

PAPER – 5: ADVANCED ACCOUNTING

PART – I: ANNOUNCEMENTS STATING APPLICABILITY & NON-APPLICABILITY FOR NOVEMBER, 2016 EXAMINATION

A. Applicable for November, 2016 Examination

(i) Companies Act, 2013

Relevant Sections of the Companies Act, 2013 notified up to 30th April, 2016 will be applicable for November, 2016 Examination.

(ii) Maintenance of Statutory Liquidity Ratio (SLR)

As per Notification No. DBR.No.Ret.BC.64/12.01.001/2015-16 dated December 10, 2015, the SLR of Scheduled Commercial Banks, Local Area Banks, primary (Urban) co-operative banks (UCBs), state co-operative banks and central co-operative banks from 21.5 per cent of their Net Demand and Time Liabilities (NDTL) to:

- (i) 21.25 per cent from April 2, 2016;
- (ii) 21.00 per cent from July 9, 2016;
- (iii) 20.75 per cent from October 1, 2016; and
- (iv) 20.50 per cent from January 7, 2017

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.

Students may note that SLR of 21.25% SLR is applicable for November, 2016 exam.

(iii) Maintenance of Cash Reserve Ratio (CRR)

Reserve Bank of India has decided to reduce the Cash Reserve Ratio (CRR) of Scheduled Commercial Banks by 25 basis points from 4.25 per cent to **4.00 per cent 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 3.00 per cent of its net demand and time liabilities up to February 08, 2013 and 4.00 per cent of its net demand and time liabilities from the fortnight beginning from February 09, 2013.

B. Not applicable for November, 2016 examination

I. Non-Applicability of Ind ASs for November, 2016 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 have not been made applicable for November, 2016 Examination.

II. Non-applicability of Amendments made by MCA in the Companies (Accounting Standards) Rules, 2006 and Companies (Indian Accounting Standards) Rules, 2015

Amendments made by MCA on 30.3.2016 in the Companies (Accounting Standards) Rules, 2006 and Companies (Indian Accounting Standards) Rules, 2015 have not been made applicable for November, 2016 examination.

PART – II : QUESTIONS AND ANSWERS

QUESTIONS

Partnership Accounts

Dissolution of a partnership firm

1. A partnership firm was dissolved on 30th June, 2016. Its Balance Sheet on the date of dissolution was as follows:

Liabilities	₹	₹	Assets	₹
Capitals:			Cash	10,800
A	76,000		Sundry Assets	1,89,200
B	48,000			
C	<u>36,000</u>	1,60,000		
Loan A/c – B		10,000		
Sundry Creditors		<u>30,000</u>		
		<u>2,00,000</u>		<u>2,00,000</u>

The assets were realized in instalments and the payments were made on the proportionate capital basis. Creditors were paid ₹ 29,000 in full settlement of their account. Expenses of realization were estimated to be ₹ 5,400 but actual amount spent was ₹ 4,000. This amount was paid on 15th September. Draw up a statement showing distribution of cash, which was realized as follows:

	₹
On 5 th July, 2016	25,200
On 30 th August, 2016	60,000
On 15 th September, 2016	80,000

The partners shared profits and losses in the ratio of 2 : 2 : 1. Prepare a statement showing distribution of cash amongst the partners by 'Highest Relative Capital' method.

Amalgamation of partnership firms

2. Vinod and Raj are partners of M/s Vinod and Co., sharing profits and losses in the ratio of 3 : 1 and Raj and Kumar are partners of M/s Raj & Co., sharing profits and losses in the ratio of 2: 1. On 31st March, 2016, they decide to amalgamate and form a new firm M/s VRK & Co., wherein Vinod, Raj and Kumar would be partners sharing profits and losses in the ratio of 3 :2 :1. The Balance Sheets of two firms on the above date are as under:

Liabilities	Vinod & Co.	Raj & Co.	Assets	Vinod & Co.	Raj & Co.
	₹	₹		₹	₹
Capitals:			Fixed Assets:		
Vinod	9,60,000	–	Building	2,00,000	-
Raj	6,40,000	8,00,000	Machinery	6,00,000	6,40,000
Kumar	-	4,00,000	Furniture	80,000	24,000
Reserves	2,00,000	6,00,000	Current Assets:		
Creditors	4,80,000	4,64,000	Stock	4,80,000	5,60,000
Due to Vinod & Co.	-	4,00,000	Debtors	6,40,000	8,00,000
Bank Loan	3,20,000	-	Cash at Bank	1,20,000	3,60,000
			Cash in hand	80,000	40,000
			Due from Raj & Co.	4,00,000	-
			Advances	-	2,40,000
	26,00,000	26,64,000		26,00,000	26,64,000

The amalgamated firm took over the business on the following terms:

- Building of Vinod & Co., was valued at ₹ 4,00,000.
- Machinery of Vinod & Co., was valued at ₹ 9,00,000 and that of Raj & Co. at ₹ 8,00,000.
- Goodwill valued Vinod and Co. ₹ 2,00,000 and Raj & Co., ₹ 1,64,000 but the same will not appear in the books of VRK & Co.,
- Partners of the new firm will bring the necessary cash to pay other partners to adjust their capitals according to the profit sharing ratio.

You are required to pass journal entries in the books of M/s VRK & Co. and prepare the Balance Sheet as at 31.3.2016.

Conversion of Partnership firm to Company

3. A, B and C share profits and losses of a business as to 3:2:1 respectively. Their balance sheet as at 31st March, 2016 was as follows:

Liabilities	₹	Assets	₹
Capital Accounts:		Goodwill	10,000
A	70,000	Land	20,000
B	80,000	Buildings	1,10,000
C	10,000	Machinery	50,000
General Reserve	18,000	Motor Car	28,000
Investment Fluctuation Fund	4,000	Furniture	12,000
C Loan	33,000	Investments	18,000
Mrs. A's loan	15,000	Loose tools	7,000
Creditors	96,000	Stock	18,000
Bills Payable	14,000	Bills receivable	20,000
Bank overdraft	60,000	Debtors: 40,000	
		Less: Provision <u>2,000</u>	38,000
		Cash	1,000
		C's current A/c	56,000
		Profit and Loss A/c	<u>12,000</u>
	<u>4,00,000</u>		<u>4,00,000</u>

The partners decide to convert their firm into a Joint Stock Company. For this purpose ABC Ltd. was formed with an authorized capital of ₹ 10,00,000 divided into ₹ 100 equity Shares. The business of the firm was sold to the company as at the date of balance sheet given above on the following terms:

- Motor car, furniture, investments, loose tools, debtors and cash are not to be taken over by the company.
- Liabilities for bills payable and bank overdraft are to be taken over by the company.
- The purchase price is settled at ₹ 1,95,500 payable as to ₹ 75,500 in cash and the balance in company's fully paid shares of ₹ 100 each.
- The remaining assets and liabilities of the firm are directly disposed of by the firm as per details given below:

Investments are taken over by A for ₹ 13,000; debtors realize in all ₹ 20,000; Motor Car, furniture and loose tools fetch ₹ 24,000, ₹ 4,000, and ₹ 1,000 respectively. A agrees to pay his wife's loan. The creditors were paid ₹ 94,000 in final settlement of their claims. The realization expenses amount to ₹ 500.

- (v) The equity share received from the vendor company are to be divided among the partners in profit-sharing ratio.

You are required to prepare the necessary ledger accounts.

Sale of Partnership firm

4. Mohit, Neel and Om were Partners sharing Profits and Losses in the ratio of 5:3:2 respectively. The Trial Balance of the Firm 31st March, 2016 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/c:		
Mohit		1,36,000
Neel		90,000
Om		46,000
Drawing A/c:		
Mohit	50,000	
Neel	46,000	
Om	34,000	
Depreciation on Machinery		80,000
Profit for the year ended 31 st March		2,48,600
Cash at Bank	<u>1,78,600</u>	<u> </u>
	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 in shares of ₹ 10 each to be divided in different classes to take over the business of Partnership firm.

You are provided the following information:

- 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 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.

Employees Stock Option Plan

5. Kanika Ltd. provides you the following information:

No. of employees	2,500
No. of option to be granted to each employee	500
Vesting period	4 Years
No. of employees not expected to fulfill the vesting conditions other than market conditions	
1 st Year	20%
2 nd Year	15%
3 rd Year	10%
4 th Year	10%
Fair value of the option per share	₹ 5
Exercise Price	₹ 50
Exercise Period	3 Years
Face value of each share	₹ 10

At the end of third year it has been re-estimated that all vesting conditions have been fulfilled and no other further conditions are required for options to vest and 600 employees exercise their option at the end of 4th year, 800 employees exercise their option at the end of 5th year and 100 employees exercise their option at the end of 6th year. Rights of 30 employees expired unexercised at the end of the 6th year.

You are required to pass necessary journal entries for first 3 years.

Buy Back of Securities

6. Umesh Ltd. resolves to buy back 4 lakhs of its fully paid equity shares of ₹ 10 each at ₹ 22 per share. For the purpose, it issues 1 lakh 11 % preference shares of ₹ 10 each at par, the entire amount being payable with applications. The company uses ₹ 16 lakhs of its balance in Securities Premium Account apart from its adequate balance in General Reserve to fulfill the legal requirements regarding buy-back. Give necessary journal entries to record the above transactions.

Redemption of Debentures

7. Soumya Limited recently made a public issue in respect of which the following information is available:
- No. of partly convertible debentures issued 2,00,000; face value and issue price ₹ 100 per debenture.
 - Convertible portion per debenture 60%, date of conversion on expiry of 6 months from the date of closing of issue.
 - Date of closure of subscription lists 1.5.2015, date of allotment 1.6.2015, rate of interest on debenture 15% payable from the date of allotment, value of equity share for the purpose of conversion ₹ 60 (Face Value ₹ 10).
 - Underwriting Commission 2%.
 - No. of debentures applied for 1,50,000.
 - Interest payable on debentures half-yearly on 30th September and 31st March.

Write relevant journal entries for all transactions arising out of the above during the year ended 31st March, 2016 (including cash and bank entries).

Amalgamation of Companies

8. The following is the summarized Balance Sheet of A Ltd. as at 31st March, 2016:

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

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

- (1) B Ltd. would take over all assets, except bank balance at their book values less 10%. Goodwill is to be valued at 4 year's purchase of super profits, assuming that the normal rate of return be 8% on the combined amount of share capital and general reserve.
- (2) B Ltd. is to take over trade payables at book value.
- (3) The purchase consideration is to be paid in cash to the extent of ₹ 6,00,000 and the balance in fully paid equity shares of ₹ 100 each at ₹ 125 per share.

The average profit is ₹ 1,24,400. The liquidation expenses amounted to ₹ 16,000. B Ltd. sold prior to 31st March, 2015 goods costing ₹ 1,20,000 to A Ltd. for ₹ 1,60,000. ₹ 1,00,000 worth of goods are still in Inventory of A Ltd. on 31st March, 2015. Trade payables of A Ltd. include ₹ 40,000 still due to B Ltd.

Show the necessary Ledger Accounts to close the books of A Ltd. and prepare the Balance Sheet of B Ltd. as at 1st April, 2016 after the takeover.

Internal Reconstruction of a Company

9. The summarised Balance Sheet of M/s. Ice Ltd. as on 31-03-2016 is given below:

Liabilities	₹	Assets	₹
1,00,000 Equity shares of ₹ 10 each fully paid up	10,00,000	Freehold property	5,50,000
4,000, 8% Preference shares of ₹ 100 each fully paid	4,00,000	Plant and machinery	2,00,000
6% Debentures 4,00,000 (secured by freehold property)		Trade investment (at cost)	2,00,000
Arrear interest <u>24,000</u>	4,24,000	Trade receivables	4,50,000
Trade payables	1,01,000	Inventories-in trade	3,00,000
Director's loan	<u>3,00,000</u>	Profit and loss account	5,25,000
	<u>22,25,000</u>		<u>22,25,000</u>

The Board of Directors of the company decided upon the following scheme of reconstruction with the consent of respective stakeholders:

- (i) Preference shares are to be written down to ₹ 80 each and equity shares to ₹ 2 each.
- (ii) Preference dividend in arrear for 3 years to be waived by 2/3rd and for balance 1/3rd, equity shares of ₹ 2 each to be allotted.

- (iii) Debentureholders agreed to take one freehold property at its book value of ₹ 3,00,000 in part payment of their holding. Balance debentures to remain as liability of the company.
- (iv) Arrear debenture interest to be paid in cash.
- (v) Remaining freehold property to be valued at ₹ 4,00,000.
- (vi) Investment sold out for ₹ 2,50,000.
- (vii) 75% of Director's loan to be waived and for the balance, equity shares of ₹ 2 each to be allotted.
- (viii) 40% of Trade receivables, 80% of Inventories and 100% of debit balance of profit and loss account to be written off.
- (ix) Company's contractual commitments amounting to ₹ 6,00,000 have been settled by paying 5% penalty of contract value.

Show the Journal Entries for giving effect to the internal re-construction and draw the Balance Sheet of the company after effecting the scheme.

Liquidation of Company

10. The following particulars relate to V Limited Company which has gone into voluntary liquidation.

Share capital issued:

5,000 Preference shares of ₹ 100 each fully paid up.

25,000 Equity shares of ₹ 10 each fully paid up.

15,000 Equity shares of ₹ 10 each, ₹ 8 paid up.

Assets realized ₹ 10,00,000 excluding the amount realized by sale of securities held by partly secured creditors.

	₹
Preferential creditors	25,000
Unsecured creditors	9,00,000
Partly secured creditors (Assets realized ₹ 1,60,000)	1,75,000
Debentureholders having floating charge on all assets of the company	3,00,000
Expenses of liquidation	5,000

A call of ₹ 2 per share on the partly paid equity shares was duly received except in case of one shareholder owning 500 shares.

You are required to prepare the Liquidator's Statement of Account allowing for his remuneration @ 2½% on all assets realized excluding call money received and 2% on

the amount paid to unsecured creditors including preferential creditors. Also calculate the percentage of amount paid to the unsecured creditors to the total unsecured creditors.

Financial Statements of Insurance Companies

11. On 31st March, 2016 the books of Lal Insurance Company Limited, contained the following particulars in respect of fire insurance:

Particulars	Amount
	₹
Reserve for unexpired risks on March 31 2015	10,00,000
Additional Reserve for unexpired risks on March 31 2015	2,00,000
Premiums	22,40,000
Claims paid	12,80,000
Estimated liability in respect of outstanding claims:	
On March 31 2015	1,30,000
On March 31 2016	1,80,000
Expenses of management (including ₹ 60,000 legal expenses paid in connection with the claims)	5,60,000
Interest and dividend	1,28,500
Income tax on the above	13,040
Profit on sale of investments	22,000
Commission paid	3,04,000

On 31st March, 2015 provide ₹ 11,20,000 as unexpired risk reserve and ₹ 1,50,000 as additional reserve.

You are required to prepare the Fire Insurance Revenue account as per regulations of IRDA, for the year ended 31st March, 2015.

Financial Statements of Banking companies

12. Given below is an extract from the trial balance of PT Bank Limited as on 31st December, 2015:

Particulars	Debit (₹)	Credit (₹)
Bills discounted	6,32,000	----
Rebate on bills discounted (1.1. 2015)	----	4,170
Discount received for the year		42,956

An analysis of the bills discounted is shown below:

Amount ₹	Due date in 2016	Rate of discount (% p.a.)
70,000	March 6 th	5
2,18,000	March 12 th	4.5
1,41,000	March 26 th	6
2,03,000	April 6 th	4

Show the workings, how the relevant items will appear in the bank's Profit and Loss account as on 31st December, 2015 and in bank's Balance Sheet as on 31st December, 2015.

Departmental Accounts

13. Department P sells goods to Department S at a profit of 25% on cost and to Department Q at a profit of 15% on cost. Department S sells goods to P and Q at a profit of 20% and 30% on sales respectively. Department Q sells goods to P and S at 20% and 10% profit on cost respectively.

Departmental Managers are entitled to 10% commission on net profit subject to unrealized profit on departmental sales being eliminated. Departmental profits after charging Manager's commission, but before adjustment of unrealized profits are as below:

	₹
Department P	90,000
Department S	60,000
Department Q	45,000

Stock lying at different Departments at the end of the year are as below:

	Figures in ₹		
	DEPARTMENTS		
	P	S	Q
Transfer from P	-	18,000	14,000
Transfer from S	48,000	-	38,000
Transfer from Q	12,000	8,000	-

Find out correct Departmental Profits after charging Managers' Commission. Branch Accounting

Branch Accounting

14. From the following particulars relating to Pune branch for the year ending December 31, 2015, prepare Branch Account in the books of Head office.

		₹
Stock at Branch on January 1, 2015		10,000
Branch Debtors on January 1, 2015		4,000
Branch Debtors on Dec. 31, 2015		4,900
Petty cash at branch on January 1, 2015		500
Furniture at branch on January 1, 2015		2,000
Prepaid fire insurance premium on January 1, 2015		150
Salaries outstanding at branch on January 1, 2015		100
Good sent to Branch during the year		80,000
Cash Sales during the year		1,30,000
Credit Sales during the year		40,000
Cash received from debtors		35,000
Cash paid by the branch debtors directly to the Head Office		2,000
Discount allowed to debtors		100
Cash sent to branch for Expenses:		
Rent	2,000	
Salaries	2,400	
Petty Cash	1,000	
Insurance up to March 31, 2016	<u>600</u>	6,000
Goods returned by the Branch		1,000
Goods returned by the debtors		2,000
Stock on December 31, 2015		5000
Petty Cash spent by branch		850
Provide depreciation on furniture 10% p.a.		

Goods costing ₹ 1,200 were destroyed on account of fire and a sum of ₹ 1,000 was received from the Insurance Company.

Foreign branch

15. Ganesh Ltd. has head office at Delhi (India) and branch at New York. New York branch is an integral foreign operation of Ganesh Ltd. New York branch furnishes

you with its trial balance as on 31st March, 2016 and the additional information given thereafter:

	<i>Dr. (\$)</i>	<i>Cr. (\$)</i>
Stock on 1st April, 2015	300	–
Purchases and sales	800	1,500
Sundry Debtors and creditors	400	300
Bills of exchange	120	240
Sundry expenses	1,080	–
Bank balance	420	–
Delhi office A/c	–	1,080
	3,120	3,120

The rates of exchange may be taken as follows:

- on 1.4.2015 @ ₹40 per US \$
- on 31.3.2016 @ ₹42 per US \$
- average exchange rate for the year @ ₹ 41 per US \$.

New York branch account showed a debit balance of ₹ 44,380 on 31.3.2016 in Delhi books and there were no items pending reconciliation.

You are asked to prepare trial balance of New York in ₹ in the books of Ganesh Ltd.

Problems based on Accounting Standards

AS 4 Contingencies and Events Accruing after Balance Sheet Date

16. A Company follows April to March as its financial year. The Company recognizes cheques dated 31st March or before, received from customers after balance sheet date, but before approval of financial statement by debiting 'Cheques in hand account' and crediting 'Debtors account'. The 'cheques in hand' is shown in the Balance Sheet as an item of cash and cash equivalents. All cheques in hand are presented to bank in the month of April and are also realised in the same month in normal course after deposit in the bank. State with reasons, whether the collection of cheques bearing date 31st March or before, but received after Balance Sheet date is an adjusting event and how this fact is to be disclosed by the company?

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

17. Bela Ltd. has a vacant land measuring 20,000 sq. mts, which it had no intention to use in the future. The Company decided to sell the land to tide over its liquidity problems and made a profit of ₹10 Lakhs by selling the said land. There was a fire in the factory and a

part of the unused factory shed valued at ₹ 8 Lakhs was destroyed. The loss from fire was set off against the profit from sale of land and profit of ₹2 lakhs was disclosed as net profit from sale of assets. Do you agree with the treatment and disclosure? If not, state your views.

AS 11 The Effects of Changes in Foreign Exchange Rates

18. (a) "The company had a engineering contract with a foreign government, work to be carried out in foreign country and payments to be received in dollars. The work was completed in the year 2015, and the entire contracted amount was duly recorded in the books of the company at the prevalent exchange rate on the date of completion of the work. However, payments to the extent of ₹ 40 crores could not be released by the Foreign Government because of temporary foreign exchange crisis in that country. This ₹ 40 crores unrealized at the end, if converted at the year end rate would amount to ₹ 40.50 crores. The Company has adopted and follows the following accounting policy:

"In respect of foreign currency transactions, current assets and current liabilities are revalued at year end rates. However, if there is a net loss, due to exchange difference, the same is charged off to the P&L account, but if there is a net gain, the same is ignored in view of the prudent accounting policies of not recording unrealized gains due to exchange rate fluctuations".

Comment on the appropriateness of the above.

AS 12 Accounting for Government Grants

- (b) D Ltd. acquired a machine on 01-04-2012 for ₹ 20,00,000. The useful life is 5 years. The company had applied on 01-04-2012, for a subsidy to the tune of 80% of the cost. The sanction letter for subsidy was received in November 2015. The Company's Fixed Assets Account for the financial year 2015-16 shows a credit balance as under:

Particulars	₹
Machine (Original Cost)	20,00,000
Less: Accumulated Depreciation (from 2012-13- to 2014-15 on Straight Line Method)	<u>12,00,000</u>
	8,00,000
Less: Grant received	<u>(16,00,000)</u>
Balance	<u>(8,00,000)</u>

How should the company deal with this asset in its accounts for 2015-16? Can it charge depreciation or negative depreciation for 2015-16? Can it credit ₹ 8,00,000 to Capital Reserve?

AS 16 Borrowing Costs

19. (a) A company capitalizes interest cost of holding investments and adds to cost of investment every year, thereby understating interest cost in profit and loss account. Comment on the accounting treatment done by the company in context of the relevant AS.

AS 19 Leases

- (b) Annual lease rent = ₹ 80,000 at the end of each year
 Lease period = 5 years
 Guaranteed residual value = ₹ 28,000
 Fair value at the inception (beginning) of lease = ₹ 3,00,000
 Interest rate implicit on lease is 12.6%. The present value factors at 12.6% are 0.89, 0.79, 0.7, 0.622, 0.552 at the end of first, second, third, fourth and fifth year respectively.
 Show the Journal entry to record the asset taken on finance lease in the books of the lessee.

AS 26 Intangible Assets

20. (a) K Ltd. launched a project for producing product X in October, 2015. The Company incurred ₹ 40 lakhs towards Research and Development expenses upto 31st March, 2016. Due to prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years.
 Advise the Company as per the applicable Accounting Standard.

AS 29 Provisions, Contingent Liabilities and Contingent Assets

- (b) The company has not made provision for warrantee in respect of certain goods considering that the company can claim the warranty cost from the original supplier. Comment.

SUGGESTED ANSWERS/HINTS

1. Statement showing distribution of cash amongst the partners

	<i>Creditors</i>	<i>B's Loan</i>	<i>A</i>	<i>B</i>	<i>C</i>
2016	₹	₹	₹	₹	₹
June 30 Balance b/d	30,000	10,000	76,000	48,000	36,000

Cash balance less Provision for expenses (₹ 10,800 – ₹ 5,400)	5,400	-	-	-	-
Balances unpaid	24,600	10,000	76,000	48,000	36,000
July 5					
1 st Instalment of ₹ 25,200	23,600	1,600	-	-	-
Discount received on full settlement	1,000	8,400	76,000	48,000	36,000
Less: Transferred to Realisation A/c	1,000				
	Nil				
August 30					
2 nd instalment of ₹ 60,000 (W.N. 2)		8,400	32,640	4,640	14,320
Balance unpaid		Nil	43,360	43,360	21,680
September 15					
Amount realised ₹ 80,000					
Add: Balance out of the Provision for Expenses A/c _____ 1,400					
			32,560	32,560	16,280
Amount unpaid being loss on Realisation in the ratio of 2 : 2 : 1			10,800	10,800	5,400

Working Notes:**1. Highest relative capital basis**

		A	B	C
		₹	₹	₹
1.	Present Capitals	76,000	48,000	36,000
2.	Profit-sharing ratio	<u>2</u>	<u>2</u>	<u>1</u>
3.	Capital per unit of Profit share (1 ÷ 2)	<u>38,000</u>	<u>24,000</u>	<u>36,000</u>
4.	Proportionate capitals taking B, whose capital is the least, as the basis	48,000	48,000	24,000
5.	Excess capital (1-4)	28,000	Nil	12,000
6.	Profit-sharing ratio	<u>2</u>	<u>-</u>	<u>1</u>
7.	Excess capital per unit of Profit share (5 ÷ 6)	14,000		12,000

8.	Proportionate capitals as between A and C taking C capital as the basis	24,000	-	12,000
9.	Excess of A's Capital over C's Excess capital (5-8)	4,000	-	-
10.	Balance of Excess capital (5-9)	24,000		12,000
11.	Distribution sequence:			
	First ₹ 4,000 (2 : 0 : 0)	4,000	-	-
	Next ₹ 36,000 (2 : 0 : 1)	24,000	-	12,000
	Over ₹ 40,000 (2 : 2 : 1)			

2. Distribution of Second instalment

	Creditors	A	B	C
First ₹ 8,400	8,400	-	-	-
Next ₹ 4,000 (2 : 0 : 0)		4,000	-	-
Next ₹ 36,000 (2 : 0 : 1)		24,000	-	12,000
Balance ₹ 11,600 (2 : 2 : 1)		4,640	4,640	2,320
60,000	8,400	32,640	4,640	14,320

2.

Journal Entries

In the books of VRK & Co.

Particulars	Dr. (₹)	Cr. (₹)
Goodwill A/c	Dr. 2,00,000	
Building A/c	Dr. 4,00,000	
Machinery A/c	Dr. 9,00,000	
Furniture A/c	Dr. 80,000	
Stock A/c	Dr. 4,80,000	
Debtors A/c	Dr. 6,40,000	
Cash at Bank A/c	Dr. 1,20,000	
Cash in hand A/c	Dr. 80,000	
Due from Raj & Co. A/c	Dr. 4,00,000	
To Creditors A/c		4,80,000
To Bank Loan A/c		3,20,000
To Vinod's Capital A/c		16,35,000
To Raj's Capital A/c		8,65,000

(Being the Assets and Liabilities of Vinod & Co. taken over)			
Goodwill A/c	Dr.	1,64,000	
Machinery A/c	Dr.	8,00,000	
Furniture A/c	Dr.	24,000	
Stock A/c	Dr.	5,60,000	
Debtors A/c	Dr.	8,00,000	
Cash at Bank A/c	Dr.	3,60,000	
Cash in hand A/c	Dr.	40,000	
Advances A/c	Dr.	2,40,000	
To Creditors A/c			4,64,000
To Due to Vinod & Co. A/c			4,00,000
To Raj's Capital A/c			14,16,000
To Kumar's Capital A/c			7,08,000
(Being the Assets and Liabilities of Raj & Co. taken over)			
Vinod's Capital A/c	Dr.	1,82,000	
Raj's Capital A/c	Dr.	1,21,334	
Kumar's Capital A/c	Dr.	60,666	
To Goodwill A/c	Dr.		3,64,000
(Being Goodwill written off)			
Bank A/c	Dr.	7,39,666	
To Vinod's Capital A/c			6,77,000
To Kumar's Capital A/c			62,666
(Being the Cash brought in by Vinod and Kumar to make capitals proportionate)			
Raj's Capital A/c	Dr.	7,39,666	
To Bank A/c			7,39,666
(Being the excess capital withdraw by Raj)			
Due to Vinod & Co. A/c	Dr.	400,000	
To Due from Raj & Co. A/c			4,00,000
(Being the elimination of mutual indebtedness of the merged firms Vinod & Co., and Raj & Co.)			

Balance Sheet of M/s VRK& Co. as at 31st March, 2016

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Capitals:		Building	4,00,000
Vinod	21,30,000	Machinery	17,00,000
Raj	14,20,000	Furniture	1,04,000
Kumar	7,10,000	Stock	10,40,000
Creditors	9,44,000	Debtors	14,40,000
Bank Loan	3,20,000	Advances	2,40,000
		Cash at Bank	4,80,000
		Cash in hand	1,20,000
	55,24,000		55,24,000

Working Notes:**1. Statement showing the Computation of Purchase Consideration**

<i>Particulars</i>	<i>Vinod & Co.</i>	<i>Raj & Co.</i>
	₹	₹
A. Assets		
Goodwill	2,00,000	1,64,000
Building	4,00,000	
Machinery	9,00,000	8,00,000
Furniture	80,000	24,000
Stock	4,80,000	5,60,000
Debtors	6,40,000	8,00,000
Cash at Bank	1,20,000	3,60,000
Cash in hand	80,000	40,000
Due from Raj & Co.	4,00,000	--
Advances	--	2,40,000
	33,00,000	29,88,000
B. Liabilities		
Creditors	4,80,000	4,64,000
Due to Vinod & Co.	--	4,00,000
Bank Loan	3,20,000	--
	8,00,000	8,64,000
C. Purchase consideration (A-B)	25,00,000	21,24,000

2. Statement showing the Computation of Proportionate Capitals

Particulars	₹
A. M/s VRK & Co. (₹ 25,00,000+₹ 21,24,000)	46,24,000
B. Less: Goodwill Adjustment	(3,64,000)
C. Total Capital of new Firm	42,60,000
D. Vinod's proportionate Capital (₹ 42,60,000 x 3/6)	21,30,000
E. Raj's proportionate Capital (₹ 42,60,000 x 2/6)	14,20,000
F. Kumar's Proportionate Capital (₹ 42,60,000 x 1/6)	7,10,000
	42,60,000

3. Statement showing the Computation of Capital Adjustments

Particulars	Vinod	Raj	Kumar	Total
	₹	₹	₹	₹
Balance transferred from Vinod and Co. (W.N. 4)	16,35,000	8,65,000	-	25,00,000
Balance transferred from Raj and Co. (W.N.5)	-	14,16,000	7,08,000	21,24,000
	16,35,000	22,81,000	7,08,000	46,24,000
Less: Goodwill written off in the ratio of (3:2:1)	(1,82,000)	(1,21,334)	(60,666)	(3,64,000)
(a) Existing Capital	14,53,000	21,59,666	6,47,334	42,60,000
(b) Proportionate Capital (W.N. 2)	21,30,000	14,20,000	7,10,000	42,60,000
(c) Amount to be brought in (paid off) (a-b)	6,77,000	7,39,666	62,666	-

4. Capital Accounts (in the Books of Vinod & Co.)

Particulars	Vinod	Raj	Particulars	Vinod	Raj
	₹	₹		₹	₹
To Capital A/c – M/s VRK & Co. (Transfer)	16,35,000	8,65,000	By Balance b/d	9,60,000	6,40,000
			By Reserve (3:1)	1,50,000	50,000
			By Goodwill (3:1)	1,50,000	50,000
			By Realisation A/c* -Profit (3:1)	3,75,000	1,25,000
	<u>16,35,000</u>	<u>8,65,000</u>		<u>16,35,000</u>	<u>8,65,000</u>

*For Building ₹ 2,00,000 (4,00,000 -2,00,000) and Machinery ₹ 3,00,000 (9,00,000 – 6,00,000).

5. Capital Accounts (in the Books of Raj & Co.)

Particulars	Raj	Kumar	Particulars	Raj	Kumar
₹		₹		₹	₹
VRK & Co. (Transfer)	14,16,000	7,08,000	By Balance b/d	8,00,000	4,00,000
			By Reserve (2:1)	4,00,000	2,00,000
			By Goodwill (2:1)	1,09,334	54,666
			By Realisation A/c* -Profit (2:1)	1,06,666	53,334
	14,16,000	7,08,000		14,16,000	7,08,000

*For Machinery ₹ 1,60,000 (8,00,000 – 6,40,000).

3. Realisation Account

Particulars	₹	₹	Particulars	₹	₹
To Goodwill		10,000	By Provision to doubtful Debts		2,000
To Land		20,000	By Trade creditors		96,000
To Buildings		1,10,000	By Bills Payable		14,000
To Machinery		50,000	By Bank overdraft		60,000
To Motor Car		28,000	By Mrs. A's loan		15,000
To Furniture		12,000	By ABC Ltd. (Purchase price)		1,95,500
To Investments		18,000	By A's Capital A/c (Investments)		13,000
To Loose tools		7,000	By Cash A/c:		
To Stock		18,000	Debtors	20,000	
To Bill receivable		20,000	Motor Car	24,000	
To Debtors		40,000	Furniture	4,000	
To A's Capital A/c (Mrs. A's Loan)		15,000	Loose tools	<u>1,000</u>	49,000
To Cash A/c:					
Creditors	94,000				
Realisation expenses	<u>500</u>	94,500			
To Profit on Realisation t/f to:					
A's Capital A/c	1,000				
B's Capital A/c	667				
C's Capital A/c	<u>333</u>	<u>2,000</u>			
		4,44,500			<u>4,44,500</u>

ABC Ltd. Account

Particulars	₹	Particulars	₹
To Realisation A/c	1,95,500	By Cash A/c	75,500
	<u>1,95,500</u>	By Shares in ABC Ltd.	<u>1,20,000</u>
			1,95,500

Partners' Capital Accounts

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To Profit and Loss A/c	6,000	4,000	2,000	By Balance b/d	70,000	80,000	10,000
To Realisation A/c	13,000	-	-	By C's Loan A/c	-	-	33,000
To C's Current A/c	-	-	56,000	By General reserve	9,000	6,000	3,000
To shares in ABC Ltd.	60,000	40,000	20,000	By Investment Fluctuation Fund	2,000	1,333	667
To Cash A/c	18,000	44,000	-	By Realization A/c	1,000	667	333
				By Realisation A/c (Mrs. A's loan A/c)	15,000	-	-
				By Cash A/c	-	-	<u>31,000</u>
	<u>97,000</u>	<u>88,000</u>	<u>78,000</u>		<u>97,000</u>	<u>88,000</u>	<u>78,000</u>

C's Current Account

Particulars	₹	Particulars	₹
To Balance b/d	<u>56,000</u>	By C's Capital A/c-transfer	<u>56,000</u>
	<u>56,000</u>		<u>56,000</u>

Shares in ABC Ltd. Account

Particulars	₹	Particulars	₹
To ABC Ltd. Account	1,20,000	By A's Capital A/c	60,000
		By B's Capital A/c	40,000
		By C's Capital A/c	20,000
	<u>1,20,000</u>		<u>1,20,000</u>

Cash Account

Particulars	₹	Particulars	₹
To Balance b/d	1,000	By Realisation A/c (Liabilities)	94,500

To ABC Ltd.	75,500	and expenses)	
To Realisation A/c (sale of assets)	49,000	By A's Capital A/c	18,000
To C's Capital A/c	<u>31,000</u>	By B's Capital A/c	44,000
	<u>1,56,500</u>		<u>-</u>
			<u>1,56,500</u>

Note: Investment Fluctuation Fund Account may be transferred to Realisation Account.

4. (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 (3,32,000 - 2,72,000) (issued in profit sharing ratio)	<u>30,000</u>	<u>18,000</u>	<u>12,000</u>	<u>60,000</u>
	<u>1,66,000</u>	<u>1,08,000</u>	<u>58,000</u>	<u>3,32,000</u>

(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 drawings (W.N. 2)	54,300	17,420	6,880	By Machinery* A/c	10,000	6,000	4,000
Total	<u>2,70,300</u>	<u>1,71,420</u>	<u>98,880</u>		<u>2,70,300</u>	<u>1,71,420</u>	<u>98,880</u>

* 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, 2016 (after Takeover of Firm)

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

Notes to Accounts

	Particulars	₹
1.	Shares capital	
	Authorised 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	<u>2,72,000</u>
	(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**

Particulars	₹	₹	Particulars	₹
To Interest on Capital:			By Net Profit	2,48,600
M [₹ 1,36,000 x 10%]	13,600		(given)	
N [₹ 90,000 x 10%]	9,000			

O [₹ 46,000 x 10%]	<u>4,600</u>	27,200	
To Profits transferred to Capital in profit sharing ratio 5:3:2			
M	1,10,700		
N	66,420		
O	<u>44,280</u>	<u>2,21,400</u>	
Total		2,48,600	<u>2,48,600</u>

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

(a) **Funds available for Drawings**

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

(b) **Ascertainment of Additional Drawings**

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

5. **Journal Entries in the books of Kanika Ltd.**

<i>Particulars</i>	<i>Dr. (₹)</i>	<i>Cr. (₹)</i>
At the end of 1 year		
Employees Compensation Expense A/c To Employee Stock Options Outstanding A/c (Being the compensation expenses recognized in respect of the ESOP)	Dr. 8,60,625	8,60,625
Profit and Loss A/c To Employee Compensation Expense A/c (Being Expenses of the year transferred to P & L A/c)	Dr. 8,60,625	8,60,625
At the end of Year 2		

Employees Compensation Expense A/c To Employee Stock Options Outstanding A/c (Being expense in respect of ESOP recognized for the year 2)	Dr.	8,60,625	8,60,625
Profit and Loss A/c To Employee Compensation Expense A/c (Being Expenses of the year transferred to P & L A/c)	Dr.	8,60,625	8,60,625
At the end of Year 3			
Employees Compensation Expense A/c To Employee Stock Options Outstanding A/c (Being expense in respect of ESOP recognized for the year 3)	Dr.	21,03,750	21,03,750
Profit and Loss A/c To Employee Compensation Expense A/c (Being Expenses of the year transferred to P & L A/c)	Dr.	21,03,750	21,03,750

Working Notes:

- A. No. of Employees expected to take options = $2,500 \times .80 \times .85 \times .90 \times .90 = 1377$
- B. No. of Options to be granted to each employee = 500
- C. Fair Value of each option = ₹ 5
- D. Total Fair Value of Options expected to vest (A x B x C) = ₹ 34,42,500
- E. Amount of Fair Value of Options to be recognized as an expense
- 1st year $(34,42,500/4) = ₹ 8,60,625$
- 2nd Year $(34,42,500 \times (2/4) - 8,60,625) = ₹ 8,60,625$
- 3rd Year $[(1530 \text{ employees} \times 500 \text{ options} \times ₹ 5) - (8,60,625 + 8,60,625)] = ₹ 21,03,750$

Since vesting period has been revised in 3rd year all the remaining liabilities in respect of employees stock option plan has been recognized at the end of 3rd year and data for the 4th year has been ignored.

6.

Journal Entries

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

	To 11% Preference Share Capital A/c (Being allotment of 1 lakh preference shares)		10,00,000
3.	General Reserve A/c To Capital Redemption Reserve A/c (Being creation of capital redemption reserve for buy back of shares)	Dr. 30,00,000	30,00,000
4.	Equity share capital A/c Securities Premium A/c General reserve A/c To Equity shareholders/Equity Shares buy back A/c (Amount payable to equity shareholder on buy back)	Dr. 40,00,000 Dr. 16,00,000 Dr. 32,00,000	88,00,000
5.	Equity shareholders/ Equity Shares buy back A/c To Bank A/c (Being payment made for buy back of shares)	Dr. 88,00,000	88,00,000

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

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

2. Amount to be transferred to Capital Redemption Reserve account

	₹
Nominal value of shares bought back (4,00,000 shares x ₹10)	40,00,000
Less: Nominal value of Preference Shares issued for such buy back (1,00,000 shares x ₹10)	<u>(10,00,000)</u>
Amount transferred to Capital Redemption Reserve Account	<u>30,00,000</u>

Note: It is assumed that the buy-back of 4,00,000 equity shares is within the prescribed 25% limit of total equity shares.

7. **In the books of Soumya Ltd.**

Journal Entries

<i>Date</i>	<i>Particulars</i>	<i>Amount Dr.</i>	<i>Amount Cr.</i>
		₹	₹
1.5.2015	Bank A/c To Debenture Application A/c (Application money received on 1,50,000 debentures @ ₹ 100 each)	Dr. 1,50,00,000	1,50,00,000
1.6.2015	Debenture Application A/c Underwriters A/c To 15% Debentures A/c (Allotment of 1,50,000 debentures to applicants and 50,000 debentures to underwriters)	Dr. 1,50,00,000 Dr. 50,00,000	2,00,00,000
	Underwriting Commission To Underwriters A/c (Commission payable to underwriters @ 2% on ₹ 2,00,00,000)	Dr. 4,00,000	4,00,000
	Bank A/c To Underwriters A/c (Amount received from underwriters in settlement of account)	Dr. 46,00,000	46,00,000
30.9.2015	Debenture Interest A/c To Bank A/c (Interest paid on debentures for 4 months @ 15% on ₹ 2,00,00,000)	Dr. 10,00,000	10,00,000
30.10.2015	15% Debentures A/c To Equity Share Capital A/c To Securities Premium A/c (Conversion of 60% of debentures into shares of ₹ 60 each with a face value of ₹ 10)	Dr. 1,20,00,000	20,00,000 1,00,00,000
31.3.2016	Debenture Interest A/c	Dr. 7,50,000	

	To Bank A/c (Interest paid on debentures for the half year)		7,50,000
--	---	--	----------

Working Note :**Calculation of Debenture Interest for the half year ended 31st March, 2016**

On ₹ 80,00,000 for 6 months @ 15% = ₹6,00,000

On ₹ 1,20,00,000 for 1 months @ 15% = ₹ 1,50,000

₹ 7,50,000

8.

**Books of A Limited
Realisation Account**

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

Bank Account

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

10% Debentures Account

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

Loan Account

To Bank	<u>1,60,000</u>	By Balance b/d	<u>1,60,000</u>
	<u>1,60,000</u>		<u>1,60,000</u>

Share Issue Expenses Account

To Balance b/d	<u>34,000</u>	By Equity shareholders	<u>34,000</u>
	<u>34,000</u>		<u>34,000</u>

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

B Ltd**Balance Sheet as on 1st April, 2016 (An extract)***

	<i>Particulars</i>	<i>Notes</i>	<i>₹</i>
	Equity and Liabilities		
1	Shareholders' funds		
a	Share capital	1	4,88,000
b	Reserves and Surplus	2	1,07,000
2	Current liabilities		
a	Trade Payables	3	2,80,000
b	Bank overdraft		6,00,000
	Total		<u>14,75,000</u>

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

Assets			
1	Non-current assets		
a	Fixed assets		
	Tangible assets	4	8,82,000
	Intangible assets	5	2,16,000
2	Current assets		
a	Inventories	6	1,83,000
b	Trade receivables	7	1,94,000
			14,75,000

Notes to accounts

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

6 Inventories	Opening balance	1,98,000	1,83,000
	Less: Cancellation of profit upon amalgamation	(15,000)	
7 Trade receivables	Opening balance (2,60,000 x 0.90)	2,34,000	1,94,000
	Less: Intercompany transaction cancelled upon amalgamation	(40,000)	

Working Notes:

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

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

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

9.

In the books of Ice Ltd.

Journal Entries

	Particulars		Debit ₹	Credit ₹
i	8% Preference share capital A/c (₹ 100 each) Dr. To 8% Preference share capital A/c (₹ 80 each) To Capital reduction A/c (Being the preference shares of ₹ 100 each reduced to ₹ 80 each as per the approved scheme)		4,00,000	3,20,000 80,000
ii	Equity share capital A/c (₹ 10 each) Dr. To Equity share capital A/c (₹ 2 each) To Capital reduction A/c (Being the equity shares of ₹ 10 each reduced to ₹ 2 each)		10,00,000	2,00,000 8,00,000
iii	Capital reduction A/c Dr. To Equity share capital A/c (₹ 2 each) (Being arrears of preference share dividend of one year to be satisfied by issue of 16,000 equity shares of ₹ 2 each)		32,000	32,000
iv	6% Debentures A/c Dr. To Freehold property A/c (Being claim settled in part by transfer of freehold property)		3,00,000	3,00,000
v	Accrued debenture interest A/c Dr. To Bank A/c (Being accrued debenture interest paid)		24,000	24,000
vi	Freehold property A/c Dr. To Capital reduction A/c (Being appreciation in the value of freehold property)		1,50,000	1,50,000
vii	Bank A/c Dr. To Trade investment A/c To Capital reduction A/c (Being trade investment sold on profit)		2,50,000	2,00,000 50,000
viii	Director's loan A/c Dr.		3,00,000	

	To Equity share capital A/c (₹ 2 each)		75,000
	To Capital reduction A/c		2,25,000
	(Being director's loan waived by 75% and balance being discharged by issue of 37,500 equity shares of ₹ 2 each)		
ix	Capital Reduction A/c	Dr.	9,75,000
	To Profit and loss A/c		5,25,000
	To Trade receivables A/c		1,80,000
	To Inventories-in-trade A/c		2,40,000
	To Bank A/c		30,000
	(Being various assets, penalty on cancellation of contract, profit and loss account debit balance written off through capital reduction account)		
x	Capital Reduction A/c	Dr.	2,98,000
	To Capital reserve A/c		2,98,000
	(Being balance transferred to capital reserve account as per the scheme)		

Balance Sheet of Ice Ltd. (As reduced)

Particulars		Notes No.	₹
Equity and Liabilities			
1	Shareholders' funds		
a	Share capital	1	6,27,000
b	Reserves and Surplus	2	2,98,000
2	Non-current liabilities		
	Long-term borrowings	3	1,00,000
3	Current liabilities		
a	Trade Payables		<u>1,01,000</u>
	Total		<u>11,26,000</u>
Assets			
1	Non-current assets		
a	Fixed assets		
	Tangible assets	4	6,00,000

2	Current assets		
a	Inventories		60,000
b	Trade receivables		2,70,000
c	Cash and cash equivalents	5	<u>1,96,000</u>
	Total		<u>11,26,000</u>

Note to Accounts

₹

1.	Share Capital		
	1,53,500 Equity shares of ₹ 2 each (out of which 53,500 shares have been issued for consideration other than cash)		3,07,000
	4,000, 8% Preference shares of ₹ 80 each fully paid up		<u>3,20,000</u>
	Total		<u>6,27,000</u>
2.	Reserves and Surplus		
	Capital Reserve		2,98,000
3.	Long-term borrowings		
	Secured		
	6% Debentures		1,00,000
4.	Tangible assets		
	Freehold property		4,00,000
	Plant and machinery		<u>2,00,000</u>
	Total		<u>6,00,000</u>
5.	Cash and cash equivalents		
	Cash at bank (2,50,000 – 24,000 – 30,000)		1,96,000

10. (i) Liquidator's Statement of Account

	₹			₹
To Assets Realised	10,00,000	By Liquidator's remuneration		
To Receipt of call money on 14,500 equity shares @ 2 per share	29,000	2.5% on 11,60,000*	29,000	
		2% on 25,000	500	
		2% on 6,56,373 (W.N.3)	<u>13,127</u>	42,627
		By Liquidation Expenses		5,000

* Total assets realised = ₹ 10,00,000 + ₹ 1,60,000 = ₹ 11,60,000

	By Debenture holders having a floating charge on all assets	3,00,000
	By Preferential creditors	25,000
	By Unsecured creditors	<u>6,56,373</u>
		<u>10,29,000</u>
	<u>10,29,000</u>	<u>10,29,000</u>

(ii) Percentage of amount paid to unsecured creditors to total unsecured creditors

$$= \frac{6,56,373}{9,15,000} \times 100 = 71.73\%$$

Working Notes:

1. Unsecured portion in partly secured creditors = ₹ 1,75,000 – ₹ 1,60,000 = ₹ 15,000
2. Total unsecured creditors = 9,00,000 + 15,000 (W.N.1) = ₹ 9,15,000
3. Liquidator's remuneration on payment to unsecured creditors

Cash available for unsecured creditors after all payments including payment to preferential creditors & liquidator's remuneration on it = ₹ 6,69,500

Liquidator's remuneration on unsecured creditors = ₹ 6,69,500 x 2/102 ₹ 13,127

or on ₹ 6,56,373 x 2/100 = ₹ 13,127

11. FORM B- RA

Name of the Insurer: Lal Insurance Company Limited

Registration No. and Date of registration with IRDA:

Revenue Account for the year ended 31st March, 2016

Particulars	Schedule	Amount (₹)
Premium earned (net)	1	21,70,000
Profit or loss on sale/redemption of investment		22,000
Others		-
Interest dividend & rent (Gross)		<u>1,28,500</u>
Total (A)		<u>23,20,500</u>
Claim incurred (Net)	2	13,90,000
Commission	3	3,04,000
Operating expenses related to insurance	4	<u>5,00,000</u>
Total (B)		<u>21,94,000</u>
Operating profit/loss from insurance business		<u>1,26,500</u>

Schedule –1 (Premium earned net)	₹
Premium received	22,40,000
Less: Adjustment for change in Reserve for Unexpired risk (as per W.N.)	<u>70,000</u>
Total premium earned	<u>21,70,000</u>
Schedule -2 (Claims incurred net)	
Claim paid	12,80,000
Add: Legal expenses regarding claims	<u>60,000</u>
	13,40,000
Add: Claims outstanding as on 31st March 2016	<u>1,80,000</u>
	15,20,000
Less: Claims outstanding as on 31st March 2015	<u>1,30,000</u>
	<u>13,90,000</u>
Schedule-3 (Commission)	
Commission paid	3,04,000
Schedule-4 (Operating expenses related to Insurance Business)	-
Expenses of management (5,60,000 – 60,000)	5,00,000

Working Note:

Calculation for change in Reserve for Unexpired risk:	₹
As on 31 st March, 2016:	
Reserve for Unexpired Risk	11,20,000
Additional Reserve	<u>1,50,000</u> 12,70,000
Less: Reserve for Unexpired risks as on 31 st March, 2015	10,00,000
Additional reserve as on 31 st March, 2015	<u>2,00,000</u> <u>12,00,000</u>
	<u>70,000</u>

Note: Interest and dividends are shown at gross value in Revenue A/c. Income tax on the above will not be included in revenue A/c of an insurance company as it is the part of Profit and Loss A/c.

12. **Profit & Loss Account (an extract)
for the period ending 31.12. 2015**

	₹
Transfer from 'Rebate on bills discounted account' (01.01. 2015)	4,170
Add: Discount for the year 2015	<u>42,956</u>

	47,126
Less: Rebate on bills discounted carried forward to the year 2016	<u>(6,637)</u>
	<u>40,489</u>

Balance Sheet (an extract) as on 31.12.2015

	₹
Other liabilities & provisions:	
Rebate on bills discounted	6,637

Working Note:**Statement of rebate on bills discounted as on 31.12. 2015**

Due date	Amount (₹)	No. of days after 31.12.2015	Rate of discount (%)	Discount of the unexpired period
March 6 th	70,000	65	5	623
March 12 th	2,18,000	71	4.5	1,908
March 26 th	1,41,000	85	6	1,970
April 6 th	2,03,000	96	4	<u>2,136</u>
Total rebate on bills discounted to be carried forward				<u>6,637</u>

13.

Calculation of correct Departmental Profits

	Department P (₹)	Department S (₹)	Department Q (₹)
Profit after charging Manager's Commission	90,000	60,000	45,000
Add: Manager's Commission (1/9)	10,000	6,667	5,000
	1,00,000	66,667	50,000
Less: Unrealised profit on Stock (WN)	(5,426)	(21,000)	(2,727)
Profit Before Manager's Commission	94,574	45,667	47,273
Less: Manager's Commission 10%	(9,457)	(4,567)	(4,727)
Correct Profit after Manager's Commission	85,117	41,100	42,546

Working Notes:

	Department P (₹)	Department S (₹)	Department Q (₹)	Total (₹)
Unrealized Profit of:				
Department P	-	25/125X18,000 =3,600	15/115X14,000 =1,826	5,426
Department S	20/100X48,000 =9,600	-	30/100X38,000 =11,400	21,000
Department Q	20/120X12,000 =2,000	10/110X8,000 =727		2,727

14. Pune Branch Account

Particulars		₹	Particulars	₹	₹
To Opening Balance			By Opening Balance:		
Stock		10,000	Salaries outstanding		100
Debtors		4,000	By Remittances:		
Petty Cash		500	Cash sales	1,30,000	
Furniture		2,000	Cash received from debtors	35,000	
Prepaid Insurance		150	Cash paid by debtors directly to H.O.	2,000	
To Goods sent to Branch Account		80,000	Received from Insurance Company	<u>1,000</u>	1,68,000
To Bank (expenses)			By Goods sent to branch (return of goods by the branch to H.O.)		1,000
Rent	2,000		By Closing Balances:		
Salaries	2,400		Stock		5,000
Petty Cash	1,000		Petty Cash		650
Insurance	<u>600</u>	6,000	Debtors		4,900
To Net Profit		78,950	Furniture (2,000 - 10% depreciation)		1,800
			Prepaid insurance (1/4 x ₹ 600)		150
		1,81,600			1,81,600

Working Note:

Calculation of petty cash balance at the end:	₹
Opening balance	500
Add: Cash received form the Head Office	<u>1,000</u>
Total Cash with branch	1,500
Less : Spent by the branch	<u>850</u>
Closing balance	<u>650</u>

15.

In the books of Ganesh Ltd.**New York Branch Trial Balance in (₹)
as on 31st March, 2016**

	<i>Conversion rate per US \$ (₹)</i>	<i>Dr. ₹</i>	<i>Cr. ₹</i>
Stock on 1.4.15	40	12,000	
Purchases and sales	41	32,800	61,500
Sundry debtors and creditors	42	16,800	12,600
Bills of exchange	42	5,040	10,080
Sundry expenses	41	44,280	
Bank balance	42	17,640	
Delhi office A/c	–		44,380
		<u>1,28,560</u>	<u>1,28,560</u>

16. Even if the cheques bear the date 31st March or before, the cheques received after 31st March do not represent any condition existing on the balance sheet date i.e. 31st March. Thus, the collection of cheques after balance sheet date is not an adjusting event. Cheques that are received after the balance sheet date should be accounted for in the period in which they are received even though the same may be dated 31st March or before as per AS 4 "Contingencies and Events Occurring after the Balance Sheet Date". Moreover, the collection of cheques after balance sheet date does not represent any material change affecting financial position of the enterprise on the balance sheet date, so no disclosure is necessary.
17. As per para 8 of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

In the given case the selling of land to tide over liquidation problems as well as fire in the Factory does not constitute ordinary activities of the Company. These items are distinct from the ordinary activities of the business. Both the events are material in nature and expected not to recur frequently or regularly. Thus, these are Extraordinary Items.

Therefore, in the given case, disclosing net profits by setting off fire losses against profit from sale of land is not correct. The profit on sale of land, and loss due to fire should be disclosed separately in the statement of profit and loss.

18. (a) In given case the recoverability of ₹ 40 Crores is not doubtful or uncertain but just deferred temporarily hence it should be translated using exchange rates at the close of the year. Further AS-11 clearly mentions that net difference shall be transferred to profit and loss account. Hence, we can say that exchange difference favourable or unfavorable both shall be considered at the year end rather to ignore the gains and recording just losses.
- (b) From the above account, it is inferred that the Company follows Reduction Method for accounting of Government Grants. Accordingly, out of the ₹ 16,00,000 that has been received, ₹ 8,00,000 (being the balance in Machinery A/c) should be credited to the machinery A/c.

The balance ₹ 8,00,000 may be credited to P&L A/c, since already the cost of the asset to the tune of ₹ 12,00,000 had been debited to P&L A/c in the earlier years by way of depreciation charge, and ₹ 8,00,000 transferred to P&L A/c now would be partial recovery of that cost.

There is no need to provide depreciation for 2015-16 or 2016-17 as the depreciable amount is now Nil.

In respect of Depreciable Assets, AS-12 does not permit the crediting of the grant or any part thereof to Capital Reserve A/c.

19. (a) The Accounting Standard Board (ASB) has opined that investments other than investment in properties are not qualifying assets as per AS-16 Borrowing Costs. Therefore, interest cost of holding such investments cannot be capitalized. Further, even interest in respect of investment properties can only be capitalized if such properties meet the definition of qualifying asset, namely, that it necessarily takes a substantial period of time to get ready for its intended use or sale. Also, where the investment properties meet the definition of 'qualifying asset', for the capitalization of borrowing costs, the other requirements of the standard such as that borrowing costs should be directly attributable to the acquisition or construction of the investment property and suspension of capitalization as per paragraphs 17 and 18 of AS-16 have to be complied with.

(b) Journal entry in the books of Lessee

		₹	₹
Asset A/c	Dr.	2,99,776	
To Lessor			2,99,776
(Being recognition of finance lease as an asset and a liability)			

Working Note:

Year	Lease Payments ₹	Discounting Factor (12.6%)	Present Value ₹
1	80,000	0.89	71,200
2	80,000	0.79	63,200
3	80,000	0.70	56,000
4	80,000	0.622	49,760
5	80,000	0.552	44,160
5	28,000 (GRV)	0.552	15,456
			2,99,776

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

Hence, the expenses amounting ₹ 40 lakhs incurred on the research and development project has to be written off in the current year ending 31st March, 2016.

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

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

PAPER – 6: AUDITING AND ASSURANCE

PART – I : ACADEMIC UPDATE

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

1. Duty to report on frauds:

I. 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.

II. Reporting to the Audit Committee or Board - Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

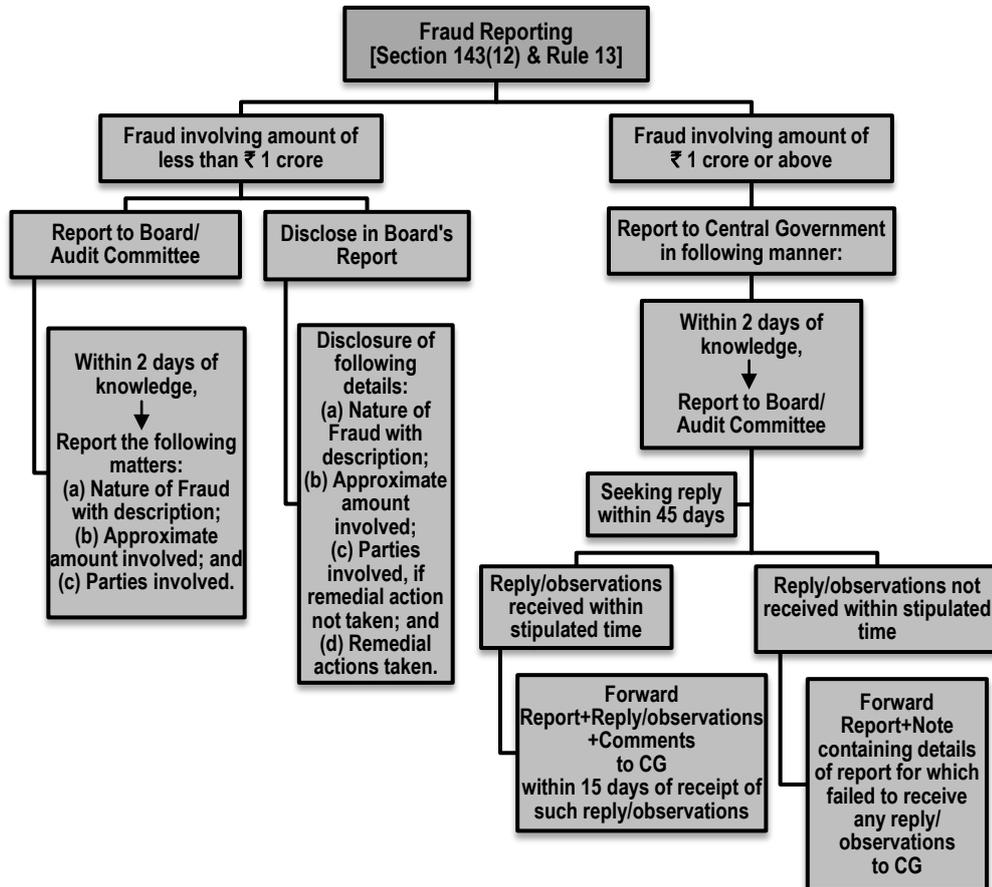
In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub-rule (1) [i.e. less than ₹ 1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

- (a) Nature of Fraud with description;
- (b) Approximate amount involved; and
- (c) Parties involved.

III. Disclosure in the Board's Report: Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.

In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that the auditor is also required to disclose in the Board's Report the following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year:

- (a) Nature of Fraud with description;
- (b) Approximate Amount involved;
- (c) Parties involved, if remedial action not taken; and
- (d) Remedial actions taken.



2. **Ceiling on Number of Company Audits:** As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies, other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.

3. **Guidance Note on Reporting under Section 143(3)(f) and (h) of the Companies Act, 2013:**

Introduction

1. Section 143 of the Companies Act, 2013 (hereinafter referred to as the “Act”) deals with the powers and duties of the auditors of companies. Section 143(1) of the Act requires the auditor to make certain specific enquiries during the course of the audit. Section 143(2) of the Act requires the auditor to, *inter alia*, give his report to the members of company on the accounts examined by him, and on every financial statement which are laid before the company in a general meeting. Sub-section (3) of section 143 of the Act also lays down certain matters required to be reported upon by the auditor in his report. Sub-section (3) of section 143 of Act provides as follows:

"(3) The auditor's report shall also state -

- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;
- (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
- (e) whether, in his opinion, the financial statements comply with the accounting standards;
- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- (g) whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
- (i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

- (j) such other matters as may be prescribed.¹

Scope of the Guidance Note

2. This Guidance Note is intended to assist the auditors in discharging their duties in respect of clauses (f) and (h) of sub-section (3) of section 143 of the Act. Clause (f) of the said sub-section creates a requirement for the auditor to consider observations or comments of the auditor on financial transactions or matters which have an adverse effect on the functioning of the company. Such observations or comments would ordinarily lead to the modification of or an emphasis of matter in the auditor's report on financial statements. It may be noted that the matters that lead to modification in the auditor's report on financial statements are matters that give rise to a qualified opinion, adverse opinion or a disclaimer of opinion². Further, matters that lead to an emphasis of matter paragraphs are matters appropriately presented or disclosed in the financial statements that, in the auditor's judgement, are of such importance that they are fundamental to the users' understanding of the financial statements³. If the matter leading to the modification of the auditor's opinion or an emphasis of matter in the auditor's report on financial statements is likely to have an adverse effect on the functioning of the company, the auditor is required to report such matter. Under clause (h) of sub-section (3) of section 143 of the Act, the auditor is required to state whether any matter leading to a qualification, reservation or adverse remark, that is, effectively the modification of the auditor's report on financial statements, relates to the maintenance of accounts and other matters connected therewith.

Reporting under Section 143(3)(f) of the Act

3. The relevant extracts of section 143(3)(f) of the Act are reproduced below:

“(3). *The auditor's report shall also state –*

.....

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;”

¹ Refer Rule 11 of Companies (Audit and Auditors) Rules, 2014.

² Reference may be made to Standard on Auditing (SA) 705, “Modifications to the Opinion in the Independent Auditor's Report.”

³ Reference may be made to paragraphs 6 and 7 of Standard on Auditing (SA) 706, “Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report.”

4. Clause (f) requires the auditor to report "the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company". An auditor's report may contain matters leading to modifications to the auditor's opinion or emphasis of matter in the auditor's report on the financial statements. Such matters may be related to issues which may have an adverse effect on the functioning of the company. The words "observations" or "comments" as appearing in clause (f) of section 143(3) are construed to have the same meaning as referring to "emphasis of matter paragraphs, situations leading to modification in the auditor's report. Accordingly, the auditor should have made an "observation" or "comment" in the auditor's report in order to determine the need to report under clause (f) of section 143(3). Therefore, only such "observations" or "comments" of the auditors on financial transactions or matters that have been made by the auditor in the auditor's report which have an adverse effect on the functioning of the company are required to be reported under this clause. For the sake of clarity, it may be noted that neither the auditor's observations nor the comments made by him have any adverse effect on the functioning of a company. These observations or comments made by the auditor might contain matters which might have an adverse effect on the functioning of a company.
5. The Act does not specify the meaning of the phrase 'adverse effect on the functioning of the company'. The expression should not be interpreted to mean that any event affecting the functioning of the company, observed by the auditor, should be reported upon even though it does not affect the financial statements, e.g., revocation of a license to manufacture one out of the many products during the year to which the financial statements relate, where such product that does not have any material contribution to the revenues of the company, etc. Such an interpretation would not only be beyond the scope of the audit of financial statements of the company but would also not be in accordance with the objective and concept of audit stipulated under the Act. A more logical and harmonious interpretation is that this reporting requirement does not intend to change the basic objective and the concept of audit of financial statements of a company, which is to examine the financial statements with a view to express an opinion thereon.
6. The scope of the audit and auditor's role remains as contemplated under the Standards on Auditing (SAs) and other relevant pronouncements issued by the Institute of Chartered Accountants of India as well as laid down in the Act, i.e., to lend credibility to the financial statements by reporting whether they reflect a true and fair view. SA 200, *Objective of the Independent Auditor and the Conduct of an Audit in Accordance with Standards of Auditing*, specifies that the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. An audit conducted in

accordance with SAs and relevant ethical requirements enables the auditor to form the opinion of the true and fair view of the financial position and operating result of an enterprise. The auditor's opinion, therefore, does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. SAs require auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. At this juncture, it may also be noted that SA 200 also clearly states that the concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

7. There is no change in the objective and scope of an audit of financial statements because of inclusion of clause (f) in sub-section (3) of section 143 of the Act. The auditor expresses his opinion on the true and fair view presented by the financial statements through his report which may be modified in certain circumstances. However, the auditor would now have to evaluate the subject matters leading to modification of the audit report or emphasis of matter in the auditor's report to make judgement as to which of them has an adverse effect on the functioning of the company within the overall context of audit of financial statements of the company. Only such matters which, in the opinion of the auditor, have an adverse effect on the functioning of the company should be reported under this clause. Conversely, such qualifications or adverse opinions or disclaimer of opinion or emphasis of matters of the auditor, which do not deal with matters that have adverse effect on the functioning of the company, need not be reported under this clause.
8. As far as inquiries under section 143(1) are concerned, the auditor is not required to report on these matters unless he has any comments to make on any of the items referred to therein. If the auditor has any comments or observations on any of the matters stated in section 143(1), the auditor should consider such comments or observations when reporting under this clause if they contain matters that may have any adverse effect on the functioning of the company.
9. Auditor's will need to apply professional judgement in considering matters of emphasis that may have an adverse effect on the functioning of the company. Ordinarily matters that are pervasive in nature such as going concern or matters that will significantly impact the operations of the company due to its size and

nature will need to be reported under clause (f) of sub-section (3) of section 143 of the Act. Examples of emphasis of matter which may have an adverse effect on the functioning of the company include situations where:

- the going concern assumption is appropriate but there are several factors leading to a material uncertainty that may cast a significant doubt about the Company's ability to continue as a going concern; or
- a material uncertainty regarding the outcome of a litigation wherein an unfavourable decision could result in a significant outflow of resources for the company, etc.

Examples of emphasis of matter which may not have an adverse effect on the functioning of the company include a situation where there is an emphasis of matter:

- on managerial remuneration which is subject to the approval of the Central Government;
- relating to accrual of a contractually receivable claim based on management estimate where the ultimate realisation could be different from the amount accrued;
- on frauds that have been dealt with in the financial statements of the company and would not have any continuing effect on the financial statements.

10. Another issue which arises is whether any observations or comments made by the auditor under clause (i) of section 143(3) in respect of the company's internal financial controls over financial reporting, which may have any adverse effect on the functioning of the company, should also be reported in terms of this clause. In this regard, it is noted that reporting under section 143(3)(i) is part of the auditor's report though it may be reported in an annexure to the auditor's report. Accordingly, if any observations or comments made by the auditor on the adequacy or operating effectiveness of internal financial controls over financial reporting contain such matters, which, in his opinion, may have any adverse effect on the functioning of the company, should also be reported under clause (f) of section 143(3) even if such observation did not result in a modification to the audit opinion on the financial statements of the company. An example in this regard may be where an auditor reports that the company did not have an appropriate internal control system for inventory with regard to receipts, issue for production and physical verification.

Reporting under Section 143(3)(h) of the Act

11. The relevant extracts of section 143(3)(h) of the Act are reproduced below:

“(3). *The auditor's report shall also state –*

.....

(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;”

12. Clause (h) requires the auditor to report "any qualification, reservation or adverse remark" relating to the maintenance of accounts and other matters connected therewith. An auditor's report may contain matters leading to modifications in the auditor's report on financial statements. The matters that cause such modification may have a consequential effects or possible effects on the books of account maintained by the company and other matters connected therewith.
13. Section 128 of the Act, *inter alia*, states that every company shall prepare and keep its books of account and other relevant books and papers and financial statements that give a true and fair view of the state of affairs of the company. Section 129(1) of the Act, *inter alia*, states that the financial statements shall comply with the accounting standards notified under section 133 of the Act. Section 2(13) of the Act defines "books of account" to include records maintained in respect of—
- (i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;
 - (ii) all sales and purchases of goods and services by the company;
 - (iii) the assets and liabilities of the company; and
 - (iv) the items of cost as may be prescribed under section 148 in the case of a company which belongs to any class of companies specified under that section;

Clause (b) of section 143(3) requires the auditor to, *inter alia*, state whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books.

14. Matters to be reported under clause (h) of section 143(3) needs to be evaluated based on the financial statements prepared under the Act. This is also consistent with the other reporting responsibilities of the auditor on books of account and compliance with notified/specified accounting standards that are reported by him under section 143(3). Accordingly, reporting under this clause is determined based on the financial statements prepared i.e., as at the balance sheet date.
15. The words "qualification", "adverse remark" and "reservation" used in clause (h) of section 143(3) should be considered to be similar to the terms "qualified opinion", "adverse opinion" and "disclaimer of opinion", respectively, referred to in SA 705 "Modifications to the Opinion in the Independent Auditor's Report".
16. Accordingly, the auditor would need to report under clause (h) of section 143(3) any matter that causes a qualification, adverse remark or disclaimer of opinion on the financial statements since such matters will or possibly will have an effect on the books of account maintained by the company.
17. Further, reporting under clause (h) of section 143(3) will be required if the auditor makes any observation under clause (b) of section 143(3) relating to whether proper

books of account as required by law have been kept by the company. For example, the auditor may have made an observation on maintenance of cost records under clause (b) of section 143(3) and this may not have had an effect on the financial statements of the company or the auditor's opinion on the financial statements.

18. As a corollary, reporting under clause (h) of section 143(3) will not be required if there are no modifications, i.e., no qualified, adverse or disclaimer of opinion, and there are no such observations under clause (b) of section 143(3) regarding books of account kept by the company.
19. Since clause (h) of section 143(3) requires the auditor to report under this clause only if the auditor has "any qualification, reservation or adverse remark", it is appropriate to conclude that a matter reported under emphasis of matter paragraph in the audit report need not be considered for reporting under this clause as an emphasis of matter is not in the nature of a qualification, reservation (disclaimer) or adverse remark.
20. Any material weakness in internal financial controls that is reported by the auditor under clause (i) of section 143(3) may not have an impact on the maintenance of books of account if such material weakness did not result in a modification to the opinion on the financial statements of the company. However, if the material weakness in internal financial controls resulted in a modification to the audit opinion on the financial statements, then such modification may be covered for reporting under clause (h) of section 143(3) as stated in paragraph 17 above.
21. The Appendix to this Guidance Note contains illustrations on matters that may give rise to reporting under section 143(3)(f) and/or section 143(3)(h) of the Companies Act, 2013.

APPENDIX

Illustrative Matters Forming Basis For Modified Opinion Or Emphasis Of Matter Paragraph in the Auditor's Report and Requiring Reporting Under Section 143(3)(f) and/or Section 143(3)(h) of the Companies Act, 2013

ILLUSTRATION 1

Basis for Qualified Opinion

The Company's inventories are carried in the Balance Sheet at ₹ XXX (As at 31st March 20YY: ₹ YYY). The Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from the Accounting Standard - 2 "Valuation of Inventories". The Company's records indicate that had the Management stated the inventories at the lower of cost and net realisable value, an amount of ₹ XXX (As at 31st March 20YY: ₹ YYY) would have been

required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by ₹ XXX (*Previous year ended 31st March, 20YY: ₹ YYY*), and income tax, profit for the year and shareholders' funds would have been reduced by ₹ X, ₹ XX and ₹ XXX, respectively (*Previous year ended 31st March, 20YY: ₹ Y, ₹ YY and ₹ YYY, respectively*). This matter was also qualified in our report/ the report of the predecessor auditors on the financial statements for the year ended 31st March 20YY.⁴

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion paragraph above, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

.....

Report on Other Legal and Regulatory Requirements

As required by Section 143 (3) of the Act, we report that:

- (a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit;

.....

- (f) The matter described in the Basis for Qualified Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....

- (h) The qualification relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Qualified Opinion paragraph above.”

⁴ Where applicable and only in such case, disclosure of previous year figures is required - Attention of the readers is drawn to the provisions of Standard on Auditing (SA) 710, *Comparative Information—Corresponding Figures And Comparative Financial Statements* .

ILLUSTRATION 2[#]**Opinion**

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

Emphasis of Matters

We draw attention to the following matters in the Notes to the financial statements:

- (a) Note X to the financial statements which, describes the uncertainty related to the outcome of the lawsuit filed against the Company by XYZ Company.
- (b) Note Y in the financial statements which indicates that the Company has accumulated losses and its net worth has been fully / substantially eroded, the Company has incurred a net loss/net cash loss during the current and previous year(s) and, the Company's current liabilities exceeded its current assets as at the balance sheet date. These conditions, along with other matters set forth in Note Y, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern. However, the financial statements of the Company have been prepared on a going concern basis for the reasons stated in the said Note.

Our opinion is not modified in respect of these matters.

.....

Report on Other Legal and Regulatory Requirements

As required by Section 143 (3) of the Act, we report that:

.....

- (f) The going concern matter described in sub-paragraph (b) under the Emphasis of Matters paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

[#] In this case there is nothing reportable under sec 143(3)(h).

ILLUSTRATION 3**Basis for Qualified Opinion**

ABC Company Limited's investment in XYZ Company, a foreign associate whose net worth has been fully/substantially eroded, is carried at ₹ XXX in the Balance Sheet as at March 31, 20XX. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC Company Limited's investment in XYZ Company as at March 31, 20XX because we were denied access to the financial information, management, and the auditors of XYZ Company. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects⁵ of the matter described in the Basis for Qualified Opinion paragraph, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31st March 20XX, and its profit/loss and its cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

As required by section 143 (3) of the Act, we report that:

.....

(f) The matter described in the Basis for Qualified Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....

(h) The qualification relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Qualified Opinion paragraph above.

ILLUSTRATION 4**Basis for Adverse Opinion**

The Company's financing arrangements expired and the amount outstanding was payable on March 31, 20XX. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue

⁵ Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.

as a going concern and, therefore, it may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give the information required by the Companies Act, 2013 in the manner so required and also do not give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31st March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

As required by section 143 (3) of the Act, we report that:

(f) The matter described in the Basis for Adverse Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

(h) The adverse remarks relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Adverse Opinion paragraph above.

ILLUSTRATION 5

Basis for Disclaimer of Opinion

We were appointed as auditors of the Company after March 31, 20X1 and thus could not observe the counting of physical inventories at the beginning and end of the year. Accordingly, we were unable to satisfy ourselves by alternative means concerning the inventory quantities held at March 31, 20X0 and March 31, 20X1 which are stated in the Balance Sheet at ₹ XXX and ₹ XXX, respectively.

In addition, the introduction of a new computerised accounts receivable system in September 20X0 resulted in numerous errors in accounts receivable. As of the date of our audit report, Management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the Balance Sheet at a total amount of ₹ XXX as at March 31, 20X1.

As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and

accounts receivable in the Balance Sheet, and the corresponding elements making up the Statement of Profit and Loss and Cash Flow Statement.

Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Report on Other Legal and Regulatory Requirements

As required by section 143 (3) of the Act, we report that:

.....

.....

(f) The matter described in the Basis for Disclaimer of Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....

(h) The reservation relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Disclaimer of Opinion paragraph above.

4. **Reporting under Companies (Auditor's Report) Order, 2016 [CARO, 2016]:** In exercise of the powers conferred by sub-section (11) of section 143 of the Companies Act, 2013 (18 of 2013) and in supersession of the Companies (Auditor's Report) Order, 2015 published in the Gazette of India, Extraordinary, Part II, Section 3, Sub-section (ii), vide number S.O. 990 (E), dated the 10th April, 2015, except as respects things done or omitted to be done before such supersession, the Central Government, after consultation with the, committee constituted under proviso to sub-section (11) of section 143 of the Companies Act, 2013 hereby makes the following Order dated 29th March, 2016, namely:—

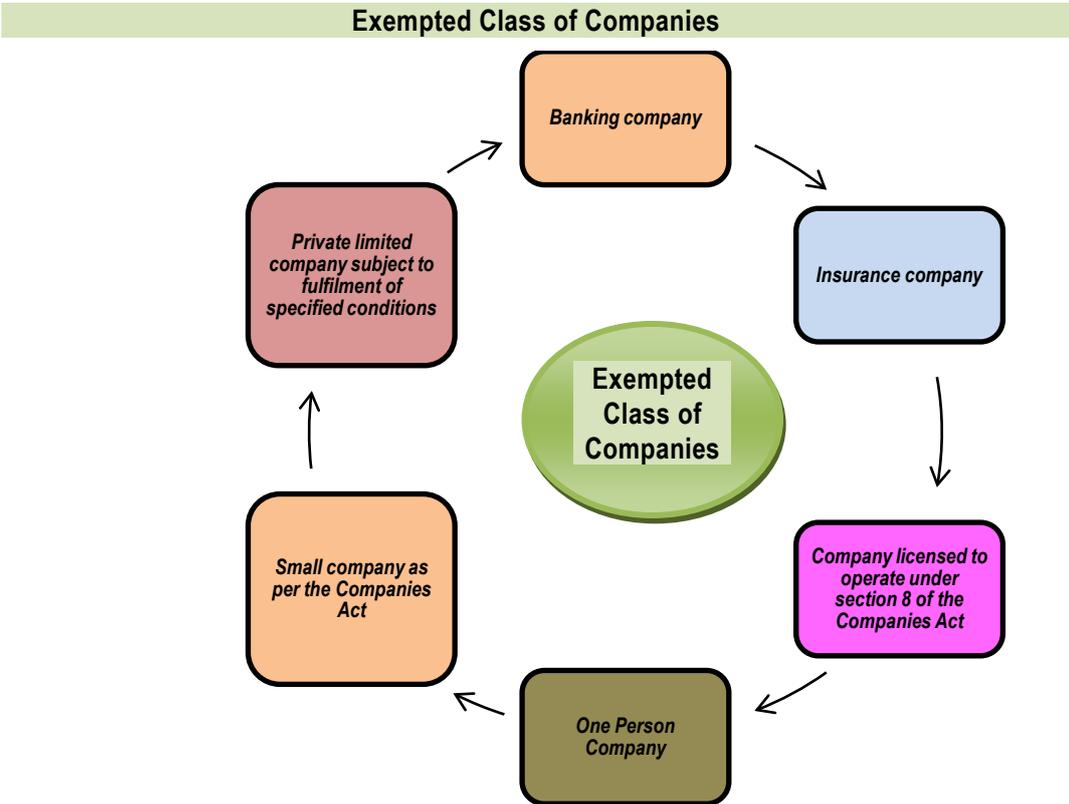
I. Short title, application and commencement-

- (1) This Order may be called the Companies (Auditor's Report) Order, 2016.
- (2) **Applicability of the Order:** The CARO, 2016 is an additional reporting requirement Order. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013 [hereinafter referred to as the Companies Act],

However, the Order specifically exempts the following class of companies-

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
- (ii) an insurance company as defined under the Insurance Act, 1938 (4 of 1938);

- (iii) a company licensed to operate under section 8 of the Companies Act;
- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act and a small company as defined under clause (85) of section 2 of the Companies Act; and
- (v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.



II. **Auditor's report to contain matters specified in paragraphs 3 and 4.** - Every report made by the auditor under section 143 of the Companies Act, 2013 on the accounts of every company audited by him, to which this Order applies, for the financial years commencing on or after 1st April, 2015, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable:

It may be noted that the Order shall not apply to the auditor's report on consolidated financial statements.

III. Matters to be included in the auditor's report. - The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:-

- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
- (b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- (c) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof;
- (ii) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account;
- (iii) whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,
 - (a) whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;
 - (b) whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
 - (c) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;
- (iv) in respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.
- (v) in case, the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?

- (vi) whether maintenance of cost records has been specified by the Central Government under section 148(1) of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.
- (vii) (a) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;
- (b) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not be treated as a dispute).
- (viii) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).
- (ix) whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;
- (x) whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;
- (xi) whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act? If not, state the amount involved and steps taken by the company for securing refund of the same;
- (xii) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1: 20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;
- (xiii) whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;

- (xiv) whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;
- (xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with;
- (xvi) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

IV. Reasons to be stated for unfavourable or qualified answers.-

- (1) Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is unfavourable or qualified, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be.
- (2) Where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons as to why it is not possible for him to give his opinion on the same.

5. **Companies (Cost Records and Audit) Rules, 2014:** The Central Government has amended the Companies (Cost Records and Audit) Rules, 2014 dated 31st December, 2014 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

Maintenance of Cost Records: Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ₹ 35 crore or more during the immediately preceding financial year, required to include cost records in their books of account. These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006.

The said rule has divided the list of companies into regulated sectors and non-regulated sectors. Some of the companies/industry/sector/product/service prescribed under the said rule are given below:

(A) Regulated Sectors-

- (i) Telecommunication services made available to users by means of any transmission or reception of signs, signals, images etc. (other than broadcasting services) and regulated by the Telecom Regulatory Authority of India.

- (ii) Generation, transmission, distribution and supply of electricity regulated by the relevant regulatory body or authority under the Electricity Act, 2003, other than for captive generation.
- (iii) Petroleum products regulated by the Petroleum and Natural Gas Regulatory Board.
- (iv) Drugs and Pharmaceutical.
- (v) Fertilisers.
- (vi) Sugar and industrial alcohol.

(B) Non-Regulated Sectors-

- (i) Machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item or items.
- (ii) Turbo jets and turbo propellers.
- (iii) Tyres and Tubes.
- (iv) Steel.
- (v) Cement.
- (vi) Production, import and supply or trading of following medical devices, such as heart valves; orthopaedic implants; pacemaker (temporary and permanent), etc. The rule excludes the foreign companies having only liaison offices.

As per Rule 5 of the Companies (Cost Records and Audit) Rules, 2014, every company under these rules including all units and branches thereof, shall, in respect of each of its financial year, is required to maintain cost records in Form CRA-1. The cost records shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.

Additionally, as per clause (vi) to Paragraph 3 of the CARO, 2016, where maintenance of cost records has been specified by the Government under section 148(1) of the Companies Act, 2013, the auditor has to report whether such accounts and records have been made and maintained.

Applicability of Cost Audit: Rule 4 of the Companies (Cost Records and Audit) Rules, 2014 states the provisions related to the applicability of cost audit depending on the turnover of the company as follows-

- (i) Classes of companies specified under item (A) "Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 50 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 25 crore or more.

- (ii) Classes of companies specified under item (B) "Non-Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 100 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 35 crore or more.

Casual Vacancy in the Office of a Cost Auditor: Any casual vacancy in the office of a Cost Auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors within 30 days of occurrence of such vacancy and the company shall inform the central government in Form CRA-2 within 30 days of such appointment of cost auditor.

PART – II: QUESTIONS AND ANSWERS

QUESTIONS

1. State with reason (in short) whether the following statements are true or false:
- (i) The company shall place the matter relating to appointment of auditors for ratification by members at 5th AGM only.
 - (ii) There is no need of written consent of the auditor for appointing him as an auditor in a company.
 - (iii) Letter of weakness is issued by the management.
 - (iv) Every auditor of a company shall have a right of access at all times to the books of account and vouchers of the company kept at the registered office of the company only.
 - (v) Scrutiny of Bank Reconciliation statement is one of the audit techniques.
 - (vi) The remuneration of subsequent auditors appointed under the Companies Act, 2013 shall be fixed by the Board of Directors.
 - (vii) At every annual general meeting of a company, the Board of directors of the company shall lay before the company the financial statements for the financial year.
 - (viii) Purchase invoice is an example of internal evidence.
 - (ix) Standards on Review Engagements (SREs) - to be applied in the audit of historical financial information.
 - (x) Check list is a complete and exhaustive description of the system as found in operation by the auditor.

Nature of Auditing

2. (a) Mention briefly the conditions or events, which increase the risk of fraud or error leading to material misstatement in Financial Statements.
(b) “The process of auditing is such that it suffers from certain limitations which cannot be overcome irrespective of the nature and extent of audit procedures.” Explain.
3. (a) The auditor is responsible for maintaining an attitude of professional skepticism throughout the audit. Do you agree with the statement?
(b) “Having accounts audited by independent auditor, among other advantages, acts as a moral check on the employees from committing fraud.” Explain stating the advantages of Independent audit.
4. (a) “Auditor is expected to be familiar with the overall economic environment in which his client is operating.” Discuss.
(b) Give six examples of operating Conditions that may cast doubt about going concern assumption.

Basic Concepts in Auditing

5. “Risk of material misstatement at the assertion level for classes of transactions, account balances and disclosures need to be considered.” Explain stating the different categories of assertions used by the auditor.
6. (a) “Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements whereas for some accounting estimates there may be relatively high estimation uncertainty particularly where they are based on significant assumptions”. Explain by giving examples.
(b) Discuss the concept of “True and Fair”.
7. (a) Explain the test of controls and substantive procedures as audit procedure of obtaining sufficient appropriate audit evidence for forming an audit opinion.
(b) The audit working papers constitute the link between the auditor’s report and the client’s records. Discuss stating clearly the objectives of audit working papers.

Preparation for an Audit

8. (a) Discuss the methods of Sampling in the light of SA 530.
(b) Mention any four areas where surprise checks can significantly improve the effectiveness of an audit.
9. (a) “SA 320 “Materiality in Planning and Performing an Audit”, establishes standards on the concept of materiality and the relationship with audit risk while conducting an audit. Hence, the auditor requires more reliable evidence in support of material items”. Explain.

- (b) For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. Describe some of the techniques commonly adopted by the auditors.

Internal Control

10. (a) Your firm of Chartered Accountants has been allotted Information Systems Audit of 4 branches of SBI. How would you assess the reliability of internal control system in computerised information system?
- (b) Explain the important requirements which should be kept in mind to establish or evaluate a system of internal control for application process at Service Bureau?
11. (a) Explain the special steps involved in framing a system of Internal Check.
- (b) What is an Audit Trail? Briefly state the special audit techniques using the computer as an audit tool.

Vouching & Verification of Assets and Liabilities

12. (a) "It is necessary that transactions of one period be separated from those in the ensuing period so that the results of the working of each period can be correctly ascertained." Explain
- (b) "No entry is passed for cheques received by the auditee on the last day of the year and not yet deposited with the bank". Give your comments and observations.
13. How will you verify/vouch the following:
- (a) Contingent Liabilities.
- (b) Goods sent on consignment.
- (c) Sales Commission Expenditure.
- (d) Endowment Policies.
14. Explain the factors to be considered while "Vouching of travelling expenses".

The Company Audit

15. (a) Discuss the provisions contained in the Companies Act, 2013 regarding Appointment of First Auditor of a Non-Government Company.
- (b) "Provisions regarding rotation of auditors affect only specific class of companies". Discuss.
16. State the circumstances which could lead to any of the following in an Auditor's Report:
- (a) A modification of opinion
- (b) Disclaimer of opinion
- (c) Adverse opinion
- (d) Qualified opinion.

17. (a) ABC Company Ltd. removed its First Auditor before the expiry of his term without obtaining approval of the Central Government. Comment.
- (b) Briefly discuss the provisions of the Companies Act, 2013 with regard to issue of shares at a discount.
- (c) A vacancy arose in the office of an auditor of XYZ Ltd due to death of the Auditor Mr Z and the Managing Director of the company filled that vacancy. Comment citing the provisions of the Companies Act, 2013.
18. (a) Sri & Company, a firm of Chartered Accountants was appointed as statutory auditors of Aaradhana Company Ltd. Aaradhana Company Ltd. holds 51% shares in Sarang Company Ltd. Mr. Sri, one of the partners of Sri & Company, owed ₹ 1,500 as on the date of appointment to Sarang Company Ltd. for goods purchased in normal course of business. Comment.
- (b) Audit Committee is to be formed by each and every company and the auditor has right to vote in the meeting of such Audit Committee. Comment.
- (c) "CARO, 2016 applies to all companies". Discuss.

Special Audits

19. (a) What role is played by Comptroller and Auditor General of India in the audit of a Government company?
- (b) "Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG." Discuss.
20. Mention any ten special points to be examined by you in the audit of Income and Expenditure of a Charitable Institution running a hospital.

SUGGESTED ANSWERS / HINTS

1. (i) **Incorrect:** The company shall place the matter relating to appointment of auditors for ratification by members at every AGM.
- (ii) **Incorrect:** Before appointing an auditor, the written consent of the auditor to such appointment and a certificate from him that appointment shall be in accordance with the conditions as may be prescribed shall be obtained from the auditor.
- (iii) **Incorrect:** Letter of weakness is a report issued by the auditor stating the weakness in the internal control mechanism. It also suggests measures by which the weakness in the system to be corrected and the control system be made better protected.
- (iv) **Incorrect:** As per Section 143(1) of the Companies Act, 2013, every auditor of a company shall have a right of access at all times to the books of account and

vouchers of the company kept not only at the registered office of the company but also at any other place too.

- (v) **Correct:** For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. Scrutiny of Bank Reconciliation statement is one of the audit techniques commonly adopted by the auditors.
 - (vi) **Incorrect:** According to Section 142 of the Companies Act, 2013, the remuneration of subsequent auditors of a company shall be fixed in its general meeting or in such manner as may be determined therein.
 - (vii) **Correct:** As per Section 129(2) of the Companies Act, 2013, at every annual general meeting of a company, it shall be the duty of the Board of Directors of the company to lay before the company the financial statements for the financial year.
 - (viii) **Incorrect:** Internal evidence is the evidence that originates within the client's organisation. Since purchase invoice originates outside the client's organisation, therefore, it is an example of external evidence.
 - (ix) **Incorrect:** Standards on Review Engagements (SREs) - to be applied in the review of historical financial information.
 - (x) **Incorrect:** Narrative Record is a complete and exhaustive description of the system as found in operation by the auditor. On the other hand, a Check List is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer.
2. (a) **Conditions Which Increase the Risk of Fraud or Error:** In planning and performing an examination, the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. Weaknesses in the design of the internal control system and non-compliance with identified control procedures amongst other conditions or events which increase the risk of fraud or error are-
- (i) Weaknesses in the design of internal control system and non-compliance with the laid down control procedures, e.g., a single person is responsible for the receipt of all *dak* and marking it to the relevant sections or two persons are responsible for receipt of *dak* but the same is not followed in actual practice, etc.
 - (ii) Doubts about the integrity or competence of the management, e.g., domination by one person, high turnover rate of employees, frequent change of legal counsels or auditors, significant and prolonged understaffing of the accounts department, etc.
 - (iii) Unusual pressures within the entity, for example, industry is doing well but the company is not performing accordingly, heavy dependence on a single line of

product, inadequate working capital, entity needs raising share prices to support the market price in the wake of public offer, etc.

- (iv) Unusual transactions such as transactions with related parties, excessive payment for certain services to lawyers, etc.
 - (v) Problems in obtaining sufficient and appropriate audit evidence, e.g., inadequate documentation, significant differences between the figures as per the accounting records and confirmation received from third parties, etc.
- (b) **Inherent limitations of Audit:** As per SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, the objectives of an audit of financial statements, prepared with in a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy him that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The process of auditing, however, is such that it suffers from certain limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. The limitations of an audit arise from:
- (i) **The Nature of Financial Reporting:** The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures.
 - (ii) **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. 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.

- (iii) **Timeliness of Financial Reporting and the Balance between Benefit and Cost:** The relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.
- (iv) **Other Matters that Affect the Limitations of an Audit:** In the case of certain assertions or subject matters, the potential effects of the 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 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.

Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

3. (a) **Professional Skepticism:** As per SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Therefore, professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of overlooking unusual circumstances, over generalising when drawing conclusions from audit observations or using

inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Further, while obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. This requirement is also designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Therefore, we do agree with the statement.

(b) Advantages of Independent Audit: Advantages of having the accounts audited by an independent auditor are:-

- (i) It safeguards the financial interest of persons not associated with the management like partners or shareholders.
- (ii) It acts as a moral check on the employees from committing fraud.
- (iii) It is helpful in settling tax liability, negotiations for loans and for determining purchase consideration for sale/merger.
- (iv) It is also helpful in settling trade or labour disputes for higher wages/bonus.
- (v) It helps in detection and minimizing wastages and losses.
- (vi) It ensures maintenance of adequate books and records, statutory register etc.

4. **(a) Auditing and Economics:** As, it is well known, accounting is concerned with the accumulation and presentation of data relating to economic activity. Though the concept of income as put forward by economists is different as compared to the accountants concept of income, still, there are lot of similar grounds on which the accounting has flourished. From the auditing view point, the auditors are more concerned with Micro economics rather than with the Macro economics. The knowledge of Macro economics should include the nature of economic force that affect the firm, relationship of price, productivity and the role of Government and Government regulations. Auditor is expected to be familiar with the overall economic environment in which his client is operating.

(b) Operating Conditions Casting Doubt About Going Concern Assumption: The following are examples of operating events or conditions that, may cast significant doubt about the going concern assumption-

- (i) Management intentions to liquidate the entity or to cease operations.
- (ii) Loss of key management without replacement.
- (iii) Loss of a major market, key customer(s), franchise, license, or principal supplier(s).

- (iv) Labour difficulties.
- (v) Shortages of important supplies.
- (vi) Emergence of a highly successful competitor.

- 5. Risk of Material Misstatement at the Assertion Level:** According to SA 315 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms-

(a) Assertions about classes of transactions and events for the period under audit:

- (i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.
- (ii) Completeness—all transactions and events that should have been recorded have been recorded.
- (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
- (iv) Cut-off—transactions and events have been recorded in the correct accounting period.
- (v) Classification—transactions and events have been recorded in the proper accounts.

(b) Assertions about account balances at the period end:

- (i) Existence—assets, liabilities, and equity interests exist.
- (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.
- (iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(c) Assertions about presentation and disclosure:

- (i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.
- (ii) Completeness—all disclosures that should have been included in the financial statements have been included.
- (iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.
- (iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts

6. (a) Accounting Estimates: Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.

For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.

Additional examples of accounting estimates are:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.
- Financial Obligations / Costs arising from litigation settlements and judgments.

(b) Concept of “True and Fair”: The concept of “true and fair” is a fundamental concept in auditing. The phrase “true and fair” in the auditor’s report signifies that the auditor is required to express his opinion as to whether the state of affairs and

the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.

This requires that the auditor should examine the accounts with a view to verifying that all assets and liabilities, incomes and expenses are stated at the amounts which are in accordance with accounting principles and policies, and no material item has been omitted.

The importance of the concept of true and fair view can also be understood and appreciated from the facts that sections 128, 129 and 143 of the Companies Act, 2013 also discusses this concept in relation to account books, financial statements and reporting on financial statements respectively.

Section 128(1) of the said Act provides that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any. The company shall be in a position to explain the transactions effected both at the registered office and its branches. Such books of Accounts shall be kept on accrual basis and according to the double entry system of accounting.

Section 129(1) of the Companies Act, 2013 provides that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 of the Companies Act, 2013, (in which the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority) and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III to the said Act.

The term "financial statement" shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under the said Act.

It may be noted that nothing contained in sub-section (1) shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.

However, the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose-

- (a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;

- (b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;
- (c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;
- (d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

It may be noted that where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

Further, according to section 143(2) of the said Act, the auditor is required to make a report to the members of the company indicating that, to the best of his information and knowledge, the financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

SA 700 "Forming an Opinion and Reporting on Financial Statements", requires the auditor to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and express clearly that opinion through a written report that also describes the basis for the opinion. The auditor is required to express his opinion on the financial statements that it gives a true and fair view in conformity with the accounting principles generally accepted in India (a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX; (b) in the case of the Statement of Profit and Loss, of the profit/loss for the year ended on that date; and (c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

7. (a) **Collection of Evidence to Form Audit Opinion:** Auditor should obtain sufficient and appropriate audit evidence and test them before framing an opinion about the assertions the financial statements reveal. For this, the auditor checks evidences through (a) Test of Controls and (b) Substantive Procedure.

According to SA 330 "The Auditor's Responses to Assessed Risks", 'test of controls' means an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

- (i) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e.,

the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

- (ii) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

SA 330 further explains the 'substantive procedure' as an audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

- (i) Tests of details (of classes of transactions, account balances, and disclosures), and
- (ii) Substantive analytical procedures.

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures.

- (b) Audit Working Papers:** The audit working papers constitute the link between the auditor's report and the client's records. SA 230 on "Audit Documentation" states that Audit Working papers are the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. The object of Audit working papers is to provide:

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

Besides above, they serve a number of additional purposes, including the following:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220.
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Working papers should contain audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained. The auditor shall assemble the audit working papers in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. The retention period for audit working papers ordinarily is no shorter than ten years from the date of the auditor's report, or, if later, the date of the group auditor's report. Unless otherwise specified by law or regulation, audit working papers are the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients.

8. (a) **Methods of Sampling:** There are many methods of selecting samples. The principal methods are as follows -

(i) **Random selection** (applied through random number generators, for example, random number tables). Stratified Sampling is one of the methods of Random Sampling. This method involves dividing the whole population to be tested in a few groups called strata and taking a sample from each of them. Each stratum is treated as if it were a separate population and if proportionate items are selected from each of the stratum. The groups into which the whole population is divided is determined by the auditor on the basis of his judgement e.g. entire expense vouchers may be divided into:

- (1) Vouchers above ₹ 1,00,000
- (2) Vouchers between ₹ 25,000 and ₹ 1,00,000
- (3) Vouchers below ₹ 25,000

The auditor can then decide to check all vouchers above ₹ 1,00,000, 50% between ₹ 25,000 and ₹ 1,00,000 and 25% of those below ₹ 25,000.

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

(ii) **Systematic selection**, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

- (iii) **Monetary Unit Sampling** is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
 - (iv) **Haphazard selection**, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.
 - (v) **Block selection** 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.
- (b) **Where Surprise Checks can Significantly Improve the Effectiveness of an Audit:** Surprise checks constitute an important part of normal audit procedure. An element of surprise both with regard to the time of checking and selection of items, significantly improves the effectiveness of an audit. Normally, areas over which surprise check can be employed are-
- (i) Verification of cash and investments.
 - (ii) Inventory.
 - (iii) Internal control and internal checks.
 - (iv) Books of prime entries and statutory registers.
9. (a) **Concept of Materiality:** SA 320 "Materiality in Planning and Performing an Audit", establishes standards on the concept of materiality and the relationship with audit risk while conducting an audit. Hence, the auditor requires more reliable evidence in support of material items. SA 320 defines material items as relatively important and relevant items, i.e., items the knowledge of which would influence the decision of the user of financial statements. Financial statements materially affect if such statement is erroneously stated or omitted to be stated there in and economic decision of the users taken on the basis of such information is influenced by such misstatements or omissions.
- The auditor has to ensure that such items are properly and distinctly disclosed in the financial statements.

The concept of materiality is fundamental to the process of accounting. It covers all the stages from recording to classification and presentation. It is very important for the auditor who has constantly to judge whether a particular item is material or not.

There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

Factors to be considered for determining materiality:

- (i) Item of materiality may be determined individually or in aggregate.
- (ii) The materiality depends on the regulatory or legal considerations.
- (iii) Materiality is not often reckoned with respect to quantitative details above. It has qualitative dimensions as well.
- (iv) Even insignificant items in terms of quality may be material in special circumstances.
- (v) Sometimes the materiality of an item in terms of quantity is described in law itself. For example, Schedule III requires disclosure of items of expenditures which are in excess of one percent of the revenue from operations or ₹ 1,00,000, whichever is higher.
- (vi) An item whose impact is insignificant at present, but in future it may be significant, may be material item.

(b) Audit Techniques: For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. Some of the techniques commonly adopted by the auditors are the following:

- (i) Posting checking
- (ii) Casting checking
- (iii) Physical examination and count
- (iv) Confirmation
- (v) Inquiry
- (vi) Year-end scrutiny
- (vii) Re-computation
- (viii) Tracing in subsequent period
- (ix) Bank Reconciliation

It may be noted that the two terms, procedure and techniques, are often used interchangeably; in fact, however, a distinction does exist. Procedure may comprise a

number of techniques and represents the broad frame of the manner of handling the audit work; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve techniques of inspection and checking computation of documentary evidence.

10. (a) **Reliability of Internal Control System in CIS:** For evaluating the reliability of internal control system in CIS, the auditor would consider the followings -
- (i) That authorised, correct and complete data is made available for processing.
 - (ii) That it provides for timely detection and corrections of errors.
 - (iii) That in case of interruption due to mechanical, power or processing failures, the system restarts without distorting the completion of entries and records.
 - (iv) That it ensures the accuracy and completeness of output.
 - (v) That it provides security to application softwares & data files against fraud etc.
 - (vi) That it prevents unauthorised amendments to programs.
- (b) **Requirements of Internal Control System at a Service Bureau:** Various requirements to establish or evaluate a system of internal control for applications processed at a service bureau are stated below-
- (i) Liaison between bureau and user should be clearly defined. Senior member of the user's staff is appointed as liaison officer.
 - (ii) Need for a system testing including all clerical procedures at the user company.
 - (iii) Control over physical movement of data and in this respect whether a copy or microfilm of documents sent to the service bureau is kept.
 - (iv) Planning procedure so that error is identified by documents provided by the bureau. The user must ensure that prompt correction and resubmission of rejection to meet the bureau processing schedule.
 - (v) Establishing a system in the user company to ensure that all exceptional reports are received from bureau.
 - (vi) Establish clerical control to verify the accuracy of computer processing.
 - (vii) Normally, user has no physical control over the files; therefore, high control over the maintenance of data on master files should be established.
11. (a) **General Considerations in Framing a System of Internal Check:** The term "internal check" is defined as the "checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being

the prevention or early detection of errors or fraud”. The following aspects should be considered in framing a system of internal check:

- (i) No single person should have an independent control over any important aspect of the business. The work done by one person should automatically be checked by another person in routine course.
 - (ii) The duties/work of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.
 - (iii) Every member of the staff should be encouraged to go on leave at least once in a year so that frauds successfully concealed by such a person can be detected in his absence.
 - (iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.
 - (v) There should be an accounting control in respect of each important class of assets, in addition, these should be periodically inspected so as to establish their physical condition.
 - (vi) The system of Budgetary Control should be introduced.
 - (vii) For inventory-taking, at the close of the year, trading activities should, if possible, be suspended. The task of inventory-taking, and evaluation should be done by staff belonging to other than inventory section.
 - (viii) The financial and administrative powers should be sub divided very judiciously and the effect of such division should be reviewed periodically.
 - (ix) Finally, the system must be capable of being expanded or contracted to correspond to the size of the concern.
- (b) Audit Trail:** ‘Audit trail’ refers to a situation where it is possible to relate, on a “one – to –one” basis, the original input with the final output. In a manual accounting system, it is possible to relate the recording of a transaction of each successive stage enabling an auditor to locate and identify all documents from beginning to end for the purposes of examining documents, totalling and cross – referencing. In first and early second generation computer systems, a complete audit trail was generally available. However, with the advent of modern machines, the CIS environment has become more complex. This led to use of exception reporting by the management which effectively eliminated the audit trail between input and output. The lack of visible evidence may occur at different stages in the accounting process, for example-
- (i) Input documents may be non-existent where sales orders are entered online. In addition, accounting transactions such as discounts and interest calculations may be generated by computer programmes with no visible authorization of individual transactions.

- (ii) The system may not produce a visible audit trail of transactions processed through the computer. Delivery notes and suppliers invoices may be matched by a computer programme. In addition, programmed control procedures such as checking customer credit limits, may provide visible evidence only on an exception basis. In such cases, there may be no visible evidence that all transactions have been processed.
- (iii) Output reports may not be produced by system or a printed report may only contain summary totals while supporting details are retained in computer files.

Special Audit Techniques: In the absence of audit trail, the auditor needs the assurance that the programmes are functioning correctly in respect of specific items by using special audit techniques. The absence of input documents or the lack of visible audit trail may require the use of Computer Assisted Audit Techniques (CAATs) i.e. using the computer as an audit tool. The auditor can use the computer to test-

- the logic and controls existing within the system, and
- the records produced by the system.

Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor. The effectiveness and efficiency of auditing procedure may be enhanced through the use of CAATs. Properly, two common types of CAATs are in vogue, viz., test pack or test data and audit software or computer audit programmes.

12. (a) **Cut-off Arrangement:** Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separated from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for this purpose is technically known as “cut-off arrangement”. It essentially forms part of the internal control system of the organisation. Accounts, other than sales, purchase and inventory are not usually affected by the continuity of the business and therefore, this arrangement is generally applied only to sales, purchase and inventory. The auditor satisfies by examination and test-checks that the cut-off procedures are adequately followed and ensure that:
- (i) Goods purchased, property in which passed on to the client, have in fact been included in the inventories and that the liability has been provided for in case credit purchase.
 - (ii) Goods sold have been excluded from the inventories and credit has been taken for the sales. If the value of sales is to be received, the concerned party has been debited.

The auditor may examine a sample of documents, evidencing the movement of inventory into and out of stores, including documents pertaining to period shortly before and after the cut-off date and check whether inventories represented by those documents were included or excluded as appropriate during inventory taking for perfect and correct presentation in the financial statements.

- (b) **Cheques Received on the Last Day of Accounting Year:** It is a quite normal that in any ongoing business entity many a times cheques are received from the customers on the last day of the accounting year. It is also quite likely, that cheques received on the last day of the accounting year could not be deposited in the bank. Though normally speaking, it is expected that all cheques should be deposited in the bank daily. But there may be a possibility that such cheques which are received particularly during the late hours could not be deposited in the bank. Therefore, it is quite important to ensure that the system of internal control is effective and such cheques should be properly accounted for to avoid any frauds and that the financial statements reflect a true and fair view.

As far as internal control system is concerned, it should be ensured that a list of such cheques is prepared in duplicate and a copy of the same has been sent to person controlling the trade receivables' ledger and a second copy is handed over to cashier along with the cheques received. The person who is controlling the trade receivables' ledger should ensure that proper accounting entries have been passed by crediting respective trade receivables' accounts. The balance of cheques-in-hand should also be disclosed along with the cash and bank balances in the financial statements.

13. (a) **Contingent liabilities:** Accounting Standard (AS) 29 on 'Provisions, Contingent Liabilities and Contingent Assets', defines 'Contingent Liability' as a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or as a present obligation that arises from past events but is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a reliable estimate of the amount of the obligation cannot be made.

The auditor may take following steps to vouch or verify the contingent liabilities:

- (i) Inspect the minute books of the company to ascertain all contingent liabilities known to the company.
- (ii) Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating therefrom.
- (iii) Scrutinise the lawyer's bills to track unreported contingent liabilities.
- (iv) Examine bank letters in respect of bills discounted and not matured.

- (v) Examine bank letters to ascertain guarantees on behalf of other companies or individuals.
- (vi) Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.
- (vii) Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.
- (viii) Ensure that proper disclosure has been made as per Schedule III to the Companies Act, 2013 and AS 29, "Provisions, Contingent Liabilities and Contingent Assets".

(b) Goods Sent on Consignment:

- (i) Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.
- (ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.
- (iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.
- (iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.
- (v) See that goods in hand with the consignee have been shown distinctly under inventories.

(c) Sales Commission Expenditure:

- (i) Ascertain agreement, if any, in respect of sales transaction actually occurred during the year carried out by authorized parties on its behalf. If yes, the commission should be in accordance with the terms and conditions as specified.
- (ii) Check evidence of services rendered by the party to whom commission is paid with reference to correspondence etc.
- (iii) Ensure that the sales in fact have taken place and the same has been charged to Statement of Profit and Loss.

- (iv) Compare the amount incurred in previous years with reference to total turnover.
- (v) Check entries regarding TDS on commission at the time of credit to Payee's Account, or payment, whichever is earlier.
- (vi) Ensure that the payment has been made through cheque only, if limit as stated in the clause of tax audit is exceeded.

(d) Endowment Policies:

- (i) Ascertain the specific purpose for which the endowment policy is taken, e.g., Sinking Fund policies for redemption of debentures, redemption of leases or policies taken for other similar purposes, etc.
- (ii) Verify the terms and conditions of policies and ensure that all such conditions are in force and being followed.
- (iii) Check that premium has been deposited in time and the policy is in force.
- (iv) Examine that proper disclosures have been made in the financial statements in respect of items for which the policy has been taken.

14. Vouching of Travelling Expenses: The following factors are to be considered while "Vouching of Travelling Expenses":

- (i) Travelling expenses are normally payable to staff according to rules approved by directors or partners. Where no rules exist, the auditor should recommend that these be framed for controlling the expenditure. In the absence of T.A. Rules, the expenditure should be vouched on the basis of actual expenditure incurred. A voucher should be demanded for all items of expenses incurred, except those which are capable of independent verification.
- (ii) As regards travelling expenses claimed by directors the auditor should satisfy himself that these were incurred by them in the interest of the business and that the directors were entitled to receive the amount from the business.
- (iii) The voucher for travelling expenses should normally contain the under mentioned information:
 - (1) Name and designation of the person claiming the amount.
 - (2) Particulars of the journey.
 - (3) Amount of railway or air fare.
 - (4) Amount of boarding or lodging expenses or daily allowance alongwith the dates and times of arrival and departure from each station.
 - (5) Other expenses claimed
- (iv) If the journey was undertaken by air, the counterfoil of the air ticket should be attached to the voucher; this should be inspected. For travel by rail or road, the amount of the fare claimed should be checked from some independent source.

- (v) Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified.
 - (vi) The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned. All vouchers for travelling expenses should be authorised by some responsible official. In the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be sanctioned by the Board.
 - (vii) The travelling advance taken, if any, should be settled on receipt of final bills. At the year end, the amount not settled should be shown appropriately in the Balance Sheet.
 - (viii) Unless the articles specifically provide or their payment has been authorised by a resolution of shareholders, directors are not entitled to charge travelling expenses for attending Board Meetings.
15. (a) **Appointment of First Auditor of a Non-Government Company:** As per Section 139(6) of the Companies Act, 2013, the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

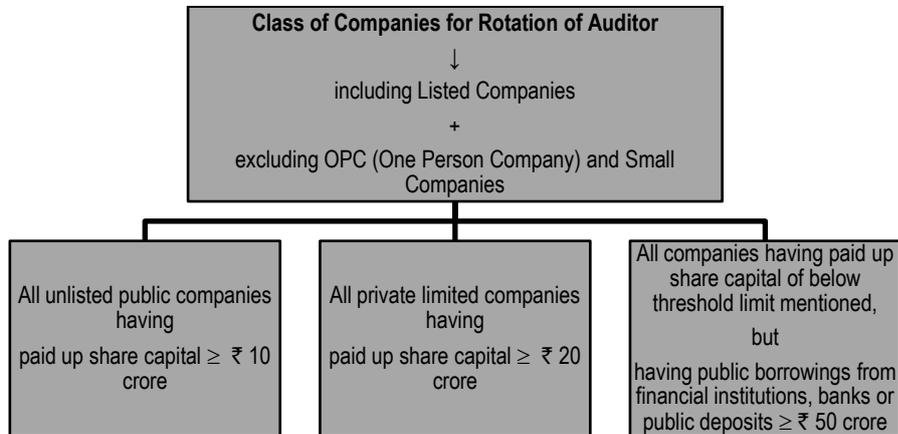
The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

- (b) **Applicability of provisions related to Rotation of Auditors:** The provisions related to rotation of auditor as provided under section 139(2) of the Companies Act, 2013 are applicable to all listed companies and other class or classes of companies as prescribed under Companies (Audit and Auditors) Rules, 2014.

As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the class of companies shall mean the following classes of companies excluding one person companies and small companies -

- (I) all unlisted public companies having paid up share capital of rupees ten crore or more;
- (II) all private limited companies having paid up share capital of rupees twenty crore or more;
- (III) all companies having paid up share capital of below threshold limit mentioned in (I) and (II) above, but having public borrowings from financial institutions,

banks or public deposits of rupees fifty crores or more.



16. (a) **Modification of Opinion:** The auditor shall modify the opinion in the auditor's report when-

- (i) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- (ii) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

(b) **Disclaimer of Opinion:** The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

(c) **Adverse Opinion:** The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

(d) **Qualified Opinion:** The auditor shall express a qualified opinion when-

- (i) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not

pervasive, to the financial statements; or

- (ii) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

17. (a) Removal of Auditor Before Expiry: As per sub-section (1) of Section 140 of the Companies Act, 2013, an 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 prior approval of the Central Government in that behalf as per Rule 7 prescribed under Companies (Audit & Auditors) Rules, 2014:

- (i) The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.
- (ii) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.
- (iii) The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.

It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

In the instant case, the first auditor was removed by the company before the expiry of his term without obtaining approval of the Central Government.

Therefore, it may be concluded that the action of the company for removal of the auditor before expiry of term is not justified and auditor may be removed from his office only by following the above mentioned procedure.

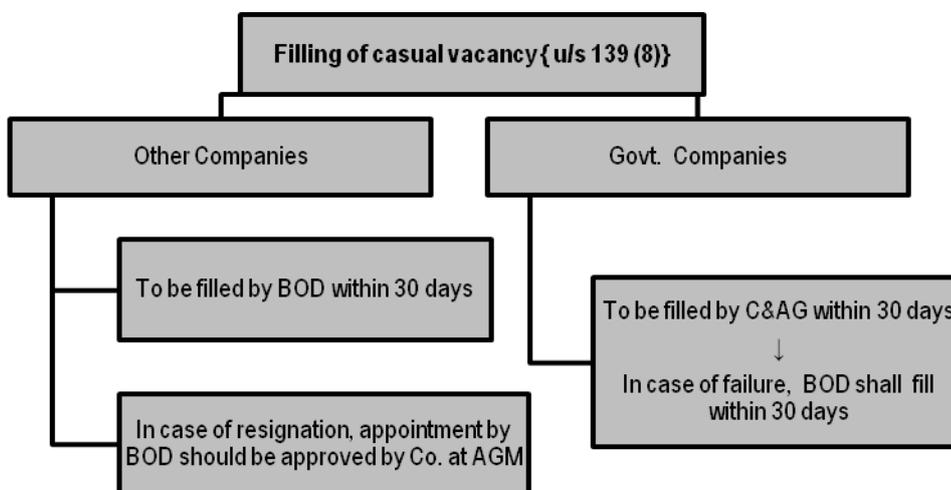
(b) Issue of Shares at a Discount: According to Section 53 of the Companies Act, 2013, except sweat equity shares issued as mentioned in section 54, any share issued by a company at a discounted price shall be void.

Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

(c) Filling of Casual Vacancy: Section 139(8) of the Companies Act, 2013 states that any casual vacancy in the office of an auditor shall in the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within

thirty days. But if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

In the given case, vacancy in the office of an auditor has arisen because of death and not due to resignation, therefore applying the above provisions it would be filled by the Board of Directors within thirty days. Appointment made by the Managing Director of the Company is not valid.



18. (a) **Indebtness to the Subsidiary Company:** As per Section 141(3)(d)(ii) of the Companies Act, 2013, a person who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company, or a subsidiary of its holding company, for an amount exceeding ₹ 5,00,000, then he is not qualified for appointment as an auditor of a company.

Where an auditor purchases goods or services from a company audited by him or its subsidiary, or its holding or associate company, or a subsidiary of its holding company, whether in normal course of business, he is definitely indebted to the company and if the amount outstanding exceeds ₹ 5,00,000, he is disqualified for appointment as an auditor of the company. In such a case, he becomes indebted to the company and consequently he has deemed to have vacated his office.

In the given case, Sri & Company, a firm of Chartered Accountants was appointed as statutory auditors of Aaradhana Company Ltd. where the company holds 51% shares in Sarang Company Ltd. Mr. Sri, one of the partners of Sri & Company owed ₹ 1,500 as on the date of appointment to Sarang Company Ltd. for goods purchased.

Accordingly, the partner Mr Sri is not disqualified to be appointed as auditor of the company as he is indebted to the company for an amount not exceeding ₹ 5,00,000.

Due to this, Sri & Company, is not disqualified to be appointed as an auditor of Aaradhana Company Ltd.

(b) Formation of Audit Committee: As per section 177 of the Companies Act, 2013 read with the Companies (Meeting of Board and its Powers) Rules, 2014, audit committee is to be formed by every listed companies and following classes of companies:

- (i) all public companies with a paid up capital of ten crore rupees or more,
- (ii) all public companies having turnover of one hundred crore rupees or more,
- (iii) all public companies having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

Further, the auditor shall have the right to be heard in the meetings of the Audit Committee when it considers the Auditor's Report but shall not have the right to vote.

(c) Applicability of CARO, 2016: It shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013 except–

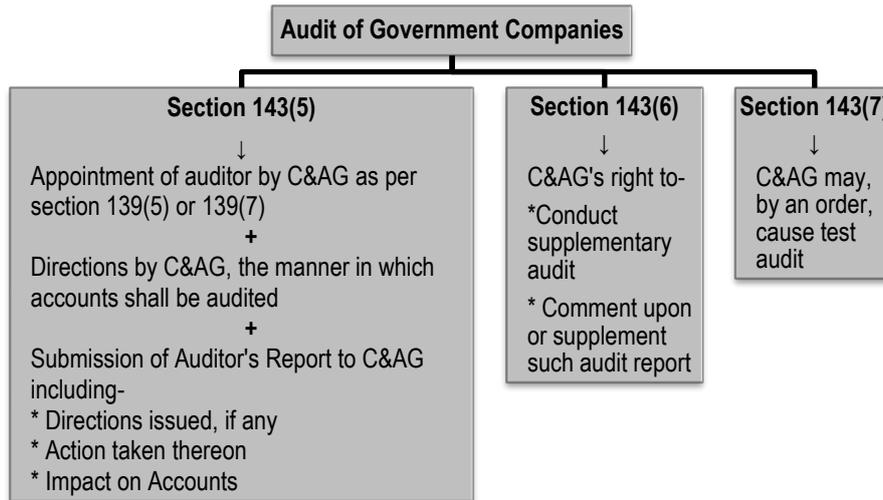
- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
- (ii) an insurance company as defined under the Insurance Act, 1938 (4 of 1938);
- (iii) a company licensed to operate under section 8 of the Companies Act;
- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act and a small company as defined under clause (85) of section 2 of the Companies Act; and
- (v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.

From the above it is clear that CARO, 2016 does not apply to all companies.

19. (a) Role of C&AG in the Audit of a Government company: Role of C&AG is prescribed under sub section (5), (6) and (7) of section 143 of the Companies Act, 2013.

In the case of a Government company, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be

audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.



The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report have a right to,

- (i) conduct a **supplementary audit** of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and
- (ii) **comment upon or supplement such audit report:** It may be noted that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

Test Audit: Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor-General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the

accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

- (b) **Audit of Stores and Inventories:** Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out. The aim is also to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control. The audit of purchase of stores is conducted in the same manner as audit of expenditure, namely, that these are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority. The auditor has to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit. Accounts of receipts, issues and balances are checked regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding. Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.
20. **Audit of Hospital:** While auditing the Income and Expenditure Account of a charitable institution running a hospital, following special points may be examined -
- (i) Verify the register of patients with duplicate copy of bills and patients admission record to see that bills have been properly and correctly prepared for all the services, tests and treatments.
 - (ii) Check cash collections from patients by tracing the receipt issued into cash book.
 - (iii) Check receipt of interest, rent, dividend etc., with receipt counterfoil into cash book and bank book and ensure that all such income has been duly accounted for.
 - (iv) Check collection of subscription, donations from the receipt issued, correspondence etc., into cash book.
 - (v) Verify that all grants from government and other bodies have been duly accounted for and have been applied in the manner as specified.

- (vi) Verify all recurring nature of revenue expenditure, with necessary evidence like bill, authority, period etc.
- (vii) Examine the internal check as regards the receipt and issue of stores, medicines, linen etc., to ensure that these have been properly recorded and issued/consumed only on proper authorisation.
- (viii) See that depreciation has been written off in respect of all the assets at appropriate rate and method as in the earlier year.
- (ix) Verify the receipts from supply of food and canteen receipts and compare the same with previous year as regards number of patients.
- (x) Ensure that all outstanding liabilities have been adequately provided for and similarly all accrued incomes and receipts have been duly accounted for.
- (xi) Obtain inventory of stock and stores as at the end of the year and physically check a percentage of items.

PAPER – 7: INFORMATION TECHNOLOGY AND STRATEGIC MANAGEMENT

SECTION – A: INFORMATION TECHNOLOGY

QUESTIONS

1. Define the following terms briefly:
 - (i) Cache Memory
 - (ii) Six Sigma
 - (iii) Task Management feature of Operating System
 - (iv) SSH File Transfer Protocol (SFTP)
 - (v) Communication Satellites
 - (vi) n-tier architecture
 - (vii) Context Diagram
 - (viii) Supply Chain Management (SCM)
 - (ix) Topological Controls under Communication Controls
 - (x) Resource Balancing in Grid Computing
2. Differentiate between the following:
 - (i) Coaxial Cable and Fiber Optics
 - (ii) Infrastructure as a Service (IaaS) and Network as a Service (NaaS)
 - (iii) Mobile Hardware and Mobile Software
 - (iv) System Flowchart and Program Flowchart
 - (v) Boxes in E-R Diagram and Diamonds in E-R Diagram
 - (vi) Plain Text and Cipher Text
 - (vii) Strategic Level Systems and Operational Level Systems
 - (viii) Example based Expert System and Frame based Expert System
 - (ix) Quality Assurance Management Controls and Security Management Controls
 - (x) Concurrent Audit and Post-Implementation Audit
3. Write short note on the following:
 - (i) Business Risks of failure of IT
 - (ii) Organizational Business Processes
 - (iii) Bluetooth
 - (iv) Advantages of Business-to-Consumer (B2C) e-Commerce
 - (v) Payroll Management
 - (vi) Batch Processing

- (vii) Travel Management Systems
- (viii) MIS - An integrated Application
- (ix) Human Resource Management System (HRMS)
- (x) Fixed Length Instructions

BPM's Principles and Practices

4. Discuss Business Process Management (BPM) Principles and Practices.

Information System Life Cycle

5. Discuss Information System Life Cycle and its phases in brief.

System Security

6. (a) Discuss the types of System Security.
(b) Distinguish between Threat and Vulnerability.

Business Reporting through MIS and IT

7. How do Business Reports streamline any business's concerns and helps in taking smarter decisions and increase the productivity of enterprises?

Accounts BPM

8. Discuss the processing cycles of an Account Business Process Management.

Business Process Automation

9. What are the three critical pillars of Business Process Automation (BPA)? Discuss in brief, the steps involved in BPA.

Mapping Systems

10. (a) Discuss different types of relationships in an E-R Diagram.
(b) Discuss advantages of using Flowchart.

Grid Computing

11. A company is reluctant to setup Grid Computing infrastructure. As a consultant, explain the management the benefits of Grid Computing.

Internet Architecture

12. Discuss Internet Architecture in brief.

Telecommunication Network Model

13. Discuss, in brief, the components of Telecommunication Network Model.

Executive Information Systems

14. Discuss Executive Information System (EIS) and its components.

Controls in BPA

15. Define Controls in Business Process Automation (BPA). Also discuss controls' objectives and their importance.

SUGGESTED ANSWERS / HINTS

1. (i) **Cache Memory:** Cache is a smaller, faster memory, which stores copies of the data from the most frequently used main memory locations so that Processor/Registers can access it more rapidly than main memory. It is the property of locality of reference, which allows improving substantially the effective memory access time in a computer system. The cache memory bridges the gap between huge speed differences of Registers and Primary Memory.
- (ii) **Six Sigma:** Six Sigma is a set of strategies, techniques, and tools for process improvement. It seeks to improve the quality of process outputs by identifying and removing the causes of defects and minimizing variability in manufacturing and business processes.
- (iii) **Task Management feature of Operating System:** Task Management in Operating system helps in allocating resources to make optimum utilization of resources. This facilitates a user to work with more than one application at a time i.e. multitasking and also allows more than one user to use the system i.e. timesharing.
- (iv) **SSH File Transfer Protocol (SFTP):** The SSH File Transfer Protocol (also known as Secure FTP or SFTP) is a computing network protocol for accessing and managing files on remote file systems. Unlike standard File Transfer Protocol, SFTP encrypts commands and data both, preventing passwords and sensitive information from being transmitted in the clear over a network.
- (v) **Communication Satellites:** Communication satellites use the atmosphere as the medium through which to transmit signals. A satellite is some solar-powered electronic device that receives, amplifies, and retransmits signals; the satellite acts as a relay station between satellite transmissions stations on the ground (earth stations). They are used extensively for high-volume as well as long-distance communication of both data and voice. It is cost-effective method for moving large quantities of data over long distances. However, satellites are very expensive to develop and place in orbit and have an age limit of 7-10 years. Signals weaken over long distances; weather conditions and solar activity can also cause noise interference. Anyone can listen in on satellite signals, so sensitive data must be sent in a secret, or encrypted, form.
- (vi) **n-tier architecture:** n-Tier Architecture is client-server architecture in which presentation, application processing, and data management functions are logically separated. By segregating an application into tiers; developers acquire the option of

modifying or adding a specific layer, instead of reworking the entire application. For example, an application that uses middleware to service data requests between a user and a database employs multitier architecture. The most widespread use of multi-tier architecture is the Three-tier architecture.

- (vii) **Context Diagram:** The Context Diagram is a high-level Data Flow Diagram (DFD) that shows the entire system as a single process and shows the interaction between the system and external agents which act as data sources and data sinks, and gives no clues as to its internal organization. The context-level DFD is next "exploded", to produce Level 1 DFDs for each process that show how the system is divided into sub-systems (processes), each of which deals with one or more of the data flows to or from an external agent, and which together provide all of the functionality of the system as a whole.
 - (viii) **Supply Chain Management (SCM):** It is a chain that starts with customers and ends with customers. Supply Chain Management may be defined as the process of planning, implementing and controlling the operations of the supply chain with the purpose of satisfying the customer's requirement as efficiently as possible. Supply Chain spans all movement and storage of raw materials, Work-in-process, inventory and finished goods from the point of origin to the point of consumption.
 - (ix) **Topological Controls under Communication Controls:** A communication network topology specifies the location of nodes within a network, the ways in which these nodes will be linked, and the data transmission capabilities of the links between the nodes. Some of the basic topologies include Bus, Ring, Star and Tree Topology.
 - (x) **Resource Balancing in Grid Computing:** For applications that are grid-enabled, the grid can offer a resource balancing effect by scheduling grid jobs on machines with low utilization. This feature of grid computing handles occasional peak loads of activity in parts of a larger organization. An unexpected peak can be routed to relatively idle machines in the grid; and if the grid is already fully utilized, the lowest priority work being performed on the grid can be temporarily suspended or even cancelled and performed again later to make room for the higher priority work.
2. (i) **Coaxial Cable:** This telecommunications media consists of copper or aluminium wire wrapped with spacers to insulate and protect it. Insulation minimizes interference and distortion of the signals the cable carries. Coaxial cables can carry a large volume of data and allows high-speed data transmission used in high-service metropolitan areas for cable TV systems, and for short-distance connection of computers and peripheral devices. These cables can be bundled together into a much larger cable for ease of installation and can be placed underground and laid on the floors of lakes and oceans. It is used extensively in office buildings and other work sites for local area networks. The only disadvantage of coaxial cable is that it is more expensive than twisted pair.

Fiber Optics: This media consists of one or more hair-thin filaments of glass fiber wrapped in a protective jacket. Signals are converted to light form and fired by laser in bursts. Optical fibers can carry digital as well as analog signals and provides increased speed and greater carrying capacity than coaxial cable and twisted-pair lines. It is not affected by electromagnetic radiation and not susceptible to electronic noise and so it has much lower error rates than twisted-pair and coaxial cable. Fiber optic cables are easy to install since they are smaller and more flexible and can be used undersea for transatlantic use. Speed of communications is 10,000 times faster than that of microwave and satellite systems.

- (ii) **Infrastructure as a Service (IaaS):** It is the foundation of cloud services. It provides clients with access to server hardware, storage, bandwidth and other fundamental computing resources. The service is typically paid for on a usage basis. The service may also include dynamic scaling so that if the customer needs more resources than expected, s/he can get them on the fly (probably to a given limit). It provides access to shared resources on need basis, without revealing details like location and hardware to clients.

Network as a Service (NaaS): It is a category of cloud services where the capability provided to the cloud service user is to use network/transport connecting services. NaaS involves optimization of resource allocation by considering network and computing resources as a whole. Some of the examples are: Virtual Private Network, Mobile Network Virtualization etc.

- (iii) **Mobile Hardware:** Mobile Hardware includes mobile devices or device components that receive or access the service of mobility. They would range from Portable laptops, Smart phones, Tablet PC's to Personal Digital Assistants (PDA). These devices will have receptors that are capable of sending and receiving signals. These devices are configured to operate in full-duplex, whereby they are capable of sending and receiving signals at the same time.

Mobile Software: Mobile Software is the actual program that runs on the mobile hardware. It deals with the characteristics and requirements of mobile applications. This is the engine of that mobile device. In other terms, it is the operating system of that appliance. It is the essential component that makes the mobile device operates.

- (iv) **System Flowchart:** This typically depicts the electronic flow of data and processing steps in an Information System. While Document Flowcharts focus on tangible documents, system flowchart concentrates on the computerized data flows of Information systems.

Program Flowchart: It is most detailed and is concerned with the logical/arithmetic operations on data within the CPU and the flow of data between the CPU on the one hand and the input/output peripherals on the other.

- (v) **Boxes in E-R Diagram:** Boxes are commonly used to represent entities. An entity may be a 'physical object' such as a house or a car, an 'event' such as a house sale or a car service, or a 'concept' such as a customer transaction or order. The entity is represented by a rectangle and labelled with a singular noun.

Diamonds in E-R Diagram: Diamonds are normally used to represent relationships. A relationship is an association that exists between two entities. For example, Instructor teaches Class or Student attends Class. Most relationships can also be stated inversely. For example, Class is taught by Instructor. The relationships on an E-R Diagram are represented by lines drawn between the entities involved in the association.

- (vi) **Plain Text:** In Cryptography, it is the message that is to be encrypted. It is transformed by a function that is parameterized by a key.

Cipher Text: In Cryptography, it is the output of the encryption process that is transmitted often by a messenger or radio.

- (vii) **Strategic-Level Systems:** These systems are for strategic managers to track and deal with strategic issues, assisting long-range planning. A principle area is tracking changes in the external conditions (market sector, employment levels, share prices, etc.) and matching these with the internal conditions of the organization.

Operational-Level Systems: These support operational managers tracking elementary activities. These can include tracking customer orders, invoice tracking, etc. Operational level systems ensure that business procedures are followed.

- (viii) **Example based Expert System:** In Example-based system, developers enter the case facts and results. Through induction the Expert System converts the examples to a decision tree that is used to match the case at hand with those previously entered in the knowledge base.

Frame based Expert System: Frame based systems organize all the information (data, description, rules etc.) about a topic into logical units called frames, which are similar to linked records in data files. Rules are then established about how to assemble or inter-relate the frames to meet the user's needs.

- (ix) **Quality Assurance Management Controls:** Organizations are increasingly producing safety-critical systems and users are becoming more demanding in terms of the quality of the software they employ to undertake their work. Organizations are undertaking more ambitious information systems projects that require more stringent quality requirements and are becoming more concerned about their liabilities if they produce and sell defective software.

Security Management Controls: Information security administrators are responsible for ensuring that information systems assets are secure. Assets are secure when the expected losses that will occur over some time are at an acceptable level. Some of the major threats and to the security of information

systems and their controls are Fire, water, energy variations, structural damages, viruses and worms etc.

- (x) **Concurrent Audit:** In this, Auditors are members of the system development team. They assist the team in improving the quality of systems development for the specific system they are building and implementing.

Post-Implementation Audit: In this, Auditors seek to help an organization learn from its experiences in the development of a specific application system. In addition, they might be evaluating whether the system needs to be scrapped, continued, or modified in some way.

3. (i) **Business Risks of failure of IT:** The numerous stumbling-blocks that organizations face with Business Process Management Systems (BPMS) are primarily due to inadequate investment in ongoing training for involved personnel, as well as, lack of corporate policy protecting the integrity of the data in the BPM systems. Some of the other reasons for failure of BPMS include the following:
- Superficial or deficient executive involvement;
 - Deficient project management;
 - Breakdown in gap analysis;
 - Limited options for customization of the BPM software is required;
 - Not flexible enough or too complicated to be customized to meet the precise workflow and business process;
 - Failure to identify future business needs;
 - Inadequate assessment of the need for change management;
 - Persistent compatibility problems with the diverse legacy systems of the partners;
 - Resources not available when desirable;
 - Software fails to meet business needs;
 - System may be over-engineered when compared to the actual requirements; and
 - Technological obsolescence.
- (ii) **Organizational Business Processes:** Organizational business processes are high-level processes that are typically specified in textual form by their inputs, their outputs, their expected results and their dependencies on other organizational business processes. These business processes act as supplier or consumer processes. To manage incoming raw materials provided by a set of suppliers is an example of an organizational business process. While organizational business processes characterize coarse-grained business functionality, there are multiple operational business processes that contribute to one organizational business process.

- (iii) **Bluetooth:** Bluetooth is a wireless technology standard for exchanging data over short distances up to 50 meters (164 feet) from fixed and mobile devices, creating Personal Area Networks (PANs) with high levels of security. It is a feature which is used every day through a number of compatible devices. Bluetooth is really like a very low-power, short-range radio signal. Bluetooth signals are secure from the moment they're sent, so unlike any other wireless network we don't have to worry about turning on security. Few devices that utilize Bluetooth technology are Keyboards and mice, Printers, Cell phones and headsets, PDAs (Personal Digital Assistants), Desktop and laptop computers, Digital cameras, and Remotes: replacing IR (infrared). Through the use of a mobile phone with Bluetooth enabled in them, we can send pictures, videos, exchange business cards and also transfer files to our PC. Both data and voice transmissions can be sent and received through the use of short range networks.
- (iv) Advantages of B2C E-Commerce are as follows:
- Shopping can be faster and more convenient.
 - Offerings and prices can change instantaneously.
 - Call centers can be integrated with the website.
 - Broadband telecommunications will enhance the buying experience.
- (v) **Payroll Management:** It is one of the key modules under Human Resource Management Systems (HRMS) in which training programs can be entered with future dates that allow managers to track progress of employees through these programs, examine the results of courses taken and reschedule specific courses when needed. The module tracks the trainer or training organization; costs associated with training schedules, tracks training locations and required supplies and equipment and registered attendees. All employees are linked to a skills profile. The skill profile lists the skills brought with them and acquired through training after they were hired. The skills profile is updated automatically through the training module.
- (vi) **Batch Processing:** It is defined as a processing of large set of data in a specific way, automatically, without needing any user intervention. The data is first collected, during a work day, for example, and then batch-processed, so all the collected data is processed in one go. This could happen at the end of the work day, for example, when computing capacities are not needed for other tasks. It is possible to perform repetitive tasks on a large number of pieces of data rapidly without needing the user to monitor it. Batched jobs can take a long time to process. Batch processing is used in producing bills, stock control, producing monthly credit card statements, etc.
- (vii) **Travel Management Systems:** Many business processes specific to Travel Industry have been automated, including ticket booking for air, bus, train, hotel, etc.

It has features such as streamlined foreign travel approval process, configurable to match enterprise's foreign travel program, build-in and manage travel policy compliance, 'safe return' process for people tracking, traveller portal for up to date information, secure traveller profile information, online retrieval of e-tickets, reservations, visas & inoculation records, management of entry visas & medical requirements, front, mid and back office tools on a single, and web based platform.

- (viii) **MIS - An integrated Application:** Management Information System (MIS) is an integrated information system that serves all departments within an enterprise. MIS implies the use of packaged software rather than proprietary software in black and white by or for one customer.

Groundwork examination: The problem; Magnitude and scope; Alternatives; and Viability and cost effectiveness.

Requirements psychoanalysis: Knowing the primary and secondary users; Ascertaining user needs; Primary and secondary sources of information; and Design, development and implementation needs.

Systems blueprint: Inputs; Processing; Outputs; Storage; Procedures; and Human resources.

Acquirement /procurement: Compatibility; Cost effectiveness; Performance standards; After sales service; Configuration; and Portability.

- (ix) **Human Resource Management System (HRMS):** A HRMS is a software application that coalesce many human resources functions, together with benefits administration, payroll, recruiting and training, and performance analysis and assessment into one parcel. In other words, HRMS or Human Resources Information System (HRIS) refers to the systems and processes at the intersection between human resource management (HRM) and information technology. Some of the key modules of HRMS are Workforce Management, Time and Attendance Management, Payroll Management, Training Management, Compensation Management, Recruitment Management, Personnel Management, Organizational Management etc.

- (x) **Fixed Length Instructions:** Instructions are translated to machine code. In some architecture, all machine code instructions are of the same length i.e. fixed length. Fixed length instructions are commonly used with Reduced Instruction Set Computer (RISC) processors. Since each instruction occupies the same amount of space, every instruction must be long enough to specify a memory operand, even if the instruction does not use one. Hence, memory space is wasted by this form of instruction. The advantage of fixed length instructions is that they make the job of fetching and decoding instructions easier and more efficient, which means that they can be executed in less time than the corresponding variable length instructions.

4. BPM's Principles

- **Processes are assets:** BPM's first principle is **processes are assets** that create value for customers. They are to be managed and continuously improved. Because processes are assets, core processes and processes that generate the most value to customers should be carefully managed.
- **Value to customers:** A managed process produces consistent **value to customers** that entails the tasks of measuring, monitoring, controlling, and analyzing business processes. Measuring of business processes provides information regarding these business processes. Process information allows organizations to predict, recognize, and diagnose process deficiencies, and it suggests the direction of future improvements.
- **Continuous improvement:** The third principle is **continuous improvement** of processes. This is a natural result of process management. Process improvement is facilitated by the availability of process information. The business environment usually dictates that organizations need to improve to stay competitive. Business processes are central to an organization's value creation. It follows that processes should be continuously improved.

BPM's Practices

- (i) **Process-oriented organizational structure:** Processes are the core assets of an organization, and they produce the values that justify an organization's existence. In order for processes to be effectively managed and improved, BPM identifies three types of process-oriented structures - Process Organization, Case management organization and Horizontal process management organization.
- (ii) **Appoint Process Owners:** The process owners are assigned to the core processes who are responsible for the performance of the process assigned. The process owner designs, deploys, and improves the process and is responsible for influencing functional workers and functional heads on how best to perform functions associated with the process. The process owner should be a senior member of the organization who has the power to influence other senior managers.
- (iii) **Top-Down Commitment, Bottom - Up Execution:** In order for BPM to work, top management needs to commit to it and support the process-focused management approach it requires. Executing process improvement should use a bottom-up approach that encounters less resistance from the employees most directly affected by the change.
- (iv) **Use Information Technology (IT) to Manage Processes:** BPMS aligns the IT solution to be more in line with the process and once implemented, allows organizations to measure, monitor, control, and analyze processes real time.

- (v) **Collaborate with Business Partners:** It is necessary to extend process management outside the enterprise that involves sharing information with business partners and helping business partners with their business processes.
 - (vi) **Continuous Learning and Process Improvement:** In the BPM world, employees will be introduced to new technologies and work activities. In a process-focused environment, workers belong to processes and they can be expected to perform broader sets of tasks than in traditional functional organizations. BPM organizations thrive on continuous improvement.
 - (vii) **Align Employee Rewards to Process Performance:** In the BPM organization, delivering customer value and optimizing process performance are two central goals. When employee rewards are aligned to process performance, they further collaborate among workers who are engaged in the same process in order to increase the business process performance.
 - (viii) **Utilize BPR, TQM, and Other Process Improvement Tools:** Many business process experts describe BPM as the convergence of business process improvement approaches. Under the BPM approach, the previous process-focused business improvement approaches could be seen as tools for improving the processes. For example - Six Sigma (Define, Measure, Analysis, Improve, and Control (DMAIC)) could be deployed for incremental improvements.
5. **Information System Life Cycle:** This is commonly referred as Software/System Development Life Cycle (SDLC) which is a methodology used to describe the process of building information systems. It is the logical starting point in the entire life cycle of a computerized system. SDLC framework provides a sequence of activities for system designers and developers to follow. It consists of a set of steps or phases in which each phase of the SDLC uses the results of the previous one.

Phase 1: System Investigation

This phase examines that 'What is the problem and is it worth solving'? We would be doing a feasibility study under the following dimensions:

- ◆ **Technical feasibility:** Does the technology exist to implement the proposed system or is it a practical proposition?
- ◆ **Economic feasibility:** Is proposed system cost-effective: if benefits do not outweigh costs, it's not worth going ahead?
- ◆ **Legal feasibility:** Is there any conflict between the proposed system and legal requirements?
- ◆ **Operational feasibility:** Are the current work practices and procedures adequate to support the new system?
- ◆ **Schedule feasibility:** How long will the system take to develop, or can it be done in a desired time-frame?

Phase 2: System Analysis

This phase examines that 'What must the Information System do to solve the problem'? System analyst would be gathering details about the current system and will involve Interviewing staff; Examine current business; Sending out questionnaires; and Observation of current procedures.

The Systems Analyst will examine data and information flows in the enterprise using data flow diagrams; establish what the proposed system will actually do (not how it will do it); analyze costs and benefits; outline system implementation options. (e.g. in-house or using consultants); consider possible hardware configurations; and make recommendations.

Phase 3: System Designing

This phase examines that 'How will the Information System do what it must do to obtain the solution to the problem'? This phase specifies the technical aspects of a proposed system in terms of Hardware platform; Software; Outputs; Inputs; User interface; Modular design; Test plan; Conversion plan; and Documentation.

Phase 4: System Implementation

This phase examines that 'How will the Solution be put into effect'? This phase involves the following steps:

- ◆ Coding and testing of the system;
- ◆ Acquisition of hardware and software; and
- ◆ Either installation of the new system or conversion of the old system to the new one.

Phase 5: System Maintenance and Review

This phase evaluates results of solution and modifies the system to meet the changing needs. Post implementation review would be done to address programming amendments, adjustment of clerical procedures, modification of Reports, and request for new programs.

System maintenance could be with different objectives - Perfective Maintenance; Adaptive Maintenance; and Corrective Maintenance.

This is often the longest of the stages since it is an on-going process having some sort of long term continuum.

6. (a) There are two types of Systems Security.
 - **Physical Security:** A Physical security is implemented to protect the physical systems assets of an organization like the personnel, hardware, facilities, supplies and documentation.
 - **Logical Security:** A Logical security is intended protect data/information and software. Security administrators tend to have responsibility for controls over

malicious and non-malicious threats to physical security, and malicious threats to logical security itself.

- (b) **Threat:** A Threat is a possible danger that can disrupt the operation, functioning, integrity, or availability of a network or system. Network security threats can be categorized into four broad themes - Unstructured Threats, Structured Threats, External Threats and Internal Threats.

Vulnerability: Vulnerability is an inherent weakness in the design, configuration, or implementation of a network or system that renders it susceptible to a threat.

7. Business Reports streamline any business's concerns and helps in taking smarter decisions and increase the productivity.

Benefits for micro-businesses and small to medium enterprises are as follows:

- ◆ **Paperless lodgement:** Eliminates the hassle of paper work and associated costs;
- ◆ **Electronic record keeping:** Stores the reports securely in the accounting or bookkeeping system;
- ◆ **Pre-filled forms:** Reports are automatically pre-filled with information existing in the accounting or bookkeeping system, as well as from information held by government, saving valuable time;
- ◆ **Ease of sharing:** Sharing between client, accountant, tax agent or bookkeeper for checking;
- ◆ **Secure AUSkey authentication:** AUSkey is a common authentication solution for business-to-government online services.
- ◆ **Same-time validation:** receive a fast response that any lodgement has been received.

Benefits for large business are as follows:

- ◆ **A single reporting language to report to government:** eXtensible Business Reporting Language (XBRL) is an international standards-based business reporting language developed by accountants for financial reporting;
- ◆ **Reduce costs:** Reduction in the cost of assembling, analyzing, and providing data to government;
- ◆ **Streamline the process of aggregating data:** Opportunities exist for streamlining the process of aggregating data across different internal departments, or business units of a company;
- ◆ **Increased access to comparable performance information:** Standard Business Report (SBR) uses the same standard (XBRL) that simplifies and adds integrity to the performance of capital market comparisons by analysts and investors;

- ◆ **Secure AUSkey authentication:** Lodge online securely to a range of government agencies; and
 - ◆ **Same-time validation** - Rapid response that any lodgement has been received.
8. The processing cycles of an Accounts Business Process Management are namely Financing Cycle, Revenue Cycle, Expenditure Cycle, Human Resource and the General Ledger & Reporting Systems and the flow of data between them. These systems are discussed below:
- (i) **Financing Cycle:** A transaction processing cycle combines one or more types of transactions having related features or similar objectives. The cycle consists of a set of transactions leading to the recognition of a major economic event on the financial statements. It is through the study of transaction cycles that we gain a clear view of a firm's processing framework.
 - (ii) **Revenue Cycle:** It includes transactions surrounding the recognition of revenue involving accounts like Sales, Accounts Receivable, Inventory and General Ledger. It involves capturing and recording of customer orders; shipment of the goods; recording of the cost of goods sold; the billing process and the recording of sales and accounts receivable; and capturing and recording of cash receipts. Common Source Documents are Sales Order, Delivery Ticket, Remittance Advice, Deposit Slip and Credit Memo.
 - (iii) **Expenditure Cycle:** It includes transactions surrounding the recognition of expenditures involving accounts like Purchases, Accounts Payable, Cash Disbursements, Inventory and General Ledger. It includes preparation and recording of purchase orders; receipt of goods and the recording of the cost of inventory; receipt of vendor invoices; recording of accounts payable and preparation and recording of cash disbursements. The cycle also includes the preparation of employee pay-checks and the recording of payroll activities. Common Source Documents are Purchase Requisition, Purchase Order, Receiving Report, and Cheque.
 - (iv) **Human Resource Cycle:** Common Source Documents are W4 forms, Time cards and Job time tickets.
 - (v) **General Ledger & Reporting System:** Common Source Document is Journal Voucher.
 - (vi) **Data Processing Cycle:** In the Data Processing Cycle, the processes of business activities about which data must be collected and processed are identified. Further, the emphasize could be on the activities, resources affected by that event, the agents who participate in that event; where the event could be the Input, Output, Processing, Storage, Alerts, Controls and Feedback. All the above cycles of processing involves data processing activities which has been updated and stored. The stored information has details about the resources affected by the event and agents who participated in the activity.

9. Business Process Automation (BPA) solutions feature three critical pillars – **Integration**, **Orchestration**, and **Automation**. Tight coupling of these elements enables organizations to streamline and automate business processes regardless of scope, scale, and complexity. BPA application ties up the following activities:
- ◆ **Integration:** BPA allows applications and operating systems not only to read data that the systems produce, but also to pass data between the component applications of the business process and to modify the data as necessary.
 - ◆ **Orchestration:** The process of orchestration enables the ability to bring tasks that exist across multiple computers and different business departments or branches under one umbrella that is the business process itself.
 - ◆ **Automation:** Orchestration and integration unite with automation to deliver the capability to provide a rules-based process of automatic execution that can span multiple systems and enable a more effective, nimble and efficient business process.

Steps involved in BPA

BPA can make the business processes faster and more efficient, robust, and flexible. The approach to business process automation entails understanding how information is collected and processed on a day-to-day basis and then making recommendations on how best to automate those processes for maximum benefit. The steps involved in any BPA are as follows:

- ◆ Step 1: Define why we plan to implement BPA?
 - ◆ Step 2: Understand the rules/ regulation under which it needs to comply with?
 - ◆ Step 3: Document the process, we wish to automate.
 - ◆ Step 4: Define the objectives/goals to be achieved by implementing BPA.
 - ◆ Step 5: Engage the business process consultant.
 - ◆ Step 6: Calculate the ROI for project.
 - ◆ Step 7: Development of BPA.
 - ◆ Step 8: Testing the BPA.
10. (a) The various types of relationships in E-R Diagram are as follows:
- (i) **One-to-One relationship (1:1)** - A One-to-One relationship is shown on the diagram by a line connecting the two entities.

Example: A Teacher may be in-charge of a class. Each class must be in-charge of by one teacher.



A student has one and only one Report card. Each report card is owned by one and only one student.



- (ii) **One-to-Many relationships (1:N)** – A One-to-Many relationship is shown on the diagram by a line connecting the two entities with a “crow's foot” symbol denoting the 'many' end of the relationship.

Example: A student may borrow some books from the library. A book in the library may be borrowed by at most a student.



A class is formed by a group of atleast one student. Each student is allocated to one and only one class.



Further, a teacher teaches many courses.

- (iii) **Many-to-One relationships (M:1)** – It is the reverse of One-to-Many relationship.

Example: As in two or more parent records to a single child record. For example,



When three administrators in a small town report to one minister.



- (iv) **Many-to-Many relationships (M:N)** – A Many-to-Many relationship is shown on the diagram by a line connecting the two entities with 'crow's foot' symbols at both ends.

Example: A student enrolls in atleast one course. A course is enrolled by at least one student.



A student may apply for more than one scholarship. Each scholarship may receive some applications from student, or none.



(b) Advantages of using Flowchart are as follows:

- (i) **Quicker grasp of relationships** – Before any application can be solved, it must be understood, the relationship between various elements of the application must be identified. The programmer can chart a lengthy procedure more easily with the help of a flowchart than by describing it by means of written notes.
- (ii) **Effective Analysis** – The flowchart becomes a blue print of a system that can be broken down into detailed parts for study. Problems may be identified and new approaches may be suggested by flowcharts.
- (iii) **Communication** – Flowcharts aid in communicating the facts of a business problem to those whose skills are needed for arriving at the solution.
- (iv) **Documentation** – Flowcharts serve as a good documentation which aid greatly in future program conversions. In the event of staff changes, they serve as training function by helping new employees in understanding the existing programs.
- (v) **Efficient coding** – Flowcharts act as a guide during the system analysis and program preparation phase. Instructions coded in a programming language may be checked against the flowchart to ensure that no steps are omitted.
- (vi) **Orderly check out of problem** – Flowcharts serve as an important tool during program debugging. They help in detecting, locating and removing mistakes.
- (vii) **Efficient program maintenance** – The maintenance of operating programs is facilitated by flowcharts. The charts help the programmer to concentrate attention on that part of the information flow which is to be modified.

11. Benefits of Grid Computing are as follows:

- **Making use of Underutilized Resources:** In most organizations, there are large amounts of underutilized computing resources. In some organizations, even the server machines can often be relatively idle. Grid computing provides a framework for exploiting these underutilized resources and thus has the possibility of substantially increasing the efficiency of resource usage. Grid computing (more specifically, a data grid) can be used to aggregate this unused storage into a much larger virtual data store, possibly configured to achieve improved performance and reliability over that of any single machine.

- **Resource Balancing:** For applications that are grid-enabled, the grid can offer a resource balancing effect by scheduling grid jobs on machines with low utilization. This feature of grid computing handles occasional peak loads of activity in parts of a larger organization. An unexpected peak can be routed to relatively idle machines in the grid; and if the grid is already fully utilized, the lowest priority work being performed on the grid can be temporarily suspended or even cancelled and performed again later to make room for the higher priority work.
- **Parallel CPU Capacity:** A CPU-intensive grid application can be thought of as many smaller sub-jobs, each executing on a different machine in the grid. To the extent that these sub-jobs do not need to communicate with each other, the more scalable the application becomes. A perfectly scalable application will, for example, finish in one tenth of the time if it uses ten times the number of processors.
- **Virtual resources and virtual organizations for collaboration:** Another capability enabled by grid computing is to provide an environment for collaboration among a wider audience. The users of the grid can be organized dynamically into a number of virtual organizations, each with different policy requirements. These virtual organizations can share their resources such as data, specialized devices, software, services, licenses, and so on, collectively as a larger grid.
- **Access to additional resources:** In addition to CPU and storage resources, a grid can provide access to other resources as well. For example, if a user needs to increase their total bandwidth to the Internet to implement a data mining search engine, the work can be split among grid machines that have independent connections to the Internet. In this way, total searching capability is multiplied, since each machine has a separate connection to the Internet.
- **Reliability:** High-end conventional computing systems use expensive hardware to increase reliability. The machines also use duplicate processors in such a way that when they fail, one can be replaced without turning the other off. Power supplies and cooling systems are duplicated. The systems are operated on special power sources that can start generators if utility power is interrupted. All of this builds a reliable system, but at a great cost, due to the duplication of expensive components.
- **Management:** The goal to virtualize the resources on the grid and more uniformly handle heterogeneous systems create new opportunities to better manage a larger, more distributed IT infrastructure. The grid offers management of priorities among different projects. Aggregating utilization data over a larger set of projects can enhance an organization's ability to project future upgrade needs. When maintenance is required, grid work can be rerouted to other machines without crippling the projects involved.

12. Internet Architecture

- (a) To join the Internet, the computer is connected to an Internet Service Provider (ISP) from whom the user purchases Internet access or connectivity. This lets the computer exchange packets with all of the other accessible hosts on the Internet.
- (b) A common way to connect to an ISP is to use the phone line to our house, in which case our phone company is our ISP. ISP networks may be regional, national, or international in scope. However, there are several other popular ways like DSL (Digital Subscriber Line), CMTS (Cable Modem Termination System), and POP (Point of Presence) to connect to an ISP.
- (c) Internet Service Provider's architecture is made up of long-distance transmission lines that interconnect routers at POPs in the different cities that the ISPs serve. This equipment is called the backbone of the ISP. If a packet is destined for a host served directly by the ISP, that packet is routed over the backbone and delivered to the host. Otherwise, it must be handed over to another ISP.
- (d) ISPs connect their networks to exchange traffic at IXPs (Internet eXchange Points) in cities around the world. Basically, an IXP is a room full of routers, at least one per ISP. A LAN in the room connects all the routers, so packets can be forwarded from any ISP backbone to any other ISP backbone. IXPs can be large and independently owned facilities.
- (e) The peering that happens at IXPs depends on the business relationships between ISPs. There are many possible relationships. For example, a small ISP might pay a larger ISP for Internet connectivity to reach distant hosts, much as a customer purchases service from an Internet provider.
- (f) The path a packet takes through the Internet depends on the peering choices of the ISPs. If the ISP delivering a packet peers with the destination ISP, it might deliver the packet directly to its peer. Otherwise, it might route the packet to the nearest place at which it connects to a paid transit provider so that provider can deliver the packet.
- (g) Often, the path a packet takes will not be the shortest path through the Internet. At the top of the food chain are a small handful of companies that operate large international backbone networks with thousands of routers connected by high-bandwidth fiber optic links.

Companies that provide lots of content, such as Google and Yahoo!, locate their computers in data centers that are well connected to the rest of the Internet. These data centers are so large (tens or hundreds of thousands of machines) that electricity is a major cost, so data centers are sometimes built in areas where electricity is cheap.

- 13. Telecommunication Network Model:** Generally, a communication network is any arrangement where a sender transmits a message to a receiver over a channel consisting of some type of medium. The model consists of five basic categories of components:
- (i) **Terminals:** Terminals are the starting and stopping points in any telecommunication network environment. Any input or output device that is used to transmit or receive data can be classified as a terminal component. These include Video Terminals, Microcomputers, Telephones, Office Equipment, Telephone and Transaction Terminals.
 - (ii) **Telecommunications Processors:** Telecommunications Processors support data transmission and reception between terminals and computers by providing a variety of control and support functions. They include Network Interface Card, Modem, Multiplexer and Internetworked Processors such as switches, routers, hubs, bridges, repeaters and gateways.
 - (iii) **Telecommunications Media/Channels:** Telecommunications channels are the part of a telecommunications network that connects the message source with the message receiver. Data are transmitted and received over channels, which use a variety of telecommunications media. Telecommunications media are grouped into Guided Media and Unguided Media. Some of the common examples of guided media are Twisted Pair, Coaxial cable and Fiber optics. Some of the common examples of unguided media are Terrestrial Microwave, Radio waves, Micro Waves, Infrared Waves and Communications Satellites.
 - (iv) **Computers:** In a telecommunications networks, computers of all sizes and types are connected through media to perform their communication assignments. They include Host Computers (mainframes), Front-End Processors (minicomputers) and Network Servers (microcomputers).
 - (v) **Telecommunications Control Software:** This consists of programs that control telecommunications activities and manage the functions of telecommunications networks. They include Telecommunication Monitors, Network Operating Systems for network servers, Network Management Components and Communication Packages. This software can reside on almost any component of the network and can provide such features as performance monitoring, activity monitoring, priority assigning, transmission error correction and network problem mitigation.
- 14. Executive Information Systems (EIS):** An Executive Information System (EIS) is the nature of Information System used by executives to access and administer the data they entail to make informed business decisions. In the hierarchical structure of information systems, the EIS is at the pinnacle and is designed to renovate all significant data (from project to process to budget) into aggregated information that makes sense and brings value to the by and large business strategy. EIS is able to link data from various sources both internal and external to provide the amount and kind of information executives find

useful. These systems are designed for top management; easy to use; present Information in condensed view; access organization's databases and data external to the organization.

The components of an EIS can typically be classified as below:

Component	Description
Hardware	Includes Input data-entry devices, CPU, Data Storage files and Output Devices.
Software	Includes Text base software, Database, and Graphic types such as time series charts, scatter diagrams, maps, motion graphics, sequence charts, and comparison-oriented graphs (i.e., bar charts) Model base.
User Interface	Includes hardware (physical) and software (logical) components by which people (users) interact with a machine. Several types of interfaces can be available to the EIS structure, such as scheduled reports, questions/answers, menu driven, command language, natural language, and input/output.
Telecommunication	Involves transmitting data from one place to another in a reliable networked system.

15. **Controls in Business Process Automation:** Controls are defined as policies, procedures, practices and organization structure that are designed to provide reasonable assurance that business objectives are achieved and undesired events are prevented or detected and corrected.

Controls' Objectives

Major controls' objectives are given as follows:

- ◆ **Authorization** – This ensures that all transactions are approved by responsible personnel in accordance with their specific or general authority before the transactions are recorded.
- ◆ **Completeness** – This ensures that no valid transactions have been omitted from the accounting records.
- ◆ **Accuracy** - This ensures that all valid transactions are accurate, consistent with the originating transaction data, and information is recorded in a timely manner.
- ◆ **Validity** - This ensures that all recorded transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management's general authorization.

- ◆ **Physical Safeguards and Security** - This ensures that access to physical assets and information systems are controlled and properly restricted to authorized personnel.
- ◆ **Error Handling** - This ensures that errors detected at any stage of processing receive prompts corrective action and are reported to the appropriate level of management.
- ◆ **Segregation of Duties** - This ensures that duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures relative to processing a transaction.

Importance of Controls in BPA

In today's computerized information systems, most of the business processes are being automated. Enterprises are increasingly relying on IT for business information and transaction processing. The innovations in IT components such as hardware, software, networking technology, communication technology and ever-increasing bandwidth are leading to evolution completely new business models.

All these new business models and new methods presume that the information required by business managers is available all the time and is accurate. However, there is a need to ensure that all information that is generated from system is accurate, complete and reliable for decision making, hence the requirement for proper controls.

SECTION – B: STRATEGIC MANAGEMENT

Correct/Incorrect with reasoning

1. State with reasons which of the following statements are correct/incorrect:
 - (a) Strategy evolves over a period of time.
 - (b) Core competence is a unique strength of an organization.
 - (c) In strategic process organizational potential is not matched with the environmental opportunities.
 - (d) Control systems run parallel with strategic levels.
 - (e) A strategic group consists of rival firms with similar competitive approaches and positions in the market.
 - (f) Strategic planning is an attempt to improve operational efficiency.
 - (g) Production strategy implements, supports and drives higher strategies.
 - (h) SBU concepts facilitate multi-business operations.
 - (i) E-commerce technology opens up a host of opportunities for reconfiguring industry and company value chains.
 - (j) Logistics is a process that integrates the flow of supplies into, through and out of an organization.

Differences between the two concepts

2. Distinguish between the following:
 - (a) Operational control and management control.
 - (b) Top-down and bottom-up strategic planning.
 - (c) Mergers and acquisitions.

Short notes

3. Write short notes on the following:
 - (a) Concept of strategic Intent
 - (b) Strategic business unit
 - (c) DMADV – A six sigma methodology
 - (d) Global strategy

Brief answers

4. Briefly answer the following questions:
 - (a) 'Kieretsu' involves sharing of purchasing, distribution and other functions. Discuss the statement in light of its advantage in a competitive environment.
 - (b) Briefly explain the role of experience curve in strategic management.
 - (c) Explain an organisation as an element of micro-environment.
 - (d) What is strategic control? Also explain briefly premise control.

Descriptive answers*Chapter 1-Business Environment*

5. The external environment holds considerable power over the organization. How?
6. Explain PESTLE as a tool for analyzing the macro environment. Illustrate your answer with environmental influences that may be considered.

Chapter 2-Business Policy and Strategic Management

7. What is meant by organizational objectives? Explain the six characteristics of organizational objectives.
8. What do you understand by 'Strategy'? Explain the four generic strategies as discussed by Glueck and Jauch.

Chapter 3-Strategic Analysis

9. A CEO of a company recently attended a seminar on strategic management. He is quite enthusiastic but does not understand how to use SWOT analysis for his Company. Act as a consultant and advise him on how to use SWOT analysis to formulate business strategies.
10. Describe the construction of BCG matrix and discuss its utility in strategic management.

Chapter 4-Strategic Planning

11. Discuss strategic alternatives with reference to Michael Porter's strategies.
12. What do you understand by the term 'Strategic uncertainty'? What is its impact on strategic planning?

Chapter 5-Formulation of Functional Strategy

13. Do you think that Management of a business house needs to formulate strategies for different functional areas when it already has developed higher level corporate and business strategies? If yes, enumerate the reasons why functional strategies are needed.
14. What do you understand by the term marketing mix? Discuss its various constituents.

Chapter 6-Strategic Implementation and Control

15. Define corporate culture. Also elucidate the statement “Culture is a strength that can also be a weakness”.
16. Transformational leadership style may be appropriate in turbulent environment while transactional leadership style may be appropriate in settled environment. Comment.

Chapter 7-Reaching Strategic Edge

17. Discuss briefly the characteristics of E-commerce which have reshaped the economic landscape and altered traditional industry boundaries.
18. Define business process reengineering. Briefly outline the steps therein.

SUGGESTED ANSWERS/HINTS

1. (a) **Correct:** Strategy of a business, at a particular point of time, is result of a series of small decisions taken over an extended period of time. A manager who makes an effort to increase the growth momentum of an organization is materially changing strategy. A company strategy evolves over time as a consequence of changing environmental conditions and need to keep strategy in tune with the changes that have a bearing on the functioning of organizations..
- (b) **Correct:** A core competence is a unique strength of an organization which may not be shared by others. If business is organized on the basis of core competence, it is likely to generate competitive advantage. A core competence provides potential access to a wide variety of markets. Core competencies should be such that it is difficult for competitors to imitate them.
- (c) **Incorrect:** In the process of strategic management an organisation continuously scan its relevant environment to identify various opportunities and threats. Organisations keen to grow and expand often look for promising opportunities that match their potential. Such opportunities become a good stepping stone for achieving the goals of the organisation.
- (d) **Correct:** There are three strategic levels – corporate, business and functional. Control systems are required at all the three levels. At the top level, strategic controls are built to check whether the strategy is being implemented as planned and the results produced by the strategy are those intended. Down the hierarchy management controls and operational controls are built in the systems. Operational controls are required for day-to-day management of business.
- (e) **Correct:** A strategic group consists of those rival firms that have similar competitive approaches and positions in the market. Organisations in the same strategic group can resemble one another in any of the several ways: they may have comparable product-line breadth, sell in the same price/quality range, emphasize the same

distribution channels, use essentially the same product attributes to appeal to similar types of buyers, depend on identical technological approaches, or offer buyers similar services and technical assistance.

- (f) **Incorrect:** Strategic planning, an important component of strategic management, involves developing a strategy to meet competition and ensure long-term survival and growth. Strategic Planning is a function of top management level in the organisation and relate the organisation with its environment. Operational efficiency is not a direct outcome of strategic planning.
 - (g) **Correct:** For effective implementation of higher level strategies, strategists need to provide direction to functional managers, including production, regarding the plans and policies to be adopted. Production strategy provides a path for transmitting corporate and business level strategy to the production systems and makes it operational. It may relate to production planning, operational system, control and research & development.
 - (h) **Correct:** Organizing business along SBU lines and creating strategic business units has become a common practice for multi-product/service and global organizations. It is a convenient and intelligent grouping of activities along distinct businesses and has replaced the conventional groupings. SBU facilitates strategic planning, gaining product-related/market-related specialization, gaining cost-economies and more rational organizational structure.
 - (i) **Correct:** The impact of e-commerce technology on industry and company value chains is profound, paving the way for fundamental changes in the ways business is conducted both internally, and with suppliers and customers. Using the network to link the customers and the suppliers enables just-in-time delivery, reducing inventory costs and allowing production to match demand.
 - (j) **Correct:** Logistics is a process that integrates the flow of supplies into, through and out of an organization to achieve a level of service that facilitate movement and availability of materials in a proper manner. When a company creates a logistics strategy, it is defining the service levels at which its logistics is smooth and is cost effective.
2. (a) Differences between operational control and management control are as under:
- (i) The thrust of operational control is on individual tasks or transactions as against total or more aggregative management functions. When compared with operational, management control is more inclusive and more aggregative, in the sense of embracing the integrated activities of a complete department, division or even entire organisation, instead or mere narrowly circumscribed activities of sub-units. For example, procuring specific items for inventory is a matter of operational control, in contrast to inventory management as a whole.
 - (ii) Many of the control systems in organisations are operational and mechanistic in nature. A set of standards, plans and instructions are formulated. On the

other hand the basic purpose of management control is the achievement of enterprise goals – short range and long range – in an effective and efficient manner.

- (b) Top-down and bottom-up strategic planning: Strategic planning determines where an organization is going over the next few and ways for reaching there. The process is organization-wide, or focused on a major function such as a division or other major function. As such strategic planning is a top level management function. The flow of planning can be from corporate to divisional level or vice-versa. There are two approaches for strategic planning - top down or bottom up.

Top down strategic planning describes a centralized approach to strategy formulation in which the corporate centre or head office determines mission, strategic intent, objectives and strategies for the organization as a whole and for all parts. Unit managers are seen as implementers of pre-specified corporate strategies.

Bottom up strategic planning is the characteristic of autonomous or semi-autonomous divisions or subsidiary companies in which the corporate centre does not conceptualize its strategic role as being directly responsible for determining the mission, objectives, or strategies of its operational activities. It may prefer to act as a catalyst and facilitator, keeping things reasonably simple and confining itself to perspective and broader strategic intent.

- (c) Merger and acquisition in simple words are defined as a process of combining two or more organizations together.

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 acquisitions. 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 its power. The combined operations then run under the name of the powerful entity. A deal in case of an acquisition is often done in an unfriendly manner, it is more or less a forced association.

3. (a) *Concept of Strategic Intent*: A company exhibits strategic intent when it relentlessly pursues an ambitious strategic objective and concentrates on allocation of all resources and take competitive actions on achieving that objective. A company's

objectives sometimes play another role – that of signaling unmistakable strategic intent to make quantum gains in competing against key rivals and establish itself as a clear-cut winner in the marketplace. A company's strategic intent can entail becoming the dominant company in the industry, unseating the existing industry leader, delivering the best customer service of any company in the industry (or the world), or turning a new technology into products capable of changing the way people work and live. Ambitious companies almost invariably begin with strategic intents that are out of proportion to their immediate capabilities and market positions. They set aggressive objectives and pursue them relentlessly, sometimes even obsessively.

- (b) **Strategic Business Unit:** A strategic business unit (SBU) is a unit of the company that has a separate mission and objectives which can be planned independently from other company businesses. SBU can be a company division, a product line within a division or even a single product/brand, specific group of customers or geographical location. The SBU is given the authority to make its own strategic decisions within corporate guidelines as long as it meets corporate objectives.
 - (c) DMADV methodology is an acronym for five different steps used in six sigma directed for designing new products, processes and services.
 - *Define:* As in case of DMAIC six sigma experts have to formally define goals of the design activity that are consistent with strategy of the organization and the demands of the customer.
 - *Measure:* Next identify the factors that are critical to quality (CTQs). Measure factors such as product capabilities and production process capability. Also assess the risks involved.
 - *Analyze:* Develop and design alternatives. Create high-level design and evaluate to select the best design.
 - *Design:* Develop details of design and optimise it. Verify designs may require using techniques such as simulations.
 - *Verify:* Verify designs through simulations or pilot runs. Verified and implemented processes are handed over to the process owners.
 - (d) A global strategy assumes more standardization of products across country boundaries. Under this strategy, the company tries to focus on a low cost structure by leveraging their expertise in providing certain products and services and concentrating the production of these standard products and services at a few favourable locations around the world. Competitive strategy is centralized and controlled by the home office.
4. (a) *Kieretsus* is a loosely-coupled group of companies, usually in related industries. It is a Japanese term which is used for large cooperative networks of businesses. *Kieretsus* members are peers and may own significant amounts of each other's

stock and have many board members in common.

The primary purpose of a kieretsu is not to share information or agree industry standards, but to share purchasing, distribution or any other functions. In kieretsu members remain independent companies in their own right. The only strategy they have in common is to prefer to do business with other kieretsu members, both when buying and selling. The formation of kieretsu allows a manufacturer to establish, stable, long term partnerships, which in term helps them to stay lean and focus on core business requirements.

- (b) Experience curve is an important concept used for applying a portfolio approach. The concept is akin to a learning curve which explains the efficiency gained by workers through repetitive productive work. Experience curve is based on the commonly observed phenomenon that unit costs decline as a firm accumulates experience in terms of a cumulative volume of production. The implication is that larger firms in an industry would tend to have lower unit costs as compared to those of smaller organizations, thereby gaining a competitive cost advantage. Experience curve results from a variety of factors such as learning effects, economies of scale, product redesign and technological improvements in production.

The concept of experience curve is relevant for a number of areas in strategic management. For instance, experience curve is considered a barrier for new firms contemplating entry in an industry. It is also used to build market share and discourage competition.

- (c) An organisation in itself constitutes an element of its micro environment. An organisation has several non-specific elements of the organisation's surroundings that may affect its activities. These consist of organisation/groups which are as follows:
- **Owners** are individuals, shareholders, groups or organisations who have a major stake in the organisation. They have a vested interest in the well-being of the company.
 - **Board of directors** are found in companies formed under the Companies Act, 2013. The board of directors are elected by the shareholders and are charged with overseeing the general management of the organisation to ensure that it is being run in a way that best serves the shareholder's interests.
 - **Employees** are the people who actually do the work in an organisation. Employees are the major force within an organisation. It is important for an organisation that employees embrace the same values and goals as the organisation. However, they differ in beliefs, education, attitudes, and capabilities.
- (d) Strategic control involves monitoring the activity and measuring results against pre-established standards, analysing and correcting deviations as necessary and

maintaining/adapting the system. The task of control is intended to enable the organisation to continuously learn from its experience and to improve its capability to cope with the demands of organisational growth and development. It focus on the dual questions of whether (1) the strategy is being implemented as planned; and (2) the result produced by the strategy are those intended.

Premise control is a tool for systematic and continuous monitoring of the environment to verify the validity and accuracy of the premises on which the strategy has been built. It primarily involves monitoring two types of factors:

- (i) Environmental factors such as economic (inflation, liquidity, interest rates), technology, social and regulatory.
- (ii) Industry factors such as competitors, suppliers, substitutes.

It is neither feasible nor desirable to control all types of premises in the same manner. Different premises may require different amount of control. Thus, managers are required to select those premises that are likely to change and would severely impact the functioning of the organization and its strategy.

5. The external environment holds considerable power over the organization both by virtue of its being more inclusive as also by virtue of its command over resources, information and other inputs. It offers a range of opportunities, incentives and rewards on the one hand and a set of constraints, threats and restrictions on the other. In both ways, the organization is conditioned and constrained. The external environment is also in a position to impose its will over the organization and can force it to fall in line. Governmental control over the organization is one such power relationship. Other organizations, competitors, markets, customers, suppliers, investors etc., also exercise considerable collective power and influence over the planning and decision making processes of the organization.

In turn, the organization itself is sometimes in a position to wield considerable power and influence over some of the elements of the external environment by virtue of its command over resources and information. The same elements which exercise power over the organization are also subject to the influence and power of the organization in some respects. To the extent that the organization is able to hold power over the environment increases its autonomy and freedom of action. It can dictate terms to the external forces and mould them to its will.

6. The term PESTLE is used to describe a framework for analysis of macro environmental factors. PESTLE analysis involves identifying the political, economic, socio-cultural, technological, legal and environmental influences on an organization and providing a way of scanning the environmental influences that have affected or are likely to affect an organization or its policy. PESTLE is an acronym for:

P-political; E-economic; S-socio-cultural; T-technological; L-legal; E-environmental

The PESTLE analysis is a simple to understand and quick to implement. The advantage of this tool is that it encourages management into proactive and structured thinking in its decision making.

The Key Factors

- **Political** factors are how and to what extent a government intervenes in the economy and the activities of corporate. Political factors may also include goods and services which the government wants to provide or be provided and those that the government does not want to be provided.
- **Economic** factors have major impacts on how businesses operate and take decisions. For example, interest rates affect a firm's cost of capital and therefore to what extent a business grows and expands. The money supply, inflation, credit flow, per capita income, growth rates have a bearing on the business decisions.
- **Social** factors affect the demand for a company's products and how that company operates.
- **Technological** factors can determine barriers to entry, minimum efficient production level and influence outsourcing decisions. Furthermore, technological shifts can affect costs, quality, and lead to innovation.
- **Legal** factors affect how a company operates, its costs, and the demand for its products.
- **Environmental** factors affect industries such as tourism, farming, and insurance. Growing awareness to climate change is affecting how companies operate and the products they offer.

On the basis of these, it should be possible to identify a number of key environmental influences, which are in effect, the drivers of change. These are the factors that require to be considered in matrix. A typical example is as follows:

<p>Political</p> <ul style="list-style-type: none"> • Political stability • Political principles and ideologies • Current and future taxation policy • Regulatory bodies and processes • Government policies • Government term and change • Thrust areas of political leaders. 	<p>Economic</p> <ul style="list-style-type: none"> • Economic situation & trends • Market and trade cycles • Specific industry factors • Customer/end-user drivers • Interest and exchange rates • Inflation and unemployment • Strength of consumer spending
<p>Social</p> <ul style="list-style-type: none"> • Lifestyle trends • Demographics 	<p>Technological</p> <ul style="list-style-type: none"> • Replacement technology/solutions • Maturity of technology

<ul style="list-style-type: none"> • Consumer attitudes and opinions • Brand, company, technology image • Consumer buying patterns • Ethnic/religious factors • Media views and perception 	<ul style="list-style-type: none"> • Manufacturing maturity and capacity • Innovation potential • Technology access, licensing, patents • Intellectual property rights and copyrights
<p>Legal</p> <ul style="list-style-type: none"> • Business and Corporate Laws • Employment Law • Competition Law • Health & Safety Law • International Treaty and Law • Regional Legislation 	<p>Environmental</p> <ul style="list-style-type: none"> • Ecological/environmental issues • Environmental hazards • Environmental legislation • Energy consumption • Waste disposal

7. Organizational objectives are performance targets-the result and outcomes it wants to achieve. They function as yardstick for tracking an organizations performance and progress. Objectives, to be meaningful to serve the intended role, must possess the following characteristics:
- ◆ Objectives should define the organization’s relationship with its environment.
 - ◆ Objectives should be facilitative towards achievement of mission and purpose.
 - ◆ Objectives should provide the basis for strategic decision-making.
 - ◆ Objectives should provide standards for performance appraisal.
 - ◆ Objectives should be understandable.
 - ◆ Objectives should be concrete and specific.
 - ◆ Objectives should be related to a time frame.
 - ◆ Objectives should be measurable and controllable.
 - ◆ Objectives should be challenging.
 - ◆ Different objectives should correlate with each other.
 - ◆ Objectives should be set within constraints.
8. Strategies provide an integral framework for management and negotiate their way through a complex and turbulent external environment. Strategy seeks to relate the goals of the organisation to the means of achieving them.

Strategy may be defined as a long range blueprint of an organisation's desired image, direction and destination what it wants to be, what it wants to do and where it wants to

go. Strategy is meant to fill in the need of organisations for a sense of dynamic direction, focus and cohesiveness.

The Generic Strategies

According to Glueck and Jauch there are four generic ways in which strategic alternatives can be considered. These are stability, expansion, retrenchment and combinations.

- (i) **Stability strategies:** One of the important goals of a business enterprise is stability to safeguard its existing interests and strengths, to pursue well established and tested objectives, to continue in the chosen business path, to maintain operational efficiency on a sustained basis, to consolidate the commanding position already reached, and to optimise returns on the resources committed in the business.
 - (ii) **Expansion Strategy:** Expansion strategy is implemented by redefining the business by adding the scope of business substantially increasing the efforts of the current business. Expansion is a promising and popular strategy that tends to be equated with dynamism, vigor, promise and success. Expansion includes diversifying, acquiring and merging businesses.
 - (iii) **Retrenchment Strategy:** A business organisation can redefine its business by divesting a major product line or market. Retrenchment or retreat becomes necessary for coping with particularly hostile and adverse situations in the environment and when any other strategy is likely to be suicidal. In business parlance also, retreat is not always a bad proposition to save the enterprise's vital interests, or even to regroup and recoup the resources before a fresh assault and ascent on the growth ladder is launched.
 - (iv) **Combination Strategies:** Stability, expansion or retrenchment strategies are not mutually exclusive. It is possible to adopt a mix to suit particular situations. An enterprise may seek stability in some areas of activity, expansion in some and retrenchment in the others. Retrenchment of ailing products followed by stability and capped by expansion in some situations may be thought of. For some organisations, a strategy by diversification and/or acquisition may call for a retrenchment in some obsolete product lines, production facilities and plant locations.
9. As a consultant of a company, first of all the CEO will be explained about the concept and significance of SWOT analysis. The comparison of strengths, weaknesses, opportunities, and threats is normally referred to as a 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.

- ◆ **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.

Its central purpose is to identify the strategies that will create a firm-specific business model that will best align, fit, or match an organisational resources and capabilities to the demands of the environment in which it operates. Strategic managers compare and contrast the various alternative possible strategies against each other with respect to their ability to achieve major goals and superior profitability. Thinking strategically requires managers to identify the set of strategies that will create and sustain a competitive advantage.

The significance of SWOT analysis lies in the following points:

- ◆ *It provides a Logical Framework:* SWOT analysis provides us with a logical framework for systematic and sound thrashing of issues having bearing on the business situation, generation of alternative strategies and the choice of a strategy.
- ◆ *It presents a Comparative Account:* SWOT analysis presents the information about both external and internal environment in a structured form where it is possible to compare external opportunities and threats with internal strengths and weaknesses. The helps in matching external and internal environments so that a strategist can come out with suitable strategy by developing certain patterns of relationship.
- ◆ *It guides the strategist in Strategy Identification:* SWOT analysis guides the strategist to think of overall position of the organization that helps to identify the major purpose of the strategy under focus.

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, global competitive environment that characterizes most industries today.

After explaining the concept and significance of SWOT analysis, the CEO of the company should be asked to undertake the SWOT analysis of his company for knowing the strengths, weaknesses, opportunities, and threats. Further, he should be asked to compare external opportunities and threats with internal strengths and weaknesses of his company for crafting suitable strategy which matches with the company's overall objectives.

10. The BCG matrix can be used to determine what priorities should be given in the product portfolio of a business unit. Using the BCG approach, a company classifies its different businesses on a two-dimensional growth share matrix. Two dimensions are market share and market growth rate. In the matrix:

- The vertical axis represents market growth rate and provides a measure of market attractiveness.
- The horizontal axis represents relative market share and serves as a measure of company strength in the market.

Thus the BCG matrix depicts four quadrants as per following:

		Relative Market Share	
		<i>High</i>	<i>Low</i>
Market Growth Rate	<i>High</i>	Stars	Question Marks
	<i>Low</i>	Cash Cows	Dogs

Different types of business represented by either products or SBUs can be classified for portfolio analyses through BCG matrix. They have been depicted as follows:

- Stars** are products or SBUs that are growing rapidly. They also need heavy investment to maintain their position and finance their rapid growth potential.
- Cash Cows** are low-growth, high market share businesses or products. They generate cash and have low costs. They are established, successful, and need less investment to maintain their market share.
- Question Marks**, sometimes called problem children or wildcats, are low market share business in high-growth markets. They require a lot of cash to hold their share. They need heavy investments with low potential to generate cash. Question marks can become stars if properly managed, however, if left unattended they are capable of becoming cash traps.
- Dogs** are low-growth, low-share businesses and products. They may generate enough cash to maintain themselves, but do not have much future. Sometimes they may need cash to survive. Dogs should be minimised by means of divestment or liquidation.

The BCG matrix is useful for classification of products, SBUs, or businesses, and for selecting appropriate strategies for each type as follows.

- Build with the aim for long-term growth and strong future.
 - Hold or preserve the existing market share.
 - Harvest or maximize short-term cash flows.
 - Divest, sell or liquidate and ensure better utilization of resources elsewhere.
11. According to Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus. Porter calls these base

generic strategies. Cost leadership emphasizes producing standardized products at a very low per-unit cost for consumers who are price-sensitive. Differentiation is a strategy aimed at producing products and services considered unique industry wide and directed at consumers who are relatively price-insensitive. Focus means producing products and services that fulfill the needs of small groups of consumers.



Figure: Michael Porter’s Generic Strategy

Cost Leadership Strategies

A primary reason for pursuing forward, backward, and horizontal integration strategies is to gain cost leadership benefits. But cost leadership generally must be pursued in conjunction with differentiation. A number of cost elements affect the relative attractiveness of generic strategies, including economies or diseconomies of scale achieved, capacity utilization and linkages with suppliers and distributors and so on.

Differentiation Strategies

Different strategies offer different degrees of differentiation. A differentiation strategy should be pursued only after a careful study of buyers’ needs and preferences to determine the feasibility of incorporating one or more differentiating features into a unique product that features the desired attributes. A successful differentiation strategy allows a firm to charge a higher price for its product and to gain customer loyalty. Special features that differentiate one's product can include superior service, spare parts availability, design, product performance, useful life, or ease of use and so on.

Focus Strategies

A successful focus strategy depends on an industry segment that is of sufficient size, has good growth potential, and is not crucial to the success of other major competitors. Strategies such as market penetration and market development offer substantial focusing advantages. Midsize and large firms can effectively pursue focus-based strategies only in

conjunction with differentiation or cost leadership-based strategies. All firms in essence follow a differentiated strategy.

12. Strategic uncertainty is that which has strategic implications and is a key construct in strategy formulation. A typical external analysis will emerge with dozens of strategic uncertainties. To be manageable, they need to be grouped into logical clusters or themes. It is then useful to assess the importance of each cluster in order to set priorities with respect to Information gathering and analysis.

Sometimes the strategic uncertainty is represented by a future trend or event that has inherent unpredictability. Information gathering and additional analysis will not be able to reduce the uncertainty. In that case, scenario analysis can be employed. Scenario analysis basically accepts the uncertainty as given and uses it to drive a description of two or more future scenarios. Strategies are then developed for each. One outcome could be a decision to create organizational and strategic flexibility so that as the business context changes the strategy will adapt.

Impact of a strategic uncertainty: Each strategic uncertainty involves potential trends or events that could have an impact on present, proposed, and even potential strategic business units (SBUs). For example, a trend toward natural foods may present opportunities for juices for a firm producing aerated drinks on the basis of a strategic uncertainty. The impact of a strategic uncertainty will depend on the importance of the impacted SBU to a firm. Some SBUs are more important than others. The importance of established SBUs may be indicated by their associated sales, profits, or costs. However, such measures might need to be supplemented for proposed or growth SBUs for which present sales, profits, or costs may not reflect the true value to a firm. Finally, because an information-need area may affect several SBUs, the number of involved SBUs can also be relevant to a strategic uncertainty's impact.

13. Yes, major corporate and business strategies need to be translated to lower levels to give holistic strategic direction to an organisation. Therefore, management formulates strategies for different functional areas owing to the following reasons:
- ◆ The development of functional strategies is aimed at making the strategies-formulated at the top management level-practically feasible at the functional level.
 - ◆ Functional strategies facilitate flow of strategic decisions to the different parts of an organization.
 - ◆ Functional strategies act as basis for controlling activities in the different functional areas of business.
 - ◆ Functional strategies reduce the time spent by functional managers in decision-making.
 - ◆ Functional strategies help in bringing harmony and coordination as they remain part of major strategies.

- ◆ Similar situations occurring in different functional areas are handled in a consistent manner by the functional managers.
14. Marketing mix forms an important part of overall competitive marketing strategy. The marketing mix is the set of controllable marketing variables that the firm blends to produce the response it wants in the target market. These variables are often referred to as the “4 Ps.” The 4 Ps stands for product, price, place and promotion.
- **Product** stands for the “goods-and-service” combination the company offers to the target market. Strategies are needed for managing existing product over time adding new ones and dropping failed products. Strategic decisions must also be made regarding branding, packaging and other product features.
 - **Price** stands for the amount of money customers have to pay to obtain the product. Necessary strategies pertain to the location of the customers, price flexibility, related items within a product line and terms of sale.
 - **Place** stands for company activities that make the product available to target consumers. One of the most basic marketing decision is choosing the most appropriate marketing channel. Strategies should be taken for the management of channel(s) by which ownership of product is transferred from producers to customers and in many cases, the system(s) by which goods are moved.
 - **Promotion** stands for activities that communicate the merits of the product and persuade target consumers to buy it. Strategies are needed to combine individual methods such as advertising, personal selling, and sales promotion into a coordinated campaign. In addition, promotional strategies must be adjusted as a product move from earlier stages from a later stage of its life.
15. The phenomenon which often distinguishes good organizations from bad ones could be summed up as ‘corporate culture’. Corporate culture refers to a company’s values, beliefs, business principles, traditions, ways of operating and internal work environment. Every corporation has a culture that exerts powerful influences on the behaviour of managers. Culture affects not only the way managers behave within an organization but also the decisions they make about the organization’s relationships with its environment and its strategy.

“Culture is a strength that can also be a weakness”. This statement can be explained by splitting it in to two parts.

Culture as a strength: As a strength, culture can facilitate communication, decision-making & control and create cooperation & commitment. An organization’s culture could be strong and cohesive when it conducts its business according to a clear and explicit set of principles and values, which the management devotes considerable time to communicating to employees and which values are shared widely across the organization.

Culture as a weakness: As a weakness, culture may obstruct the smooth implementation of strategy by creating resistance to change. An organization's culture could be characterized as weak when many subcultures exist, few values and behavioural norms are shared and traditions are rare. In such organizations, employees do not have a sense of commitment, loyalty and sense of identity.

16. Two basic approaches to leadership can be transformational leadership style and transactional leadership style.

Transformational leadership style use charisma and enthusiasm to inspire people to exert them for the good of the organization. Transformational leadership style may be appropriate in turbulent environments, in industries at the very start or end of their life-cycles, in poorly performing organizations when there is a need to inspire a company to embrace major changes. Transformational leaders offer excitement, vision, intellectual stimulation and personal satisfaction. They inspire involvement in a mission, giving followers a 'dream' or 'vision' of a higher calling so as to elicit more dramatic changes in organizational performance. Such a leadership motivates followers to do more than originally affected to do by stretching their abilities and increasing their self-confidence, and also promote innovation throughout the organization.

Whereas, transactional leadership style focus more on designing systems and controlling the organization's activities and are more likely to be associated with improving the current situation. Transactional leaders try to build on the existing culture and enhance current practices. Transactional leadership style uses the authority of its office to exchange rewards, such as pay and status. They prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement or non-achievement.

Transactional leadership style may be appropriate in settled environment, in growing or mature industries, and in organizations that are performing well. The style is better suited in persuading people to work efficiently and run operations smoothly.

17. The impact of the Internet and the rapidly emerging e-commerce environment is substantial and widespread. Growing use of the Internet by businesses and consumers reshapes the economic landscape and alters traditional industry boundaries. Characteristics of E-commerce environment changing competitive scenario are as under:
- (a) The Internet makes it feasible for companies everywhere to compete in global markets.
 - (b) There are new e-commerce strategic initiatives of existing rivals and new entrants in form of e-commerce rivals.
 - (c) Entry barriers into the e-commerce world are relatively low.
 - (d) Increased bargaining power of customers to compare the products, prices and other terms.

- (e) Possibility for business organizations to locate the best suppliers across the world to gain cost advantage and collaborate closely with them to achieve efficiency gains and cost savings.
 - (f) Internet and PC technologies are advancing rapidly, often in uncertain and unexpected directions. Such changes are often bringing in new opportunities and challenges.
 - (g) Organisations in emerging countries and elsewhere can use the internet to monitor the latest technological developments and to stay abreast of what is happening in developed markets.
 - (h) The e-commerce environment demands that companies move swiftly. In the exploding e-commerce world, speed is a condition of survival.
 - (i) E-commerce technology opens up a host of opportunities for reconfiguring industry and company value chains.
 - (j) The Internet can be an economical means of delivering customer service. Organisations are discovering ways to deliver service in a centralised manner – online or through telephone.
 - (k) The capital for funding potentially profitable e-commerce businesses is readily available.
 - (l) The needed e-commerce resource in short supply is human talent-in the form of both technological expertise and managerial know-how.
18. Business Process Reengineering (BPR) is an approach to unusual improvement in operating effectiveness through the redesigning of critical business processes and supporting business systems. It is revolutionary redesign of key business processes that involves examination of the basic process itself. BPR refers to the analysis and redesign of workflows and processes both within the organization and between the organization and the external entities like suppliers, distributors, and service providers.
- BPR involves the following steps:
1. **Determining objectives and framework:** Objectives are the desired end results of the redesign process which the management and organization attempts to achieve. This will provide the required focus, direction, and motivation for the redesign process. It helps in building a comprehensive foundation for the reengineering process.
 2. **Identify customers and determine their needs:** The designers have to understand customers – their profile, their steps in acquiring, using and disposing a product. The purpose is to redesign business process that clearly provides added value to the customer.

3. **Study the existing process:** The existing processes will provide an important base for the redesigners. The purpose is to gain an understanding of the 'what', and 'why' of the targeted process. However, some companies go through the reengineering process with clean perspective without laying emphasis on the past processes.
4. **Formulate a redesign process plan:** The information gained through the earlier steps is translated into an ideal redesign process. Formulation of redesign plan is the real crux of the reengineering efforts. Customer focused redesign concepts are identified and formulated. In this step alternative processes are considered and the best is selected.
5. **Implement the redesign:** It is easier to formulate new process than to implement them. Implementation of the redesigned process and application of other knowledge gained from the previous steps is key to achieve dramatic improvements. It is the joint responsibility of the designers and management to operationalise the new process.