two branches. Select the terminology referring to the above concern.

(a) Resilience

(b) Contention

(c) Bandwidth

(d) Routing

5. In both branches of ABC bank, all the fixed asset acquisitions will be recorded as the control objective related to certain risk. Under which category this control objective falls?

(a) Configuration general ledger

(b) Transaction Fixed asset

(c) Master fixed asset

(d) Transaction general ledger

Descriptive Questions

Chapter 1: Automated Business Processes

6. Though Human Resource (HR) Department plays an important role in development of any enterprise, yet it has certain risks associated at every stage of its life cycle. Describe all the risks related to Human Resource Department.

7. In an organization, effective risk management involves identification of high-level risk exposures and their analysis. Discuss all the risk management strategies out of which Senior Management of an organization may choose to adopt any of the risk management strategy based on the analysis of risks.

© The Institute of Chartered Accountants of India

Chapter 2: Financial and Accounting Systems

8. Discuss the different ways in which Database Administrator (DBA) can store the data of ABC enterprise implementing Accounting Information System (AIS).

9. ERP implementation is the difficult task as the organization which is in the process of implementing ERP should keep abreast of latest technological development. Describe the different risks associated with technology while implementing ERP.

Chapter 3: Information Systems and Its Components

10. Mr. A is a System Administrator of the company who must ensure the protection of Operating System used in information system of the company. How can this purpose be achieved?

11. Database Management System (DBMS) provides the facility to create and maintain a well organised database for any enterprise. Describe the various advantages of Database Management System used in an organization.

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

12. DEF is a car battery manufacturing company which intends to provide online business to its customers. Briefly explain various components involved in any e-Commerce transaction.

13. ABC university wants to conduct online exams for its different courses for which a contract is given to vendor XYZ. The vendor provides computing resources such as processing power, memory, storage, and networks to ABC university users to run their online exam application on-demand. Identify the Service Model of Cloud Computing that vendor XYZ is providing to ABC university and also describe its characteristics.

Chapter 5: Core Banking Systems

14. Internal controls must be integrated in the IT solution implemented at the bank's branches to mitigate risks. State few examples indicating the internal controls in banks.

15. Money laundering is used by anti-social elements to make 'dirty' money appear 'clean' that affects the economy of any country. Discuss the various stages involved in the process of Money Laundering.

SUGGESTED ANSWERS/HINTS

<u>Multiple Choice Answers</u>

1. **(a)** Section 43

2. **(d)** Access rights need to be defined very carefully and to be given on "Need to know" and Need to do" basis only.

© The Institute of Chartered Accountants of India

3. **(c)** Written Record not to be maintained

4. **(b)** Contention

5. **(b)** Transaction general ledger

Descriptive Answers

6. The risks associated with Human Resource Department are as given below:

(a) Employees who have left the company continue to have system access.

(b) Employees have system access in excess of their job requirements.

(c) Additions to the payroll master files do not represent valid employees.

(d) New employees are not added to the payroll master files.

(e) Terminated employees are not removed from the payroll master files.

(f) Employees are terminated without following statutory requirements.

(g) Deletions from the payroll master files do not represent valid terminations.

(h) Invalid changes are made to the payroll master files.

(i) Changes to the payroll master files are not accurate.

(j) Changes to the payroll master files are not processed in a timely manner.

(k) Payroll master file data is not up to date.

(l) Payroll is disbursed to inappropriate employees.

(m) System access to process employee master changes has not been restricted to the authorized users.

7. When risks are identified and analyzed, it is not always appropriate to implement controls to counter them. Some risks may be minor, and it may not be cost effective to implement expensive control processes for them. Risk management strategy is explained below:

- **Tolerate/Accept the risk:** One of the primary functions of management is managing risk. Some risks may be considered minor because their impact and probability of occurrence is low. In this case, consciously accepting the risk as a cost of doing business is appropriate, as well as periodically reviewing the risk to ensure its impact remains low.
- **Terminate/Eliminate the risk:** It is possible for a risk to be associated with the use of a technology, supplier, or vendor. The risk can be eliminated by replacing the technology with more robust products and by seeking more capable suppliers and vendors.
- **Transfer/Share the risk:** Risk mitigation approaches can be shared with trading partners and suppliers. A good example is outsourcing infrastructure management. In such a case, the supplier mitigates the risks associated with managing the IT

© The Institute of Chartered Accountants of India

infrastructure by being more capable and having access to more highly skilled staff than the primary organization. Risk also may be mitigated by transferring the cost of realized risk to an insurance provider.

- **Treat/mitigate the risk:** Where other options have been eliminated, suitable controls must be devised and implemented to prevent the risk from manifesting itself or to minimize its effects.
- **Turn back:** Where the probability or impact of the risk is very low, then management may decide to ignore the risk.

8. In Accounting Information System, the data is stored in following two ways:

A. **Master Data:** Master data is relatively permanent data that is not expected to change again and again. It may change, but not again and again. In accounting systems, there may be following type of master data.

- **Accounting Master Data –** This includes names of ledgers, groups, cost centres, accounting voucher types, etc. E.g. Capital Ledger is created once and not expected to change frequently.
- **Inventory Master Data –** This includes stock items, stock groups, godowns, inventory voucher types, etc. Stock item is something which is bought and sold for business purpose, trading goods. For a person running a medicine shop, all types of medicines shall be stock items for him/her.
- **Payroll Master Data –** Payroll is a system for calculation of salary and recoding of transactions relating to employees. Master data in case of payroll can be names of employees, group of employees, salary structure, pay heads, etc. These data are not expected to change frequently.
- **Statutory Master Data –** This is a master data relating to statute/law. It may be different for different type of taxes. E.g. Goods and Service Tax (GST). In case of change in tax rates, forms, categories, we need to update/change our master data.

All business process modules must use common master data.

B. **Non-Master Data:** It is a data which is expected to change frequently, again and again and not a permanent data. E.g. Amounts recorded in each transaction shall be different every time and expected to change again and again. Date recorded in each transaction is expected to change again and again and will not be constant in all the transactions.

9. Various risks associated with technology while implementing ERP are as following:

- **Software Functionality:** ERP systems offer a myriad of features and functions, however, not all organizations require those many features. Implementing all the

© The Institute of Chartered Accountants of India

functionality and features just for the sake of it can be disastrous for an organization.

- **Technological Obsolescence:** With the advent of more efficient technologies every day, the ERP system also becomes obsolete as time goes on.
- **Enhancement and Upgrades:** ERP Systems are not upgraded and kept up-to-date. Patches and upgrades are not installed and the tools are underutilised.
- **Application Portfolio Management:** These processes focus on the selection of new business applications and the projects required delivering them.

10. Operating System protection can be achieved using following steps.

- **Automated terminal identification:** This will help to ensure that a specified session could only be initiated from a certain location or computer terminal.
- **Terminal log-in procedures:** A log-in procedure is the first line of defence against unauthorized access as it does not provide unnecessary help or information, which could be misused by an intruder. When the user initiates the log-on process by entering user-id and password, the system compares the ID and password to a database of valid users and accordingly authorizes the log-in.
- **Access Token:** If the log on attempt is successful, the Operating System creates an access token that contains key information about the user including user-id, password, user group and privileges granted to the user. The information in the access token is used to approve all actions attempted by the user during the session.
- **Access Control List:** This list contains information that defines the access privileges for all valid users of the resource. When a user attempts to access a resource, the system compasses his or her user-id and privileges contained in the access token with those contained in the access control list. If there is a match, the user is granted access.
- **Discretionary Access Control:** The system administrator usually determines; who is granted access to specific resources and maintains the access control list. However, in distributed systems, resources may be controlled by the end-user. Resource owners in this setting may be granted discretionary access control, which allows them to grant access privileges to other users.
- **User identification and authentication:** The users must be identified and authenticated in a fool-proof manner. Depending on risk assessment, more stringent methods like Biometric Authentication or Cryptographic means like Digital Certificates should be employed.

© The Institute of Chartered Accountants of India

- **Password management system:** An operating system could enforce selection of good passwords. Internal storage of password should use one-way hashing algorithms and the password file should not be accessible to users.
- **Use of system utilities:** System utilities are the programs that help to manage critical functions of the operating system e.g. addition or deletion of users. This utility should not be accessible to a general user. Use and access to these utilities should be strictly controlled and logged.
- **Duress alarm to safeguard users:** If users are forced to execute some instruction under threat, the system should provide a means to alert the authorities.
- **Terminal time out:** Log out the user if the terminal is inactive for a defined period. This will prevent misuse in absence of the legitimate user.
- **Limitation of connection time:** Define the available time slot. Do not allow any transaction beyond this time.

11. Major advantages of Database Management System (DBMS) are as follows:

- ♦ **Permitting Data Sharing:** One of the principle advantages of a DBMS is that the same information can be made available to different users.
- ♦ **Minimizing Data Redundancy:** In a DBMS, duplication of information or redundancy is, if not eliminated, carefully controlled or reduced i.e. there is no need to repeat the same data repeatedly. Minimizing redundancy reduces significantly the cost of storing information on storage devices.
- ♦ **Integrity can be maintained:** Data integrity is maintained by having accurate, consistent, and up-to-date data. Updates and changes to the data only must be made in one place in DBMS ensuring Integrity.
- ♦ **Program and File consistency:** Using a DBMS, file formats and programs are standardized. The level of consistency across files and programs makes it easier to manage data when multiple programmers are involved as the same rules and guidelines apply across all types of data.
- ♦ **User-friendly:** DBMS makes the data access and manipulation easier for the user. DBMS also reduces the reliance of users on computer experts to meet their data needs.
- ♦ **Improved security:** DBMS allows multiple users to access the same data resources in a controlled manner by defining the security constraints. Some sources of information should be protected or secured and only viewed by select individuals. Using passwords, DBMS can be used to restrict data access to only those who should see it.

© The Institute of Chartered Accountants of India

- **Achieving program/data independence:** In a DBMS, data does not reside in applications, but data base program & data are independent of each other.
- **Faster Application Development:** In the case of deployment of DBMS, application development becomes fast. The data is already therein databases, application developer has to think of only the logic required to retrieve the data in the way a user need.

12. Various components of e-Commerce transaction are as follows:

(i) **User:** This may be individual / organization or anybody using the e-commerce platforms. As e-commerce, has made procurement easy and simple, just on a click of button, e-commerce vendors need to ensure that their products are not delivered to wrong users.

(ii) **E-commerce Vendors:** This is the organization / entity providing the user, goods/ services asked for. E-commerce vendors further needs to ensure Suppliers and Supply Chain Management, Warehouse operations, Shipping and returns, e-Commerce catalogue and product display, Marketing and loyalty programs, Showroom and offline purchase, different ordering Methods, Guarantees, Privacy Policy and Security etc. for better, effective and efficient transaction.

(iii) **Technology Infrastructure:** The computers, servers, database, mobile apps, digital libraries, data interchange enabling the e-commerce transactions.

- **Computers, Servers and Database:** These are the backbone for the success of the venture. Big e-commerce organization invest huge amount of money/time in creating these systems.
- **Mobile Apps:** A mobile app is a software application programmed to run specifically on a mobile device. Smartphone's and tablets have become a dominant form of computing, with many more smartphones being sold than personal computers.
- **Digital Library:** A Digital Library is a special library with a focused collection of digital objects that can include text, visual material, audio material, video material, stored as electronic media formats, along with means for organizing, storing, and retrieving the files and media contained in the library collection.
- **Data Interchange:** Data Interchange is an electronic communication of data. For ensuring the correctness of data interchange between multiple players in e-commerce, business specific protocols are being used. There are defined standards to ensure seamless / exact communication in e-commerce.

(iv) **Internet/Network:** This is the key to success of e-commerce transactions. Internet connectivity is important for any e-commerce transactions to go through. The faster net connectivity leads to better e-commerce. At a global level, it is linked to the countries capability to create a high-speed network.

© The Institute of Chartered Accountants of India

(v) **Web portal:** This shall provide the interface through which an individual/ organization shall perform e-commerce transactions. Web Portal is an application through which user interacts with the e-commerce vendor. The front end through which user interacts for an e-commerce transaction. These web portals can be accessed through desktops/laptops/PDA/hand-held computing devices/mobiles and now through smart TVs also.

(vi) **Payment Gateway:** Payment gateway represents the way e-commerce vendors collects their payments. These assures seller of receipt of payment from buyer of goods/services from e-commerce vendors. Presently numerous methods of payments by buyers to sellers are being used, including Credit / Debit Card Payments, Online bank payments, Vendors own payment wallet, Third Party Payment wallets, Cash on Delivery (CoD) and Unified Payments Interface (UPI).

13. The Service Model provided by vendor XYZ to ABC university is **Infrastructure as a Service (IaaS)**.

Characteristics of Infrastructure as a Service (IaaS) of Cloud Computing are as follows:

- **Web access to the resources:** The IaaS model enables the IT users to access infrastructure resources over the Internet. When accessing a huge computing power, the IT user need not get physical access to the servers.
- **Centralized Management:** The resources distributed across different parts are controlled from any management console that ensures effective resource management and effective resource utilization.
- **Elasticity and Dynamic Scaling:** Depending on the load, IaaS services can provide the resources and elastic services where the usage of resources can be increased or decreased according to the requirements.
- **Shared infrastructure:** IaaS follows a one-to-many delivery model and allows multiple IT users to share the same physical infrastructure and thus ensure high resource utilization.
- **Metered Services:** IaaS allows the IT users to rent the computing resources instead of buying it. The services consumed by the IT user will be measured, and the users will be charged by the IaaS providers based on the amount of usage.

14. Some examples of Internal Controls in bank's branch are as below:

- Work of one staff member is invariably supervised/ checked by another staff member, irrespective of the nature of work (Maker-Checker process).
- A system of job rotation among staff exists.
- Financial and administrative powers of each official/ position is fixed and communicated to all persons concerned.

© The Institute of Chartered Accountants of India

- Branch managers must send periodic confirmation to their controlling authority on compliance of the laid down systems and procedures.
- All books are to be balanced periodically. Balancing is to be confirmed by an authorized official.
- Details of lost security forms are immediately advised to controlling so that they can exercise caution.
- Fraud prone items like currency, valuables, draft forms, term deposit receipts, traveller's cheques and other such security forms are in the custody of at least two officials of the branch.

15. Stages of Money Laundering are as follows:

i. **Placement:** The first stage involves the Placement of proceeds derived from illegal activities - the movement of proceeds frequently currency from the scene of the crime to a place, or into a form, less suspicious and more convenient for the criminal.

ii. **Layering:** Layering involves the separation of proceeds from illegal source using complex transactions designed to obscure the audit trail and hide the proceeds. The criminals frequently use shell corporations, offshore banks or countries with loose regulation and secrecy laws for this purpose. Layering involves sending the money through various financial transactions to change its form and make it difficult to follow. Layering may consist of several banks to bank transfers or wire transfers between different accounts in different names in different countries making deposit and withdrawals to continually vary the amount of money in the accounts changing the money's currency purchasing high value items to change the form of money-making it hard to trace.

iii. **Integration:** Integration involves conversion of illegal proceeds into apparently legitimate business earnings through normal financial or commercial operations. Integration creates the illusion of a legitimate source for criminally derived funds and involves techniques as numerous and creative as those used by legitimate businesses.

© The Institute of Chartered Accountants of India

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):

(i) Strategy is-

(a) Proactive in action

(b) Reactive in action

(c) A blend of proactive and reactive actions

(d) None of the above

(ii) 'Strategic group mapping' helps in-

(a) Identifying the strongest rival companies

(b) Identifying weakest rival companies

(c) Identifying weakest and strongest rival companies

(d) None of the above

(iii) In which phase of strategic management are annual objectives especially important?

(a) Formulation

(b) Control

(c) Evaluation

(d) Implementation

(iv) Retrenchment strategy in the organization can be explained as

(a) Reducing trenches (gaps) created between individuals.

(b) Divesting a major product line or market.

(c) Removal of employees from job through the process of reorganization.

(d) Removal of employees from job in one business to relocate them in other business.

(v) Differentiation Strategy can be achieved by following measures:

1. Match products with tastes and preferences of customers.
2. Elevate the performance of the product.
3. Rapid product innovation

Which of the above is true?

(a) (1) and (2)

(b) (1) and (3)

© The Institute of Chartered Accountants of India

(c) (2) and (3)

(d) (1), (2) and (3)

(vi) Supply chain refers to the linkages between:

(a) Suppliers

(b) Customers

(c) Manufacturers

(d) All the above

(vii) An entrepreneur is one who:

(a) Initiates and innovates a new concept.

(b) Does not recognize and utilizes opportunities.

(c) Does not want to face risks and uncertainties.

(d) None of these.

(viii) After an earnest attempt to bring in a strategic change in your organization, you the operational head of XYZ ltd, succeeded but still your organization couldn't achieve the desired competitive position in the market. Out of the following what could be the reason?

(a) Strategy Formulation

(b) Strategy Model

(c) Strategy Implementation

(d) Strategy Decision

(ix) Which of the following are responsible for formulating and developing realistic and attainable strategies?

(a) Corporate level and business level managers

(b) Corporate level and functional level managers

(c) Functional managers and business level managers

(d) Corporate level managers, business level managers and functional level managers

(x) A tool by which management identifies and evaluates the various businesses that make up a company is termed as:

(a) Value Chain Analysis

(b) Portfolio Analysis

(c) Competition Analysis

(d) Strategic Analysis

© The Institute of Chartered Accountants of India

(xi) Which one is not the element of strategic intent?

(a) Business model

(b) Vision

(c) Business definition

(d) Business standard

(xii) Vertical integration may be beneficial when

(a) Lower transaction costs and improved coordination are vital and achievable through vertical integration.

(b) Flexibility is reduced, providing a more stationary position in the competitive environment.

(c) Various segregated specializations will be combined.

(d) The minimum efficient scales of two corporations are different.

(xiii) Competitive rivalry has the most effect on the firm's ____ strategies than the firm's other strategies.

(a) Business level

(b) Corporate level

(c) Functional level

(d) All of these

(xiv) The marketing strategy which is used to reduce or shift the demand is:

(a) Enlightened Marketing

(b) Synchro-Marketing

(c) Place Marketing

(d) Demarketing

(xv) In strategic management, there are two main styles of leadership. These are transformational and:

(a) Transparent

(b) Transitional

(c) Translational

(d) Transactional

(xvi) You being the core strategist of your company, entrusted with bringing about strategic change in your company, how will you initiate “unfreezing of the situation”?

(a) Promoting new ideas throughout the organization

(b) Promoting compliance throughout the organization

© The Institute of Chartered Accountants of India

(c) Promoting change in process throughout the organization

(d) None of the above

Descriptive answers

Chapter 1-Introduction to Strategic Management

2. Health Wellnow is a Delhi based charitable organisation promoting healthy lifestyle amongst the office-goers. It organises free of cost programmes to encourage and guide office-goers on matters related to stress relief, yoga, exercises, healthy diet, weight management, work-life balance and so on. Many business organisations and resident welfare associations are taking services of Health Wellnow in Delhi and adjoining areas and make financial contributions to its cause. The Health Wellnow is able to generate sufficient funds to meet its routine expenses.

   How far strategic management is relevant for Health Wellnow? Discuss.

3. Explain the difference between three levels of strategy formulation.

Chapter 2-Dynamics of Competitive Strategy

4. Capabilities that are valuable, rare, costly to imitate, and non-substitutable are core competencies. Explain these four specific criteria of sustainable competitive advantage that firms can use to determine those capabilities that are core competencies.

5. What is the purpose of SWOT analysis? Why is it necessary to do a SWOT analysis before selecting a particular strategy for a business organization?

Chapter 3-Strategic Management Process

6. Rohit Seth in an informal discussion with his friend shared that he has to move very cautiously in his organisation as the decisions taken by him have organisation wide impact and involve large commitments of resources. He also said that his decisions decide the future of his organisation.

   Where will you place Rohit Seth in organisational hierarchy? What are the dimensions of the decisions being taken by him?

7. What are the elements in strategic intent of organisation?

Chapter 4-Corporate Level Strategies

8. *Organo* is a large supermarket chain. It is considering the purchase of a number of farms that provides *Organo* with a significant amount of its fresh produce. *Organo* feels that by purchasing the farms, it will have greater control over its supply chain. Identify and explain the type of diversification opted by *Organo*?

9. Write short note on expansion through acquisitions and mergers.

Chapter 5-Business Level Strategies

10. Eco-carry bags Ltd., a recyclable plastic bags manufacturing and trading company has seen a potential in the ever-growing awareness around hazards of plastics and the positive outlook of the society towards recycling and reusing plastics.

© The Institute of Chartered Accountants of India

A major concern for Eco-carry bags Ltd. are paper bags and old cloth bags. Even though they are costlier than recyclable plastic bags, irrespective, they are being welcomed positively by the consumers.

Identify and explain that competition from paper bags and old cloth bags fall under which category of Porter's Five Forces Model for Competitive Analysis?

11. A differentiation strategy may help to remain profitable even with rivalry, new entrants, suppliers' power, substitute products, and buyers' power. Explain.

Chapter 6-Functional Level Strategies

12. ABC Ltd is a company that has grown eleven times its size in last five years. With the increase in size the company is facing difficulty in managing things. Many a times functional level is not in sync with the corporate level. What will you like to advise to the company and why?

13. What do you mean by financial strategy of an organization? How the worth of a business is evaluated?

Chapter 7-Organisation and Strategic Leadership

14. KaAthens Ltd., a diversified business entity having business operations across the globe. The company leadership has just changed as Mr. D. Bandopadhyay handed over the pedals to his son Aditya Bandopadhyay, due to his poor health. Aditya is a highly educated with an engineering degree from IIT, Delhi. However, being very young he is not clear about his role and responsibilities.

    In your view, what are the responsibilities of Aditya Bandopadhyay as CEO of the company.

15. What is a strategic business unit? What are its advantages?

Chapter 8-Strategy Implementation and Control

16 Kewal Kapadia is the Managing Director of KK industries located in Kanpur. In a review meeting with the head of finance, Kuldeep Khaitan he said that in the first five years of last decade the company grew between 8-10 percent every year, then the growth rate started falling and in previous year the company managed 1 per cent. Kuldeep replied that the company is facing twin issues, one the strategy is not being implemented as planned; and two the results produced by the strategy are not in conformity with the intended goals. There is mismatch between strategy formulation and implementation. Kewal disagreed and stated that he takes personal care in implementing all strategic plans.

    You have been hired as a strategy consultant by the KK Industries. Advise way forward for the company to identify problem areas and correct the strategic approaches that have not been effective.

17. What is strategic control? Briefly explain the different types of strategic control?

SUGGESTED ANSWERS / HINTS

Multiple Choice Questions

Answer 1

(i) (c)	(ii) (c)	(iii) (d)	(iv) (b)	(v) (d)	(vi) (d)
(vii) (a)	(viii) (c)	(ix) (d)	(x) (b)	(xi) (d)	(xii) (a)
(xiii) (a)	(xiv) (d)	(xv) (d)	(xvi) (a)		

Descriptive answers

2. The concepts of strategic management are relevant for Health Wellnow.

Organizations can be classified as commercial and non-commercial on the basis of the interest they have. Health Wellnow falls in the category of a non-commercial organisation. While non-commercial organisations may have objectives that are different from the commercial organisations, they need to employ the strategic management tools to efficiently use their resources, generate sufficient surpluses to meet daily expenses and achieve their objectives. In fact, many non-profit and governmental organizations outperform private firms and corporations on innovativeness, motivation, productivity, and human relations.

The strategic management in Health Wellnow needs to cover aspects such as:

(i) Generate sufficient funds for meeting its objectives.

(ii) Efficiently reach office-goers and help them to have health in life.

(iii) Promote itself to cover more offices, resident welfare associations.

(iv) Have a deep collaboration with health experts, including dieticians, psychologist, fitness trainers, yoga experts.

3. A typical large organization is a multidivisional organisation that competes in several different businesses. It has separate self-contained divisions to manage each of these. There are three levels of strategy in management of business - corporate, business, and functional.

The corporate level of management consists of the chief executive officer and other top level executives. These individuals occupy the apex of decision making within the organization. The role of corporate-level managers is to oversee the development of strategies for the whole organization. This role includes defining the mission and goals of the organization, determining what businesses it should be in, allocating resources among the different businesses and so on rests at the Corporate Level.

The development of strategies for individual business areas is the responsibility of the general managers in these different businesses or business level managers. A business unit is a self-contained division with its own functions - for example, finance, production, and marketing. The strategic role of business-level manager, head of the division, is to

© The Institute of Chartered Accountants of India

translate the general statements of direction and intent that come from the corporate level into concrete strategies for individual businesses.

Functional-level managers are responsible for the specific business functions or operations such as human resources, purchasing, product development, customer service, and so on. Thus, a functional manager's sphere of responsibility is generally confined to one organizational activity, whereas general managers oversee the operation of a whole company or division.

4. Four specific criteria of sustainable competitive advantage that firms can use to determine those capabilities that are core competencies. Capabilities that are valuable, rare, costly to imitate, and non-substitutable are core competencies.

i. **Valuable:** Valuable capabilities are the ones that allow the firm to exploit opportunities or avert the threats in its external environment. A firm created value for customers by effectively using capabilities to exploit opportunities. Finance companies build a valuable competence in financial services. In addition, to make such competencies as financial services highly successful require placing the right people in the right jobs. Human capital is important in creating value for customers.

ii. **Rare:** Core competencies are very rare capabilities and very few of the competitors possess this. Capabilities possessed by many rivals are unlikely to be sources of competitive advantage for any one of them. Competitive advantage results only when firms develop and exploit valuable capabilities that differ from those shared with competitors.

iii. **Costly to imitate:** Costly to imitate means such capabilities that competing firms are unable to develop easily. *For example*: Intel has enjoyed a first-mover advantage more than once because of its rare fast R&D cycle time capability that brought SRAM and DRAM integrated circuit technology, and brought microprocessors to market well ahead of the competitor. The product could be imitated in due course of time, but it was much more difficult to imitate the R&D cycle time capability.

iv. **Non-substitutable:** Capabilities that do not have strategic equivalents are called non-substitutable capabilities. This final criterion for a capability to be a source of competitive advantage is that there must be no strategically equivalent valuable resources that are themselves either not rare or imitable.

5. An important component of strategic thinking requires the generation of a series of strategic alternatives, or choices of future strategies to pursue, given the company's internal strengths and weaknesses and its external opportunities and threats. The comparison of strengths, weaknesses, opportunities, and threats is normally referred to as SWOT analysis.

- **Strength:** Strength is an inherent capability of the organization which it can use to gain strategic advantage over its competitors.

- **Weakness:** A weakness is an inherent limitation or constraint of the organization which creates strategic disadvantage to it.

© The Institute of Chartered Accountants of India

- **Opportunity:** An opportunity is a favourable condition in the organisation's environment which enables it to strengthen its position.
- **Threat:** A threat is an unfavourable condition in the organisation's environment which causes a risk for, or damage to, the organisation's position.

SWOT analysis helps managers to craft a business model (or models) that will allow a company to gain a competitive advantage in its industry (or industries). Competitive advantage leads to increased profitability, and this maximizes a company's chances of surviving in the fast-changing, competitive environment. Key reasons for SWOT analyses are:

- It provides a logical framework.
- It presents a comparative account.
- It guides the strategist in strategy identification.

6. As the decisions taken by Rohit Seth have organisation wide impact, involves large commitments and have implication on the future, he is at the top level in organisational hierarchy. These characteristics also indicate that he is taking strategic decisions in the organisation. The major dimensions of strategic decisions are as follows:

- **Strategic decisions require top-management involvement:** Strategic decisions involve thinking in totality of the organization. Hence, problems calling for strategic decisions require to be considered by the top management.
- **Strategic decisions involve commitment of organisational resources:** For example, Strategic decisions to launch a new project by a firm requires allocation of huge funds and assignment of a large number of employees.
- **Strategic decisions necessitate consideration of factors in the firm's external environment:** Strategic focus in organization involves orienting its internal environment to the changes of external environment.
- **Strategic decisions are likely to have a significant impact on the long-term prosperity of the firm:** Generally, the results of strategic implementation are seen on a long-term basis and not immediately.
- **Strategic decisions are future oriented:** Strategic thinking involves predicting the future environmental conditions and how to orient for the changed conditions.
- **Strategic decisions usually have major multifunctional or multi-business consequences:** As they involve organization in totality they affect different sections of the organization with varying degree.

7. Strategic intent can be understood as the philosophical base of strategic management. It implies the purposes, which an organization endeavours to achieve. It is a statement that provides a perspective. Strategic intent gives an idea of what the organization desires to

© The Institute of Chartered Accountants of India

attain in future. Strategic intent provides the framework within which the firm would adopt a predetermined direction and would operate to achieve strategic objectives. Elements of strategic management are as follows:

(i) **Vision:** Vision implies the blueprint of the company's future position. It describes where the organisation wants to land. It depicts the organisation's aspirations and provides a glimps of what the organization would like to become in future. Every sub system of the organization is required to follow its vision.

(ii) **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. A mission statement helps to identify, 'what business the company undertakes.' It defines the present capabilities, activities, customer focus and role in society.

(iii) **Business Definition:** It seeks to explain the business undertaken by the firm, with respect to the customer needs, target markets, and alternative technologies. With the help of business definition, one can ascertain the strategic business choices.

(iv) **Business Model:** Business model, as the name implies is a strategy for the effective operation of the business, ascertaining sources of income, desired customer base, and financial details. Rival firms, operating in the same industry rely on the different business model due to their strategic choice.

(v) **Goals and Objectives:** These are the base of measurement. Goals are the end results, that the organization attempts to achieve. On the other hand, objectives are time-based measurable targets, which help in the accomplishment of goals. These are the end results which are to be attained with the help of an overall plan. However, in practice, no distinction is made between goals and objectives and both the terms are used interchangeably.

8. *Organo* is a large supermarket chain. By opting backward integration and purchase a number of farms, it will have greater control over its supply chain. Backward integration is a step towards, creation of effective supply by entering business of input providers. Strategy employed to expand profits and gain greater control over production of a product whereby a company will purchase or build a business that will increase its own supply capability or lessen its cost of production.

9. Acquisitions and mergers are basically combination strategies. Some organizations prefer to grow through mergers. Merger is considered to be a process when two or more companies come together to expand their business operations. In such a case the deal gets finalized on friendly terms and both the organizations share profits in the newly created entity. In a merger two organizations combine to increase their strength and financial gains along with breaking the trade barriers.

When one organization takes over the other organization and controls all its business operations, it is known as acquisition. In this process of acquisition, one financially strong organization overpowers the weaker one. Acquisitions often happen during recession in economy or during declining profit margins. In this process, one that is financially stronger and bigger establishes it power. The combined operations then run under the name of the

© The Institute of Chartered Accountants of India

powerful entity. A deal in case of an acquisition is often done in an unfriendly manner, it is more or less a forced association where the powerful organization either consumes the operation or a company in loss is forced to sell its entity.

10. Eco-carry bags Ltd. faces competition from paper bags and old cloth bags and falls under *Threat of Substitutes* force categories in Porter's Five Forces Model for Competitive Analysis. Paper and cloth bags are substitutes of recyclable plastic bags as they perform the same function as plastic bags. Substitute products are a latent source of competition in an industry. In many cases, they become a major constituent of competition. Substitute products offering a price advantage and/or performance improvement to the consumer can drastically alter the competitive character of an industry.

11. A differentiation strategy may help to remain profitable even with: rivalry, new entrants, suppliers' power, substitute products, and buyers' power.

1. 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.
2. Buyers – They do not negotiate for price as they get special features and also they have fewer options in the market.
3. Suppliers – Because differentiators charge a premium price, they can afford to absorb higher costs of supplies and customers are willing to pay extra too.
4. Entrants – Innovative features are an expensive offer. 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.
5. Substitutes – Substitute products can't replace differentiated products which have high brand value and enjoy customer loyalty.

12. The higher-level corporate strategies need to be segregated into viable plans and policies that are compatible with each other and communicated down the line. The higher-level strategies need to be broken into functional strategies for implementation. These functional strategies, in form of marketing, finance, human resource, production, research and development help in achieving the organisational objective. The reasons why functional strategies are needed can be enumerated as follows:

- Functional strategies lay down clearly what is to be done at the functional level. They provide a sense of direction to the functional staff.
- They are aimed at facilitating the implementation of corporate strategies and the business strategies formulation at the business level.
- They act as basis for controlling activities in the different functional areas of business.
- They help in bringing harmony and coordination as they are formulated to achieve major strategies.
- Similar situations occurring in different functional areas are handled in a consistent manner by the functional managers.

© The Institute of Chartered Accountants of India

13. The financial strategies of an organization are related to several finance/ accounting concepts considered to be central to strategy implementation. These are: acquiring needed capital/sources of fund, developing projected financial statements/budgets, management/ usage of funds, and evaluating the worth of a business.

Various methods for determining a business's worth can be grouped into three main approaches which are as follows:

(i) **Net worth or stockholders' equity:** Net worth is the total assets minus total outside liabilities of an organisation.

(ii) **Future benefits to owners through net profits:** These benefits are considered to be much greater than the amount of profits. A conservative rule of thumb is to establish a business's worth as five times the firm's current annual profit. A five-year average profit level could also be used.

(iii) **Market-determined business worth:** This, in turn, involves three methods. First, the firm's worth may be based on the selling price of a similar company. The second approach is called the price-earnings ratio method whereby the market price of the firm's equity shares is divided by the annual earnings per share and multiplied by the firm's average net income for the preceding years. The third approach can be called the outstanding shares method whereby one has to simply multiply the number of shares outstanding by the market price per share and add a premium.

14. Aditya Bandopadhyay, an effective strategic leader of KaAthens Ltd. must be able to deal with the diverse and cognitively complex competitive situations that are characteristic of today's competitive landscape.

A Strategic leader has several responsibilities, including the following:

- Making strategic decisions.
- Formulating policies and action plans to implement strategic decision.
- Ensuring effective communication in the organisation.
- Managing human capital (perhaps the most critical of the strategic leader's skills).
- Managing change in the organisation.
- Creating and sustaining strong corporate culture.
- Sustaining high performance over time.

15. A strategic business unit (SBU) is any part of a business organization which is treated separately for strategic management purposes. The concept of SBU is helpful in creating an SBU organizational structure. It is discrete element of the business serving product markets with readily identifiable competitors and for which strategic planning can be concluded. It is created by adding another level of management in a divisional structure

© The Institute of Chartered Accountants of India

after the divisions have been grouped under a divisional top management authority based on the common strategic interests.

Advantages of SBU are:

- Establishing coordination between divisions having common strategic interests.
- Facilitates strategic management and control on large and diverse organizations.
- Fixes accountabilities at the level of distinct business units.
- Allows strategic planning to be done at the most relevant level within the total enterprise.
- Makes the task of strategic review by top executives more objective and more effective.
- Helps allocate corporate resources to areas with greatest growth opportunities.

16. The company needs to conduct strategy audit.

A strategy audit is needed under the following conditions:

- When the performance indicators reflect that a strategy is not working properly or is not producing desired outcomes.
- When the goals and objectives of the strategy are not being accomplished.
- When a major change takes place in the external environment of the organization.
- When the top management plans:
  - to fine-tune the existing strategies and introduce new strategies and
  - to ensure that a strategy that has worked in the past continues to be in-tune with subtle internal and external changes that may have occurred since the formulation of strategies.

Adequate and timely feedback is the cornerstone of effective strategy audit. Strategy audit can be no better than the information on which it is based.

Strategy Audit includes three basic activities:

(i) Examining the underlying bases of a firm's strategy,

(ii) Comparing expected results with actual results, and

(iii) Taking corrective actions to ensure that performance conforms to plans.

17. Strategic Control focuses on the dual questions of whether: (1) the strategy is being implemented as planned; and (2) the results produced by the strategy are those intended.

There are four types of strategic control:

- **Premise control**: A strategy is formed on the basis of certain assumptions or premises about the environment. Premise control is a tool for systematic and

© The Institute of Chartered Accountants of India

continuous monitoring of the environment to verify the validity and accuracy of the premises on which the strategy has been built.

- **Strategic surveillance**: Strategic surveillance is unfocussed. It involves general monitoring of various sources of information to uncover unanticipated information having a bearing on the organizational strategy.
- **Special alert control:** At times, unexpected events may force organizations to reconsider their strategy. Sudden changes in government, natural calamities, unexpected merger/acquisition by competitors, industrial disasters and other such events may trigger an immediate and intense review of strategy.
- **Implementation control:** 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.

© The Institute of Chartered Accountants of India

PAPER – 8: FINANCIAL MANAGEMENT AND ECONOMICS FOR FINANCE

SECTION A: FINANCIAL MANAGEMENT

QUESTIONS

Ratio Analysis

1. MT Limited has the following Balance Sheet as on March 31, 2019 and March 31, 2020:

Balance Sheet

	₹ in lakhs	
	March 31, 2019	**March 31, 2020**
Sources of Funds:		
Shareholders' Funds	2,500	2,500
Loan Funds	3,500	3,000
	6,000	5,500
Applications of Funds:		
Fixed Assets	3,500	3,000
Cash and bank	450	400
Receivables	1,400	1,100
Inventories	2,500	2,000
Other Current Assets	1,500	1,000
Less: Current Liabilities	(1,850)	(2,000)
	6,000	5,500

The Income Statement of the MT Ltd. for the year ended is as follows:

	₹ in lakhs	
	March 31, 2019	**March 31, 2020**
Sales	22,500	23,800
Less: Cost of Goods sold	(20,860)	(21,100)
Gross Profit	1,640	2,700
Less: Selling, General and Administrative expenses	(1,100)	(1,750)
Earnings before Interest and Tax (EBIT)	540	950
Less: Interest Expense	(350)	(300)
Earnings before Tax (EBT)	190	650
Less: Tax	(57)	(195)
Profits after Tax (PAT)	133	455

© The Institute of Chartered Accountants of India

Required:

CALCULATE for the year 2019-20-

(a) Inventory turnover ratio

(b) Financial Leverage

(c) Return on Capital Employed (ROCE)

(d) Return on Equity (ROE)

(e) Average Collection period.

[Take 1 year = 365 days]

Cost of Capital

2. PK Ltd. has the following book-value capital structure as on March 31, 2020.

	(₹)
Equity share capital (10,00,000 shares)	2,00,00,000
11.5% Preference shares	60,00,000
10% Debentures	1,00,00,000
	3,60,00,000

The equity shares of the company are sold for ₹ 200. It is expected that the company will pay next year a dividend of ₹ 10 per equity share, which is expected to grow by 5% p.a. forever. Assume a 35% corporate tax rate.

Required:

(i) COMPUTE weighted average cost of capital (WACC) of the company based on the existing capital structure.

(ii) COMPUTE the new WACC, if the company raises an additional ₹50 lakhs debt by issuing 12% debentures. This would result in increasing the expected equity dividend to ₹12.40 and leave the growth rate unchanged, but the price of equity share will fall to ₹ 160 per share.

Capital Structure Decisions

3. CALCULATE the level of earnings before interest and tax (EBIT) at which the EPS indifference point between the following financing alternatives will occur.

(i) Equity share capital of ₹60,00,000 and 12% debentures of ₹40,00,000.

Or

© The Institute of Chartered Accountants of India

(ii) Equity share capital of ₹40,00,000, 14% preference share capital of ₹20,00,000 and 12% debentures of ₹40,00,000.

Assume the corporate tax rate is 35% and par value of equity share is ₹100 in each case.

Leverage

4. The following information is related to YZ Company Ltd. for the year ended 31st March, 2020:

Equity share capital (of ₹ 10 each)	₹ 50 lakhs
12% Bonds of ₹ 1,000 each	₹ 37 lakhs
Sales	₹ 84 lakhs
Fixed cost (excluding interest)	₹ 6.96 lakhs
Financial leverage	1.49
Profit-volume Ratio	27.55%
Income Tax Applicable	40%

You are required to CALCULATE:

(i) Operating Leverage;

(ii) Combined leverage; and

(iii) Earnings per share.

Show calculations up-to two decimal points.

Capital Budgeting

5. A company is considering the proposal of taking up a new project which requires an investment of ₹800 lakhs on machinery and other assets. The project is expected to yield the following earnings (before depreciation and taxes) over the next five years:

Year	Earnings (₹ in lakhs)
1	320
2	320
3	360
4	360
5	300

The cost of raising the additional capital is 12% and assets have to be depreciated at 20% on written down value basis. The scrap value at the end of the five year period may be taken as zero. Income-tax applicable to the company is 40%.

© The Institute of Chartered Accountants of India

You are required to CALCULATE the net present value of the project and advise the management to take appropriate decision. Also CALCULATE the Internal Rate of Return of the Project.

Note: Present values of Re. 1 at different rates of interest are as follows:

Year	10%	12%	14%	16%	20%
1	0.91	0.89	0.88	0.86	0.83
2	0.83	0.80	0.77	0.74	0.69
3	0.75	0.71	0.67	0.64	0.58
4	0.68	0.64	0.59	0.55	0.48
5	0.62	0.57	0.52	0.48	0.40

Management of Receivables (Debtors)

6. TM Limited, a manufacturer of colour TV sets is considering the liberalization of existing credit terms to three of their large customers A, B and C. The credit period and likely quantity of TV sets that will be sold to the customers in addition to other sales are as follows:

Quantity sold (No. of TV Sets)

Credit Period (Days)	A	B	C
0	10,000	10,000	-
30	10,000	15,000	-
60	10,000	20,000	10,000
90	10,000	25,000	15,000

The selling price per TV set is ₹15,000. The expected contribution is 50% of the selling price. The cost of carrying receivable averages 20% per annum.

You are required to COMPUTE the credit period to be allowed to each customer.

(Assume 360 days in a year for calculation purposes).

Risk Analysis in Capital Budgeting

7. G Ltd. using certainty-equivalent approach in the evaluation of risky proposals. The following information regarding a new project is as follows:

Year	Expected Cash flow	Certainty-equivalent quotient
0	(8,00,000)	1.0
1	6,40,000	0.8
2	5,60,000	0.7

© The Institute of Chartered Accountants of India

3	5,20,000	0.6
4	4,80,000	0.4
5	3,20,000	0.3

Riskless rate of interest on the government securities is 6 per cent. DETERMINE whether the project should be accepted?

Dividend Decisions

8. Following information relating to Jee Ltd. is given:

Particulars

Profit after tax	₹ 10,00,000
Dividend pay-out ratio	50%
Number of Equity Shares	50,000
Cost of Equity	10%
Rate of Return on Investment	12%

(i) CALCULATE market value per share as per Walter's Model?

(ii) What is the optimum dividend pay-out ratio according to Walter's Model and Market value of equity share at that pay-out ratio?

Management of working Capital

9. Day Ltd., a newly formed company has applied to the Private Bank for the first time for financing it's Working Capital Requirements. The following information is available about the projections for the current year:

Estimated Level of Activity	Completed Units of Production 31,200 plus unit of work in progress 12,000
Raw Material Cost	₹ 40 per unit
Direct Wages Cost	₹ 15 per unit
Overhead	₹ 40 per unit (inclusive of Depreciation ₹10 per unit)
Selling Price	₹ 130 per unit
Raw Material in Stock	Average 30 days consumption
Work in Progress Stock	Material 100% and Conversion Cost 50%
Finished Goods Stock	24,000 Units
Credit Allowed by the supplier	30 days
Credit Allowed to Purchasers	60 days

© The Institute of Chartered Accountants of India

Direct Wages (Lag in payment)	15 days
Expected Cash Balance	₹ 2,00,000

Assume that production is carried on evenly throughout the year (360 days) and wages and overheads accrue similarly. All sales are on the credit basis. You are required to CALCULATE the Net Working Capital Requirement on Cash Cost Basis.

Miscellaneous

10. (i) "The profit maximization is not an operationally feasible criterion." IDENTIFY.

(ii) EXPLAIN the basics of debt securitisation process.

SUGGESTED HINTS/ANSWERS

1. Ratios for the year 2019-2020

(a) Inventory turnover ratio

$$= \frac{\text{COGS}}{\text{Average Inventory}} = \frac{₹\ 21,100}{\frac{₹\ (2,500 + 2,000)}{2}} = 9.4$$

(b) Financial leverage

$$= \frac{\text{EBIT}}{\text{EBT}} = \frac{₹\ 950}{₹\ 650} = 1.46$$

(c) ROCE

$$= \frac{\text{EBIT (1-t)}}{\text{Average Capital Employed}} = \frac{₹\ 950\ (1-0.3)}{₹\left(\frac{6,000+5,500}{2}\right)} = \frac{₹\ 665}{₹\ 5,750} \times 100 = 11.56\ \%$$

[Here Return on Capital Employed (ROCE) is calculated after Tax]

(d) ROE

$$= \frac{\text{Profits after tax}}{\text{Average shareholders' funds}} = \frac{₹\ 455}{₹\ 2,500} \times 100 = 18.2\%$$

(e) Average Collection Period

$$\text{Average Sales per day} = \frac{₹\ 23,800}{365} = ₹\ 65.20 \text{ lakhs}$$

© The Institute of Chartered Accountants of India

$$\text{Average collection period} = \frac{\text{Average Receivables}}{\text{Average sales per day}}$$

$$= \frac{\frac{₹(1,400+1,100)}{2}}{₹\,65.2} = \frac{₹\,1,250}{₹\,65.2} = 19.17\text{days}$$

2. (i) **Computation of Weighted Average Cost of Capital based on existing capital structure**

Source of Capital	Existing Capital structure (₹)	Weights (a)	After tax cost of capital (%) (b)	WACC (%) (a) × (b)
Equity share capital (W.N.1)	2,00,00,000	0.555	10.00	5.55
11.5% Preference share capital	60,00,000	0.167	11.50	1.92
10% Debentures (W.N.2)	1,00,00,000	0.278	6.50	1.81
	3,60,00,000	1.000		9.28

Working Notes (W.N.):

1. **Cost of equity capital:**

$$K_e = \frac{\text{Expected Dividend}(D_1)}{\text{Current Market Price per share}(P_0)} + \text{Growth}(g)$$

$$= \frac{₹10}{₹200} + 0.05 = 10\%$$

2. **Cost of 10% Debentures:**

$$= \frac{I(1-t)}{NP} = \frac{₹10,00,000(1-0.35)}{₹1,00,00,000} = 0.065 \text{ or } 6.5\%$$

(ii) **Computation of Weighted Average Cost of Capital based on new capital structure**

Source of Capital	New Capital structure (₹)	Weights (b)	After tax cost of capital (%) (a)	WACC (%) (a) × (b)
Equity share capital (W.N. 3)	2,00,00,000	0.488	12.75	6.10
Preference share	60,00,000	0.146	11.50	1.68

© The Institute of Chartered Accountants of India

10% Debentures (W.N. 2)	1,00,00,000	0.244	6.50	1.59
12% Debentures (W.N.4)	50,00,000	0.122	7.80	0.95
	4,10,00,000	1.00		10.32

Working Notes (W.N.):

3. Cost of equity capital:

$$K_e = \frac{\text{Expected Dividend}(D_1)}{\text{Current Market Price per share}(P_0)} + \text{Growth}(g)$$

$$= \frac{₹12.4}{₹160} + 0.05 = 0.1275 \text{ or } 12.75\%$$

4. Cost of 12% Debentures

$$= \frac{₹6,00,000(1-0.35)}{₹50,00,000} = 0.078 \text{ or } 7.8\%$$

$$K_d = \frac{₹2,40,000(1\text{-}0.35)}{₹20,00,000} = 0.078 \text{ or } 7.8\%$$

3. Computation of level of earnings before interest and tax (EBIT)

In case, alternative (i) is accepted, then the EPS of the firm would be:

$$\text{EPS}_{\text{Alternative (i)}} = \frac{(\text{EBIT} - \text{Interest})\ (1 - \text{tax rate})}{\text{No. of equity shares}}$$

$$= \frac{(\text{EBIT} - 0.12 \times ₹40,00,000)\ (1-0.35)}{60,000 \text{ shares}}$$

In case, alternative (ii) is accepted, then the EPS of the firm would be:

$$\text{EPS}_{\text{Alternative (ii)}} = \frac{(\text{EBIT} - 0.12 \times ₹40,00,000)(1-0.35) - (0.14 \times ₹20,00,000)}{40,000 \text{ shares}}$$

In order to determine the indifference level of EBIT, the EPS under the two alternative plans should be equated as follows:

$$\frac{(\text{EBIT} - 0.12 \times ₹40,00,000)(1-0.35)}{60,000 \text{ shares}} = \frac{(\text{EBIT} - 0.12 \times ₹40,00,000)(1-0.35) - (0.14 \times ₹20,00,000)}{40,000 \text{ shares}}$$

Or $\frac{0.65 \text{ EBIT} - ₹3,12,000}{3} = \frac{0.65 \text{ EBIT} - ₹5,92,000}{2}$

Or 1.30 EBIT – ₹6,24,000 = 1.95 EBIT – ₹17,76,000

Or (1.95 – 1.30) EBIT = ₹17,76,000 – ₹6,24,000 = ₹11,52,000

© The Institute of Chartered Accountants of India

Or EBIT $= \frac{₹11,52,000}{0.65}$

Or EBIT = ₹17,72,308

4. Computation of Profits after Tax (PAT)

Particulars	Amount (₹)
Sales	84,00,000
Contribution (Sales × P/V ratio)	23,14,200
Less: Fixed cost (excluding Interest)	(6,96,000)
EBIT (Earnings before interest and tax)	16,18,200
Less: Interest on debentures (12% × ₹37 lakhs)	(4,44,000)
Less: Other fixed Interest (balancing figure)	(88,160)
EBT (Earnings before tax)	10,86,040*
Less: Tax @ 40%	4,34,416
PAT (Profit after tax)	6,51,624

(i) Operating Leverage:

$$= \frac{\text{Contribution}}{\text{EBIT}} = \frac{₹23,14,200}{₹16,18,200} = 1.43$$

(ii) Combined Leverage:

= Operating Leverage × Financial Leverage

= 1.43 × 1.49 = 2.13

Or,

$$\text{Combined Leverage} = \frac{\text{Contribution}}{\text{EBIT}} \times \frac{\text{EBIT}}{\text{EBT}}$$

$$\text{Combined Leverage} = \frac{\text{Contribution}}{\text{EBT}} = \frac{₹23,14,200}{₹10,86,040} = 2.13$$

$$^{*}\text{Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}} = \frac{₹16,18,200}{\text{EBT}} = 1.49$$

$$\text{So, EBT} = \frac{₹16,18,200}{1.49} = ₹10,86,040$$

Accordingly, other fixed interest

= ₹ 16,18,200 - ₹ 10,86,040 - ₹ 4,44,000 = ₹ 88,160

(iii) Earnings per share (EPS):

$$= \frac{\text{PAT}}{\text{No. of shares outstanding}} = \frac{₹\ 6{,}51{,}624}{5{,}00{,}000 \text{ equity shares}} = ₹\ 1.30$$

5. (i) Calculation of Net Cash Flow

(₹ in lakhs)					
Year	**Profit before dep. and tax**	**Depreciation (20% on WDV)**	**PBT**	**PAT**	**Net cash flow**
(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(3) + (5)**
1	320	800 × 20% = 160	160	96	256
2	320	(800 – 160)× 20% = 128	192	115.20	243.20
3	360	(640 – 128)× 20% = 102.4	257.6	154.56	256.96
4	360	(512 – 102.4)× 20% = 81.92	278.08	166.85	248.77
5	300	(409.6 – 81.92) = 327.68*	–27.68	–16.61	311.07

*this is treated as a short term capital loss.

(ii) Calculation of Net Present Value (NPV)

(₹ in lakhs)

Year	**Net Cash Flow**	**12%**		**16%**		**20%**	
		D.F	**P.V**	**D.F**	**P.V**	**D.F**	**P.V**
1	256	0.89	227.84	0.86	220.16	0.83	212.48
2	243.20	0.80	194.56	0.74	179.97	0.69	167.81
3	256.96	0.71	182.44	0.64	164.45	0.58	149.03
4	248.77	0.64	159.21	0.55	136.82	0.48	119.41
5	311.07	0.57	177.31	0.48	149.31	0.40	124.43
			941.36		850.71		773.16
	Less: Initial Investment		800.00		800.00		800.00
		NPV	141.36		50.71		-26.84

(iii) Advise: Since Net Present Value of the project at 12% = 141.36 lakhs, therefore the project should be implemented.

(iv) Calculation of Internal Rate of Return (IRR)

$$\text{IRR} = 16\% + \frac{50.71 \times 4}{50.71 - (-26.84)}$$

$$= 16\% + \frac{2.03}{77.55} = 16\% + 2.62\% = 18.62\%.$$

6. In case of customer A, there is no increase in sales even if the credit is given. Hence comparative statement for B & C is given below:

Particulars	Customer B				Customer C			
1. Credit period (days)	0	30	60	90	0	30	60	90
2. Sales Units	10,000	15,000	20,000	25,000	-	-	10,000	15,000
	₹ in lakh				₹in lakh			
3. Sales Value	1,500	2,250	3,000	3,750	-	-	1,500	2,250
4. Contribution at 50% (A)	750	1,125	1,500	1,875	-	-	750	1,125
5. Receivables:- $\frac{\text{Credit Period} \times \text{Sales}}{360}$	-	187.5	500	937.5	-	-	250	562.5
6. Debtors at cost	-	93.75	250	468.75	-	-	125	281.25
7. Cost of carrying debtors at 20% (B)	-	18.75	50	93.75	-	-	25	56.25
8. Excess of contributions over cost of carrying debtors (A – B)	750	1,106.25	1,406.25	1,781.25	-	-	725	1,068.75

The excess of contribution over cost of carrying Debtors is highest in case of credit period of 90 days in respect of both the customers B and C. Hence, credit period of 90 days should be allowed to B and C.

7. Determination of Net Present Value (NPV)

Year	Expected Cash flow (₹)	Certainty-equivalent (CE)	Adjusted Cash flow (Cash flow × CE) (₹)	PV factor (at 0.06)	Total PV (₹)
0	(8,00,000)	1.0	(8,00,000)	1.000	(8,00,000)
1	6,40,000	0.8	5,12,000	0.943	4,82,816
2	5,60,000	0.7	3,92,000	0.890	3,48,880
3	5,20,000	0.6	3,12,000	0.840	2,62,080

4	4,80,000	0.4	1,92,000	0.792	1,52,064
5	3,20,000	0.3	96,000	0.747	71,712
	NPV = (13,17,552 – 8,00,000)				5,17,552

As the Net Present Value is positive the project should be accepted.

8. (i) Walter's model is given by –

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

Where,

P = Market price per share,

E = Earnings per share = ₹ 10,00,000 ÷ 50,000 = ₹ 20

D = Dividend per share = 50% of 20 = ₹ 10

r = Return earned on investment = 12%

K_e = Cost of equity capital = 10%

$$\therefore\ P = \frac{10 + (20 - 10) \times \frac{0.12}{0.10}}{0.10} = \frac{22}{0.10} = ₹\ 220$$

(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:

$$\frac{0 + (20 - 0) \times \frac{0.12}{0.10}}{0.10} = \frac{24}{0.10} = ₹\ 240$$

9. Calculation of Net Working Capital requirement:

	(₹)	**(₹)**
A. Current Assets:		
Inventories:		
Stock of Raw material (Refer to Working note (iii)	1,44,000	
Stock of Work in progress (Refer to Working note (ii)	7,50,000	
Stock of Finished goods (Refer to Working note (iv)	20,40,000	
Debtors for Sales(Refer to Working note (v)	1,02,000	
Cash	2,00,000	
Gross Working Capital	32,36,000	32,36,000

© The Institute of Chartered Accountants of India

B. Current Liabilities:		
Creditors for Purchases (Refer to Working note (vi)	1,56,000	
Creditors for wages (Refer to Working note (vii)	23,250	
	1,79,250	1,79,250
Net Working Capital (A - B)		**30,56,750**

Working Notes:

(i) Annual cost of production

	(₹)
Raw material requirements {(31,200 × ₹ 40) + (12,000 x ₹ 40)}	17,28,000
Direct wages {(31,200 ×₹ 15) +(12,000 X ₹ 15 x 0.5)}	5,58,000
Overheads (exclusive of depreciation) {(31,200 × ₹ 30) + (12,000 x ₹ 30 x 0.5)}	11,16,000
Gross Factory Cost	34,02,000
Less: Closing W.I.P [12,000 (₹ 40 + ₹ 7.5 + ₹15)]	(7,50,000)
Cost of Goods Produced	26,52,000
Less: Closing Stock of Finished Goods (₹ 26,52,000 × 24,000/31,200)	(20,40,000)
Total Cash Cost of Sales*	6,12,000

[*Note: Alternatively, Total Cash Cost of Sales = (31,200 units – 24,000 units) x (₹ 40 + ₹ 15 + ₹ 30) = ₹ 6,12,000]

(ii) Work in progress stock

	(₹)
Raw material requirements (12,000 units × ₹40)	4,80,000
Direct wages (50% × 12,000 units × ₹ 15)	90,000
Overheads (50% × 12,000 units × ₹ 30)	1,80,000
	7,50,000

(iii) Raw material stock

It is given that raw material in stock is average 30 days consumption. Since, the company is newly formed; the raw material requirement for production and work in progress will be issued and consumed during the year. Hence, the raw material consumption for the year (360 days) is as follows:

© The Institute of Chartered Accountants of India

	(₹)
For Finished goods (31,200 × ₹ 40)	12,48,000
For Work in progress (12,000 × ₹ 40)	4,80,000
	17,28,000

Raw material stock = $\frac{₹17,28,000}{360\,\text{days}} \times 30\,\text{days}$ = ₹1,44,000

(iv) Finished goods stock:

24,000 units @ ₹ (40+15+30) per unit = ₹20,40,000

(v) Debtors for sale: $₹\,6,12,000 \times \frac{60\,\text{days}}{360\,\text{days}} = ₹\,1,02,000$

(vi) Creditors for raw material Purchases [Working Note (iii)]:

Annual Material Consumed (₹12,48,000 + ₹4,80,000)	₹17,28,000
Add: Closing stock of raw material [(₹17,28,000 x 30 days) / 360 days]	₹ 1,44,000
	₹18,72,000

Credit allowed by suppliers = $\frac{₹18,72,000}{360\,\text{days}} \times 30\,\text{days}$ = ₹ 1,56,000

(vii) Creditors for wages:

Outstanding wage payment = [(31,200 units x ₹ 15) + (12,000 units x ₹ 15 x .50)] x 15 days / 360 days

= $\frac{₹\,5,58,000}{360\,\text{days}} \times 15\,\text{days}$ = ₹ 23,250

10. (i) The profit maximisation is not an operationally feasible criterion." This statement is true because profit maximisation can be a short-term objective for any organisation and cannot be its sole objective. Profit maximization fails to serve as an operational criterion for maximizing the owner's economic welfare. It fails to provide an operationally feasible measure for ranking alternative courses of action in terms of their economic efficiency. It suffers from the following limitations:

(a) Vague term: The definition of the term profit is ambiguous. Does it mean short term or long term profit? Does it refer to profit before or after tax? Total profit or profit per share?

(b) Timing of Return: The profit maximization objective does not make distinction between returns received in different time periods. It gives no consideration to the time value of money, and values benefits received today and benefits received after a period as the same.

© The Institute of Chartered Accountants of India

(c) It ignores the risk factor.

(d) The term maximization is also vague.

(ii) Process of Debt Securitisation:

(a) *The origination function* – A borrower seeks a loan from a finance company or a bank. The credit worthiness of borrower is evaluated and contract is entered into with repayment schedule structured over the life of the loan.

(b) *The pooling function* – Similar loans on receivables are clubbed together to create an underlying pool of assets. The pool is transferred in favour of Special purpose Vehicle (SPV), which acts as a trustee for investors.

(c) *The securitisation function* – SPV will structure and issue securities on the basis of asset pool. The securities carry a coupon and expected maturity which can be asset-based/mortgage based. These are generally sold to investors through merchant bankers. Investors are – pension funds, mutual funds, insurance funds.

The process of securitization is generally without recourse i.e. investors bear the credit risk and issuer is under an obligation to pay to investors only if the cash flows are received by him from the collateral. The benefits to the originator are that assets are shifted off the balance sheet, thus giving the originator recourse to off-balance sheet funding.

© The Institute of Chartered Accountants of India

SECTION: B: ECONOMICS FOR FINANCE

QUESTIONS

1. (a) Calculate the Operating Surplus with the help of following data-

Particulars	₹ (In Crore)
Sales	4,000
Compensation to employees	800
Intermediate consumption	600
Rent	400
Interest	300
Net indirect taxes	500
Consumption of fixed capital	200
Mixed income	400

(b) Why do pensions and other security payments get excluded while calculating National Income?

2. (a) Suppose you are given following information-

Consumption function $C = 10 + 0.8Y_d$

Tax $T = 50$

Investment spending $I = 135$

Government Spending $G = 60$

Exports $X = 35$

Imports $M = 0.05\ Y$

Where Y and Y_d are income and personal disposable income respectively.

Find the equilibrium level of income and net exports.

(b) How are the following transactions treated in national income calculation? What is the rationale in each case?

i. Electricity sold to a steel plant.

ii. Electric power sold to a consumer household.

iii. A car manufacturer procuring parts and components from the market.

iv. A computer producer buys a robot produced in the same country and uses it in production of computers.

© The Institute of Chartered Accountants of India

3. (a) Government's stabilization intervention may be through monetary policy as well as fiscal policy. How ?

   (b) How do government correct market failure resulting from demerits goods?

4. (a) Reflect on the externalities presents in each of the following. Also examine their market implications-

   i. A decision to stop smoking

   ii Switching from conventional farming to organic farming

   iii Started to drive a car and increased road congestion

   iv Water polluted by industries

   v Building Lighthouse

   (b) Suppose country X is passing through recession, what type of tax policy should be framed during this period?

5. How does the monetary policy influence the price level and the national income?

6. (a) Answer the following question using Keynesian framework of demand for money.

   An investment consultant suggests holding of cash instead of bonds. What could be the reason to encourage holding of money balances? Explain

   (b) Calculate liquidity aggregate L2 when the following information is given-

Particulars	₹ in crore
Term deposits with term lending institutions	750
Term borrowing by refinancing institutions	450
All deposits with post office savings banks	1320
Term deposits with refinancing institutions	590
Certificate of deposits issued by FIs	290
Public deposits of non-banking financial companies	450
NM3	2650
National saving certificates	240

7. (a) Explain how a tariff levied on an imported product affects both the country exporting a product and the country importing that product.

   (b) Why GATT lost its relevance by 1980?

8 Even if one nation is less efficient than the other nation in the production of all commodities, there is still scope for mutually beneficial trade. Explain in detail.

© The Institute of Chartered Accountants of India

9. Many apprehensions have been raised in respect of the WTO and its ability to maintain and extend a system of liberal world trade. Comment.

10. (a) Explain the principle motivations of a country seeking FDI?

    (b) Explain the role of Liquidity Adjustment Facility (LAF).

SUGGESTED ANSWERS/ HINTS

1. (a) GVA_{MP} = Gross Value $Output_{MP}$ – Intermediate consumption

= (Sales + change in stock) – Intermediate consumption

= 4000-600 = 3400 crore

$GDP_{MP} = GVA_{MP}$ = 3400 crore

$NDP_{MP} = GDP_{MP}$ – consumption of fixed capital

= 3400 – 200

= 3200 crore

$NDP_{FC} = NDP_{MP}$ – NIT

= 3200 – 500

= 2700 crore

NDP_{FC} = Compensation of employees + Operating surplus + Mixed income

2700 = 800 + Operating Surplus + 400

Operating surplus = 1500 crore

(b) GDP measures what is produced or created over the current time period and excludes all non-production transactions. Only incomes earned by owners of primary factors of production for services rendered in production are included in national income. Transfer payments, both private and government, are made without goods or services being received in return. These payments do not correspond to return for contribution to production because they do not directly absorb resources or create output. Therefore, transfer incomes such as pensions and other social security payments are excluded from national income.

2. (a) Here,

$C = 10 + 0.8Y_d$

$= 10+0.8\,(Y - 50)$

$Y = C + I + G + (X - M)$

$= 10 + 0.8(Y - 50) + 135 + 60 + (35 – 0.05Y)$

© The Institute of Chartered Accountants of India

$$Y - 0.8Y + 0.05Y = 10 - 40 + 135 + 60 + 35$$

$$0.25Y = 200$$

$$Y = 800$$

$$\text{Net Exports} = (X - M) = 35 - 0.05Y$$

$$35 - 0.05 \times 800 = -5$$

Thus, Trade is in deficit.

(b) **i** Being an intermediate good, electricity sold to a steel plant will not be included in national income calculation. The underlying principle is that only finished goods and services which are directly sold to the consumer for final consumption would be included.

ii. Electric power sold to a consumer household would be included in the calculation of GDP since it is a final good consumed by the end user.

iii. The value of parts and components procured from the market by a car manufacturer will not be included in national income calculation because these are intermediate goods used in car production.

iv. The value of the robot bought by a computer producer for use in the production of computers would be included in national income calculation because the computer producer is the "final consumer" of the robot and the robot is not resold in the market after value addition.

3. **(a)** Government's stabilization intervention may be through monetary policy as well as through fiscal policy. Monetary policy has a singular objective of controlling the size of money supply and interest rate in the economy which in turn would affect consumption, investment and prices. On the other hand, Fiscal policy for stabilization purposes attempts to direct the actions of individuals and organizations by means of its expenditure and taxation decisions. On the expenditure side, Government can choose to spend in such a way that it stimulates other economic activities. For example, government expenditure on building infrastructure may initiate a series of productive activities. Production decisions, investments, savings etc can be influenced by its tax policies.

(b) Demerit goods are goods which impose significant negative externalities on the society as a whole and are believed to be socially undesirable. The production and consumption of demerit goods are likely to be more than optimal under free markets. The government should therefore intervene in the marketplace to discourage their production and consumption. The Governments correct market failure resulting from demerit goods in the following way-

- At the extreme, government may enforce complete ban on a demerit good. e.g. Intoxicating drugs. In such cases, the possession, trading or consumption of the

© The Institute of Chartered Accountants of India

good is made illegal.

- Through persuasion which is mainly intended to be achieved by negative advertising campaigns which emphasize the dangers associated with consumption of demerit goods.
- Through legislations that prohibit the advertising or promotion of demerit goods in whatsoever manner.
- Strict regulations of the market for the good may be put in place so as to limit access to the good, especially by vulnerable groups such as children and adolescents.
- Regulatory controls in the form of spatial restrictions e.g. smoking in public places, sale of tobacco to be away from schools, and time restrictions under which sale at particular times during the day is banned.

4. **(a)** **(i)** A decision to stop smoking – positive consumption externalities – as it causes benefits to other people in society who have been suffering from passive smoking.

(ii) Switching from conventional farming to organic farming- positive production externalities -as it helps the environment as there are fewer chemicals in the environment.

(iii) Started to drive a car and increased road congestion– negative consumption externalities – as individual consume road space they reduce available road space and deny this space to others.

(iv) Water polluted by industries- negative production externalities –as it adds effluent which harms plants, animals and humans.

(v) Building Lighthouse – free rider problem- as all sailors will benefit from its illumination – even if they don't pay towards its upkeep.

(b) During recession the tax policy is framed to encourage private consumption and investment. A general reduction in income taxes leaves higher disposable incomes with people inducing higher consumption. Low corporate taxes increase the prospects of profits for business and promote further investment. The extent of tax reduction required depends on the size of the recessionary gap and the magnitude of the multiplier.

5. The process or channels through which the change of monetary aggregates affects the level of product and prices is known as 'monetary transmission mechanism'. There are mainly four different mechanisms through which monetary policy influences the price level and the national income. These are: (a) the interest rate channel, (b) the exchange rate channel, (c) the quantum channel (e.g., relating to money supply and credit), and (d) the asset price channel i.e. via equity and real estate prices.

© The Institute of Chartered Accountants of India

Under the interest rate channel, changes in monetary policy are eventually reflected in the real long-term interest rates which influence aggregate demand by altering business investment and durable consumption decisions. This, in turn, gets reflected in aggregate output and prices.

The exchange rate channel works through expenditure switching between domestic and foreign goods. Appreciation of the domestic currency makes domestically produced goods more expensive compared to foreign-produced goods. This causes net exports to fall; correspondingly domestic output and employment also fall.

The Quantum channel operates by altering access of firms and households to bank credit. Most businesses and people mostly depend on bank for borrowing money. "An open market operation" that leads first to a contraction in the supply of bank reserves and then to a contraction in bank credit requires banks to cut back on their lending. This, in turn makes the firms that are especially dependent on banks loans to cut back on their investment spending. Thus, there is decline in the aggregate output and employment following a monetary contraction.

The asset price channel suggests that asset prices respond to monetary policy changes and consequently affect output, employment and inflation.

6. **(a)** The market value of bonds and the market rate of interest are inversely related. The investment consultant considers the current interest rate as low, compared to the 'normal or critical rate of interest', i.e., he expects the rate of interest to rise in future (fall in bond prices), and therefore it is advantageous to hold wealth in the form of liquid cash rather than bonds because:

(i) when interest is low, the loss suffered by way of interest income forgone is small,

(ii) one can avoid the capital losses that would result from the anticipated increase in interest rates, and

(iii) the return on money balances will be greater than the return on alternative assets

(iv) if the interest rate does increase in future, the bond prices will fall and the idle cash balances held can be used to buy bonds at lower price and can thereby make a capital-gain.

(b) L2 = L1 + Term deposits with term lending institutions + Term deposits with refinancing institutions + Term borrowing by refinancing institutions + Certificate of deposits issued by FIs

Where L1 = NM3 + All deposits with post office savings banks

= 2650 + 1320

= 3970 crore

Therefore L2 = 3970 + 750 +590 + 450 + 290

© The Institute of Chartered Accountants of India

= 6050 crore

7. **(a)** A tariff levied on an imported product affects both the country exporting a product and the country importing that product. (i) Tariff barriers create obstacles to trade, decrease the volume of imports and exports and therefore of international trade. The prospect of market access of the exporting country is worsened when an importing country imposes a tariff. (ii) By making imported goods more expensive, tariffs discourage domestic consumers from consuming imported foreign goods. Domestic consumers suffer a loss in consumer surplus because they must now pay a higher price for the good and also because compared to free trade quantity, they now consume lesser quantity of the good. (iii) Tariffs encourage consumption and production of the domestically produced import substitutes and thus protect domestic industries. (iv)Producers in the importing country experience an increase in well-being as a result of imposition of tariff. The price increase of their product in the domestic market increases producer surplus in the industry. They can also charge higher prices than would be possible in the case of free trade because foreign competition has reduced. (v) The price increase also induces an increase in the output of the existing firms and possibly addition of new firms due to entry into the industry to take advantage of the new high profits and consequently an increase in employment in the industry. (vi)Tariffs create trade distortions by disregarding comparative advantage and prevent countries from enjoying gains from trade arising from comparative advantage. Thus, tariffs discourage efficient production in the rest of the world and encourage inefficient production in the home country. (vii) Tariffs increase government revenues of the importing country by the value of the total tariff it charges.

(b) The GATT lost its relevance by 1980s because-

(i) It was obsolete to the fast evolving contemporary complex world trade scenario characterized by emerging globalization.

(ii) International investments had expanded substantially.

(iii) Intellectual property rights and trade in services were not covered by GATT.

(iv) World merchandise trade increased by leaps and bounds and was beyond its scope.

(v) The ambiguities in the multilateral system could be heavily exploited.

(vi) Efforts at liberalizing agricultural trade were not successful.

(vii) There were inadequacies in institutional structure and dispute settlement system.

(viii) It was not a treaty and therefore terms of GATT were binding only insofar as they are not incoherent with a nation's domestic rules.

© The Institute of Chartered Accountants of India

8. Yes, there is still scope for mutually beneficial trade. The first step is that nation should specialize in the production and export of the commodity in which its absolute disadvantage is smaller and import the commodity in which its absolute disadvantage is greater. This can be explained with the help of an example (Theory of Comparative Advantage).

9. The major issues are:

(i) The progress of multilateral negotiations on trade liberalization is very slow and the requirement of consensus among all members acts as a constraint and creates rigidity in the system. As a result, countries find regionalism a plausible alternative.

(ii) The complex network of regional agreements introduces uncertainties and murkiness in the global trade system.

(iii) While multilateral efforts have effectively reduced tariffs on industrial goods, the achievement in liberalizing trade in agriculture, textiles, and apparel, and in many other areas of international commerce has been negligible.

(iv) The latest negotiations, such as the Doha Development Round, have run into problems, and their definitive success is doubtful.

(v) Most countries, particularly developing countries are dissatisfied with the WTO because, in practice, most of the promises of the Uruguay Round agreement to expand global trade has not materialized.

(vi) The developing countries have raised a number of concerns and a few are presented here:

- The real expansion of trade in the three key areas of agriculture, textiles and services has been dismal.
- Protectionism and lack of willingness among developed countries to provide market access on a multilateral basis has driven many developing countries to seek regional alternatives.
- The developing countries have raised a number of issues in the Doha Agenda in respect of the difficulties that they face in implementing the present agreements.
- The North-South divide apparent in the WTO ministerial meets has fuelled the apprehension of developing countries about the prospect of trade expansion under the WTO regime.
- Developing countries complain that they face exceptionally high tariffs on selected products in many markets and this obstructs their vital exports.
- Another major issue concerns 'tariff escalation' where an importing country protects its processing or manufacturing industry by setting lower duties on imports of raw materials and components, and higher duties on finished products.

© The Institute of Chartered Accountants of India

- There is also possible erosion of preferences i.e. the special tariff concessions granted by developed countries on imports from certain developing countries have become less meaningful because of the narrowing of differences between the normal and preferential rates.
- The least-developed countries find themselves disproportionately disadvantaged and vulnerable with regard to adjustments due to lack of human as well as physical capital, poor infrastructure, inadequate institutions, political instabilities etc.

10. (a) Motivations for a country seeking investments occurs when:

I. Producers have saturated sales in their home market

II. Firms want to ensure market growth and to find new buyers and larger markets with sizable population.

III. Technological developments and economies arising from large scale production necessitate greater ability of the market to support the expected demand on which the investment is based. The minimum size of market needed to support technological development in certain industries is sometimes larger than the largest national market.

IV. There are substantial barriers to exporting from the home country

V. Firms identify country-specific consumer preferences and favourable structure of markets elsewhere.

VI. Firms realize that their products are unique or superior and that there is scope for exploiting this opportunity by extending to other regions.

(b) RBI has introduced Liquidity Adjustment Facility (LAF) in 2000. The Liquidity Adjustment Facility(LAF) is a facility extended by the Reserve Bank of India to the scheduled commercial banks (excluding RRBs) and primary dealers to avail of liquidity in case of requirement (or park excess funds with the RBI in case of excess liquidity) on an overnight basis against the collateral of government securities including state government securities. The introduction of LAF is an important landmark since it triggered a rapid transformation in the monetary policy operating environment in India. As a key element in the operating framework of the RBI, its objective is to assist banks to adjust their day to day mismatches in liquidity. Currently, the RBI provides financial accommodation to the commercial banks through repos/reverse repos under the Liquidity Adjustment Facility (LAF).

© The Institute of Chartered Accountants of India