

MOCK TEST PAPER – 2
INTERMEDIATE (NEW) : GROUP – II
PAPER – 5: ADVANCED ACCOUNTING

Question No. 1 is compulsory.

*Answer any **four** questions from the remaining **five** questions.*

Wherever necessary suitable assumptions may be made and disclosed by way of a note.

Working Notes should form part of the answer.

Time Allowed: 3 Hours

Maximum Marks: 100

1. (a) Ruby Ltd. sold goods through its agent. As per terms of sales, consideration is payable within one month. In the event of delay in payment, interest is chargeable @ 10% p.a. from the agent. The company has not realized interest from the agent in the past. For the year ended 31st March, 2017 interest due from agent (because of delay in payment) amounts to Rs. 5 lakhs. The accountant of Ruby Ltd. booked Rs. 5 lakhs as interest income in the year ended 31st March, 2017.

Examine and discuss the contention of the accountant with reference to AS 9 "Revenue Recognition".

- (b) EXOX Ltd. is in the process of finalising its accounts for the year ended 31st March, 2017. The company seeks your advice on the following:

(i) The Company's sales tax assessment for assessment year 2014-15 has been completed on 14th February, 2017 with a demand of Rs. 2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.

(ii) The Company has entered into a wage agreement in May, 2017 whereby the labour union has accepted a revision in wage from June, 2016. The agreement provided that the hike till May, 2017 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 2017.

You are required to examine and give suggestions in line with the relevant Accounting Standards.

- (c) A Ltd. has got the license to manufacture particular medicines for 10 years at a license fee of Rs. 200 lakhs. Given below is the pattern of expected production and expected operating cash inflow:

Year	Production in bottles (in lakhs)	Net operating cash flow (Rs. in lakhs)
1	300	900
2	600	1,800
3	650	2,300
4	800	3,200
5	800	3,200
6	800	3,200
7	800	3,200

8	800	3,200
9	800	3,200
10	800	3,200

Net operating cash flow has increased for third year because of better inventory management and handling method.

You are required to determine the amortization method in line with AS 26.

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

You are required to calculate the value of machinery to be considered by ABC Ltd. and the finance charges for each year. **(4 parts x 5 Marks = 20 Marks)**

2. (a) Z Limited came up with an issue of 60,00,000 equity shares of Rs. 10 each at par. 15,00,000 shares were issued to the promoters and the balance offered to the public was underwritten by three underwriters D, E and F - equally with firm underwriting of 1,40,000 shares each, Subscriptions totalled 38,91,000 shares including the marked forms which were:

D 12,75,000 shares

E 13,50,000 shares

F 10,50,000 shares

The underwriters had applied for the number of shares covered by firm underwriting. The amounts payable on application and allotment were Rs. 2.50 and Rs. 2.00 respectively. The agreed commission was 5%.

You are required to give journal entries for -

- (a) The allotment of shares to the underwriters
(b) The commission due to each of them and
(c) The net cash paid and or received.

Note: Unmarked applications are to be credited to underwriters equally. Benefit of firm underwriting is given to individual underwriter.

- (b) SMM Ltd. has the following capital structure as on 31st March, 2017: Rs. in crore

	Particulars	Situation	Situation
(i)	Equity share capital (shares of Rs. 10 each)	1,200	1,200
(ii)	Reserves:		
	General Reserves	1,080	1,080
	Securities Premium	400	400
	Profit & Loss	200	200
	Infrastructure Development Reserve (Statutory Reserve)	320	320
(iii)	Loan Funds	3,200	6,000

The company has offered buy back price of Rs. 30 per equity share. You are required to calculate maximum permissible number of equity shares that can be bought back in both situations and also required to pass necessary Journal Entries. **(10 + 10 = 20 Marks)**

3. (a) The following were the summarized Balance Sheets of P Ltd. and V Ltd. as at 31-3-20X1:

Liabilities	P Ltd. (Rs. in lakhs)	V Ltd. (Rs. in lakhs)
Equity Share Capital (Fully paid shares of Rs. 10 each)	15,000	6,000
Securities Premium	3,000	–
Foreign Project Reserve	–	310
General Reserve	9,500	3,200
Profit and Loss Account	2,870	825
12% Debentures	–	1,000
Trade payables	1,200	463
Provisions	<u>1,830</u>	<u>702</u>
	33,400	12,500

Assets	P Ltd. (Rs. in lakhs)	V Ltd. (Rs. in lakhs)
Land and Buildings	6,000	–
Plant and Machinery	14,000	5,000
Furniture, Fixtures and Fittings	2,304	1,700
Inventory	7,862	4,041
Trade receivables	2,120	1,100
Cash at Bank	1,114	609
Cost of Issue of Debentures	–	50
	<u>33,400</u>	<u>12,500</u>

All the bills receivable held by V Ltd. were P Ltd.'s acceptances.

On 1st April 20X1, P Ltd. took over V Ltd in an amalgamation in the nature of merger. It was agreed that in discharge of consideration for the business P Ltd. would allot three fully paid equity shares of Rs. 10 each at par for every two shares held in V Ltd. It was also agreed that 12% debentures in V Ltd. would be converted into 13% debentures in P Ltd. of the same amount and denomination.

Details of trade receivables and trade payables as under:

Assets	P Ltd. (Rs. in lakhs)	V Ltd. (Rs. in lakhs)
Trade payables		
Bills Payable	120	–
Creditors	<u>1,080</u>	<u>463</u>
	<u>1,200</u>	<u>463</u>

Trade receivables

Debtors	2,120	1,020
Bills Receivable	<u>—</u>	<u>80</u>
	<u>2,120</u>	<u>1,100</u>

Expenses of amalgamation amounting to Rs. 1 lakh were borne by P Ltd.

You are required to:

- Prepare journal entries in the books of P Ltd. and
 - Prepare P Ltd.'s Balance Sheet immediately after the merger considering that the cost of issue of debentures shown in the balance sheet of the V Ltd. company is not transferred to the P Ltd. company.
- (b) XYZ Limited is being wound up by the tribunal. All the assets of the company have been charged to the company's bankers to whom the company owes Rs. 5 crores. The company owes following amounts to others:

Dues to workers – Rs. 1,25,00,000

Taxes Payable to Government – Rs. 30,00,000

Unsecured Creditors – Rs. 60,00,000

You are required to compute with the reference to the provision of the Companies Act, 2013 the amount each kind of creditors is likely to get if the amount realized by the official liquidator from the secured assets and available for distribution among creditors is only Rs. 4,00,00,000/-

(15 + 5 = 20 Marks)

4. (a) The following are the figures extracted from the books of TOP Bank Limited as on 31.3.2017.

	Rs.
Interest and discount received	59,29,180
Interest paid on deposits	32,59,920
Issued and subscribed capital	16,00,000
Salaries and allowances	3,20,000
Directors fee and allowances	48,000
Rent and taxes paid	1,44,000
Postage and telegrams	96,460
Statutory reserve fund	12,80,000
Commission, exchange and brokerage	3,04,000
Rent received	1,04,000
Profit on sale of investments	3,20,000
Depreciation on bank's properties	48,000
Statutory expenses	44,000
Preliminary expenses	40,000
Auditor's fee	28,000

The following further information is given:

- (i) A customer to whom a sum of Rs. 16 lakhs has been advanced has become insolvent and it is expected only 40% can be recovered from his estate.
- (ii) There were also other debts for which a provision of Rs. 2,10,000 was found necessary by the auditors.
- (iii) Rebate on bills discounted on 31.3.2016 was Rs. 19,000 and on 31.3.2017 was Rs. 25,000.
- (iv) Preliminary expenses are to be fully written off during the year.
- (v) Provide Rs. 9,00,000 for Income-tax.
- (vi) Profit and Loss account opening balance was Nil as on 31.3.2016.

You are required to Prepare the Profit and Loss account of TOP Bank Limited for the year ended 31.3.2017.

- (b) From the following particulars of M/s. Tsunami Marine Insurance Limited for the year ending 31st March, 2016, find out the

- (i) Net Premium earned
- (ii) Net Claims incurred

	Direct Business	Re- Insurance
	(Rs.) lakhs	(Rs.) lakhs
PREMIUM:		
Received	4,400	376
Receivable -01.04.2015	220	18
Receivable -31.3.2016	189	16
Paid		305
Payable - 01.04.2015		14
Payable - 31.3.2016		9
CLAIMS:		
Paid	3,450	277
Payable - 01.04.2015	45	8
Payable - 31.3.2016	48	6
Received		101
Receivable - 01.04.2015		20
Receivable - 31.3.2016		19

(16+ 4= 20 Marks)

5. (a) Consider the following summarized balance sheets of subsidiary Neel Ltd.:

	2015	2016		2015	2016
	Rs.	Rs.		Rs.	Rs.
Share-Capital			Fixed Assets		
Issued & subscribed			Cost	1,60,000	1,60,000
2,500 equity shares			Less: Accumulated		
of Rs. 100 each	2,50,000	2,50,000	depreciation	(24,000)	(48,000)
Reserves & Surplus				1,36,000	1,12,000

Revenue reserves	1,43,000	3,57,000	Investments at cost		
Current Liabilities & Provisions:			Current Assets:	—	2,00,000
Trade Payables	2,45,000	2,47,000	Inventory	2,98,500	3,71,000
Bank overdraft	—	85,000	Trade Receivables	2,97,000	4,45,500
Provision for taxation	1,55,000	2,15,000	Prepaid Expenses	36,000	24,000
			Cash at Bank	25,500	1,500
	<u>7,93,000</u>	<u>11,54,000</u>		<u>7,93,000</u>	<u>11,54,000</u>

Also consider the following information:

- Neel Ltd. is a subsidiary of Sky Ltd. Both the companies follow calendar year as the accounting year.
- Sky Ltd. values inventory on LIFO basis while Neel Ltd. used FIFO basis. To bring Neel Ltd.'s values in line with those of Sky Ltd. its value of inventory is required to be reduced by Rs. 6,000 at the end of 2015 and Rs. 17,000 at the end of 2016.
- Neel Ltd. deducts 1% from Trade Receivables as a general provision against doubtful debts.
- Prepaid expenses in Neel Ltd. include advertising expenditure carried forward of Rs. 30,000 in 2015 and Rs. 15,000 in 2016, being part of initial advertising expenditure of Rs. 45,000 in 2015 which is being written off over three years. Similar amount of advertising expenditure of Sky Ltd. has been fully written off in 2015.

You are required to restate the balance sheet of Neel Ltd. as on 31st December, 2016 after considering the above information, for the purpose of consolidation. Make the necessary restatement which is necessary to make the accounting policies adopted by Sky Ltd. and Neel Ltd. uniform.

- The summarized Balance Sheet of K Ltd. for the year ended on 31st March, 2015, 2016 and 2017 are as follows:

	(Rs. in thousands)		
	31.3.2015	31.3.2016	31.3.2017
Liabilities			
1,60,000 equity shares of Rs. 10 each, fully paid	1,600	1,600	1,600
General reserve	1,200	1,400	1,600
Profit and Loss account	140	160	240
Trade Payables	600	800	1,000
	<u>3,540</u>	<u>3,960</u>	<u>4,440</u>
Assets			
Goodwill	1,000	800	600
Building and Machinery less, depreciation	1,400	1,600	1,600
Inventory	1,000	1,200	1,400
Trade Receivables	20	160	440
Bank balance	120	200	400
	<u>3,540</u>	<u>3,960</u>	<u>4,440</u>

Additional information:

(a) Actual valuations were as under:

Building and machinery less, depreciation	1,800	2,000	2,200
Inventory	1,200	1,400	1,600
Net profit (including opening balance after writing off depreciation, goodwill, tax provision and transferred to general reserve)	420	620	820

(b) Capital employed in the business at market value at the beginning of 2014-15 was Rs. 36,60,000 which included the cost of goodwill. The normal annual return on average capital employed in the line of business engaged by K Ltd. is 12½%.

(c) The balance in the general reserve on 1st April, 2014 was Rs. 10 lakhs.

(d) The goodwill shown on 31.3.2015 was purchased on 1.4.2014 for Rs. 10 lakhs on which date the balance in the Profit and Loss account was Rs. 1,20,000. Compute the average capital employed in each year.

Goodwill is to be valued at 5 year's purchase of Super profit (Simple average method). Also find out the total value of the business as on 31.3.2017. **(12 Marks + 8 Marks = 20 Marks)**

6. (a) A consumer goods producer has changed the product line as follows:

	Dish washing Bar (Per month)	Clothes washing Bar (Per month)
January 2016 - September 2016	2,00,000	2,00,000
October 2016 - December 2016	1,00,000	3,00,000
January 2017 - March 2017	Nil	4,00,000

The company has enforced a gradual enforcement of change in product line on the basis of an overall plan. The Board of Directors has passed a resolution in March 2016 to this effect. The company follows calendar year as its accounting year. You are required to advise whether it should be treated as discontinuing operation as per AS 24?

(b) Explain, in brief, the investment valuation norms for traded securities in case of mutual funds as per SEBI(Mutual fund) Regulations.

(c) **Balance Sheets of X Ltd.**

As on 31st March 2014 and 31st March 2015

(Rs. In lakhs)

Liabilities	31.3.14	31.3.15	Assets	31.3.14	31.3.15
Share Capital	18,00	18,00	Fixed assets	24,00	26,00
General Reserve	6,00	6,00	Investments	1,00	2,00
Profit & Loss A/c	6,80	9,40	Inventory	6,00	5,50
12% Debentures	2,00	2,00	Trade receivables	3,00	3,50
18% Term Loan	3,00	3,20	Cash and Bank	4,00	3,40

Cash Credit	1,20	80			
Trade payables	70	60			
Tax Provision	<u>30</u>	<u>40</u>			
	38,00	40,40		<u>38,00</u>	<u>40,40</u>

Non-trade investments were 75% of the total investments. Find capital employed as on 31.3.14 and as on 31.3.15 and average capital employed.

- (d) XYZ Ltd. purchased 80% shares of ABC Ltd. on 1st January, 2016 for Rs. 2,80,000. The issued capital of ABC Ltd., on 1st January, 2016 was Rs. 2,00,000 and the balance in the Profit & Loss Account was Rs. 1,20,000.

During the year ended 31st December, 2016, ABC Ltd. earned a profit of Rs. 40,000 and at year end, declared and paid a dividend of Rs. 60,000.

Show by an entry how the dividend should be recorded in the books of XYZ Ltd.

What is the amount of minority interest as on 1st January, 2016 and 31st December, 2016?

(4 Parts x 5 Marks = 20 Marks)

MOCK TEST PAPER - 2
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PAPER – 5: ADVANCED ACCOUNTING
SUGGESTED ANSWERS/HINTS

1. (a) As per AS 9 “Revenue Recognition”, “where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, the revenue recognition is postponed to the extent of uncertainty involved. In such cases, the revenue is recognized only when it is reasonably certain that the ultimate collection will be made”. In this case, the company never realized interest for the delayed payments made by the agent. Hence, based on the past experience, the realization of interest for the delayed payments by the agent is very much uncertain. The interest should be recognized only if the ultimate collection is certain. Therefore, the interest income of Rs. 5 lakhs should not be recognized in the books for the year ended 31st March, 2017. Thus the contention of accountant is incorrect. However, if the agents have agreed to pay the amount of interest and there is an element of certainty associated with these receipts, the accountant is correct regarding booking of Rs. 5 lakhs as interest amount.
- (b) (i) Since the company is not appealing against the addition of Rs. 0.66 crore the same should be provided for in its accounts for the year ended on 31st March, 2017. The amount paid under protest can be kept under the heading ‘Loans & Advances’ and disclosed along with the contingent liability of Rs. 2.10 crore.
- (ii) The arrears for the period from June, 2016 to March, 2017 are required to be provided for in the accounts of the company for the year ended on 31st March, 2017.
- (c) As per AS 26 ‘Intangibles Assets’, the amortization method used should reflect the pattern in which economic benefits are consumed by the enterprise. If pattern cannot be determined reliably, then straight-line method should be used.

In the instant case, the pattern of economic benefit in the form of net operating cash flow vis-à-vis production is determined reliably. A Ltd. should amortize the license fee of Rs. 200 lakhs as under:

Year	Net operating Cash in flow (Rs.)	Ratio	Amortize amount (Rs. in lakhs)
1	900	0.03	6
2	1,800	0.06	12
3	2,300	0.08	16
4	3,200	0.12	24
5	3,200	0.12	24
6	3,200	0.12	24
7	3,200	0.12	24
8	3,200	0.12	24
9	3,200	0.12	24
10	<u>3,200</u>	<u>0.11 (bal.)</u>	<u>22</u>
	<u>27,400</u>	<u>1.00</u>	<u>200</u>

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

Value of machinery

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

Calculation of finance charges for each year

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

Working Note:

Present value of minimum lease payments

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

2. (a)

Z Ltd.

Journal Entries

	Dr. Rs.	Cr. Rs.
Bank A/c Dr. T o Share Application A/c (Application money received on firm applications for 140,000 shares each @ Rs. 2.50 per share from D, E & F)	10,50,000	10,50,000
D Dr.	2,80,000	
E Dr.	2,80,000	
F Dr.	11,30,500	
Share Application A/c Dr.	10,50,000	

* The difference between this figure and guaranteed residual value (Rs. 50,000) is due to rounding off.

To Share Capital A/c (Allotment of shares to underwriters - 1,40,000 to D; 1,40,000 to E and 3,29,000 to F; application and allotment money credited to share capital)		27,40,500
Underwriting Commission A/c Dr. To D To E To F (Amount of underwriting commission payable to D, E and F @ 5% on the amount of shares underwritten.)	22,50,000	7,50,000 7,50,000 7,50,000
Bank A/c Dr. To F (Amount received from F on shares allotted less underwriting commission)	3,80,500	3,80,500
D Dr. E Dr. To Bank A/c (Amount paid to D & E in final settlement of underwriting commission due less amount payable on shares allotted payable by them.)	4,70,000 4,70,000	9,40,000

Working Notes:

(1) Calculation of Liability of Underwriters

	D	E	F
Gross Liability (No. of shares)	15,00,000	15,00,000	15,00,000
Less: Marked Applications (excluding firm underwriting)	<u>(12,75,000)</u>	<u>(13,50,000)</u>	<u>(10,50,000)</u>
	2,25,000	1,50,000	4,50,000
Less: Unmarked Applications (equally)	<u>(72,000)</u>	<u>(72,000)</u>	<u>(72,000)</u>
	1,53,000	78,000	3,78,000
Less: Firm Underwriting	<u>(1,40,000)</u>	<u>(1,40,000)</u>	<u>(1,40,000)</u>
	13,000	(62,000)	2,38,000
Surplus of E distributed between D & F equally	<u>(31,000)</u>	<u>62,000</u>	<u>(31,000)</u>
	(18,000)	-	2,07,000
Surplus of D allocated to F totally	<u>18,000</u>	—	<u>(18,000)</u>
Net Liability, excluding Firm Underwriting	-	-	1,89,000
Add: Firm underwriting	<u>1,40,000</u>	<u>1,40,000</u>	<u>1,40,000</u>
Total liability of underwriters	<u>1,40,000</u>	<u>1,40,000</u>	<u>3,29,000</u>

(2) Calculation of Amounts Payable by Underwriters

	D	E	F
Liability (No. of shares)	1,40,000	1,40,000	3,29,000
Amount payable @ Rs. 4.50 per share	6,30,000	6,30,000	14,80,500

Less: Amount paid on Firm Applications of 1,40,000 each @ Rs. 2.50*	(3,50,000)	(3,50,000)	(3,50,000)
Balance payable	2,80,000	2,80,000	11,30,500
Underwriting Commission Receivable	7,50,000	7,50,000	7,50,000
Amount Paid	4,70,000	4,70,000	—
Amount received by the Co.	—	—	3,80,500

* Underwriters had already paid the application money on these shares.

(b) Statement determining the maximum number of shares to be bought back

Number of shares (in crores)

Particulars	When loan fund is	
	Rs. 3,200 crores	Rs. 6,000 crores
Shares Outstanding Test (W.N.1)	30	30
Resources Test (W.N.2)	24	24
Debt Equity Ratio Test (W.N.3)	32	Nil
Maximum number of shares that can be bought back [least of the above]	24	Nil

Journal Entries for the Buy Back

(applicable only when loan fund is Rs.3,200 crores)

		Rs. in crores	
		Debit	Credit
(a)	Equity share buyback account Dr.	720	
	To Bank account		720
	(Being payment for buy back of 24 crores equity shares of Rs. 10 each @ Rs. 30 per share)		
(b)	Equity share capital account Dr.	240	
	Premium Payable on buyback account Dr.	480	
	To Equity share buyback account		720
	(Being cancellation of shares bought back)		
	Securities Premium account Dr.	400	
	General Reserve / Profit & Loss A/c Dr.	80	
	To Premium Payable on buyback account		480
	(Being Premium Payable on buyback account charged to securities premium and general reserve/Profit & Loss A/c)		
(c)	General Reserve / Profit & Loss A/c Dr.	240	
	To Capital redemption reserve account		240
	(Being transfer of free reserves to capital redemption reserve to the extent of nominal value of share capital bought back out of redeemed through free reserves)		

Working Notes:**1. Shares Outstanding Test**

<i>Particulars</i>	<i>(Shares in crores)</i>
Number of shares outstanding	120
25% of the shares outstanding	30

2. Resources Test

<i>Particulars</i>	
Paid up capital (Rs. in crores)	1,200
Free reserves (Rs. in crores) (1,080 + 400 + 200)	<u>1,680</u>
Shareholders' funds (Rs. in crores)	<u>2,880</u>
25% of Shareholders fund (Rs. in crores)	Rs. 720 crores
Buy back price per share	Rs. 30
Number of shares that can be bought back	24 crores shares

3. Debt Equity Ratio Test: Loans cannot be in excess of twice the Equity Funds post Buy Back

	Particulars	When loan fund is	
		Rs. 3,200 crores	Rs. 6,000 crores
(a)	Loan funds (Rs.)	3,200	6,000
(b)	Minimum equity to be maintained after buy back in the ratio of 2:1 (Rs.) (a/2)	1,600	3,000
(c)	Present equity shareholders fund (Rs.)	2,880	2,880
(d)	Future equity shareholders fund (Rs.) (see W.N.4)	2,560 (2,880-320)	N.A.
(e)	Maximum permitted buy back of Equity (Rs.) [(d) – (b)]	960	Nil
(f)	Maximum number of shares that can be bought back @ Rs. 30 per share	32 crore shares	Nil
	As per the provisions of the Companies Act, 2013, company	Qualifies	Does not Qualify

3. (a)

Books of P Ltd.**Journal Entries**

	<i>Dr.</i>	<i>Cr.</i>
	<i>(Rs. in Lacs)</i>	<i>(Rs. in Lacs)</i>
Business Purchase A/c	Dr. 9,000	
To Liquidator of V Ltd.		9,000
(Being business of V Ltd. taken over for consideration settled as per agreement)		
Plant and Machinery	Dr. 5,000	

Furniture & Fittings	Dr.	1,700	
Inventory	Dr.	4,041	
Debtors	Dr.	1,020	
Cash at Bank	Dr.	609	
Bills Receivable	Dr.	80	
To Foreign Project Reserve			310
To General Reserve (3,200 - 3,000)			200
To Profit and Loss A/c (825 – 50*)			775
To Liability for 12% Debentures			1,000
To Creditors			463
To Provisions			702
To Business Purchase			9,000
<u>(Being assets & liabilities taken over from V Ltd.)</u>			
Liquidator of V Ltd. A/c	Dr.	9,000	
To Equity Share Capital A/c			9,000
<u>(Purchase consideration discharged in the form of equity shares)</u>			
Profit & loss A/c	Dr.	1	
To Bank A/c			1
<u>(Liquidation expenses paid by P Ltd.)</u>			
Liability for 12% Debentures A/c	Dr.	1,000	
To 13% Debentures A/c			1,000
<u>(12% debentures discharged by issue of 13% debentures)</u>			
Bills Payable A/c	Dr.	80	
To Bills Receivable A/c			80
<u>(Cancellation of mutual owing on account of bills)</u>			

Balance Sheet of P Ltd. as at 1st April, 20X1 (after merger)

Particulars		Notes	Rs. (in lakhs)
Equity and Liabilities			
1	Shareholders' funds		
A	Share capital	1	24,000
B	Reserves and Surplus	2	16,654

2	Non-current liabilities		
A	Long-term borrowings	3	1,000
3	Current liabilities		
A	Trade Payables (1,543 + 40)		1,583
B	Short-term provisions		2,532
	Total		45,769
	Assets		
1	Non-current assets		
A	Fixed assets		
	Tangible assets	4	29,004
2	Current assets		
A	Inventories		11,903
B	Trade receivables		3,140
C	Cash and cash equivalents		1,722
	Total		45,769

Notes to accounts

	Rs.
1. Share Capital	
Equity share capital	
Authorised, issued, subscribed and paid up	
24 crores equity shares of Rs. 10 each (Of the above shares, 9 crores shares have been issued for consideration other than cash)	<u>24,000</u>
Total	<u>24,000</u>
2. Reserves and Surplus	
General Reserve	9,700
Securities Premium	3,000
Foreign Project Reserve	310
Profit and Loss Account	<u>3,644</u>
Total	<u>16,654</u>
3. Long-term borrowings	
Secured	
13% Debentures	1,000
4. Tangible assets	
Land & Buildings	6,000
Plant & Machinery	19,000
Furniture & Fittings	<u>4,004</u>
Total	<u>29,004</u>

Working Note:**Computation of purchase consideration**

The purchase consideration was discharged in the form of three equity shares of P Ltd. for every two equity shares held in V Ltd.

$$\text{Purchase consideration} = \text{Rs. } 6,000 \text{ lacs} \times \frac{3}{2} = \text{Rs. } 9,000 \text{ lacs.}$$

* Cost of issue of debenture adjusted against P & L Account of V Ltd.

- (b) Section 326 of the Companies Act, 2013 talks about the overriding preferential payments to be made from the amount realized from the assets to be distributed to various kind of creditors. According to the proviso given in the section 326 the security of every secured creditor should be deemed to be subject to a paripassu change in favor of the workman to the extent of their portion.

$$\text{Workman's Share to Secured Asset} = \frac{\text{Amount Realied X Workman's Dues}}{\text{Workman's Dues} + \text{Secured Loan}}$$

$$\begin{aligned} &\text{Workman's Share to Secured Asset} \\ &= \frac{4,00,00,000 \times 1,25,00,000}{1,25,00,000 + 5,00,00,000} \end{aligned}$$

$$4,00,00,000 \times \frac{1}{5}$$

$$\text{Workman's Share to Secured Assets} = 80,00,000$$

Amount available to secured creditor is Rs. 400 Lakhs – 80 Lakhs = 320 Lakhs

Hence, no amount is available for payment of government dues and unsecured creditors.

4. (a)

TOP Bank Limited**Profit and Loss Account for the year ended 31st March, 2017**

		Schedule	Year ended 31.03.2017 (Rs. in '000s)
I.	Income:		
	Interest earned	13	5923.18
	Other income	14	728.00
	Total		<u>6,651.18</u>
II.	Expenditure		
	Interest expended	15	3259.92
	Operating expenses	16	768.46
	Provisions and contingencies (960+210+900)		2,070.00
	Total		<u>6,098.38</u>
III.	Profits/Losses		
	Net profit for the year		552.80
	Profit brought forward		nil
			<u>552.80</u>

IV. Appropriations		
Transfer to statutory reserve (25%)		138.20
Balance carried over to balance sheet		<u>414.60</u>
		<u>552.80</u>

		<i>Year ended 31.3. 2017 (Rs. in '000s)</i>
Schedule 13 – Interest Earned		
I.	Interest/discount on advances/bills (Refer W.N.)	<u>5923.18</u>
		<u>5923.18</u>
Schedule 14 – Other Income		
I.	Commission, exchange and brokerage	304
II.	Profit on sale of investments	320
III.	Rent received	<u>104</u>
		<u>728</u>
Schedule 15 – Interest Expended		
I.	Interests paid on deposits	<u>3259.92</u>
Schedule 16 – Operating Expenses		
I.	Payment to and provisions for employees	320
II.	Rent and taxes	144
III.	Depreciation on bank's properties	48
IV.	Director's fee, allowances and expenses	48
V.	Auditors' fee	28
VI.	Law (statutory) charges	44
VII.	Postage and telegrams	96.46
VIII.	Preliminary expenses	<u>40</u>
		<u>768.46</u>

Working Note:

	<i>(Rs. in '000s)</i>
Interest/discount	5,929.18
Add: Rebate on bills discounted on 31.3. 2016	19.00
Less: Rebate on bills discounted on 31.3. 2017	<u>(25.00)</u>
	<u>5,923.18</u>

(b) (i) Net Premium earned

		Rs. In lakhs
Premium from direct business received	4,400	
Add: Receivable as 31.03.16	189	
Less: Receivable as on 01.04.2015	<u>(220)</u>	4,369
Add: Premium on re-insurance accepted	376	
Add: Receivable as on 31.03.16	16	
Less: Receivable as on 01.04.2015	<u>(18)</u>	<u>374</u>
		4,743
Less: Premium on re-insurance ceded	305	
Add: Payable as on 31.03.16	9	
Less: Payable as on 01.04.15	<u>(14)</u>	<u>(300)</u>
Net Premium earned		<u>4,443</u>

(ii) Net Claims incurred

		Rs. In lakhs
Claims paid on direct business		3,450
Add: Reinsurance	277	
Add: Reinsurance outstanding as 31.03.16	6	
Less: Reinsurance outstanding as on 01.04.2015	<u>(8)</u>	275
Less: Claims Received from re-insurance	101	
Add: Receivable as on 31.03.16	19	
Less: Receivable as on 01.04.2015	<u>(20)</u>	<u>100</u>
		3,625
Add: Outstanding direct claims at the end of the year		<u>48</u>
		<u>3,673</u>
Less: Outstanding Claims at the beginning of the year		<u>(45)</u>
Net Claims Incurred		<u>3,628</u>

5. (a) Adjusted revenue reserves of Neel Ltd.

	Rs.	Rs.
Revenue reserves as given		3,57,000
Add: Provision for doubtful debts [4,45,500 / 99 X 1]		<u>4,500</u>
		3,61,500
Less: Reduction in value of Inventory	17,000	
Advertising expenditure to be written off	<u>15,000</u>	<u>(32,000)</u>
Adjusted revenue reserve		<u>3,29,500</u>

Note: Since Neel Ltd. follows FIFO basis, it is assumed that opening inventory has been sold out during the year 2015. Therefore, reduction in inventory would have been taken care of by sale value. Hence no adjustment has been made for the same.

**Restated Balance Sheet of Neel Ltd.
as at 31st December, 2016**

Particulars	Note No.	(Rs.)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		2,50,000
(b) Reserves and Surplus	1	3,29,500
(2) Current Liabilities		
(a) Short term borrowings	2	85,000
(b) Trade Payables		2,47,000
(c) Short-term provision	3	2,15,000
Total		11,26,500
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
Tangible assets	4	1,12,000
(b) Non-current Investment		2,00,000
(2) Current assets		
(a) Inventories		3,54,000
(b) Trade Receivables		4,50,000
(c) Cash & Cash Equivalents		1,500
(d) Other current assets	5	9,000
Total		11,26,500

Notes to Accounts

		Rs.
1. Reserves and Surplus		
Revenue Reserve (refer computation of adjusted revenue reserves of Neel Ltd)		3,29,500
2. Short term borrowings		
Bank overdraft		85,000
3. Short-term provision		
Provision for taxation		2,15,000
4. Tangible Assets		
Cost	1,60,000	
Less: Depreciation to date	<u>(48,000)</u>	1,12,000

5. Other current assets		
Prepaid expenses (After adjusting advertising expenditure to be written off each year)		9,000

(b)

Total value of business	Rs.
Total net Asset as on 31.3.2017	42,40,000
Less: Goodwill as per Balance Sheet	(6,00,000)
Add: Goodwill as calculated in Working Note 2	<u>20,56,250</u>
Value of Business	<u>56,96,250</u>

Working Notes:

1. Capital Employed at the end of each year

	31.3.2015	31.3.2016	31.3.2017
	Rs.	Rs.	Rs.
Goodwill	10,00,000	8,00,000	6,00,000
Building and Machinery (Revaluation)	18,00,000	20,00,000	22,00,000
Inventory (Revalued)	12,00,000	14,00,000	16,00,000
Trade Receivables	20,000	1,60,000	4,40,000
Bank Balance	<u>1,20,000</u>	<u>2,00,000</u>	<u>4,00,000</u>
Total Assets	41,40,000	45,60,000	52,40,000
Less: Trade Payables	<u>(6,00,000)</u>	<u>(8,00,000)</u>	<u>(10,00,000)</u>
Closing Capital	35,40,000	37,60,000	42,40,000
Add: Opening Capital	<u>36,60,000</u>	<u>35,40,000</u>	<u>37,60,000</u>
Total	<u>72,00,000</u>	<u>73,00,000</u>	<u>80,00,000</u>
Average Capital	36,00,000	36,50,000	40,00,000

Since the goodwill has been purchased, it is taken as a part of Capital employed.

2. Valuation of Goodwill

	31.3.2015	31.3.2016	31.3.2017
(i) Future Maintainable Profit			
Net Profit as given	4,20,000	6,20,000	8,20,000
Less: Opening Balance	(1,20,000)	(1,40,000)	(1,60,000)
Adjustment for Valuation of Opening Inventory	-	(2,00,000)	(2,00,000)
Add: Adjustment for Valuation of closing inventory	2,00,000	2,00,000	2,00,000
Goodwill written off	-	2,00,000	2,00,000
Transferred to General Reserve	<u>2,00,000</u>	<u>2,00,000</u>	<u>2,00,000</u>
Future Maintainable Profit	7,00,000	8,80,000	10,60,000
Less: 12.50% Normal Return	<u>(4,50,000)</u>	<u>(4,56,250)</u>	<u>(5,00,000)</u>
(ii) Super Profit	2,50,000	4,23,750	5,60,000

(iii) **Average Super Profit** = Rs. (2,50,000+4,23,750+5,60,000) ÷ 3 = Rs. 4,11,250

(iv) **Value of Goodwill** at five years' purchase = Rs. 4,11,250 × 5 = Rs. 20,56,250.

6. (a) As per AS 24 'Discontinuing Operations', a discontinuing operation is a component of an enterprise:
- (i) that the enterprise, pursuant to a **single plan**, is:
 - (1) disposing of substantially in its entirety,
 - (2) disposing of piecemeal, or
 - (3) terminating through abandonment; and
 - (ii) that represents a separate major line of business or geographical area of operations; and
 - (iii) that can be distinguished operationally and for financial reporting purposes.

As per provisions of the standard, business enterprises frequently close facilities, abandon products or even product lines, and change the size of their work force in response to market forces. While those kinds of terminations generally are not, in themselves, discontinuing operations, they can occur in connection with a discontinuing operation. Examples of activities that do not necessarily satisfy criterion of discontinuing operation are gradual or evolutionary phasing out of a product line or class of service, discontinuing, even if relatively abruptly, several products within an ongoing line of business;

In the given case, the company has enforced a gradual enforcement of change in product line and does not represent a separate major line of business and hence is not a discontinued operation. If it were a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

- (i) the enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or
 - (ii) the enterprises board of directors or similar governing body has both approved a detailed, formal plan for discontinuance and made an announcement of the plan.
- (b) Eight Schedule of the SEBI (Mutual Fund) Regulations, 1996 states the Investment Valuation Norms. NAV of a scheme is determined by dividing the net assets of the scheme by the number of outstanding units on the valuation date.

Traded Securities:-

- (i) The securities shall be valued at the last quoted closing price on the recognized stock exchange.
- (ii) When the securities are traded on more than one recognised stock exchange, the securities shall be valued at the last quoted closing price on the stock exchange where the security is principally traded. It would be left to the asset management company to select the appropriate stock exchange, but the reasons for the selection should be recorded in writing. There should however be no objection for all scrips being valued at the prices quoted on the stock exchange where a majority in value of the investments is principally traded.
- (iii) Once a stock exchange has been selected for valuation of a particular security, reasons for change of the exchange shall be recorded in writing by the asset management company.
- (iv) When on a particular valuation day, a security has not been traded on the selected stock exchange, the value at which it is traded on another stock exchange may be used.
- (v) When a security is not traded on any stock exchange on a particular valuation day, the value at which it was traded on the selected stock exchange or any other stock exchange, as the case may be, on the earliest previous day may be used provided such date is not more than sixty days prior to the valuation date.

(c) Computation of capital employed

	(Rs. in lakhs)			
		31.3.14		31.3.15
Total Assets as per Balance Sheet		38,00		40,40
Less: Non-trade Investments		(75)		(1,50)
		37,25		38,90
Less: Outside Liabilities:				
12% Debentures	2,00		2,00	
18% Term Loan	3,00		3,20	
Cash Credit	1,20		80	
Trade payables	70		60	
Tax Provision	30	7,20	40	7,00
Capital employed		<u>30,05</u>		<u>31,90</u>

$$\text{Average capital employed} = \frac{30,05 \text{ lakhs} + 31,90 \text{ lakhs}}{2} = \text{Rs. } 3,097.5 \text{ lakhs.}$$

(d) Total dividend paid = Rs. 60,000

Out of post-acquisition profit = Rs. 40,000

Out of pre-acquisition profit = Rs. 20,000

Hence, 2/3rd of dividend received by XYZ will be credited to P & L and 1/3rd will be credited to Investment.

XYZ Ltd.'s share of dividend = Rs. 60,000 X 80% = Rs. 48,000

In the books of XYZ Ltd.

	Rs.	Rs.
Bank A/c Dr.	48,000	
To Profit & Loss A/c		32,000
To Investments in ABC Ltd.		16,000
(Dividend received from ABC Ltd. 1/3 credited to investment A/c being out of capital profits – as explained above)		
<i>Goodwill on Consolidation:</i>		Rs.
Cost of shares less dividend out of capital profits		2,64,000
Less: Face value of capital i.e. 80% of capital	1,60,000	
Add: Share of capital profits [1,20,000-20,000 (dividend portion out of pre-acquisition profits)] X 80 %	80,000	<u>2,40,000</u>
Goodwill		24,000
Minority interest on:		64,000
1st January, 2016: 20% of Rs. 3,20,000 [2,00,000 + 1,20,000]		
31st December, 2016: 20% of Rs. 3,00,000 [2,00,000 + 1,20,000 + 40,000 – 60,000]		60,000

MOCK TEST PAPER – 2
INTERMEDIATE (NEW) GROUP – II
PAPER – 6: AUDITING AND ASSURANCE

Question No. 1 is compulsory.
*Attempt any **four** questions from the Rest.*

Time Allowed – 3 Hours

Maximum Marks – 100

Division A- Multiple Choice Questions

Questions (1-20) carry 1 Mark each

Total 30 Marks

Questions 21-25 carry 2 Marks each

1. If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to:
 - (a) the original engagement; or any procedures that may have been performed in the original engagement.
 - (b) the original engagement;
 - (c) any procedures that may have been performed in the original engagement
 - (d) the original engagement and any procedures that may have been performed in the original engagement.
2. Which of the following is correct :
 - (a) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.
 - (b) The auditor is expected to and can reduce audit risk to zero and can therefore obtain absolute assurance.
 - (c) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain reasonable assurance that the financial statements are free from material misstatement due to fraud or error.
 - (d) The auditor is expected to and can reduce audit risk to zero and can therefore obtain reasonable assurance that the financial statements are free from material misstatement due to fraud or error.
3. With reference to SA 300, the auditor shall document:
 - (a) The overall audit strategy
 - (b) The audit plan
 - (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.
 - (d) All of the above
4. Determining a percentage to be applied to a chosen benchmark (in relation to materiality) involves the exercise of _____
 - (a) Independence

- (b) Professional Judgement
 - (c) Professional skepticism
 - (d) All of the above
5. Which of the following is correct :
- (a) The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.
 - (b) The auditor shall assemble the audit documentation in an audit file and shall not complete the administrative process of assembling the final audit file.
 - (c) The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis before the date of the auditor's report.
 - (d) The auditor shall not assemble the audit documentation in an audit file..
6. Audit evidence includes
- (a) information contained in the accounting records underlying the financial statements
 - (b) both information contained in the accounting records underlying the financial statements and other information.
 - (c) other information.
 - (d) information contained in the accounting records underlying the financial statements or other information.
7. Most of the auditor's work in forming the auditor's opinion consists of :
- (a) obtaining audit evidence.
 - (b) evaluating audit evidence.
 - (c) obtaining or evaluating audit evidence.
 - (d) obtaining and evaluating audit evidence.
8. Audit risk is a function of the
- (a) risks of material misstatement and detection risk.
 - (b) audit risk and detection risk.
 - (c) control risk and detection risk.
 - (d) inherent risk and detection risk.
9. Risk of material misstatement may be defined as the risk
- (a) that the financial statements are materially misstated after audit.
 - (b) that the financial statements are materially misstated during audit.
 - (c) that the financial statements are materially misstated prior to audit.
 - (d) All of the above
10. _____ refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.
- (a) Misstatement
 - (b) Error
 - (c) Fraud

- (d) Any of the above
11. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
- (a) Discuss the matter with management and, where appropriate, those charged with governance.
 - (b) Determine whether the financial statements need amendment.
 - (c) Inquire how management intends to address the matter in the financial statements.
 - (d) All of the above
12. A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request is-
- (a) Positive confirmation request
 - (b) Non-response
 - (c) Exception
 - (d) Negative confirmation request
13. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:
- (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel.
 - (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel.
 - (c) Reviewing legal expense accounts.
 - (d) All of the above
14. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express :
- (a) a disclaimer opinion
 - (b) a qualified opinion
 - (c) a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.
 - (d) unmodified opinion
15. If, as a result of a misstatement resulting from fraud, the auditor encounters exceptional circumstances that bring into question his ability to continue performing the audit, he shall-
- (a) Withdraw from the engagement immediately.
 - (b) Report to Audit team regarding withdrawal.
 - (c) Determine the professional and legal responsibilities applicable in the circumstances.
 - (d) Ask the management for his withdrawal.
16. It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts :
- (a) Haphazard sampling
 - (b) Monetary Unit Sampling

- (c) Stratified Sampling
 - (d) Interval sampling
17. Which of the following is correct :
- (a) A firm whereof all the partners practising anywhere are qualified for appointment may be appointed by its firm name to be auditor of a company.
 - (b) A firm whereof majority of partners practising anywhere are qualified for appointment may be appointed by its firm name to be auditor of a company.
 - (c) A firm whereof all the partners practising in India are qualified for appointment may be appointed by its firm name to be auditor of a company.
 - (d) A firm whereof majority of partners practising in India are qualified for appointment may be appointed by its firm name to be auditor of a company.
18. As per **Section 139(6)**, the first auditor of a company, other than a Government company, shall be appointed
- (a) by the Board of Directors within 30 days from the date of registration of the company.
 - (b) by the audit committee within 30 days from the date of registration of the company.
 - (c) by the Managing Director within 30 days from the date of registration of the company.
 - (d) by the shareholders within 30 days from the date of registration of the company.
19. Where a company is required to constitute an Audit Committee under section 177,
- (a) all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.
 - (b) all appointments, excluding the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.
 - (c) appointment of first auditors shall be made after taking into account the recommendations of such committee.
 - (d) appointment of subsequent auditors shall be made after taking into account the recommendations of such committee.
20. which of the following is incorrect :
- (a) In terms of the general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property.
 - (b) Under section 128 of the Act, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents.
 - (c) The company provides reasonable facility to auditor for inspection of the books of account by directors and others authorised to inspect under the Act.
 - (d) working papers not being his own property, auditor can exercise lien on working papers.

(20 x 1 = 20 Marks)

Questions (21-25) carry 2 Marks each

21. You are at the planning stage for one of your firm's client XYZ Bank for the year ended 31 March 2018. The bank is a commercial bank that provides a number of products and services to the general public and other segments of the economy in the area of South Mumbai. You are assigned the audit of one of the branches of XYZ Bank. The audit engagement team was called to have a detailed discussion on the

following matters. Which one of the following should not be included in the discussion for the audit of banks?

- (a) Discuss on the error of last year in the application of accounting policies of the bank.
- (b) Discuss on the method of fraud if any perpetrated by the bank employee within particular balances and/or disclosures
- (c) Discuss with the team the appointment and remuneration to be received on this bank audit.
- (d) Discuss the effect of the results of the risk assessment procedures on other aspects to decide the nature, timing and extent of further audit procedures.

22. Which of the following is correct :

- (a) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor need not disclose the substantive reasons for the different opinion.
- (b) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with SA 706.
- (c) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an emphasis of Matter paragraph in accordance with SA 706.
- (d) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph or emphasis of matter paragraph in accordance with SA 706.

23. Which of the following is incorrect :

- (a) Communicating key audit matters in the auditor's report is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
- (b) Communicating key audit matters in the auditor's report is not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);
- (c) Communicating key audit matters in the auditor's report is not a substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern;
- (d) Communicating key audit matters in the auditor's report is a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

24. One of your junior audit team members is confused with the term 'material misstatement'. You explain him that a material misstatement is untrue information in a financial statement that could affect the financial decisions of one who relies on the statement. Which of the following would constitute material misstatement?

- (1) An error of Rs.5,000 in relation to assets of Rs.20 lakhs.
- (2) A payroll fraud of Rs.100 in a company where profit before tax is Rs.11,000.
- (3) Non-disclosure of a material uncertainty.

- (4) Financial statements have been prepared on a going concern basis when the company is in the process of being liquidated.
- (a) 1 and 2
 (b) 3 and 4
 (c) 2 and 3
 (d) 1 and 4
25. Springfield Hospital located in the rural area of Lonawala region is a government hospital run by the local doctors who are appointed by the government. The hospital was registered on 1 October 2018. Which of the following is correct in respect of the appointment of the first auditor for Springfield Hospital?
- (a) The Board of Directors of the hospital have appointed the first auditor on 5th November 2018.
 (b) The Comptroller Auditor-General of India appointed the first auditor on 15th December 2018.
 (c) Since the Comptroller Auditor-General of India did not appoint the first auditor, the Board of Director appointed the first auditor on 15th December 2018.
 (d) Since the Comptroller Auditor-General of India did not appoint the first auditor, the Board of Director appointed the first auditor on 10th November 2018. **(5 x 2 = 10 Marks)**

Division B- Descriptive Questions

Question No. 1 is compulsory.

*Attempt any **four** questions from the Rest.*

Total 70 Marks

1. Examine with reasons (in short) whether the following statements are correct or incorrect: (Attempt any 7 out of 8)
- (i) The objective of audit is to obtain absolute assurance about whether the financial statements as a whole are free from material misstatement.
 (ii) Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement.
 (iii) There is no need to put the nature of engagement to writing.
 (iv) Few members of the Board of Directors oppose the appointment of Mr. N, an employee of the company, as an Internal Auditor, stating that Mr. N is not a chartered accountant and further he is an employee of the company.
 (v) PQR & Co., Chartered Accountants, resigned from the audit of a Government Company and filed the resignation with the company and the registrar within 30 days. Comment, whether PQR & Co. has complied with the provisions of the Companies Act, 2013.
 (vi) The statutory auditor of ABC Ltd. is of the opinion that communicating key audit matters in the auditor's report constitutes a substitute for disclosure in the financial statements.
 (vii) Sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.
 (viii) The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. **(7 x 2 = 14 Marks)**
2. Discuss the following:
- (a) The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. **(3 Marks)**

- (b) Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. Explain. **(4 Marks)**
- (c) M & Co. was appointed as auditor of IGI Ltd. As an auditor what are the factors that would be considered in the development of overall audit plan? **(4 Marks)**
- (d) The Auditor is fully satisfied with the audit of an entity in respect of its systems and procedures and wants to issue a report without any hesitation. What type of opinion can be given and give reasoning. **(3 Marks)**
3. (a) State the matters to be included in the auditor's report as per CARO, 2016, regarding:
- (i) Private Placement of Preferential Issues. **(2 Marks)**
- (ii) Utilisation of IPO and further public offer. **(2 Marks)**
- (b) Briefly discuss the limitations of Internal Control. **(4 Marks)**
- (c) What are the provisions prescribed under Companies Act, 2013 in respect of ceiling on number of audits in a company to be accepted by an auditor? **(3 Marks)**
- (d) While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind? **(3 Marks)**
4. (a) During the audit of PQR Ltd. you as an auditor requested officers of the company to have access to secretarial records and correspondence which they refused to provide. Comment. **(4 Marks)**
- (b) Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Explain. **(4 Marks)**
- (c) Write the circumstances that indicate the possibility of fraud due to problematic or unusual relationship between the auditor and management. **(6 Marks)**
5. (a) Discuss with reference to SA-230, factors affecting form, contents and extent of audit documentation. **(4 Marks)**
- (b) State six important advantages of audit of accounts of a Partnership firm. **(4 Marks)**
- (c) State assertions that are implied in the extract of financial statement given below:

			(Rs.)
	Plant & Machinery (at Cost)		4,00,000
Less:	Depreciation:		
	Up to Previous year	1,40,000	
	For the year	<u>26,000</u>	<u>1,66,000</u>
			<u>2,34,000</u>

- (i) Indicate assertions in respect of transactions and events for the period relating to Fixed Assets.
- (ii) State specific assertions relating to the above extract of financial statement. **(6 Marks)**
6. (a) In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. Explain stating uses of Data analytics. **(4 Marks)**
- (b) The auditor should examine the efficacy of various internal controls over advances in case of Banks to determine the nature, timing and extent of his substantive procedures. Explain what is included in the internal controls over advances. **(4 Marks)**

OR

- (c) The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Explain **(4 Marks)**
- (d) Explain with examples the audit procedure to establish the existence of intangible fixed assets as at the period-end. **(3 Marks)**
- (e) Verification of liabilities is as important as that of assets, considering if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the entity. Explain stating also criteria for a liability to be classified as current liability. **(3 Marks)**

MOCK TEST PAPER - 2
INTERMEDIATE (NEW): GROUP – II
PAPER – 6: AUDITING AND ASSURANCE
SUGGESTED ANSWERS/HINTS
Division A - Multiple Choice Questions

1. (a)
2. (a)
3. (d)
4. (b)
5. (a)
6. (b)
7. (d)
8. (a)
9. (c)
10. (a)
11. (d)
12. (d)
13. (d)
14. (c)
15. (c)
16. (b)
17. (d)
18. (a)
19. (a)
20. (d)
21. (c)
22. (b)
23. (d)
24. (b)
25. (c)

Division B - Descriptive Answers

1. (i) **Incorrect:** The objective of audit is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. In auditing, reasonable assurance can be given which is high level assurance but not absolute assurance. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit.

- (ii) **Correct.** Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
- (iii) **Incorrect:** It is important, both for the auditor and client, that each party should be clear about the nature of the engagement. It must be reduced to writing and should exactly specify the scope of the work.
- (iv) **Incorrect:** As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.
- (v) **Incorrect:** As per **section 140(2)** the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed **Form** with the company and the Registrar, and in case of the companies referred to in **section 139(5)** i.e. Government company, the auditor shall also file such statement with the Comptroller and Auditor - General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In this case, the PQR & Co., was also required to file prescribed Form with C & AG of India but it did not file the same. Therefore, it did not comply with the provisions of the Companies Act, 2013.
- (vi) **Incorrect:** Communicating key audit matters in the auditor's report is not a substitute for disclosures in the financial statements that the applicable Financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation.
- (vii) **Correct:** The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Whatever maybe the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

- (viii) **Correct:** The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion
2. (a) Ethical Requirements Relating to an Audit of Financial Statements: The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.
- The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements :
- (a) Integrity;
 - (b) Objectivity;
 - (c) Professional competence and due care;
 - (d) Confidentiality; and
 - (e) Professional behavior.
- (b) **Familiarity threats** are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways:

- (i) close relative of the audit team working in a senior position in the client company,
- (ii) former partner of the audit firm being a director or senior employee of the client,
- (iii) long association between specific auditors and their specific client counterparts, and
- (iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.

(c) Development of an Overall Plan: The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit-

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- The degree of reliance he expects to be able to place on accounting system and internal control.
- Possible rotation of emphasis on specific audit areas.
- The nature and extent of audit evidence to be obtained.
- The work of internal auditors and the extent of their involvement, if any, in the audit.
- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.
- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.

Establishing and coordinating staffing requirements.

(d) Unqualified Opinion:

1. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements.
2. An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.
3. An unqualified opinion also indicates that:
 - (i) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;
 - (ii) the financial statements comply with relevant statutory requirements and regulations; and
 - (iii) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

3. (a) (i) **The auditor is required to report as per clause xiv of paragraph 3 of CARO 2016**, 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;
- (ii) **It is duty of the auditor to report as per clause ix of paragraph 3 of CARO 2016**, 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.

(b) Limitations of Internal Control:

- (i) **Internal control can provide only reasonable assurance:** Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.
- (ii) **Human judgment in decision-making:** Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.
- (iii) **Lack of understanding the purpose:** Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.
- (iv) **Collusion among People:** Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. **For example**, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.
- (v) **Judgements by Management:** Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.
- (vi) **Limitations in case of Small Entities:** Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

(c) Ceiling on number of Audits:

1. Section 141(3)(g) of the Companies Act, 2013 prescribes that a person shall not be eligible for appointment as an auditor of a company namely – a person who 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 Rs. 100 crore.
2. In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the

firm who is not in full time employment elsewhere. This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be $3 \times 20 = 60$ company audits.

3. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.

(d) Risk Factors while applying Sampling Techniques: As per SA 530 "Audit Sampling", sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions-

- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of tests of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (ii) In the case of test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

4. (a) Right of Access to secretarial records and correspondence:

1. Section 143(1) of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books of account and vouchers of the company kept at Registered or Head Office, branches and subsidiaries in the case of a Holding Company for conducting the audit.
2. Further, he is also entitled to require from the officers of the company such information and explanations which he considers necessary for the proper performance of his duties as Auditor. Therefore, he has a statutory right to inspect the secretarial records and correspondence.
3. In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company. It is, therefore, essential for the auditor to refer to the secretarial records and correspondence which also includes Minute book. In the absence of the same, the auditor may not be able to vouch/verify certain transactions of the company.
4. The refusal to provide access to secretarial records and correspondence shall constitute limitation of scope as far as the auditor's duties are concerned.
5. The auditor may examine whether by performing alternative procedures, the auditor can substantiate the assertions or else he shall have to either qualify the report or give a disclaimer of opinion.

(b) Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay

throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

(c) Problematic or unusual relationships between the auditor and management, including:

1. Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
2. Undue time pressures imposed by management to resolve complex or contentious issues.
3. Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
4. Unusual delays by the entity in providing requested information.
5. Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
6. Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
7. An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
8. An unwillingness to address identified deficiencies in internal control on a timely basis.
9. Unwillingness by management to permit the auditor to meet privately with those charged with governance
10. Accounting Policy that appears to be variance with industry norms
11. Frequent changes in accounting estimates that do not appear to result from changed circumstances
12. Tolerance of variations in the entity's code of conduct

5. (a) Form, Content and Extent of Audit Documentation: Working papers should record the audit plan, nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

The form, content and extent of working papers depend on factors such as:

- ◆ The size and complexity of the entity.
- ◆ The nature of the audit procedures to be performed.
- ◆ The identified risks of material misstatement.
- ◆ The significance of the audit evidence obtained.
- ◆ The nature and extent of exceptions identified.
- ◆ The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- ◆ The audit methodology and tools used.

(b) Advantages of Audit of Accounts of a Partnership: On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows:

- (1) Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated. On

this consideration, it is usually provided in and accepted by the partners, shall be binding upon them, unless some manifest error is brought to light within a specified period subsequent to the accounts having been signed.

- (2) On the retirement or death of a partner, audited accounts, which have been accepted by the partners, constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.
 - (3) The accounts of a partnership, which have been audited, are generally accepted by the Income Tax Department as the basis for computing the assessable income of the partners.
 - (4) Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.
 - (5) Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.
 - (6) An audit is an effective safeguard against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.
- (c) (i) **Assertions about transactions and events for the period relating to fixed assets :**
- (1) Occurrence—transactions and events relating to fixed assets have been recorded, have occurred and pertain to the entity.
 - (2) Completeness—all transactions and events relating to fixed assets that should have been recorded have been recorded.
 - (3) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
 - (4) Cut-off—transactions and events have been recorded in the correct accounting period.
 - (5) Classification—transactions and events have been recorded in the proper accounts.
- (ii) **The specific assertions are as follows:**
- (1) the firm owns the plant and machinery;
 - (2) the historical cost of plant and machinery is Rs. 4 lacs;
 - (3) the plant and machinery physically exists;
 - (4) the asset is being utilised in the business of the company productively;
 - (5) total charge of depreciation on this asset is Rs. 1,66,000 to date on which Rs. 26,000 relates to the year in respect of which the accounts are drawn up; and
 - (6) the amount of depreciation has been calculated on recognised basis and the calculation is correct

6. (a) **In today's digital age when companies rely on more and more on IT systems and networks** to operate business, the amount of data and information that exists in these systems is enormous. A famous businessman recently said, "Data is the new Oil".

The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics. While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results. The tools and

techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short.

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

- check completeness of data and population that is used in either test of controls or substantive audit tests
- selection of audit samples – random sampling, systematic sampling
- re-computation of balances – reconstruction of trial balance from transaction data
- reperformance of mathematical calculations – depreciation, bank interest calculation.
- analysis of journal entries as required by SA 240
- fraud investigation
- evaluating impact of control deficiencies

(b) Evaluation of Internal Controls over Advances: The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, *inter alia*, the following:

- ◆ The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
- ◆ All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- ◆ The compliance with the terms of sanction and end use of funds should be ensured.
- ◆ Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- ◆ If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- ◆ All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- ◆ In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- ◆ Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- ◆ The accounts should be kept within both the drawing power and the sanctioned limit.
- ◆ All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- ◆ The operation of each advance account should be reviewed at least once a year, and at more frequent intervals in the case of large advances.

(c) Responsibilities for the Financial Statements: The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept

responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

This section of the auditor's report shall describe management's responsibility for:

- (a) **Preparing the financial statements** in accordance with the applicable financial reporting framework, **and for such internal control** as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; [because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] and
- (b) **Assessing the entity's ability to continue as a going concern** and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.
- (d) **Since an Intangible Asset is an identifiable non-monetary asset**, without physical substance, for establishing the existence of such assets, the auditor should verify whether such intangible asset is in active use in the production or supply of goods or services, for rental to others, or for administrative purposes.

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

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

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

- (e) **Liabilities in addition to borrowings (discussed above), include** trade payables and other current liabilities, deferred payment credits and provisions. Verification of liabilities is as important as that of assets, considering if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the entity.

Further, a liability is classified as current if it satisfies any of the following criteria:

- It is expected to be settled in the entity's normal operating cycle
- It is held primarily for the purpose of being traded
- It is due to be settled within twelve months after the reporting period
- The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments does not affect its classification.

MOCK TEST PAPER – 2

INTERMEDIATE (New): GROUP – II

PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC MANAGEMENT

SECTION – A: ENTERPRISE INFORMATION SYSTEMS

Time Allowed – 1½ Hours

Maximum Marks – 50 Marks





Multiple Choice Questions

Question Nos. 1 to 5 carries 2 Marks each.

1. Auditor of a company finds that management policy of cash expenses limit of Rs. 5,000/- is not being adhered to. There are many violations of the same during the year. Auditor of the company shall report on same under which clause of Companies Act, 2013?
 - (a) 134(4)
 - (b) 143(3)
 - (c) 134(3)
 - (d) 143(4)
2. Bills of Materials (BoM) is an important feature for any ERP software. The sub-system where a BoM is located is _____.
 - (a) Manufacturing
 - (b) Financials
 - (c) Projects
 - (d) Human Resource Management
3. Database is a collection of Data. Various database models are used. The database models having using a primary key is _____.
 - (a) OODBMS
 - (b) RDBMS
 - (c) Network Database Model
 - (d) Hierarchical Database Model
4. Driverless cars are the future of personal transportation technology. Many companies have been testing these cars on roads across the world. Few fatalities have been caused by these driverless cars. The culprits are not yet booked. This reflects which risk of AI as a technology being used in driverless cars.
 - (a) The police investigations are poor.
 - (b) AI is not human.
 - (c) The law is not being able to meet the requirements of technology.
 - (d) No one is responsible.

5. A company has purchased a luxury yacht in Monte Carlo from sale of property worth Rs.100/- crores. The sale was executed in cash and money was taken out of India through dubious means. This transaction is a money laundering act by the company. Purchase of luxury yacht is best classified as _____.
- (a) Application
 - (b) Placement
 - (c) Integration
 - (d) Layering
- (5 x 2 = 10 Marks)**

Question Nos. 6 to 10 carries 1 Marks each.

6. Entity-Relationship (ER) Diagram, Data Flow Diagram, Flowcharts all use graphical symbols. All symbols given are used in all three except one.
- (a) 
 - (b) 
 - (c) 
 - (d) 
7. Pick the ODD one out.
- (a) Accounting Information System
 - (b) Input
 - (c) Output
 - (d) Process
8. Pick the odd one out.
- (a) Amazon Alexa
 - (b) Boss Speakers
 - (c) Apple Siri
 - (d) Google Talk
9. An element that has contributed to e-commerce success is payment gateways. One that does not fall in the definition is _____.
- (a) SBI Buddy
 - (b) HDFC Zapp
 - (c) Paytm
 - (d) Cash On Delivery
10. In Core banking Systems, a ____ server is a computer that offers a computer network service to allow clients to make indirect network connections to other network services.
- (a) ATM
 - (b) Network
 - (c) Proxy
 - (d) Internet Banking
- (5 x 1 = 5 Marks)**

Division B – Descriptive Questions

Total Marks: 35 Marks

Question No. 1 is compulsory.

Attempt any three questions out of remaining four questions.

1. (a) Explain the term “Data Warehouse”. **(3 Marks)**
(b) Define the term “Money Laundering”. **(2 Marks)**
2. (a) You are an IS Auditor undertaking a job of auditing the Information Systems of an ABC Bank. While performing Audit checks, you intend to ensure the placement of Input validation controls placed in the Information System by detecting errors in the transaction data before the data is processed. Determine the three levels of Input Validation Controls. **(6 Marks)**
(b) Discuss any four benefits of Enterprise Risk Management (ERM). **(4 Marks)**
3. (a) Analyze the statement “The potential benefits of Business Intelligence (BI) programs include accelerating and improving decision making; optimizing internal business processes; increasing operational efficiency; driving new revenues; and gaining competitive advantages over business rivals.” Determine its justification. **(6 Marks)**
(b) Discuss the application areas of Virtualization. **(4 Marks)**
4. (a) You attended an IT workshop as a CBS. You are required to provide a basic idea to the participants about Current & Savings Accounts (CASA) and primarily discuss the risks and controls that might be relevant in CASA process. Advise about the relevant risks and their counter controls. **(6 Marks)**
(b) Discuss the characteristics of the Hybrid Cloud. **(4 Marks)**
5. (a) Draw a flowchart to input 5 subject marks of a student. Calculate its total, percentage and also print the grade. Condition for grade are as follows:

Percentage	Grade
≥ 80	A
$< 80 \ \& \ \geq 60$	B
$< 60 \ \& \ \geq 50$	C
< 50	FAIL

(6 Marks)
(b) Discuss the factors that an IS Auditor need to determine while accessing the records in an access log of an organization. **(4 Marks)**

SECTION – B: STRATEGIC MANAGEMENT

Time Allowed – 1½ Hours

Maximum Marks – 50

Question 1 and 2 are compulsory.

Attempt any three questions out of remaining four questions.

1. (i) Strategy helps in:
 - a. Unravelling complexity
 - b. Reduce uncertainty
 - c. Relate the goals with the resources.
 - d. All of Above.
- (ii) Which of the following statement is not true:
 - a. Strategic environment is complex
 - b. Strategic environment is turbulent.
 - c. High cost of strategy makes them useless for charitable organization.
 - d. Public sector units should implement business strategy
- (iii) Which of the following is not part of external analysis:
 - a. Customer segments.
 - b. Organizational constraints.
 - c. Entry barriers.
 - d. Competitors.
- (iv) A core competence is all except?
 - a. Valuable
 - b. Rare
 - c. Impossible to imitate
 - d. Non-substitutable
- (v) Mission
 - a. is an internally-focused definition of the organization's societal goals
 - b. is a statement of a firms unique purpose and scope of operations
 - c. does not limit the firm by specifying the industry in which the firm intends to compete
 - d. is developed by a firm before the firm develops its strategic intent.
- (vi) Objectives should be:
 - (i) Concrete and specific.
 - (ii) Related to time frame.
 - (iii) Standards for performance appraisal.

Which of the above statements are true:

 - a. (i) & (ii).
 - b. (ii) & (iii).
 - c. (i) & (iii).
 - d. (i), (ii) and (iii).

- (vii) Acquisition of a company producing readymade garments by a company manufacturing yarn is.
- Horizontal integration
 - Horizontal Diversification
 - Forward integration
 - Backward integration
- (viii) Which of the following can be used in retrenchment strategy?
- Reducing assets.
 - Operational improvement.
 - Cutting cost.
 - All of the above.
- (ix) Conglomerate diversification can also be explained as:
- Merger
 - Combination strategy
 - Related diversification
 - Unrelated diversification
- (x) Michael Porter Generic strategies to gain competitive advantage include all except:
- Cost leadership
 - Differentiation
 - Focus
 - Revenue generation
- (xi) Decisions with regards to marketing mix are related to:
- Growth Strategy
 - Business level strategy
 - Functional strategy
 - Corporate decisions
- (xii) The purpose of logistics management is
- Provide customer satisfaction
 - Create automation
 - Procure better quality raw material
 - Manage inward and outward movement of goods
- (xiii) Who is a transformational leader?
- Someone who is involved in organizational change.
 - A leader, who provides new ways of carrying out management.
 - A leader who inspires the workers to new levels by offering them a vision of a better future.
 - A leader who tries to transform their staff by giving them rewards for what they do.

(xiv) Which of the following is not a phase in Kurt Lewin's Model of Change?

- a. Changing
- b. Deep freezing
- c. Refreezing
- d. Unfreezing

(xv) The following are part of Richard Rumelt's criteria for strategy audit, except:

- a. Adaptation
- b. Consistency
- c. Consonance
- d. Feasibility

(15 x 1 = 15 Marks)

2. 'Speed' is a leading retail chain, on account of its ability to operate its business at low costs. The retail chain aims to further strengthen its top position in the retail industry. The Chief executive of the retail chain is of the view that to achieve the goals they should focus on lowering the costs of procurement of products. Highlight and explain the core competence of the retail chain. **(5 Marks)**

3. (a) Enumerate the task to be performed as a strategic manager of a company. **(5 Marks)**

(b) A company manufactures computers that are of low in production cost, competitive price, and quality to their competitor's product. Profits and market share are declining day by day. Shree, a senior executive realizes that drastic strategies have to be created for the survival of a company. After SWOT analysis by assessing the strengths and weaknesses, they come up with the conclusion that they cannot compete in the computers with the competitors. The management directs Shree to act quick and develop a suitable strategic plan.

Discuss the strategy which can be opted by Shree. **(5 Marks)**

4. (a) A owner of medium size factory in Aligarh manufacturing hardware consisting handles, hinges, tower bolts and so on has a staff of about 200 in his organisation. One of the leading brand of Hardware seller in India is rebranding and selling the material from his factory. The owner believes in close supervision and takes all major and minor decisions in the organisation.

Do you think the owner should take all decisions himself? What kind of decisions should be taken by person at the level of owner of a medium size factory. **(5 Marks)**

(b) How Ansoff's Product Market Growth Matrix is a useful tool for business organizations? **(5 Marks)**

5. (a) Gennex is a company that designs, manufactures and sells computer hardware and software. Gennex is well known for its innovative products that has helped the company to have advantage over its competitors. It also spends on research and development and concerned with innovative softwares. Often the unique features of their product helps them to gain competitive advantage. Gennex using the strategy is consistently gaining its position in the industry over its competitors.

Identify and explain the strategy which Gennex has opted to gain the competitive advantage.

(5 Marks)

(b) Rohit Bhargava is the Managing Director of Smooth and Simple Pvt Ltd. The company established in 2011, with 35 employees grew very fast to become an organisation with 335 employees in the year 2016. With the increase in size Rohit started facing difficulty in managing things. Many a times he finds that personnel at the functional level are not in sync with the strategies of the top. He felt that strategies need to be segregated into viable plans and policies that are compatible with each other and communicated down the line.

Why does Rohit need to segregate the strategies into functional plans? Discuss. **(5 Marks)**

6. (a) Discuss the concept of Multi Divisional Structure
- (b) HQ is a service company? Two years back the company hired a reputed management consultant to formulate its strategy. The consultant recommended an aggressive expansion plan. Now in an internal review meeting the company finds that many of the suggestions are not even fully considered.


Which part of strategic management process is missing in HQ?

(5 Marks)

MOCK TEST PAPER - 2
INTERMEDIATE (NEW): GROUP – II
PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC MANAGEMENT
SECTION – A: ENTERPRISE INFORMATION SYSTEMS

ANSWERS

MULTIPLE CHOICE QUESTIONS

1. (b) 143(3)
2. (a) Manufacturing
3. (b) RDBMS
4. (c) The law is not being able to meet the requirements of technology.
5. (c) Integration
6. (b) 
7. (a) Accounting Information System
8. (b) Boss Speakers
9. (d) Cash on Delivery
10. (c) Proxy

DESCRIPTIVE QUESTIONS

1. (a) **Data Warehouse:** Usually this is a module that can be accessed by an organizations customers, suppliers and employees. Data warehouse is a repository of an organization's electronically stored data. Data warehouses are designed to facilitate reporting and analysis. This classic definition of the data warehouse focuses on data storage. However, the means to retrieve and analyze data, to extract, transform and load data, and to manage the data dictionary are also considered essential components of a data warehousing system. An expanded definition for data warehousing includes business intelligence tools, tools to extract, transform, and load data into the repository, and tools to manage and retrieve metadata. In contrast to data warehouses are operational systems which perform day-to-day transaction processing. The process of transforming data into information and making it available to the user in a timely enough manner to make a difference is known as data warehousing.
- (b) **Money Laundering** is the process by which the proceeds of the crime and the true ownership of those proceeds are concealed or made opaque so that the proceeds appear to come from a legitimate source. The objective in money laundering is to conceal the existence, illegal source, or illegal application of income to make it appear legitimate. Money laundering is commonly used by criminals to make "dirty" money appear "clean" or the profits of criminal activities are made to appear legitimate.
2. (a) **Validation Controls:** Input validation controls are intended to detect errors in the transaction data before the data are processed. There are three levels of input validation controls:
 - **Field Interrogation:** It involves programmed procedures that examine the characters of the data in the field. The following are some common types of field interrogation. Various field checks used to ensure data integrity have been described below:
 - o **Limit Check:** This is a basic test for data processing accuracy and may be applied to both the input and output data. The field is checked by the program against predefined limits to ensure that no input/output error has occurred or at least no input error exceeding certain pre-established limits has occurred.
 - o **Picture Checks:** These checks against entry into processing of incorrect/invalid characters.

- o **Valid Code Checks:** Checks are made against predetermined transactions codes, tables or order data to ensure that input data are valid. The predetermined codes or tables may either be embedded in the programs or stored in (direct access) files.
 - o **Check Digit:** One method for detecting data coding errors is a check digit. A check digit is a control digit (or digits) added to the code when it is originally assigned that allows the integrity of the code to be established during subsequent processing. The check digit can be located anywhere in the code, as a prefix, a suffix, or embedded someplace in the middle.
 - o **Arithmetic Checks:** Simple Arithmetic is performed in different ways to validate the result of other computations of the values of selected data fields.
 - o **Cross Checks:** may be employed to verify fields appearing in different files to see that the result tally.
 - **Record Interrogation:** These are discussed as follows:
 - o **Reasonableness Check:** Whether the value specified in a field is reasonable for that particular field?
 - o **Valid Sign:** The contents of one field may determine which sign is valid for a numeric field.
 - o **Sequence Check:** If physical records follow a required order matching with logical records.
 - **File Interrogation:** These are discussed as follows:
 - o **Version Usage:** Proper version of a file should be used for processing the data correctly. In this regard, it should be ensured that only the most current file be processed.
 - o **Internal and External Labeling:** Labeling of storage media is important to ensure that the proper files are loaded for process. Where there is a manual process for loading files, external labeling is important to ensure that the correct file is being processed. Where there is an automated tape loader system, internal labeling is more important.
 - o **Data File Security:** Unauthorized access to data file should be prevented, to ensure its confidentiality, integrity and availability. These controls ensure that the correct file is used for processing.
 - o **Before and after Image and Logging:** The application may provide for reporting of before and after images of transactions. These images combined with the logging of events enable re-constructing the data file back to its last state of integrity, after which the application can ensure that the incremental transactions/events are rolled back or forward.
 - o **File Updating and Maintenance Authorization:** Sufficient controls should exist for file updating and maintenance to ensure that stored data are protected. The access restrictions may either be part of the application program or of the overall system access restrictions.
 - o **Parity Check:** When programs or data are transmitted, additional controls are needed. Transmission errors are controlled primarily by detecting errors or correcting codes.
- (b) ERM provides enhanced capability to do the following:
- ◆ **Align risk appetite and strategy:** Risk appetite is the degree of risk, on a broad-based level that an enterprise (any type of entity) is willing to accept in pursuit of its goals. Management considers the entity's risk appetite first in evaluating strategic alternatives, then in setting objectives aligned with the selected strategy and in developing mechanisms to manage the related risks.
 - ◆ **Link growth, risk and return:** Entities accept risk as part of value creation and preservation, and they expect return commensurate with the risk. ERM provides an enhanced ability to identify and assess risks, and establish acceptable levels of risk relative to growth and return objectives.

- ◆ **Enhance risk response decisions:** ERM provides the rigor to identify and select among alternative risk responses – risk avoidance, reduction, sharing and acceptance. ERM provides methodologies and techniques for making these decisions.
 - ◆ **Minimize operational surprises and losses:** Entities have enhanced capability to identify potential events, assess risk and establish responses, thereby reducing the occurrence of surprises and related costs or losses.
 - ◆ **Identify and manage cross-enterprise risks:** Every entity faces a myriad of risks affecting different parts of the enterprise. Management needs to not only manage individual risks, but also understand interrelated impacts.
 - ◆ **Provide integrated responses to multiple risks:** Business processes carry many inherent risks, and ERM enables integrated solutions for managing the risks.
 - ◆ **Seize opportunities:** Management considers potential events, rather than just risks, and by considering a full range of events, management gains an understanding of how certain events represent opportunities.
 - ◆ **Rationalize capital:** More robust information on an entity's total risk allows management to more effectively assess overall capital needs and improve capital allocation.
3. (a) Business Intelligence (BI) is a technology-driven process for analysing data and presenting actionable information to help corporate executives, business managers and other end users make more informed business decisions.
- BI encompasses a wide variety of tools, that enable organizations to collect data from internal systems and external sources, prepare it for analysis, develop and run queries against the data, and create reports, dashboards and data visualizations to make the analytical results available to corporate decision makers as well as operational workers.
 - BI systems can also help companies identify market trends and spot business problems that need to be addressed.
 - Business Intelligence uses data from different sources and helps to find answers to various questions as shown on right hand side of above image.
 - BI data can include historical information, as well as new data gathered from source systems as it is generated, enabling BI analysis to support both strategic and tactical decision-making processes.
 - Initially, BI tools were primarily used by data analysts and other IT professionals who ran analyses and produced reports with query results for business users. Increasingly, however, business executives and workers are using BI software themselves, thanks partly to the development of self-service BI and data discovery tools.
 - Business Intelligence combines a broad set of data analysis applications, including ad hoc analysis and querying, enterprise reporting, Online Analytical Processing (OLAP), mobile BI, real-time BI, operational BI, cloud and software as a service BI, open source BI, collaborative BI and location intelligence.
 - BI technology also includes data visualization software for designing charts and other infographics, as well as tools for building BI dashboards and performance scorecards that display visualized data on business metrics and key performance indicators in an easy-to-grasp way.
 - BI applications can be bought separately from different vendors or as part of a unified BI platform from a single vendor.
 - BI programs can also incorporate forms of advanced analytics, such as data mining, predictive analytics, text mining, statistical analysis and big data analytics. In many cases, though, advanced analytics projects are conducted and managed by separate teams of data scientists, statisticians, predictive modelers and other skilled analytics professionals, while BI teams oversee more straightforward querying and analysis of business data.

- Business Intelligence data in terms of unstructured data, log files, sensor data and other types of big data are stored in a data warehouse or smaller data marts that hold subsets of a company's information. Before it's used in BI applications, raw data from different source systems must be integrated, consolidated and cleansed using data integration and data quality tools to ensure that users are analysing accurate and consistent information.

(b) Application Areas of Virtualization are as follows:

- ◆ **Server Consolidation:** Virtual machines are used to consolidate many physical servers into fewer servers, which in turn host virtual machines. Each physical server is reflected as a virtual machine "guest" residing on a virtual machine host system. This is also known as "Physical-to-Virtual" or 'P2V' transformation.
- ◆ **Disaster Recovery:** Virtual machines can be used as "hot standby" environments for physical production servers. This changes the classical "backup-and-restore" philosophy, by providing backup images that can "boot" into live virtual machines, capable of taking over workload for a production server experiencing an outage.
- ◆ **Testing and Training:** Virtualization can give root access to a virtual machine. This can be very useful such as in kernel development and operating system courses.
- ◆ **Portable Applications:** Portable applications are needed when running an application from a removable drive, without installing it on the system's main disk drive. Virtualization can be used to encapsulate the application with a redirection layer that stores temporary files, windows registry entries and other state information in the application's installation directory and not within the system's permanent file system.
- ◆ **Portable Workspaces:** Recent technologies have used virtualization to create portable workspaces on devices like iPods and USB memory sticks.

4. (a) Risks and Controls around the CASA Process of Current and Savings Account (CASA) Process are as follows:

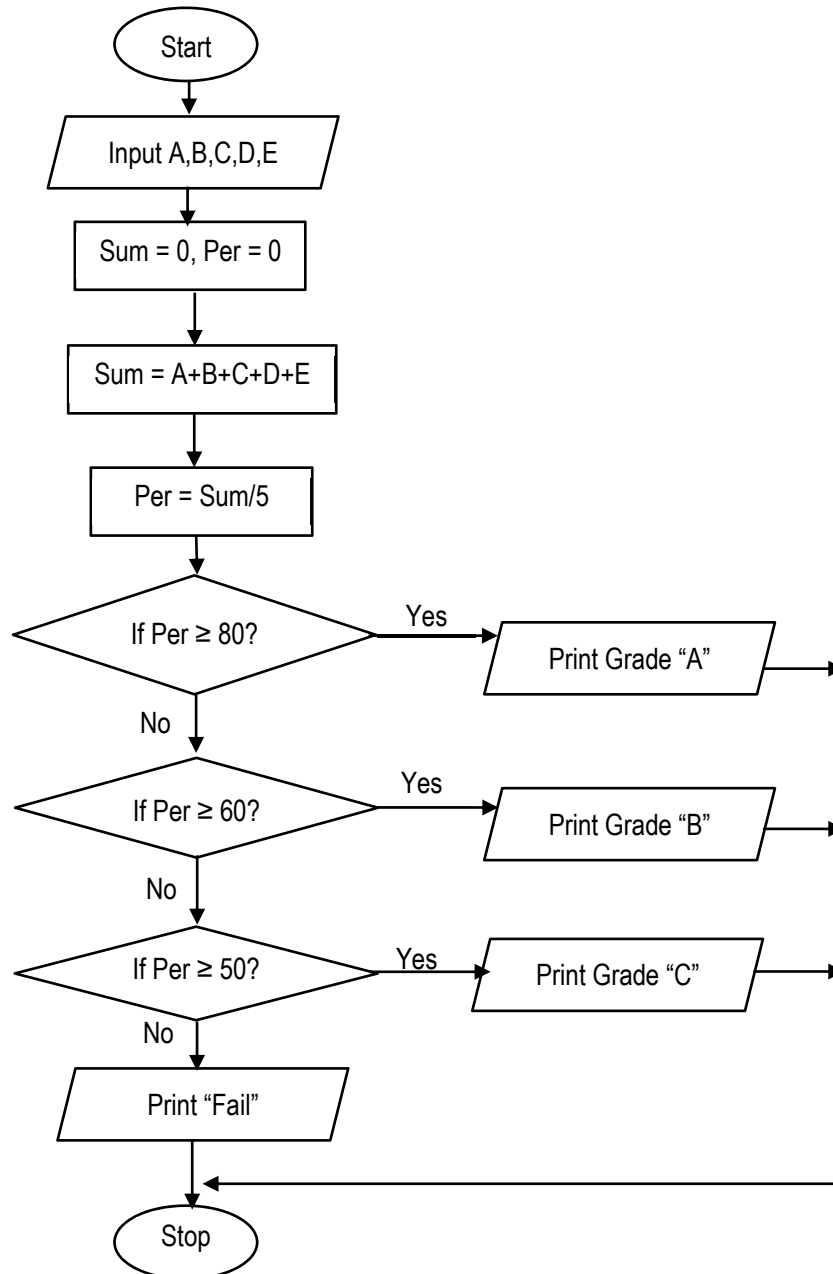
Risk	Key Controls
Credit Line setup is unauthorized and not in line with the banks policy.	The credit committee checks that the Financial Ratios, the Net-worth, the Risk factors and its corresponding mitigating factors, the Credit Line offered and the Credit amount etc. is in line with Credit Risk Policy and that the Client can be given the Credit Line.
Credit Line setup in CBS is unauthorized and not in line with the banks policy.	Access rights to authorize the credit limit in case of account setup system should be restricted to authorized personnel.
Customer Master defined in CBS is not in accordance with the Pre-Disbursement Certificate.	Access rights to authorize the customer master in CBS should be restricted to authorized personnel.
Inaccurate interest / charge being calculated in CBS.	Interest on fund based facilities are automatically calculated in the CBS as per the defined rules.
Unauthorized personnel approving the CASAS transaction in CBS.	Segregation of Duties to be maintained between the initiator and authorizer of the transaction for processing transaction in CBS.
Inaccurate accounting entries generated in CBS.	Accounting entries are generated by CBS basis the facilities requested by the customer and basis defined configurations for those facilities in CBS.

(b) The characteristics of Hybrid Cloud are as follows:

- ◆ **Scalable:** The hybrid cloud has the property of public cloud with a private cloud environment and as the public cloud is scalable; the hybrid cloud with the help of its public counterpart is also scalable.

- ◆ **Partially Secure:** The private cloud is considered as secured and public cloud has high risk of security breach. The hybrid cloud thus cannot be fully termed as secure but as partially secure.
- ◆ **Stringent SLAs:** Overall the SLAs are more stringent than the private cloud and might be as per the public cloud service providers.
- ◆ **Complex Cloud Management:** Cloud management is complex as it involves more than one type of deployment models and the number of users is high.

5. (a) The required flowchart is as below:



A,B,C,D,E: Denote the five subjects
 Sum: Sum of marks of all the subjects
 Per: Percentage

- (b) The IS auditor needs to determine what events are recorded in access logs. The IS auditor needs to understand the capabilities of the system being audited and determine if the right events are being logged, or if logging is suppressed on events that should be logged.
- ◆ **Centralized access logs:** The IS auditor should determine if the organization's access logs are aggregated or if they are stored on individual systems.
 - ◆ **Access log protection:** The auditor needs to determine if access logs can be altered, destroyed, or attacked to cause the system to stop logging events. For especially high-value and high-sensitivity environments, the IS auditor needs to determine if logs should be written to digital media that is unalterable, such as optical WORM (write once read many) media.
 - ◆ **Access log review:** The IS auditor needs to determine if there are policies, processes, or procedures regarding access log review. The auditor should determine if access log reviews take place, who performs them, how issues requiring attention are identified, and what actions are taken when necessary.
 - ◆ **Access log retention:** The IS auditor should determine how long access logs are retained by the organization and if they are back up.

SECTION – B: STRATEGIC MANAGEMENT

SUGGESTED ANSWERS/HINTS

1.

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

2. A core competence is a unique strength of an organization which may not be shared by others. Core competencies are those capabilities that are critical to a business achieving competitive advantage. In order to qualify as a core competence, the competency should differentiate the business from any other similar businesses. A core competency for a firm is whatever it does is highly beneficial to the organisation. 'Speed' is the leader on account of its ability to keep costs low. The cost advantage that 'Value for Money' has created for itself has allowed the retailer to price goods lower than competitors. The core competency in this case is derived from the company's ability to generate large sales volume, allowing the company to remain profitable with low profit margin.

3. (a) The primary tasks of the strategic manager is conceptualizing, designing and executing company strategies.

For this purpose, his tasks will include:

- Defining the mission and goals of the organization.
- Determining what businesses it should be in.
- Allocating resources among the different businesses.
- Formulating strategies.
- Implementing strategies.
- Providing leadership for the organization.

(b) Shree can opt for turnaround strategy which is a highly-targeted effort to return the company to profitability and increase positive cash flows to a sufficient level. Organizations those have faced a significant crisis that has negatively affected operations require turnaround strategy. Once turnaround is successful the organization may turn to focus on growth.

Conditions for turnaround strategies

When firms are losing their grips over market, profits due to several internal and external factors, and if they have to survive under the competitive environment they have to identify danger signals as early as possible and undertake rectification steps immediately. These conditions may be, inter alia cash flow problems, lower profit margins, high employee turnover and decline in market share, capacity underutilization, low morale of employees, recessionary conditions, mismanagement, raw material supply problems and so on.

Action plan for turnaround strategy

- Stage One – Assessment of current problems
- Stage Two – Analyze the situation and develop a strategic plan
- Stage Three – Implementing an emergency action plan
- Stage Four – Restructuring the business
- Stage Five – Returning to normal

4. (a) Decision making is a managerial process of selecting the best course of action out of several alternative courses for the purpose of accomplishment of the organizational goals. Decisions may be operational, i.e., which relate to general day-to-day operations. They may also be strategic in nature.

A owner manager at the top level should concentrate on strategic decisions. These are higher level decisions having organisation wide implications. The major dimensions of strategic decisions are as follows:

- ◆ Strategic decisions require top-management involvement as they involve thinking in totality of the organization.
 - ◆ Strategic decisions involve significant commitment of organisational resources.
 - ◆ Strategic decisions necessitate consideration of factors in the firm's external environment.
 - ◆ Strategic decisions are likely to have a significant impact on the long-term prosperity of the firm.
 - ◆ Strategic decisions are future oriented.
 - ◆ Strategic decisions usually have major multifunctional or multi-business consequences.
- (b) The Ansoff's product market growth matrix (proposed by Igor Ansoff) is a useful tool that helps businesses decide their product and market growth strategy. With the use of this matrix a business can get a fair idea about how its growth depends upon it markets in new or existing products in both new and existing markets.

Companies should always be looking to the future. Businesses that use the Ansoff matrix can determine the best strategy. The matrix can help them to decide how to do this by demonstrating their options clearly, breaking them down into four strategies, viz., *Market Penetration, Market Development, Product Development, Diversification*. Determining which of these is best for their business will depend on a number of variables including available resources, infrastructure, market position, location and budget.

5. (a) According to Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus. Porter called these base generic strategies.

Gennex has opted differentiation strategy. Its products are designed and produced to give the customer value and quality. They are unique and serve specific customer needs that are not met by other companies in the industry. Highly differentiated and unique hardware and software enables Gennex to charge premium prices for its products hence making higher profits and maintain its competitive position in the market.

Differentiation strategy is aimed at broad mass market and involves the creation of a product or service that is perceived by the customers as unique. The uniqueness can be associated with product design, brand image, features, technology, dealer network or customer service.

- (b) Rohit Bhargava needs to break higher level strategies into functional strategies for implementation. These functional strategies, in form of Marketing, Finance, Human Resource, Production, Research and Development help in achieving the organisational objective. The reasons why functional strategies are needed can be enumerated as follows:

- Functional strategies lay down clearly what is to be done at the functional level. They provide a sense of direction to the functional staff.
- They are aimed at facilitating the implementation of corporate strategies and the business strategies formulation at the business level.
- They act as basis for controlling activities in the different functional areas of business.

- They help in bringing harmony and coordination as they are formulated to achieve major strategies.

Similar situations occurring in different functional areas are handled in a consistent manner by the functional managers.

- 6. (a)** Multidivisional (M-form) structure is composed of operating divisions where each division represents a separate business to which the top corporate officer delegates responsibility for day-to-day operations and business unit strategy to division managers. By such delegation, the corporate office is responsible for formulating and implementing overall corporate strategy and manages divisions through strategic and financial controls.

Multidivisional or M-form structure was developed in the 1920s, in response to coordination- and control-related problems in large firms. Functional departments often had difficulty dealing with distinct product lines and markets, especially in coordinating conflicting priorities among the products.

Costs were not allocated to individual products, so it was not possible to assess an individual product's profit contribution. Loss of control meant that optimal allocation of firm resources between products was difficult (if not impossible). Top managers became over-involved in solving short-run problems (such as coordination, communications, conflict resolution) and neglected long-term strategic issues. Multidivisional structure calls for:

- ◆ Creating separate divisions, each representing a distinct business
- ◆ Each division would house its functional hierarchy;
- ◆ Division managers would be given responsibility for managing day-to-day operations;
- ◆ A small corporate office that would determine the long-term strategic direction of the firm and exercise overall financial control over the semi-autonomous divisions.

- (b)** Strategy implementation is missing in HQ. It is concerned with the managerial exercise of putting a chosen strategy into action. It deals with the managerial exercise of supervising the ongoing pursuit of strategy, making it work, improving the competence with which it is executed and showing measurable progress in achieving the targeted results.

Strategic implementation is concerned with translating a strategic decision into action, which presupposes that the decision itself (i.e., the strategic choice) was made with some thought being given to feasibility and acceptability. The allocation of resources to new courses of action will need to be undertaken, and there may be a need for adapting the organization's structure to handle new activities as well as training personnel and devising appropriate systems.

It is crucial to realize the difference between the formulation and implementation because they both require very different skills. Also, a company will be successful only when the strategy formulation is sound and implementation is excellent.

MOCK TEST PAPER – II
INTERMEDIATE (NEW): GROUP – II
PAPER – 8: FINANCIAL MANAGEMENT & ECONOMICS FOR FINANCE
PAPER 8A : FINANCIAL MANAGEMENT
SUGGESTED ANSWERS/HINTS

1. (a) Computation of Weighted Average Cost of Capital (WACC) for each level of Debt-equity mix.

Debt (%)	Required return (K _d)(%)	Equity (%)	Required return (K _e) (%)	K _d × Proportion of debt + K _e Proportion and equity	Weighted Average Cost of Capital (WACC)(K _o)(%)
0	5	100	15	0%(5%)+100%(15%)	15
20	6	80	16	20%(6%)+80%(16%)	14
40	7	60	18	40%(7%)+60%(18%)	13.6
60	10	40	23	60%(10%)+40%(23%)	15.2
80	15	20	35	80%(15%)+20%(35%)	19

The optimum mix is 40% debt and 60% equity, as this will lead to lowest WACC value i.e., 13.6%.

- (b) Calculation of Effective Cost of Capital

Particulars	Option 1 14% institutional Term loan (Rs. in Lakhs)	Option 2 13% Non-convertible Debentures (Rs. in lakhs)
(A) Effective capital to be raised Face value	250.00	250.00
Less: Discount	Nil	(6.25)
	250.00	243.75
Less: Cost of issue	Nil	5.00
Effective amount of capital	250.00	238.75
(B) Annual interest charges on face value of Rs. 250 lakhs	35.0	32.50
Less: Tax benefit on interest @ 50%	17.5	16.25
	17.5	16.25
(C) Effective cost of capital after tax	$\frac{B}{A} \times 100$ = 7.0%	$\frac{16.25}{238.75} \times 100$ = 6.81% (approx)

So, the better option is raising of funds of Rs.250 lakhs by issue of 13% Non-convertible Debenture

- (c)

Year 1			Year 2			Year 3		
Cash Flow (Rs.)	Probability	Expected Value (Rs.)	Cash Flow (Rs.)	Probability	Expected Value (Rs.)	Cash Flow (Rs.)	Probability	Expected Value (Rs.)
2,000	0.1	200	2,000	0.2	400	2,000	0.3	600
4,000	0.2	800	4,000	0.3	1200	4,000	0.4	1,600
6,000	0.3	1,800	6,000	0.4	2400	6,000	0.2	1,200

8,000	0.4	3,200	8,000	0.1	800	8,000	0.1	800
ENCF		6,000			4,800			4,200

The present value of the expected value of cash flow at 10 per cent discount rate has been determined as follows:

$$\begin{aligned} \text{Present Value of cash flow} &= \frac{\text{ENCF}_1}{(1+k)^1} + \frac{\text{ENCF}_2}{(1+k)^2} + \frac{\text{ENCF}_3}{(1+k)^3} \\ &= \frac{6,000}{(1.1)^1} + \frac{4,800}{(1.1)^2} + \frac{4,200}{(1.1)^3} \end{aligned}$$

$$= (6,000 \times 0.909) + (4,800 \times 0.826) + (4,200 \times 0.751)$$

$$= 12,573$$

Expected Net Present value = Present Value of cash flow - Initial Investment

$$= \text{Rs. } 12,573 - \text{Rs. } 10,000 = \text{Rs. } 2,573.$$

(d)

MNOP Ltd.

Balance Sheet

Liabilities	Rs.	Assets	Rs.
Equity share capital	1,00,000	Fixed assets	60,000
Current debt	24,000	Cash (balancing figure)	60,000
Long term debt	36,000	Inventory	40,000
	1,60,000		1,60,000

Working Notes

- Total debt = 0.60 × Equity share capital = 0.60 × Rs. 1,00,000 = Rs. 60,000
Further, Current debt to total debt = 0.40. So, current debt = 0.40 × Rs. 60,000 = Rs. 24,000,
Long term debt = Rs. 60,000 - Rs. 24,000 = Rs. 36,000
- Fixed assets = 0.60 × Equity share Capital = 0.60 × Rs. 1,00,000 = Rs. 60,000
- Total assets to turnover = 2 Times : Inventory turnover = 8 Times
Hence, Inventory / Total assets = 2/8 = 1/4, Total assets = Rs. 1,60,000
Therefore Inventory = Rs. 1,60,000/4 = Rs. 40,000

2. (a)

Sales in units	60,000 Rs.	50,000 Rs.
Sales Value	7,20,000	6,00,000
Variable Cost	(4,80,000)	(4,00,000)
Contribution	2,40,000	2,00,000
Fixed expenses	1,00,000	1,00,000
EBIT	1,40,000	1,00,000
Debenture Interest	(50,000)	(50,000)
EBT	90,000	50,000
Tax @ 30%	(27,000)	(15,000)

Profit after tax (PAT)	63,000	35,000

(i) Earning per share (EPS) = $\frac{63,000}{5,000} = \text{Rs. } 12.6$ $\frac{35,000}{5,000} = \text{Rs. } 7$

Decrease in EPS = $12.6 - 7 = 5.6$

% decrease in EPS = $\frac{5.6}{12.6} \times 100 = 44.44\%$

(ii) Operating leverage = $\frac{\text{Contribution}}{\text{EBIT}} = \frac{2,40,000}{1,40,000} = 1.71$ $\frac{2,00,000}{1,00,000} = 2$

(iii) Financial Leverage = $\frac{\text{EBIT}}{\text{EBT}} = \frac{1,40,000}{90,000} = 1.56$ $\frac{1,00,000}{50,000} = 2$

(b) Limitations are:

- 1) The lease rentals become payable soon after the acquisition of assets and no moratorium period is permissible as in case of term loans from financial institutions. The lease arrangement may, therefore, not be suitable for setting up of the new projects as it would entail cash outflows even before the project comes into operation.
- 2) The leased assets are purchased by the lessor who is the owner of equipment. The seller's warranties for satisfactory operation of the leased assets may sometimes not be available to lessee.
- 3) Lessor generally obtains credit facilities from banks etc. to purchase the leased equipment which are subject to hypothecation charge in favour of the bank. Default in payment by the lessor may sometimes result in seizure of assets by banks causing loss to the lessee.
- 4) Lease financing has a very high cost of interest as compared to interest charged on term loans by financial institutions/banks.

Despite all these disadvantages, the flexibility and simplicity offered by lease finance is bound to make it popular. Lease operations will find increasing use in the near future.

3. (a)

	Rs.
Present level of receivables is 45 lakh × 50/365	6,16,438
In case of factor, receivables would reduce to 45 lakhs × 30/365	3,69,863
The costs of the existing policy are as follows:	
Cost of financing existing receivables: 6,16,438 × 10%	61,644
Cost of bad debts: 45 lakhs × 0.4%	18,000
Cost of current policy	79,644
The cost under the factor are as follows:	
Cost of financing new receivable through factor:	
(Rs. 3,69,863 × 0.8 × 0.11) + (Rs. 3,69,863 × 0.2 × 0.10)	39,945
= (32,548 + 7,397)	

Factor's annual fee: 45 Lakhs × 0.01	45,000
Administration costs saved:	(35,000)
Net cost under factor:	49,945

From the above analysis it is clear that the factor's services are cheaper than Existing policy by Rs. 29,699 (Rs. 79,644 - Rs.49,945) per year. Hence, the services of the factor should be accepted.

- (b) The term trading on equity means debts are contracted and loans are raised mainly on the basis of equity capital. Those who provide debt have a limited share in the firm's earning and hence want to be protected in terms of earnings and values represented by equity capital. Since fixed charges do not vary with firm's earnings before interest and tax, a magnified effect is produced on earning per share. Whether the leverage is favourable, in the sense, increase in earnings per share more proportionately to the increased earnings before interest and tax, depends on the profitability of investment proposal. If the rate of returns on investment exceeds their explicit cost, financial leverage is said to be positive.
4. (a) Since funds available are restricted, the normal Net Present Value (NPV) rule of accepting investments decisions with the highest NPVs cannot be adopted straight way. Further, as the projects are divisible, a Profitability Index (PI) can be utilized to provide the most beneficial combination of investment for Rio Ltd.

Project	PV Per Rs.	Rank as per PI
Alfa (α)	Rs. 6,40,000 / Rs. 5,40,000 = 1.185	III
Beta (β)	Rs. 7,50,000 / Rs. 6,00,000 = 1.250	I
Gama (γ)	Rs. 3,18,000 / Rs. 2,60,000 = 1.223	II

Therefore Rio Ltd should invest Rs. 6,00,000 into project β (Rank I) earnings Rs. 1,50,000 and Rs.2,00,000 into project γ (Rank II) earning Rs.44,615 $\text{Rs. } 2,00,000 / \text{Rs. } 2,60,000 \times \text{Rs. } 58,000$

So, total NPV will be Rs.1,94,615 $\text{Rs. } 1,50,000 + \text{Rs. } 44,615$ from Rs. 8,00,000 of investment.

(b) **Calculation of Risk Adjusted rate**

Risk level	Risk free rate (%)	Risk Premium (%)	Risk adjusted rate (%)
Low	8	4	12
Medium	8	7	15
High	8	10	18

The cash flows of the project considered are as following:

Point in time (yearly intervals)	0	1	2
Cash flow (Rs. in crore)	(100)	45	80

If the project is judged to be Low risk

Years	0	1	2
PV (Rs. in crore)	(100)	$\frac{45}{1+0.12} = 40.18$	$\frac{80}{(1+0.12)^2} = 63.78$

NPV = 40.18 + 63.78 – 100 = 3.96: Accept

If the project is judged to be Medium risk

Years	0	1	2
PV (Rs. in crore)	(100)	$\frac{45}{1+0.15} = 39.13$	$\frac{80}{(1+0.15)^2} = 60.49$

NPV = 39.13 + 60.49 – 100 = (0.38): Reject

If the project is judged to be High risk

Years	0	1	2
PV (Rs. in crore)	(100)	$\frac{45}{1+0.18} = 38.14$	$\frac{80}{(1+0.18)^2} = 57.45$

NPV = 38.14 + 57.45 – 100 = (4.41): Reject

5. (i) The EPS of the firm is Rs. 10 (i.e., Rs. 2,00,000/ 20,000). The P/E Ratio is given at 12.5 and the cost of capital, k_e , may be taken at the inverse of P/E ratio. Therefore, k_e is 8 (i.e., 1/12.5). The firm is distributing total dividends of Rs. 1,50,000 among 20,000 shares, giving a dividend per share of Rs. 7.50. the value of the share as per Walter's model may be found as follows:

$$P = \frac{D}{K_e} + \frac{(r/K_e)(E-D)}{K_e} = \frac{7.50}{.08} + \frac{(.10/.08)(10-7.5)}{.08} = \text{Rs. } 132.81$$

The firm has a dividend payout of 75% (i.e., Rs. 1,50,000) out of total earnings of Rs. 2,00,000. since, the rate of return of the firm, r , is 10% and it is more than the k_e of 8%, therefore, by distributing 75% of earnings, the firm is not following an optimal dividend policy. The optimal dividend policy for the firm would be to pay zero dividend and in such a situation, the market price would be

$$P = \frac{D}{k_e} + \frac{(r/K_e)(E-D)}{K_e} = \frac{0}{.08} + \frac{(.10/.08)(10-0)}{.08} = \text{Rs. } 156.25$$

So, theoretically the market price of the share can be increased by adopting a zero payout.

- (ii) The P/E ratio at which the dividend policy will have no effect on the value of the share is such at which the k_e would be equal to the rate of return, r , of the firm. The K_e would be 10% (=r) at the P/E ratio of 10. Therefore, at the P/E ratio of 10, the dividend policy would have no effect on the value of the share.
- (iii) If the P/E is 8 instead of 12.5, then the K_e which is the inverse of P/E ratio, would be 12.5 and in such a situation $k_e > r$ and the market price, as per Walter's model would be

$$P = \frac{D}{K_e} + \frac{(r/K_e)(E-D)}{K_e} = \frac{7.50}{.125} + \frac{(.1/.125)(10-7.5)}{.125} = \text{Rs. } 76$$

6. (a) Bridge finance refers, normally, to loans taken by the business, usually from commercial banks for a short period, pending disbursement of term loans by financial institutions, normally it takes time for the financial institution to finalise procedures of creation of security, tie-up participation with other institutions etc. even though a positive appraisal of the project has been made. However, once the loans are approved in principle, firms in order not to lose further time in starting their projects arrange for bridge finance. Such temporary loan is normally repaid out of the proceeds of the principal term loans. It is secured by hypothecation of moveable assets, personal guarantees and demand promissory notes. Generally rate of interest on bridge finance is higher as compared with that on term loans.

(b) Virtual Banking and its Advantages

Virtual banking refers to the provision of banking and related services through the use of information technology without direct recourse to the bank by the customer.

The advantages of virtual banking services are as follows:

- Lower cost of handling a transaction.
- The increased speed of response to customer requirements.
- The lower cost of operating branch network along with reduced staff costs leads to cost efficiency.

Virtual banking allows the possibility of improved and a range of services being made available to the customer rapidly, accurately and at his convenience.

- (c) Concentration Banking:** In concentration banking the company establishes a number of strategic collection centres in different regions instead of a single collection centre at the head office. This system reduces the period between the time a customer mails in his remittances and the time when they become spendable funds with the company. Payments received by the different collection centers are deposited with their respective local banks which in turn transfer all surplus funds to the concentration bank of head office

PAPER 8B : ECONOMICS FOR FINANCE

SUGGESTED ANSWERS/HINTS

7. (a) National Income

$$Y = C+I+G+(X-M)$$

$$= (100+0.9Y_d) +100+120+200-(100+0.15Y)$$

$$= 100+0.9(Y-T) +100+120+200-100-0.15Y$$

$$= 100+0.9(Y-50) +100+120+200-100-0.15Y$$

$$Y= 375+0.75Y$$

$$Y-0.75Y= 375$$

$$0.25Y= 375$$

$$Y= 375 \times \frac{100}{25} = 1500$$

- (b) According to Milton Friedman, permanent income is a measure of wealth which is the present discounted value of all expected future incomes. As distinguished from transitory income, it is the normal income or the income that people expect to persist into the future. The nominal demand for money is a function of total wealth, which is represented by permanent income divided by the discount rate, defined as the average return on the five asset classes in the monetarist theory world, namely: money, bonds, equity, physical capital and human capital.
- (c) In order to protect the interest of consumer's government fixes the maximum price of the commodity. This maximum price is generally lower than the equilibrium price. This is called control price or ceiling price. This price is fixed by the government because poor people cannot afford to buy the commodity at equilibrium price. This situation arises when the production of a commodity is less than its demand. In India government has a control price or ceiling price of the commodities which it considers essential for the masses. For examples maximum prices of food grains and essential items like some goods such as wheat, rice, sugar, kerosene oil etc. are during scarcity.
- (d) Trade is distorted if quantities of commodities produced, bought, and sold and their prices are higher or lower than levels that would usually exist in a competitive market. For example, barriers to imports such as tariffs, domestic subsidies and quantitative restrictions can make agricultural products more costly in a market of a country. The higher prices will result in higher production of crop. Then export subsidies are needed to sell the surplus output in the world markets, where prices are low. Thus, the subsidising countries can be producing and exporting considerably more than what they normally would.
8. (a) (i) Lower interest rates increases disposable incomes and influence the spending decisions of households and businesses by reducing the amount of interest they pay on debt. Reductions in interest rates which they receive on deposits reduce the incentives for households to save and may encourage them to borrow and spend now rather than later, in particular, on durable goods, such as cars and household appliances, and housing. Lower interest rates are thus associated with higher household consumption and housing investment. Similarly, with lower interest rates the cost of borrowing declines, expected returns on investment projects increase, and these encourage businesses to borrow and increase their spending on investment (in capital assets like new equipment or buildings). Since households and businesses substitute between spending now and in the future, overall, lower interest rates should be associated with an increase in business investment.

- (ii) Perfect information which implies that both buyers and sellers have complete information about anything that may influence their decision making is an important element of an efficient competitive market. Information failure occurs when lack of information can result in consumers and producers making decisions that do not maximize welfare. Information failure is widespread in numerous market exchanges due to complex nature of goods and services that are transacted, inaccurate and incomplete data, and non-availability of correct information.
- (b) (i) Nominal GDP is calculated in terms of current prices. Nominal GDP growth refers to the percentage change in nominal GDP over a specific period of time. Since the effect of inflation/ deflation is not removed, it does not present the true picture of growth of the economy.
- (ii) Optimal output is the ideal quantity of output that ensures maximum level of social welfare. This will occur at a level of output where social marginal cost (SMC) = social marginal benefit. (SMB) At this level of output the society's resources are utilised in the most efficient way.
9. (a) (i) A direct effect of monetary policy on the firm's balance sheet comes through an increase in interest rates leading to an increase in the payments that the firm must make to repay its floating rate debts. Logically, as a firm's cost of credit rises, the strength of its balance sheet deteriorates. An indirect effect occurs when the same increase in interest rates works to reduce the capitalized value of the firm's long-lived assets. Reduced net worth of businesses and individuals make it tougher for them to qualify for loans at any interest rate, thus reducing spending and price pressures. Hence, a policy-induced increase in the short-term interest rate not only acts immediately to depress spending through the traditional interest rate channel, it also acts, possibly with a time-lag, to raise each firm's cost of capital through the balance sheet channel. These together aggravate the decline in output and employment.
- Conversely, a reduction in interest rates can increase the borrowing capacity of households and businesses. This is because lower interest rates are associated with higher asset prices. In turn, higher asset prices increase the equity (or collateral) of existing assets that a bank can lend against. As a result, borrowers with existing assets may be able to borrow more, which can lead to more spending.
- (ii) The nature of the economic system determines the size and scope of the economic functions of the government. In a centrally planned socialistic economy, the state owns all productive resources and makes all important economic decisions. On the contrary, in a market economy, all important economic decisions are made by individuals and firms who want to maximise self interest and there is only limited role for the government. In a mixed economic system, both markets and government contribute towards resource allocation decisions.
- (b) $NDP_{FC} = \text{Compensation of Employees} + \text{Operating Surplus} + \text{Mixed Income}$
 $= (\text{viii}) + (\text{ix}) + (\text{iv}) + (\text{v}) + (\text{vi}) + (\text{vii}) = 489 + 50 + 311 + 892 + 81 + 6 = 1829 \text{ Crores}$
- $GDP_{MP} = NDP_{FC} + \text{Depreciation} + \text{Net Indirect Tax}$
 $= NDP_{FC} + (\text{ii}) + (\text{i}) = 1829 + 42 + 208 = 2079 \text{ Crores}$
- $NNP_{FC} = NDP_{FC} + \text{Net Factor Income from Abroad}$
 $= NDP_{FC} + (\text{iii}) = 2079 + (-40) = 2039 \text{ Crores}$
10. (a) (i) Since FDI involves setting up of production base (in terms of factories, power plants, etc.) it generates direct employment in the recipient country. Subsequent FDI as well as domestic investments propelled in the downstream and upstream projects that come up in multitude of other services generate multiplier effects on employment and income. FDI not only creates direct employment opportunities but also, through backward and forward linkages, it is able to generate indirect employment opportunities as well. Foreign direct investments also promote relatively higher wages for skilled jobs. However, jobs that require expertise and entrepreneurial skills for creative decision making may generally be retained in the home

country and therefore the host country is left with routine management jobs that demand only lower levels of skills and ability. This may result in 'crowding in' of people in jobs requiring low skills, perpetuation of low labour standards and differential treatment.

FDIs are likely use labor-saving technology and capital-intensive methods in a labour-abundant country and cause labour displacement. Such technology is inappropriate for a labour-abundant country as it does not support generation of jobs which is a crucial requirement to address poverty and unemployment which are the two fundamental areas of concern for the less developed countries. Not only that foreign entities fail to support employment generation, but they may also drive out domestic firms from the industry resulting in serious problems of displacement of labour.

(b) (i) A final good is a good sold to final purchasers and is consumed by the end user in its present state. It does not require any further processing and therefore will not undergo any further transformation at the hands of producer. Once a final good has been sold, it passes out of the active economic flow. The value of the final goods already includes the value of the intermediate goods that have entered into their production as inputs.

(ii) Externalities, also referred to as 'spillover effects', 'neighbourhood effects' 'third-party effects' or 'side-effects', occur when the actions of either consumers or producers result in costs or benefits that do not reflect as part of the market price. Externalities cause market inefficiencies because they hinder the ability of market prices to convey accurate information about how much to produce and how much to buy. Since externalities are not reflected in market prices, they can be a source of economic inefficiency. The four possible types of externalities are negative externality initiated in production which imposes an external cost on others, positive production externality, less commonly seen, initiated in production that confers external benefits on others, negative consumption externalities initiated in consumption which produce external costs on others, positive consumption externality initiated in consumption that confers external benefits on others. Each of the above may be received by another in consumption or in production.

11. (a) (i) The allocation responsibility of the governments involves suitable corrective action when private markets fail to provide the right and desirable combination of goods and services to ensure social welfare. In the absence of appropriate government intervention, market failures may occur and the resources are likely to be misallocated by too much production of certain goods or too little production of certain other goods. Thus, market failures provide the rationale for government's allocative function.

(ii) Non tariff measures are policy measures other than ordinary customs tariffs that can potentially have an economic effect on international trade in goods, changing quantities traded, or prices or both (UNCTAD, 2010). For example, the sound use of NTMs like sanitary and phytosanitary measures and licensing could be legitimately used to ensure consumer health and to protect plant and animal life and environment

NTMs are not the same as non-tariff barriers (NTBs). NTMs are sometimes used as means to circumvent free-trade rules and favour domestic industries at the expense of foreign competition. In this case they are called non-tariff barriers (NTBs). NTBs are a subset of NTMs that have a 'protectionist or discriminatory intent' and implies a negative impact on trade. NTMs only become NTBs when they are more trade restrictive than necessary. Some examples of NTBs are compulsory standards, often not based on international norms or genuine science; stringent technical regulations requiring alterations in production processes, testing regimes which require complex procedures and product approvals requiring inspection of individual premises

(b) (i) The rate between Y and Z which is derived from the given rates of another set of two pairs of currency (say, X and Y, and, X and Z) is called cross rate.

- (ii) Local content policies requiring the purchase or use by a foreign enterprise of domestic products and employment of the local workforce seek to ensure that the maximum benefits from production activities accrue to local economic actors. These are essentially aimed at reducing the volume or value of imports or at restraining the employment of foreign labour.

OR

Open market operations are conducted by the RBI by way of sale or purchase of government securities to adjust money supply conditions. The central bank sells government securities to suck out liquidity from the system and buys back government securities to infuse liquidity into the system. When the RBI feels that there is excess liquidity in the market, it resorts to sale of securities thereby sucking out the rupee liquidity. Similarly, when the liquidity conditions are tight, the RBI will buy securities from the market, thereby releasing liquidity into the market. These operations are often conducted on a day-to-day basis in a manner that balances inflation while helping the banks to continue lending.

MOCK TEST PAPER – II
INTERMEDIATE (NEW): GROUP – II
PAPER – 8: FINANCIAL MANAGEMENT & ECONOMICS FOR FINANCE
PAPER 8A : FINANCIAL MANAGEMENT

Answers are to be given only in English except in the case of the candidates who have opted for Hindi medium.
 If a candidate has not opted for Hindi medium his/ her answers in Hindi will not be valued.

Question No. 1 is compulsory.

Attempt any **four** questions from the remaining **five** questions.

Working notes should form part of the answer.

Time Allowed – 3 Hours (Total time for 8A and 8B)

Maximum Marks – 60

1. Answer the following:

(a) The proportion and required return of debt and equity was recorded for a company with its increased financial leverage as below:

Debt (%)	Required return (K _d) (%)	Equity (%)	Required Return (K _e) (%)	Weighted Average Cost of Capital (WACC) (K _o)(%)
0	5	100	15	15
20	6	80	16	?
40	7	60	18	?
60	10	40	23	?
80	15	20	35	?

You are required to complete the table and IDENTIFY which capital structure is most beneficial for this company. (Based on traditional theory, i.e., capital structure is relevant).

(b) Annova Ltd is considering raising of funds of about Rs.250 lakhs by any of two alternative methods, viz, 14% institutional term loan and 13% non-convertible debentures. The term loan option would attract no major incidental cost and can be ignored. The debentures would have to be issued at a discount of 2.5% and would involve cost of issue of 2% on face value.

ADVISE the company as to the better option based on the effective cost of capital in each case. Assume a tax rate of 50%.

(c) Probabilities for net cash flows for 3 years of a project of Ganesh Ltd are as follows:

Year 1		Year 2		Year 3	
Cash Flow (Rs.)	Probability	Cash Flow (Rs.)	Probability	Cash Flow (Rs.)	Probability
2,000	0.1	2,000	0.2	2,000	0.3
4,000	0.2	4,000	0.3	4,000	0.4
6,000	0.3	6,000	0.4	6,000	0.2
8,000	0.4	8,000	0.1	8,000	0.1

CALCULATE the expected net cash flows and the present value of the expected cash flow, using 10 per cent discount rate. Initial Investment is Rs. 10,000

- (d) With the help of the following information ANALYSE and complete the Balance Sheet of Anup Ltd.:

Equity share capital Rs. 1,00,000

The relevant ratios of the company are as follows:

Current debt to total debt 0.40

Total debt to Equity share capital 0.60

Fixed assets to Equity share capital 0.60

Total assets turnover 2 Times

Inventory turnover 8 Times

(4 × 5 = 20 Marks)

2. (a) The capital structure of Anshu Ltd. as at 31.3.2019 consisted of ordinary share capital of Rs. 5,00,000 (face value Rs. 100 each) and 10% debentures of Rs. 5,00,000 (Rs. 100 each). In the year ended with March 2019, sales decreased from 60,000 units to 50,000 units. During this year and in the previous year, the selling price was Rs. 12 per unit; variable cost stood at Rs. 8 per unit and fixed expenses were at Rs. 1,00,000 p.a. The income tax rate was 30%.

You are required to CALCULATE the following:

(i) The percentage of decrease in earnings per share.

(ii) The degree of operating leverage at 60,000 units and 50,000 units.

(iii) The degree of financial leverage at 60,000 units and 50,000 units. **(6 Marks)**

- (b) EXPLAIN the limitations of Leasing? **(4 Marks)**

3. (a) Nava Ltd has annual credit sales of Rs. 45 lakhs. Credit terms are 30 days, but its management of receivables has been poor and the average collection period is 50 days, Bad debt is 0.4 per cent of sales. A factor has offered to take over the task of debt administration and credit checking, at an annual fee of 1 per cent of credit sales. Nava Ltd. estimates that it would save Rs. 35,000 per year in administration costs as a result. Due to the efficiency of the factor, the average collection period would reduce to 30 days and bad debts would be zero. The factor would advance 80 per cent of invoiced debts at an annual interest rate of 11 per cent. Nava Ltd. is currently financing receivables from an overdraft costing 10 per cent per year.

If occurrence of credit sales is throughout the year, COMPUTE whether the factor's services should be accepted or rejected. Assume 365 days in a year. **(6 Marks)**

- (b) EXPLAIN the principles of "Trading on equity". **(4 Marks)**

4. (a) Prem Ltd has a maximum of Rs. 8,00,000 available to invest in new projects. Three possibilities have emerged and the business finance manager has calculated Net present Value (NPVs) for each of the projects as follows :

Investment	Initial cash outlay Rs.	NPV Rs.
Alfa (α)	5,40,000	1,00,000
Beta(β)	6,00,000	1,50,000
Gama (γ)	2,60,000	58,000

DETERMINE which investment/combination of investments should the company invest in, if we assume that the projects can be divided? **(6 Marks)**

- (b) Invest Corporation Ltd. adjusts risk through discount rates by adding various risk premiums to the risk free rate. Depending on the resultant rate, the proposed project is judged to be a low, medium or high risk project.

Risk level	Risk free rate (%)	Risk Premium (%)
Low	8	4
Medium	8	7
High	8	10

DEMONSTRATE the acceptability of the project on the basis of Risk Adjusted rate. **(4 Marks)**

5. The following information is supplied to you:

	Rs.
Total Earnings	2,00,000
No. of equity shares (of Rs. 100 each)	20,000
Dividend paid	1,50,000
Price/ Earnings ratio	12.5

Applying Walter's Model

- (i) DETERMINE whether the company is following an optimal dividend policy.
- (ii) IDENTIFY, what should be the P/E ratio at which the dividend policy will have no effect on the value of the share.
- (iii) Will your decision change, if the P/E ratio is 8 instead of 12.5? ANALYSE. **(10 Marks)**
6. (a) DESCRIBE Bridge Finance.
- (b) STATE Virtual Banking? DISCUSS its advantages.
- (c) EXPLAIN Concentration Banking **(4 + 4 + 2 = 10 Marks)**

PAPER – 8B: ECONOMICS FOR FINANCE

Time Allowed – 1:15 Hours

Maximum Marks - 40

Answers are to be given only in English except in the case of the candidates who have opted for Hindi medium. If a candidate has not opted for Hindi medium his/ her answers in Hindi will not be valued.

Question 7 is compulsory question.

*Attempt any **three** from the remaining four questions*

In case, any candidate answers extra questions(s)/sub-question(s)/sub-question(s) over and above the required number, then only the requisite number of questions first answered will be the evaluated the rest answer shall be ignored

Working Notes should form part of the answer.

7. (a) Suppose in an economy:
Consumption Function (C) = $100 + 0.9 Y_d$, where $Y_d = Y - T$
Autonomous Investment (I) = Rs. 100 crores
Government Expenditure G = Rs. 120 crores
Taxes (T) = Rs.50 crores
Exports (X) = Rs.200 crores
Import Function (M) = $100 + 0.15Y$
- Where Y and Y_d National Income and Personal Disposable Income respectively. All the figures are in Rupees. Find the Equilibrium level of GDP? **(3 Marks)**
- (b) Define permanent income and state its relationship to demand for real money balances? **(3 Marks)**
- (c) Explain why government imposes price ceilings? **(2 Marks)**
- (d) What is meant by trade distortion? **(2 Marks)**
8. (a) (i) Explain how decline in interest rates influence economic activity by changing the incentives for households and businesses to save or invest? **(3 Marks)**
(ii) Define Information Failure **(3 Marks)**
- (b) (i) What is meant by nominal GDP-growth? **(2 Marks)**
(ii) Define optimal output from the point of view of social welfare? **(2 Marks)**
9. (a) (i) Explain the effects of monetary policy through balance sheet channel **(3 Marks)**
(ii) What is the major determinant of the economic functions of a government? **(2 Marks)**
- (b) Calculate (a) GDPMP and (b) NNPFPC from the following data: **(5 Marks)**

Particulars		(Rs) In Crore
(i)	Net indirect tax	208
(ii)	Consumption of fixed capital	42
(iii)	Net factor income from abroad	-40
(iv)	Rent	311
(v)	Profits	892

(vi)	Interest	81
(vii)	Royalty	6
(viii)	Wages and salary	489
(ix)	Employer's contribution to Social Security Scheme	50

10. (a) (i) How do foreign direct investments enhance human capital in recipient countries? **(3 Marks)**
(ii) Distinguish between domestic subsidy and export subsidy? **(2 Marks)**
- (b) (i) What do you understand by the term 'final good'? **(2 Marks)**
(ii) Explain the different types of Externalities? How Externalities lead to welfare loss of markets? **(3 Marks)**
11. (a) (i) What is the rationale for government intervention in allocation of resources? **(3 Marks)**
(ii) Distinguish between 'non tariff measures' and 'non tariff barriers' **(3 Marks)**
- (b) (i) What do you understand by the term 'cross rate'? **(2 Marks)**
(ii) What is the objective of policies requiring foreign entities to procure local contents? **(2 Marks)**

OR

What is meant by open market operations?