

MOCK TEST PAPER - 1
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: Three hours)

(Maximum Marks: 100)

1. (a) Sun Ltd. has entered into a sale contract of Rs. 5 crores with X Ltd. during 2015-2016 financial year. The profit on this transaction is Rs. 1 crore. The delivery of goods to take place during the first month of 2016-2017 financial year. In case of failure of Sun Ltd. to deliver within the schedule, a compensation of Rs. 1.5 crores is to be paid to X Ltd. Sun Ltd. planned to manufacture the goods during the last month of 2015-2016 financial year. As on balance sheet date (31.3.2016), the goods were not manufactured and it was unlikely that Sun Ltd. will be in a position to meet the contractual obligation.
 - (i) Should Sun Ltd. provide for contingency as per AS 29? Explain.
 - (ii) Should provision be measured as the excess of compensation to be paid over the profit?
- (b) K Ltd. launched a project for producing product X in October, 2016. The Company incurred Rs. 40 lakhs towards Research and Development expenses upto 31st March, 2018. Due to prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years. Advise the Company as per the applicable Accounting Standard
- (c) 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.
- (d) From the following information, you are required to compute the basic and adjusted Earnings per share:

Net profit for 2015-16	11 lakh
Net profit for 2016-17	15 lakh
No. of shares issued before rights issue	5 lakhs
Right issue	One for every 5 held
Right issue price	15 per share
Last date of exercising right option	1-06-2016
Fair value of shares before right issue	21 per share

(4 parts x 5 Marks = 20 Marks)

2. (a) The shareholders of Lili Ltd. decided on a corporate restructuring exercise necessitated because of economic recession. From the given summarised balance sheet as on 31-3-2017 and the information supplied, you are required to prepare (i) Journal entries reflecting the scheme of reconstruction, (ii) Capital reduction account, (iii) Cash account in the books of Lili Ltd.

Summarised Balance Sheet of Lili Ltd. as on 31.3.2017

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
<u>Share Capital</u>		<u>Fixed Assets</u>	
30,000 Equity shares of Rs.10 each	3,00,000	Trademarks and Patents	1,10,000
40,000 8% Cumulative Preference shares Rs.10 each	4,00,000	Goodwill at cost	36,100
<u>Reserves and Surplus</u>		Freehold Land	1,20,000
Securities Premium Account	10,000	Freehold Premises	2,44,000
Profit and Loss Account	(1,38,400)	Plant and Equipment	3,20,000
<u>Secured Borrowings</u>		<u>Investment</u> (marked to market)	64,000
9% Debentures (Rs.100) 1,20,000		<u>Current Assets</u>	
Accrued Interest <u>5,400</u>	1,25,400	Inventories:	
<u>Current liabilities</u>		Raw materials and packing materials 60,000	
Trade payables	1,20,000	Finished goods <u>16,000</u>	76,000
Tax payable	50,000	Trade receivables	<u>1,20,000</u>
Temporary bank overdraft	<u>2,23,100</u>		
	<u>10,90,100</u>		<u>10,90,100</u>

Note: Preference dividends are in arrears for 4 years.

The scheme of reconstruction that received the permission of the Court was on the following lines:

- (1) The authorized capital of the Company to be re-fixed at Rs.10 lakhs (preference capital of Rs.3 lakhs and equity capital of Rs.7 lakhs). Both classes of shares are of Rs.10 each.
- (2) The preference shares are to be reduced to Rs. 5 each and equity shares reduced by Rs. 3 per share. Post reduction, both classes of shares to be re-consolidated into Rs.10 shares.
- (3) Trade Investments are to be liquidated in open market.
- (4) One fresh equity shares of Rs.10 to be issued for every Rs.40 of preference dividends in arrears (ignore taxation).
- (5) Expenses for the scheme were Rs. 10,000.
- (6) The debenture holders took over freehold land at Rs.2,10,000 and settled the balance after adjusting their dues.
- (7) Unprovided contingent liabilities were settled at Rs. 54,000 and a pending insurance claim receivable settled at Rs. 12,500.
- (8) The intangible assets were all to be written off along with Rs. 10,000 worth obsolete packing material and 10% of the receivables.
- (9) Remaining cash available as a result of the above transactions is to be utilized to pay off the bank overdraft to that extent.

(10) The Equity shareholders agree that they will bring in necessary cash to liquidate the balance outstanding on the overdraft account by subscribing the fresh shares. The equity shares will be issued at par for this purpose.

- (b) A Liquidator is entitled to receive remuneration at 2% on the assets realized, 3% on the amount distributed to Preferential Creditors and 3% on the payment made to Unsecured Creditors. The assets were realized for Rs. 25,00,000 against which payment was made as follows:

Liquidation expenses	Rs. 25,000
Secured Creditors	Rs. 10,00,000
Preferential Creditors	Rs. 75,000

The amount due to Unsecured Creditors was Rs. 15,00,000. You are asked to calculate the total Remuneration payable to Liquidator. Calculation shall be made to the nearest multiple of a rupee. **(15 + 5 = 20 Marks)**

3. (a) From the following information as on 31st March, 2016 of Xeta Insurance Co. Ltd. engaged in fire insurance business, prepare the Revenue Account, reserving 50% of the net premiums for unexpired risks and an additional reserve of Rs. 7,00,000:

Particulars	Amount (Rs.)
Reserve for unexpired risk on 31 st March, 2015	15,00,000
Additional reserve on 31 st March, 2015	3,00,000
Claims paid	19,20,000
Estimated liability in respect of outstanding claims on 31 st March, 2015	1,95,000
Estimated liability in respect of outstanding claims on 31 st March, 2016	2,70,000
Expenses of management (including Rs. 90,000 incurred in connection with claims)	8,40,000
Re-insurance premium paid	2,25,000
Re-insurance recoveries	60,000
Premiums	33,60,000
Interest and dividend (gross before TDS)	1,50,000
Profit on sale of investments	30,000
Commission	50,000

- (b) As on 31st March 2016, Strong Bank Ltd. has a balance of Rs. 27 crores in "rebate on bills discounted" account. The bank provides you the following further information:

- (1) During the financial year ending 31st March 2017, Strong Bank Ltd. discounted bills of exchange of Rs. 4,000 crores charging interest @ 15% p.a. and the average period of discount being 146 days.
- (2) Bills of exchange of Rs. 600 crores were due for realization from the acceptors/customers after 31st March 2017, the average period outstanding after 31st March 2017, being 73 days.

You are required to pass necessary journal entries in the books of Strong Bank Ltd. for the above transactions.

- (c) A Mutual Fund raised 100 lakh on April 1, 2017 by issue of 10 lakh units of Rs. 10 per unit. The fund invested in several capital market instruments to build a portfolio of Rs. 90 lakhs. The initial expenses amounted to Rs. 5 lakh. During April, 2017, the fund sold certain securities of cost Rs. 38 lakhs for Rs. 40 lakhs and purchased certain other securities for Rs. 28.20 lakhs. The fund management expenses for the month amounted to Rs. 4.50 lakhs of which Rs. 0.35 lakh was in arrears. The dividend earned was Rs. 1.20 lakhs. 75% of the realized earnings were distributed. The market value of the portfolio on 30.04.2017 was Rs. 112 lakh.

Determine NAV per unit.

(10 Marks + 6 Marks + 4 Marks = 20 Marks)

4. (a) 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.

- (b) Paper Limited comes out with a public issue of share capital on 01-01-2016 of 30,00,000 equity shares of Rs. 10 each at a premium of 5%. Rs. 2.50 is payable on application (on or before 31-01-2016) and Rs. 3 on allotment (31-3-2016) including premium.

This issue was underwritten by two underwriters namely White and Black, equally, the commission being 4% of the issue price. Each of the underwriters underwrites 60,000 shares firm. Subscriptions including firm underwriting came for 28,80,000 shares, the distribution of forms being White: 15,60,000; Black; 10,80,000 and Unmarked 2,40,000.

One of the allottees (using forms marked with name of White) for 6000 shares fails to pay the amount due to allotment, all the other money due being received in full including any due from the shares devolving upon the underwriters. The commission due was paid separately.

6,000 shares of one allottee who failed to pay the allotment money were finally forfeited by 30-06-2016 and were re-allotted for payment in cash of Rs. 4 per share. You are required to prepare each underwriter's liability (in shares) in statement form and to pass necessary journal entries to record the above events and transactions (including cash). **(12 + 8 = 20 Marks)**

5. (a) A Ltd. acquired 70% of equity shares of B Ltd. on 1.4.2010 at cost of Rs. 10,00,000 when B Ltd. had an equity share capital of Rs. 10,00,000 and reserves and surplus of Rs. 80,000. In the four consecutive years, B Ltd. fared badly and suffered losses of Rs. 2,50,000, Rs. 4,00,000, Rs. 5,00,000 and Rs. 1,20,000 respectively. Thereafter in 2014-15, B Ltd. experienced turnaround and registered an annual profit of Rs. 50,000. In the next two years i.e. 2015-16 and 2016-17, B Ltd. recorded annual profits of Rs. 1,00,000 and Rs. 1,50,000 respectively.

You are required to compute the minority interests and cost of control at the end of each year for the purpose of consolidation.

- (b) The summarized Balance Sheet of R Ltd. for the year ended on 31st March, 2013, 2014 and 2015 are as follows:

	(Rs. in thousands)		
	31.3.2013	31.3.2014	31.3.2015
Liabilities			
3,20,000 equity shares of Rs. 10 each, fully paid	3,200	3,200	3,200
General reserve	2,400	2,800	3,200
Profit and Loss account	280	320	480
Trade Payables	1,200	1,600	2,000
	7,080	7,920	8,880
Assets			
Goodwill	2,000	1,600	1,200
Building and Machinery less, depreciation	2,800	3,200	3,200
Inventory	2,000	2,400	2,800
Trade Receivables	40	320	880
Bank balance	240	400	800
	7,080	7,920	8,880

Additional information:

- (i) Actual valuations were as under:

Building and machinery less, depreciation	3,600	4,000	4,400
Inventory	2,400	2,800	3,200
Net profit (including opening balance after writing off depreciation, goodwill, tax provision and transferred to general reserve)	840	1,240	1,640

- (ii) Capital employed in the business at market value at the beginning of 2012-13 was Rs. 73,20,000 which included the cost of goodwill. The normal annual return on average capital employed in the line of business engaged by R Ltd. is 12½%.
- (iii) The balance in the general reserve on 1st April, 2012 was Rs. 20 lakhs.
- (iv) The goodwill shown on 31.3.2013 was purchased on 1.4.2012 for Rs. 20 lakhs on which date the balance in the Profit and Loss account was Rs. 2,40,000. Find out the average capital employed in each year.

You are required to compute the value of Goodwill at 5 year's purchase of Super profit (Simple average method). **(10+ 10= 20 Marks)**

6. (a) Explain on 'presentation of MAT credit' in the financial statements in brief.

OR

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

- (b) A company has its share capital divided into shares of Rs. 10 each. On 1-1-20X1, it granted 5,000 employees stock options at Rs. 50, when the market price was Rs. 140. The options were to be exercised between 1-3-20X2 to 31-03-20X2. The employees exercised their options for 4,800 shares only; remaining options lapsed. Pass the necessary journal entries for the year ended 31-3-20X2, with regard to employees' stock options.

- (c) Explain “Non-Performing Assets” as per NBFC Prudential Norms (RBI) directions.
- (d) From the following data, determine the amount of holding company’s profit in the consolidated Balance Sheet assuming holding company’s own Profit & Loss Account to be Rs.2,00,000 in each case:

Case	Subsidiary Company	% shares owned	Cost	Date of acquisition		Consolidation Date	
				1.1.2018		31.12.2018	
				Share Capital	Profit & Loss Account	Share Capital	Profit & Loss Account
Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
Case 1	A	90%	1,40,000	1,00,000	50,000	1,00,000	70,000
Case 2	B	85%	1,04,000	1,00,000	30,000	1,00,000	20,000
Case 3	C	80%	56,000	50,000	20,000	50,000	20,000
Case 4	D	100%	1,00,000	50,000	40,000	50,000	55,000

(4 Parts x 5 Marks = 20 Marks)

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SUGGESTED ANSWERS/HINTS

1. (a) (i) AS 29 “Provisions, Contingent Liabilities and Contingent Assets” provides that when an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should be recognised. Sun Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Sun Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Sun Ltd. should provide for the contingency amounting Rs. 1.5 crores as per AS 29.
- (ii) Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 2016 and no profit had accrued for the financial year 2015-2016. Therefore, provision should be made for the full amount of compensation amounting Rs. 1.50 crores.
- (b) As per provisions of AS 26 “Intangible Assets”, expenditure on research should be recognized as an expense when it is incurred. An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the conditions specified in para 44 of the standard. An intangible asset (arising from development) should be derecognized when no future economic benefits are expected from its use according to para 87 of the standard. Thus, the manager cannot defer the expenditure write off to future years in the given case. Hence, the expenses amounting Rs. 40 lakhs incurred on the research and development project has to be written off in the current year ending 31st March, 2018.
- (c) 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*

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

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

(d) Computation of theoretical ex-rights fair value per share

Fair value of all outstanding shares immediately prior to exercise of rights + Total amount received from exercise of rights

$$\frac{\text{Number of shares outstanding prior to exercise + number of shares issued in the exercise}}{(\text{Rs. 21.00} \times 5,00,000 \text{ shares}) + (\text{Rs. 15.00} \times 1,00,000 \text{ shares})}$$

$$\frac{5,00,000 \text{ shares} + 1,00,000 \text{ shares}}{}$$

Theoretical ex-rights fair value per share = Rs. 20.00

(a) Computation of adjustment factor

(b) $\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex - rights value per share}} = \frac{\text{Rs. (21.00)}}{\text{Rs. (20.00)}} = 1.05$

Computation of earnings per share

	Year 2015-16	Year 2016-17
EPS for the year 2015-16 as originally reported: (Rs. 11,00,000/5,00,000 shares)	Rs. 2.20	
EPS for the year 2015-16 restated for rights issue: [Rs. 11,00,000/ (5,00,000 shares x 1.05)]	Rs. 2.10	
EPS for the year 2016-17 including effects of rights issue ₹ 15,00,000 $\frac{15,00,000}{(5,00,000 \times 1.05 \times 2/12) + (6,00,000 \times 10/12)}$		Rs. 2.55

2. (a) (i)**In the books of Lili Ltd.****Journal Entries**

			Dr.	Cr.
	2017		Rs.	Rs.
1.	March 31	Equity Share Capital A/c (Rs.10) Dr.	3,00,000	
		To Capital Reduction A/c		90,000
		To Equity Share Capital A/c (Rs.7)		2,10,000
		(Being reduction of equity shares of Rs.10 each to shares of Rs. 7 each as per Reconstruction Scheme dated...)		
2.		8% Cum. Preference Share Capital A/c (Rs. 10) Dr.	4,00,000	
		To Capital Reduction A/c		2,00,000
		To Preference Share Capital A/c (Rs. 5)		2,00,000
		(Being reduction of preference shares of Rs.10 each to shares of Rs.5 each as per reconstruction scheme)		

3.	Equity Share Capital A/c (30,000 x Rs.7) Preference Share Capital A/c (40,000 x Rs.5) To Equity Share Capital A/c (21,000 x Rs. 10) To Preference Share Capital A/c (20,000 x Rs.10) (Being post reduction, both classes of shares reconsolidated into Rs.10 each) s	Dr. Dr.	2,10,000 2,00,000	
				2,10,000
				2,00,000
4.	Cash Account To Trade Investments (Being trade investments liquidated in the open market)	Dr.	64,000	64,000
5.	Capital Reduction Account To Equity Share Capital Account (Being arrears of preference dividends of 4 years satisfied by the issue of 3,200 equity shares of Rs.10 each)	Dr.	32,000	32,000
6.	Capital Reduction Account To Cash Account (Being expenses of reconstruction scheme paid in cash)	Dr.	10,000	10,000
7.	9% Debentures Account Accrued Interest Account To Debenture holders Account (Being amount due to debenture holders)	Dr. Dr.	1,20,000 5,400	1,25,400
8.	Debenture holders Account Cash Account (2,10,000 – 1,25,400) To Freehold Land To Capital Reduction Account (2,10,000 – 1,20,000) (Being Debenture holders took over freehold land at Rs.2,10,000 and settled the balance)	Dr. Dr.	1,25,400 84,600	1,20,000 90,000
9.	Capital Reduction Account To Cash Account (Being contingent liability of Rs.54,000 paid)	Dr.	54,000	54,000
10.	Cash Account To Capital Reduction Account (Being pending insurance claim received)	Dr.	12,500	12,500
11.	Capital Reduction Account To Trademarks and Patents To Goodwill To Raw materials & Packing materials To Trade receivables (Being intangible assets written off along with raw materials and packing materials worth Rs.10,000 and 10% of trade receivables)	Dr.	1,68,100	1,10,000 36,100 10,000 12,000
12.	Cash Account To Equity Share Capital Account	Dr.	1,26,000	1,26,000

	(Being 12,600 shares issued to existing shareholders)			
13.	Bank Overdraft Account To Cash Account	Dr.	2,23,100	2,23,100
	(Being cash balance utilized to pay off bank overdraft)			
14.	Capital Reduction Account To Capital reserve Account	Dr.	1,28,400	1,28,400
	(Being balance of capital reduction account transferred to capital reserve account)			

(ii) **Capital Reduction Account**

Particulars	Rs.	Particulars	Rs.
To Equity share capital	32,000	By Preference share capital	2,00,000
To Cash (contingent liability settled)	54,000	By Equity share capital	90,000
To Trademarks and Patents	1,10,000	By Freehold land	90,000
To Goodwill	36,100	By Cash (insurance claim)	12,500
To Raw material and Packing materials	10,000		
To Trade receivables	12,000		
To Cash account	10,000		
To Capital reserve account	<u>1,28,400</u>		
	<u>3,92,500</u>		<u>3,92,500</u>

(iii) **Cash Account**

Particulars	Rs.	Particulars	Rs.
To Investment	64,000	By Capital reduction (Contingent liability)	54,000
To 9% Debenture holders (2,10,000-1,25,400)	84,600	By Expenses	10,000
To Capital reduction (insurance claim)	12,500	By Temporary bank overdraft - From available cash (64,000+84,600+12,500 -54,000-10,000) 97,100	
To Equity share capital 12,600 shares @ Rs.10 each	<u>1,26,000</u>	- From proceeds of equity share capital (2,23,100-97,100) <u>1,26,000</u>	<u>2,23,100</u>
	<u>2,87,100</u>		<u>2,87,100</u>

Note: Shares issued to existing equity shareholders for bringing cash for payment of balance of bank overdraft =Rs.2,23,100 – Rs. 97,100 = Rs.1,26,000

(b) **Calculation of Total Remuneration payable to Liquidator**

	Amount in Rs.
2% on Assets realised	25,00,000 x 2%
3% on payment made to Preferential creditors	75,000 x 3%
3% on payment made to Unsecured creditors (Refer W.N)	<u>39,255</u>
Total Remuneration payable to Liquidator	<u>91,505</u>

Working Note:

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

= Rs. 25,00,000 – Rs. 25,000 – Rs. 10,00,000 – Rs. 75,000 – Rs. 50,000 – Rs. 2,250 = Rs. 13,47,750.

Liquidator's remuneration on payment to unsecured creditors = $\frac{3}{103} \times \text{Rs. } 13,47,750 = \text{Rs. } 39,255$

3. (a) **Name of the Insurer: Xeta Insurance Company Limited**
Registration No. and Date of registration with IRDA:

Revenue Account for the year ended 31st March, 2016

<i>Particulars</i>	<i>Schedule</i>	<i>Amount (Rs.)</i>
Premium earned (net)	1	26,67,500
Profit on sale of investment		30,000
Others		–
Interest and dividend (gross)		1,50,000
Total (A)		28,47,500
Claims incurred (Net)	2	20,25,000
Commission	3	50,000
Operating expenses related to insurance	4	7,50,000
Total (B)		28,25,000
Operating profit from insurance business (A) – (B)		22,500

Schedule –1 Premium earned (net)

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

Schedule -2 Claims incurred (net)

	<i>Rs.</i>
Claims paid	19,20,000
Add: Expenses regarding claims	90,000
	20,10,000
Less: Re-insurance recoveries	<u>(60,000)</u>
	19,50,000
Add: Claims outstanding as on 31 st March, 2016	2,70,000
	22,20,000
Less: Claims outstanding as on 31 st March, 2015	<u>(1,95,000)</u>
	20,25,000

Schedule-3 Commission

	Rs.
Commission paid	50,000

Schedule-4 Operating expenses related to Insurance Business

	Rs.
Expenses of management (Rs. 8,40,000 – Rs. 90,000)	7,50,000

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

		Rs.
Reserve for Unexpired Risk as on 31 st March, 2016	15,67,500	
Additional Reserve as on 31 st March, 2016	<u>7,00,000</u>	22,67,500
Less: Reserve for Unexpired Risk as on 31 st March, 2015	15,00,000	
Additional Reserve as on 31 st March, 2015	<u>3,00,000</u>	<u>(18,00,000)</u>
		4,67,500

(b)

In the books of Strong Bank Ltd.**Journal Entries**

<i>Particulars</i>		<i>Debit (Rs.)</i>	<i>Credit (Rs.)</i>
Rebate on bills discounted A/c To Discount on bills A/c (Being the transfer of opening balance in 'Rebate on bills discounted A/c' to 'Discount on bills A/c')	Dr.	27	27
Bills purchased and discounted A/c To Discount on bills A/c To Clients A/c (Being the discounting of bills of exchange during the year)	Dr.	4,000	240 3,760
Discount on bills A/c To Rebate on bills discounted A/c (Being the unexpired portion of discount in respect of the discounted bills of exchange carried forward)	Dr.	18	18
Discount on bills A/c To Profit and Loss A/c (Being the amount of income for the year from discounting of bills of exchange transferred to Profit and loss A/c)	Dr.	249	249

Working Notes:

- Discount received on the bills discounted during the year

$$\text{Rs. } 4,000 \text{ crores} \times \frac{15}{100} \times \frac{146}{365} = \text{Rs. } 240 \text{ crores}$$

- Calculation of rebate on bill discounted

$$\text{Rs. } 600 \text{ crores} \times \frac{15}{100} \times \frac{73}{365} = \text{Rs. } 18 \text{ crores}$$

(It is assumed that discounting rate of 15% is used for the bill of Rs. 600 crores also)

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

Discount on bills A/c

Rs. in crores

<i>Date</i>	<i>Particulars</i>	<i>Amount</i>	<i>Date</i>	<i>Particulars</i>	<i>Amount</i>
31 March 2017	To Rebate on bills discounted	18	1 st April, 2016	By Rebate on bills discounted b/f	27
"	To Profit and Loss A/c (Bal. Fig.)	<u>249</u>	2016-17	By Bills purchased and discounted	<u>240</u>
		<u>267</u>			<u>267</u>

(c)

	Rs. in lakhs	Rs. in lakhs	
Opening bank balance [Rs. (100 – 90 - 5) lakhs]	5.00		
Add: Proceeds from sale of securities	40.00		
Dividend received	<u>1.20</u>	46.20	
Less: Cost of securities	28.20		
Fund management expenses [Rs. (4.50–0.35) lakhs]	4.15		
Capital gains distributed [75% of Rs. (40.00 – 38.00) lakhs]	1.50		
Dividends distributed (75% of Rs. 1.20 lakhs)	<u>0.90</u>	<u>(34.75)</u>	
Closing bank balance		11.45	
Closing market value of portfolio		<u>112</u>	
		123.45	
Less: Arrears of expenses		<u>(0.35)</u>	
Closing net assets		<u>123.10</u>	
Number of units			10,00,000
Closing Net Assets Value (NAV)			Rs. 12.31

4. (a) **Statement determining the maximum number of shares to be bought back**

Number of shares (in crores)

<i>Particulars</i>	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 To Bank account (Being payment for buy back of 24 crores equity shares of Rs. 10 each @ Rs. 30 per share)	Dr. 720	720
(b)	Equity share capital account Premium Payable on buyback account To Equity share buyback account (Being cancellation of shares bought back)	Dr. Dr. 240 480	720
	Securities Premium account General Reserve / Profit & Loss A/c To Premium Payable on buyback account (Being Premium Payable on buyback account charged to securities premium and general reserve/Profit & Loss A/c)	Dr. Dr. 400 80	480
(c)	General Reserve / Profit & Loss A/c To Capital redemption reserve account (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)	Dr. 240	240

Working Notes:

1. Shares Outstanding Test

Particulars	(Shares in crores)
Number of shares outstanding	120
25% of the shares outstanding	30

2. Resources Test

Particulars	
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 As per the provisions of the Companies Act, 2013, company	32 crore shares Qualifies	Nil Does not Qualify

4 Amount transferred to CRR and maximum equity to be bought back will be calculated by simultaneous equation method

Suppose amount transferred to CRR account is 'x' and maximum permitted buy-back of equity is 'y' Then

Equation 1 : (Present Equity- T transfer to CRR)- Minimum Equity to be maintained = Maximum Permitted Buy Back

$$= (2,880 - x) - 1,600 = y$$

$$= 1280 - x = y \quad (1)$$

Equation 2: Maximum Permitted Buy Back X Nominal Value Per Share/Offer Price Per Share

$$= \left(\frac{y}{30} \times 10 \right) = x \quad \text{Or} \quad 3x = y \quad (2)$$

by solving the above two equations we get

$$x = \text{Rs. } 320$$

$$y = \text{Rs. } 960$$

(b) Statement showing liability of underwriters

a	Particulars	Basis	White	Black
A.	Gross Liability [No. of Shares]	1:1	15,00,000	15,00,000
B.	Less: Marked Applications {Net of firm underwriting}		<u>(15,00,000)</u>	<u>(10,20,000)</u>
C.	Balance [A-B]		-	4,80,000
D.	Less: Unmarked Applications	1:1	<u>(1,20,000)</u>	<u>(1,20,000)</u>
E.	Balance [C-D]		(1,20,000)	3,60,000
F.	Less: Firm Underwriting		<u>(60,000)</u>	<u>(60,000)</u>
G.	Balance		(1,80,000)	3,00,000
H.	Credit for White 's Oversubscription		<u>1,80,000</u>	<u>(1,80,000)</u>
I.	Net Liability		-	1,20,000
J.	Add: Firm Underwriting		<u>60,000</u>	<u>60,000</u>
K.	Total Liability [No. Shares]		60,000	1,80,000

Note: In the above statement, it has been assumed that the benefit of firm underwriting is given to individual underwriter.

Journal Entries

2016				
Jan 31	Bank A/c	Dr.	72,00,000	
	To Equity Share Application A/c			72,00,000

	(Being application money received @ Rs. 2.50 per share)			
March	Equity Share Application A/c To Equity Share Capital A/c	Dr.	72,00,000	72,00,000
	(Being the transfer of application money to share capital on 28,80,000 shares vide Board's Resolution)			
March	Equity Share Allotment A/c (28,80,000 x Rs. 3) To Equity Share Capital A/c (28,80,000 x Rs. 2.5) To Securities Premium A/c (28,80,000 x Rs. 0.5)	Dr.	86,40,000	72,00,000 14,40,000
	(Being allotment money due on 28,80,000 shares allotted to public)			
	Black (1,20,000 x Rs. 5.5) To Equity Share Capital A/c (1,20,000 x Rs. 5) To Securities Premium A/c (1,20,000 x Rs. 0.5)	Dr.	6,60,000	6,00,000 60,000
	(Being the application and allotted money due on net liability of underwriter i.e. 1,20,000 shares)			
March	Bank A/c To Equity Share Allotment A/c [(28,80,000 – 6,000) x Rs. 3] To Black (1,20,000 x Rs. 5.5)	Dr.	92,82,000	86,22,000 6,60,000
	(Being the receipt of money due on allotment except from the allottee for 6,000 shares)			
March	Underwriting Commission A/c To Black A/c To White A/c	Dr.	12,60,000	6,30,000 6,30,000
	(Being commission @ 4 % on issue price of Rs. 10.50 for Rs. 30 lakh shares payable to underwriters)			
March	Black A/c White A/c To Bank A/c		6,30,000 6,30,000	12,60,000
	(Being commission paid to underwriters)			
June 30	Equity Share Capital A/c (6,000 x 5) Securities Premium A/c (6,000 x 0.5) To Share Allotment A/c (6,000 x 3) To Forfeited Shares A/c (6,000 x 2.5)	Dr. Dr.	30,000 3,000	18,000 15,000
	(Being 6,000 shares forfeited vide Board's Resolution)			
June 30	Bank A/c (6,000 x Rs. 4) Forfeited Shares A/c To Equity Share Capital A/c (6,000 x Rs. 5)	Dr. Dr.	24,000 6,000	30,000

(Being the reissue of 6,000 shares @ Rs. 4 as Rs. 5 paid up at par)			
Forfeited Shares A/c (15,000 – 6,000)	Dr.	9,000	
To Capital Reserve A/c			9,000
(Being the transfer of profit on reissue)			

5. (a) The losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the equity of the subsidiary. The excess, and any further losses applicable to the minority, are adjusted against the majority interest except to the extent that the minority has a binding obligation to, and is able to, make good the losses. If the subsidiary subsequently reports profits, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered. Accordingly,

Year	Profit/(Loss)	Minority Interest (30%)	Additional Consolidated P&L (Dr.) Cr.	Minority's Share of losses borne by A Ltd.		Cost of Control
				Rs.	Balance	
At the time of acquisition in 2010		3,24,000 (W.N.)	-			
2010-11	(2,50,000)	<u>(75,000)</u>	(1,75,000)			2,44,000 (W.N.)
Balance		2,49,000				
2011-12	(4,00,000)	<u>(1,20,000)</u>	(2,80,000)			2,44,000
Balance		1,29,000				
2012-13	(5,00,000)	<u>(1,50,000)</u>	(3,50,000)			2,44,000
		(21,000)				
	Loss of minority borne by Holding Co.	<u>21,000</u>	<u>(21,000)</u>	21,000	21,000	
Balance		Nil	<u>(3,71,000)</u>			
2013-14	(1,20,000)	(36,000)	(84,000)			2,44,000
	Loss of minority borne by Holding Co.	36,000	(36,000)	36,000	57,000	
Balance		Nil	(1,20,000)			
2014-15	50,000	15,000	35,000			2,44,000
	Profit share of minority adjusted against losses of minority absorbed by Holding Co.	(15,000)	15,000	(15,000)	42,000	
Balance		Nil	50,000			
2015-16	1,00,000	-	1,00,000	(30,000)	12,000	2,44,000
Balance		Nil				
2016-17	1,50,000	45,000	1,05,000	(12,000)	Nil	2,44,000
		<u>(12,000)</u>	<u>12,000</u>			
Balance		33,000	1,17,000			

Working Note:

Calculation of Minority interest and Cost of control on 1.4.2010

		Share of Holding Co.	Minority Interest
	100%	70%	30%
	(Rs.)	(Rs.)	(Rs.)
Share Capital	10,00,000	7,00,000	3,00,000
Reserve	80,000	<u>56,000</u>	<u>24,000</u>
		7,56,000	<u>3,24,000</u>
Less: Cost of investment		<u>(10,00,000)</u>	
Goodwill		<u>2,44,000</u>	

(b) 1. Capital Employed at the end of each year

	31.3.2013 Rs.	31.3.2014 Rs.	31.3.2015 Rs.
Goodwill	20,00,000	16,00,000	12,00,000
Building and Machinery (Revaluation)	36,00,000	40,00,000	44,00,000
Inventory (Revalued)	24,00,000	28,00,000	32,00,000
Trade Receivables	40,000	3,20,000	8,80,000
Bank Balance	<u>2,40,000</u>	<u>4,00,000</u>	<u>8,00,000</u>
Total Assets	82,80,000	91,20,000	104,80,000
Less: Trade Payables	<u>(12,00,000)</u>	<u>(16,00,000)</u>	<u>(20,00,000)</u>
Closing Capital	70,80,000	75,20,000	84,80,000
Add: Opening Capital	<u>73,20,000</u>	<u>70,80,000</u>	<u>75,20,000</u>
Total	<u>1,44,00,000</u>	<u>1,46,00,000</u>	<u>1,60,00,000</u>
Average Capital	72,00,000	73,00,000	80,00,000

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

2. Valuation of Goodwill

(i) Future Maintainable Profit	31.3.2013	31.3.2014	31.3.2015
Net Profit as given	8,40,000	12,40,000	16,40,000
Less: Opening Balance	(2,40,000)	(2,80,000)	(3,20,000)
Adjustment for Valuation of Opening Inventory	-	(4,00,000)	(4,00,000)
Add: Adjustment for Valuation of closing inventory	4,00,000	4,00,000	4,00,000
Goodwill written off	-	4,00,000	4,00,000
Transferred to General Reserve	<u>4,00,000</u>	<u>4,00,000</u>	<u>4,00,000</u>
Future Maintainable Profit	14,00,000	17,60,000	21,20,000
Less: 12.50% Normal Return	<u>(9,00,000)</u>	<u>(9,12,500)</u>	<u>(10,00,000)</u>
(ii) Super Profit	5,00,000	8,47,500	11,20,000

(iii) Average Super Profit = Rs. (5,00,000+8,47,500+11,20,000)÷3 = Rs. 8,22,500

(iv) Value of Goodwill at five years' purchase= Rs. 8,22,500 × 5 = Rs. 41,12,500.

6. (a) **Presentation of MAT credit in the financial statements:**

Balance Sheet: Where a company recognizes MAT credit as an asset on the basis of the considerations specified in the Guidance Note on Accounting for Credit Available in respect of Minimum Alternate Tax under the Income Tax Act, 1961, the same should be presented under the head 'Loans and Advances'* since, there being a convincing evidence of realization of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'.

In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph 11 of the Guidance Note.

Profit and Loss Account: According to explanation given for paragraph 21 of Accounting Standard 22, "Accounting for Taxes on Income" in the context of Section 115JB of the Income-tax Act, 1961, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the statement of profit and loss in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognized as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the statement of profit and loss and presented as a separate line item therein.

OR

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

(b) **Journal Entries in the books of company**

Date	Particulars	Dr. Rs.	Cr. Rs.
1-3-X2 to 31-3-X2	Bank A/c Employees compensation expenses A/c To Equity Share Capital A/c To Securities Premium A/c (Being allotment to employees 4,800 shares of Rs. 10 each at a premium of Rs. 130 at an exercise price of Rs. 50 each)	Dr. Dr.	2,40,000 4,32,000 48,000 6,24,000
31-3-X2	Profit and Loss account To Employees compensation expenses A/c (Being transfer of employees compensation expenses)	Dr.	4,32,000 4,32,000

Working Note:

- Employee Compensation Expenses = Discount between Market Price and option price = Rs. 140 – Rs. 50 = Rs. 90 per share = Rs. 90 x 4,800 = Rs. 4,32,000/- in total.
- The Employees Compensation Expense is transferred to Securities Premium Account.

* As per Schedule III to the Companies Act, 2013, it should be presented under the head 'Non-current Assets' sub head 'Long-term Loans and Advances'.

3. Securities Premium Account = Rs. 50 – Rs. 10 = Rs. 40 per share + Rs. 90 per share on account of discount of option price over market price = Rs. 130 per share = Rs. 130 x 4,800 = Rs. 6, 24,000/- in total.

(c) 'Non-performing asset' means:

- (a) an asset, in respect of which, interest has remained overdue for a period of six months or more;
- (b) a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;
- (c) a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;
- (d) a bill which remains overdue for a period of six months or more;
- (e) the interest in respect of a debt or the income on receivables under the head 'other current assets' in the nature of short term loans/advances, which facility remained overdue for a period of six months or more;
- (f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;

Note: As per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, the above six months criteria for the assets covered under (a) to (f) is 4 months for the financial year ending March 31, 2017; and from next year ending March 31, 2018 and thereafter it will be 3 months.

- (g) the lease rental and hire purchase instalment, which has become overdue for a period of twelve months or more;

Note: The above twelve months criteria for the assets covered under (g) is 6 months for the financial year ending March 31, 2017 and from next year ending March 31, 2018 and thereafter it will be 3 months.

- (h) in respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes non-performing asset

(d) The balance in the Profit & Loss Account on the date of acquisition (1.1.2018) is Capital profit, as such the balance of Consolidated Profit & Loss Account shall be equal to Holding Co.'s profit.

On 31.12.2018 in each case the following amount shall be added or deducted from the balance of holding Co.'s Profit & Loss account.

	% Share holding [K]	P & L as on 31.12.2018 [L]	P & L as on consolidation date [M]	P & L post acquisition [N] = [M]-[L]	Amount to be added / (deducted) from holding's P & L [O] = [K] x [N]
1	90 %	50,000	70,000	20,000	18,000
2	85 %	30,000	20,000	(10,000)	(8,500)
3	80 %	20,000	20,000	NIL	NIL
4	100 %	40,000	55,000	15,000	15,000

MOCK TEST PAPER - 1
INTERMEDIATE (NEW) GROUP – II
PAPER – 6: AUDITING AND ASSURANCE

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. The matter of difficulty, time, or cost involved is :
 - (a) not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.
 - (b) in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.
 - (c) not in itself a valid basis for the auditor to omit an audit procedure for which alternative exists.
 - (d) not in itself a valid basis for the auditor to omit an audit procedure.
2. _____ are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests.
 - (a) Self-review threats
 - (b) Familiarity threats
 - (c) Intimidation threats
 - (d) Advocacy threats
3. SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor
 - (a) should not consider materiality and its relationship with audit risk while conducting an audit.
 - (b) should consider materiality and its relationship with audit risk while conducting an audit.
 - (c) should not consider materiality but should consider its relationship with audit risk while conducting an audit.
 - (d) should consider materiality but need not consider its relationship with audit risk while conducting an audit.
4. When planning the audit,
 - (a) the auditor considers what would make the financial information materially misstated.
 - (b) the auditor need not consider what would make the financial information materially misstated.
 - (c) the auditor need not consider what would make the financial information materially misstated at planning stage
 - (d) the auditor needs to consider what would make the financial information materially misstated while conducting audit only
5. Audit documentation provides:
 - (a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; or evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.
 - (b) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

- (c) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor
 - (d) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.
6. Which of the following is not an example of audit documentation:
- (a) Audit programmes
 - (b) Summaries of significant matters
 - (c) Audit file
 - (d) Checklists.
7. SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement -
- (a) at the financial statement levels only.
 - (b) at the assertion levels only.
 - (c) at the financial statement and assertion levels.
 - (d) at the financial statement or assertion levels.
8. The risks of material misstatement at the assertion level consist of two components:
- (a) Inherent risk and detection risk
 - (b) control risk and detection risk
 - (c) audit risk and detection risk
 - (d) Inherent risk and control risk
9. Which of the following is an example of inflating cash payments?
- (a) Making payments against purchase vouchers.
 - (b) Teeming and lading.
 - (c) Not accounting for cash sales fully.
 - (d) Making payments against inflated vouchers.
10. The type of errors, existence of which becomes apparent in the process of compilation of accounts is known as-
- (a) Self-revealing errors.
 - (b) Intentional errors.
 - (c) Concealed errors.
 - (d) Unconcealed errors.
11. The Guidance Note on Audit of Internal Financial Controls over Financial Reporting has been issued by?
- (a) ICAI
 - (b) SEBI
 - (c) MCA
 - (d) RBI

12. The standard that requires auditors to analyse journal entries in an audit is?
- (a) SA 260
 - (b) SA 230
 - (c) SA 315
 - (d) SA 240
13. In the case of tests of details
- (a) the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population.
 - (b) the projected misstatement is the auditor's best estimate of misstatement in the population.
 - (c) the anomalous misstatement is the auditor's best estimate of misstatement in the population.
 - (d) the projected misstatement plus anomalous misstatement, if any, cannot be the auditor's best estimate of misstatement in the population.
14. Which of the following is correct :
- (a) When the projected misstatement exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.
 - (b) When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.
 - (c) When the anomalous misstatement exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.
 - (d) When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample provides a reasonable basis for conclusions about the population that has been tested.
15. Which of the following is correct :
- (a) As per the Standard on Auditing (SA) 520 "Analytical Procedure" "the term "analytical procedures" means evaluations of financial information through analysis of financial data.
 - (b) As per the Standard on Auditing (SA) 520 "Analytical Procedure" "the term "analytical procedures" means evaluations of financial information through analysis of non-financial data.
 - (c) As per the Standard on Auditing (SA) 520 "Analytical Procedure" "the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.
 - (d) As per the Standard on Auditing (SA) 520 "Analytical Procedure" "the term "analytical procedures" means evaluations of financial information through ratio analysis.
16. **Section 139(7)** provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India _____ from the date of registration of the company.
- (a) within 60 days
 - (b) within 30 days
 - (c) within 90 days

- (d) within 45 days
17. As per **Section 139(8)**, any casual vacancy in the office of an auditor shall in the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India,
- (a) be filled by the Audit committee within 60 days.
 - (b) be filled by the Audit committee within 30 days.
 - (c) be filled by the Board of Directors within 60 days.
 - (d) be filled by the Board of Directors within 30 days.
18. As per section 140(2) the auditor who has resigned from the company shall-
- (a) file within a period of 60 days from the date of resignation, a statement in the prescribed Form ADT-3 (as per Rule 8 of CAAR) with the company and the Registrar
 - (b) file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT-3 (as per Rule 8 of CAAR) with the company and the Registrar
 - (c) file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT-3 (as per Rule 8 of CAAR) with the company.
 - (d) file within a period of 60 days from the date of resignation, a statement in the prescribed Form ADT-3 (as per Rule 8 of CAAR) with the company.
19. Which of the following is correct :
- (a) As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein.
 - (b) As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its general meeting.
 - (c) As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its extra ordinary general meeting.
 - (d) As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its Board meeting or in such manner as may be determined therein.
20. In case of a fraud involving less than ` 1 crore, the auditor shall
- (a) report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed.
 - (b) report the matter to the audit committee constituted under section 177 within such time and in such manner as prescribed.
 - (c) report the matter to the Board within such time and in such manner as prescribed.
 - (d) report the matter to the audit committee constituted under section 177 and also to the Board within such time and in such manner as prescribed. **(20 x 1 = 20 Marks)**

Questions (21-25) carry 2 Marks each

21. Which of the following is correct in case of Banks :
- (a) The policy of income recognition should be subjective.
 - (b) The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations.
 - (c) The policy of income recognition should be objective.
 - (d) The policy of income recognition may be objective or subjective.

22. Which of the following is correct :
- (a) The auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
 - (b) The auditor shall express a disclaimer opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
 - (c) The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
 - (d) The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements
23. Which of the following is incorrect :
- (a) According to Section 140(1), the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per Rule 7 of CAAR, 2014-
 - (b) The application to the Central Government for removal of auditor shall be made in Form ADT -2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.
 - (c) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.
 - (d) The company shall hold the general meeting within 30 days of receipt of approval of the Central Government for passing the special resolution.
24. which of the following is incorrect :
- (a) Inquiry consists of seeking information of unknown persons, both financial and non- financial, within the entity or outside the entity.
 - (b) Inquiry is used extensively throughout the audit in addition to other audit procedures.
 - (c) Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.
 - (d) Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence.
25. Which of the following is incorrect :
- (a) Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements.
 - (b) Similar to responses to inquiries, written representations are audit evidence.
 - (c) Written representations are requested from those responsible for the preparation and presentation of the financial statements.
 - (d) Written representations provide necessary audit evidence and also they provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

(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) A modelling tool constructs a statistical model from financial data only of prior accounting periods to predict current account balances.
 - (ii) When we are designing audit procedures to address an inherent risk or “what can go wrong”, we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence.
 - (iii) According to SA 530 “Audit sampling”, ‘audit sampling’ refers to the application of audit procedures to 100% of items within a population of audit relevance.
 - (iv) The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven.
 - (v) Other matter paragraph is paragraph included in the auditor’s report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor’s judgment, is of such importance that it is fundamental to users’ understanding of the financial statements.
 - (vi) The auditor shall express an adverse opinion when:
 - (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
 - (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive
 - (vii) The assessment of risks is a matter capable of precise measurement.
 - (viii) The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Central Government. **(7 x 2 = 14 Marks)**
2. Discuss the following:
 - (a) The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.
Explain stating the examples of factors (**any four**) that the auditor may consider when determining the sample size for tests of controls. **(4 Marks)**
 - (b) “The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client’s business” Discuss stating clearly the broad points you would be covering in framing plan to conduct audit in an efficient and effective manner. **(4 Marks)**
 - (c) The establishment of the overall audit strategy and the detailed audit plan are closely inter-related. Explain **(3 Marks)**
 - (d) The fundamental principle of an automated environment is the ability to carry out business with less manual intervention. Explain. **(3 Marks)**

3. (a) SWM is proprietorship firm engaged in the manufacturing of different kind of yarns. It sells its finished products both in the domestic as well as in the international market. The company is making total turnover of Rs. 30 crores. It has also availed cash credit limit of Rs.. 3 crores from Dena Bank. In the year 2018-19. Proprietor of the firm is worried about the financial position of the company and is under the impression that since he is out of India, therefore firm might not run well. He approaches an Internal Auditor about as to what would be covered in Audit. Advise regarding principal aspects (any four) to be covered in getting accounts audited. **(4 Marks)**
- (b) 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. Discuss **(4 Marks)**
- (c) Any share issued by a company at a discounted price shall be void. Explain stating also the audit procedure in this regard. **(3 Marks)**
- (d) Explain the difference between reserves and provisions. **(3 Marks)**
4. (a) The objective of the IAASB is to serve the public interest by setting high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. Advise how this objective would be accomplished. **(4 Marks)**
- (b) State the matters to be included in the auditor's report as per CARO, 2016 regarding-
- (i) Default in repayment of loans or borrowing to a financial institution, bank etc. **(2 Marks)**
- (ii) Fraud by the company or on the Company by its officers or employees. **(2 Marks)**
- (c) The auditor of XYZ Ltd, engaged in FMCG (Fast Moving Consumable Goods) obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:
- (i) Management has created and maintained a culture of honesty and ethical behavior; and
- (ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.
- Advise what is included in control environment. Also explain the elements of control environment. **(6 Marks)**
5. (a) ABC Ltd is engaged in manufacturing of different type of yarns. On going through its financial statements for the past years, it is observed that inventory is material to the financial statements. You as an auditor of the company wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss, how would you proceed as an auditor. **(4 Marks)**
- (b) The auditor evaluated, in respect of T Ltd., whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.
- Auditor's evaluation included consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.
- Advise the qualitative aspects of the entity's accounting practices. **(4 Marks)**
- (c) Where a company is required to constitute an Audit Committee, all appointments of an auditor under this section shall be made after taking into account the recommendations of such committee. Explain stating also the class of companies required to constitute Audit Committee. **(3 Marks)**

- (d) Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. Explain with examples **(3 Marks)**
6. (a) The first auditors of Bhartiya Petrol Ltd., a Government company, were appointed by the Board of Directors. Analyse. **(4 Marks)**
- (b) An NGO operating in Delhi had collected large scale donations for T sunami victims. The donations so collected were sent to different NGOs operating in T amil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for T sunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention two points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations. **(4 Marks)**

OR

- (c) The engagement team of FRN & Co.- Auditors of Bank of Baroda held discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.
- The discussion between the members of the engagement team and the audit engagement partner are being done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit.
- Analyse and Advise the matters to be discussed in the engagement team discussion. **(4 Marks)**
- (d) Advise any six special points in an audit of hospital. **(6 Marks)**

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

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

Division B - Descriptive Answers

1. (i) **Incorrect:** A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).
- (ii) **Correct.** — When we are designing audit procedures to address an inherent risk or “what can go wrong”, we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been

identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

- (iii) **Incorrect:** According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.
- (iv) **Correct:** The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.
- (v) **Incorrect:** Emphasis of Matter paragraph is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.
- (vi) **Incorrect:** The auditor shall express a qualified opinion when:
 - (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
 - (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive
- (vii) **Incorrect:** The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.
- (viii) **Incorrect:** The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.

2. (a) The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.

Examples of Factors Influencing Sample Size for Tests of Controls: The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

- ◆ When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased). Thus, sample size will increase.

- ◆ If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be.
 - ◆ When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as higher the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
 - ◆ An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
 - ◆ In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.
- (b) "The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business".

Plans should be made to cover, among other things:

- (a) acquiring knowledge of the client's accounting systems, policies and internal control procedures;
- (b) establishing the expected degree of reliance to be placed on internal control;
- (c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and
- (d) coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit.

SA-300, "Planning an Audit of Financial Statements" further expounds this principle. According to it, planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

- (c) Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.
- (d) The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.

For example, if a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.

Similarly, there are several other aspects that an auditor should consider to determine the level of automation and complexity of a business environment which we will look at in the following sections.

3. (a) The principal aspect to be covered in an audit concerning final statements of account are the following:
- (i) **An examination of the system of accounting and internal control** to ascertain whether it is appropriate for the business and helps in properly recording all transactions.
 - (ii) **Reviewing the system and procedures** to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.
 - (iii) **Checking of the arithmetical accuracy of the books of account** by the verification of postings, balances, etc.
 - (iv) **Verification of the authenticity and validity of transaction** entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.
 - (v) **Ascertaining that a proper distinction has been made between items of capital and of revenue nature** and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.
 - (vi) **Comparison of the balance sheet and profit and loss account or other statements with the underlying record** in order to see that they are in accordance therewith.
 - (vii) **Verification of the title, existence and value of the assets** appearing in the balance sheet.
 - (viii) **Verification of the liabilities** stated in the balance sheet.
 - (ix) **Checking the result shown by the profit and loss** and to see whether the results shown are true and fair.
 - (x) **Where audit is of a corporate body, confirming that the statutory requirements** have been complied with.
 - (xi) **Reporting to the appropriate person/body** whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

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

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

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

Examples of such changes include:

- ◆ Deleting or discarding superseded documentation.

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

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

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

- (c) **Shares Issued at discount:** According to section 53 of the Companies Act, 2013, a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under section 54 of the Companies Act, 2013.

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

The auditor needs to verify that the Company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorizing issue of share capital and the issue price.

- (d) **Difference between Reserves and Provisions**

- The difference between the two is that provisions are amounts set aside to meet specific/ identified liabilities or diminution in recoverable value of assets. These must be provided for regardless of the fact whether the Company has earned profit or not.
- Reserves on the other hand, represent amounts appropriated out of profits, held for equalising the dividends of the company from one period to another or for financing the expansion of the company or for generally strengthening the company financially.
- If we examine the Balance Sheet of a company, at a given time, and deduct the total liabilities to outside trade payables from the value of assets shown therein, the difference between the two figures will represent the net worth of the company based on the book values of assets as on that date. The same shall include the capital contributed by the shareholders as well as total undistributed profit held either to the credit of the Statement of Profit and Loss or to reserves; the reserves again will be segregated as revenue or capital reserves.

4. (a) The objective of the IAASB is to serve the public interest by setting high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The IAASB achieves this objective by:
- Establishing high quality auditing standards and guidance for financial statement audits that are generally accepted and recognized by investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world;
 - Establishing high quality standards and guidance for other types of assurance services on both financial and non-financial matters;
 - Establishing high quality standards and guidance for other related services;
 - Establishing high quality standards for quality control covering the scope of services addressed by the IAASB; and

- Publishing other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers.
- (b) **Matters to be included in the Auditor's Report under CARO, 2016:** The auditor's report on the accounts of a company to which CARO applies shall include a statement on the following matters, namely-
- (i) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).
 - (ii) whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;
- (c) **Control Environment – Component of Internal Control:** The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
- (i) Management has created and maintained a culture of honesty and ethical behavior; and
 - (ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

What is included in Control Environment?

The control environment includes:

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

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

- (a) **Communication and enforcement of integrity and ethical values** – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
- (b) **Commitment to competence** – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
- (c) **Participation by those charged with governance** – Attributes of those charged with governance such as:
 - ◆ Their independence from management.
 - ◆ Their experience and stature.
 - ◆ The extent of their involvement and the information they receive, and the scrutiny of activities.
 - ◆ The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

- (d) **Management's philosophy and operating style** – Characteristics such as management's:
 - ◆ Approach to taking and managing business risks.
 - ◆ Attitudes and actions toward financial reporting.
 - ◆ Attitudes toward information processing and accounting functions and personnel.
 - (e) **Organisational structure** – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
 - (f) **Assignment of authority and responsibility** - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.
 - (g) **Human resource policies and practices** – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.
5. (a) When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:
- (1) Attendance at physical inventory counting, unless impracticable, to:
 - (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
 - (ii) Observe the performance of management's count procedures;
 - (iii) Inspect the inventory; and
 - (iv) Perform test counts; and
 - (2) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.
- (b) The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:
 - (i) The selective correction of misstatements brought to management's attention during the audit
 - (ii) Possible management bias in the making of accounting estimates.
4. SA 540 addresses possible management bias in making accounting estimates.

Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

- (c) **Applicability of section 177 i.e. Constitution of Audit Committee:** Where a company is required to constitute an Audit Committee under section 177, 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.

It is important to know that in addition to **listed public companies**, following classes of companies shall constitute an Audit Committee -

- (i) all public companies with a paid up capital of ten crore rupees or more;
 - (ii) all public companies having turnover of one hundred crore rupees or more;
 - (iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.
- (d) Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:
- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome.
 - A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.

Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

6. (a) A "Government company" is a company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

Section 139(7) provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

Hence, in the case of Bhartiya Petrol Ltd., being a government company, the first auditor shall be appointed by the Comptroller and Auditor General of India.

Conclusion: Thus, the appointment of first auditor made by the Board of Directors of Bhartiya Petrol Ltd., is null and void.

- (b) **Receipt of Donations:**

- (i) **Internal Control System:** Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt

books and safe custody of money.

- (ii) **Custody of Receipt Books:** Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.
- (iii) **Receipt of Cheques:** Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.
- (iv) **Bank Reconciliation:** Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.
- (v) **Cash Receipts:** Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.
- (vi) **Foreign Contributions,** if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of Donations to Different NGOs:

- (i) **Mode of Sending Remittance:** All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.
 - (ii) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.
 - (iii) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.
 - (iv) **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.
 - (v) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.
 - (vi) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.
- (c) The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference. The discussion provides:
- An opportunity for more experienced engagement team members, including the audit engagement partner, to share their insights based on their knowledge of the bank and its environment.
 - An opportunity for engagement team members to exchange information about the bank's business risks.
 - An understanding amongst the engagement team members about effect of the results of the risk assessment procedures on other aspects of the audit, including decisions about the nature, timing, and extent of further audit procedures.

The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit.

The engagement team discussion ordinarily includes a discussion of the following matters:

Errors that may be more likely to occur;

Errors which have been identified in prior years;

Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;

Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;

Need to maintain professional skepticism throughout the audit engagement;

Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

(d) Audit of Hospital: The special steps involved in such an audit are stated below-

- (1) **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.
- (2) **Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.
- (3) **Income from Investments, Rent etc:** See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities have been collected.
- (4) **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
- (5) **Reconciliation of Subscriptions:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).
- (6) **Authorisation and Sanctions:** Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.
- (7) **Grants and TDS:** Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.
- (8) **Budgets:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.
- (9) **Internal Check:** Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.
- (10) **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.
- (11) **Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.
- (12) **Inventories:** Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.
- (13) **Management Representation and Certificate:** Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

MOCK TEST PAPER - 1
INTERMEDIATE (NEW): GROUP – II
PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC MANAGEMENT
SECTION – A: ENTERPRISE INFORMATION SYSTEMS

Time Allowed – 1½ Hours

Maximum Marks – 50

Division A - Multiple Choice Questions

Total Marks: 15 Marks

Question Nos. 1 to 5 carries 2 marks each.

1. To enhance automation, a company defines re-order levels for regular consumption of raw material items in their ERP system. Once an item hits Re-order Level, the system creates a purchase requisition for Economic Order Quantity (EOQ) / Re-Order Quantity (ROQ) and emails the same to selected vendors asking them to send quotations. This method of doing business can be best defined as _____.
 - (a) Business Process Automation
 - (b) Business Process Integration
 - (c) Business Process Upgrade
 - (d) Business Process Module
2. A new system has been developed that ensures that as soon as inventory level goes below re-order level in INVENTORY SYSTEM, a purchase requisition is generated from PURCHASE SYSTEM. Which testing method shall be best suited to check whether the two systems are working properly?
 - (a) Unit Testing
 - (b) Program Testing
 - (c) Integration Testing
 - (d) Whole-of-Program Testing
3. A Bank has updated its existing Corer Banking Systems (CBS) system to a new version. It is found that the new system is not automatically sending monthly Bank Statements to its customers. The same feature was available in the previous system. This error is result of mistake in which step?
 - (a) Design
 - (b) Planning
 - (c) Implementation
 - (d) Maintenance
4. An enterprise is configuring TALLY 9.1 ERP system for fixing monthly budgets for expenses. A heated argument is going on the issue of when to fix budget for any head. Please help management in deciding on when to create budgets.
 - (a) After 3 months from today based on the average expenses
 - (b) Today itself based on past years' experience and future projected increase
 - (c) Cannot be fixed today
 - (d) Today itself based on future projections for expenses

5. Mr. X features in an advertisement of an Air conditioner of brand Z where he emphasizes that this Air Conditioner can be all controlled through a mobile. This is perfect example of _____ technology.
- (a) Cloud Computing
 - (b) Internet of Things (IoT)
 - (c) Artificial Intelligence
 - (d) Bring Your Own Device (BYOD)
- (5 x 2 = 10 Marks)**

Question Nos. 6 to 10 are of 1 mark each.

6. Which objective of Business Process Automation (BPA) is achieved using Passwords in Information Systems?
- (a) Confidentiality
 - (b) Integrity
 - (c) Timeliness
 - (d) Availability
7. The most critical resource for an Enterprise Resource Planning (ERP) System is _____.
- (a) Hardware
 - (b) Data
 - (c) Software
 - (d) People
8. In computer networking, best example of a device working on HALF DUPLEX transmission mode is ____.
- (a) Radio
 - (b) Television
 - (c) Mobile
 - (d) Walkie - Talkie
9. In computer network, a vulnerability is best defined as _____.
- (a) Risk to system
 - (b) Weakness of controls
 - (c) Value of risk
 - (d) Possible Threat
10. Which of the following combination is not a violation of maker - Checker Rule for Internal Control?
- (a) Cashier is also a Ledger Writer
 - (b) Auditor acting as an Implementation Consultant
 - (c) System Developer acting as a System Quality Control Personnel
 - (d) Auditor Suggesting Controls
- (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) Describe Role-Based Access Control (RBAC) mechanism in ERP Systems. **(3 Marks)**
(b) List the key technology components of Core Banking System (CBS). **(2 Marks)**
2. (a) You are an Information Technology Consultant to a firm who is in the process of shortlisting the resources for the controls for the environmental exposures - water damage and power spikes in that firm. Prepare a checklist for same. **(6 Marks)**
(b) Recognize the parameters based on which the success of Business Process Automation (BPA) can be evaluated? **(4 Marks)**
3. (a) As a Database Administrator, you are invited in a Conference to speak on Data Types in front of audience of aspiring CA students. You decide to segment your lecture in two - Master Data & Non-Master Data and identify different types of Master Data in Financial and Accounting systems. Determine the key points of the content of your lecture. **(6 Marks)**
(b) To an individual/user/customer, identify various benefits that (s)he can draw from E-commerce transactions. **(4 Marks)**
4. (a) The deployment and implementation of Core Banking Systems should be controlled at various stages to ensure that bank's automation objectives are achieved. Determine the different stages. **(6 Marks)**
(b) In an e-business environment, controls are required to be put in place at each participant's level. Discuss about the participants involved in any e-business environment. **(4 Marks)**
5. (a) The controls for a particular business process are implemented by breaking them down into smaller components. Determine the main components of controls for the Purchase to Pay Cycle. **(6 Marks)**
(b) Compare between Subversive Attacks and Piggybacking. **(4 Marks)**

MOCK TEST PAPER - 1
INTERMEDIATE COURSE: GROUP – II
PAPER –7: ENTERPRISE INFORMATION SYSTEMS & STRATEGIC MANAGEMENT
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) What can be defined as the art and science of formulating, implementing and evaluating cross-functional decisions that enable an organization to achieve its objectives?
 - a. Strategy formulation
 - b. Strategy evaluation
 - c. Strategy implementation
 - d. Strategic management
- (ii) Financial objectives involve all of the following except:
 - a. Growth in revenues
 - b. Larger market share
 - c. Higher dividends
 - d. Greater return on investment
- (iii) Vertical integration may be beneficial when
 - a. Lower transaction costs and improved coordination are vital and achievable through vertical integration.
 - b. Flexibility is reduced, providing a more stationary position in the competitive environment.
 - c. Various segregated specializations will be combined.
 - d. The minimum efficient scales of two corporations are different.
- (iv) During what stage of strategic management are a firm's specific internal strengths and weaknesses determined?
 - a. Formulation
 - b. Implementation
 - c. Evaluation
 - d. Feedback
- (v) In evaluating strategies, which one of Rumelt's criteria for evaluating strategies, refers to the need for strategists to examine sets of trends?
 - a. Consistency
 - b. Consonance
 - c. Feasibility
 - d. Advantage
- (vi) Individual investors are reliant on upon the organisation's managers to
 - a. Maximize short-term returns in the form of dividends.

- b. Add value to their investments in a way that the stockholders could not accomplish on their own.
 - c. Achieve risk reduction at a lower cost than stockholders could obtain on their own.
 - d. Diversify the stockholder's investments in order to reduce risk.
- (vii) Stability strategy is a _____ strategy.
- a. SBU level
 - b. Corporate level
 - c. Business level
 - d. Functional level
- (viii) What type of organizational structure do most small businesses follow?
- a. Divisional structure
 - b. Functional structure
 - c. Hour Glass structure
 - d. Matrix structure
- (ix) Conglomerate diversification is another name for which of the following?
- a. Related diversification
 - b. Unrelated diversification
 - c. Portfolio diversification
 - d. Acquisition diversification
- (x) What does Dogs symbolize in BCG matrix?
- a. Invest
 - b. Harvest
 - c. Build
 - d. Divest
- (xi) Which of these basic questions should a vision statement answer?
- a. What is our business?
 - b. Who are our competitors?
 - c. Where we are to go?
 - d. Why do we exist?
- (xii) Internal _____ are activities in an organization that are performed especially well.
- a. Opportunities
 - b. Competencies
 - c. Strengths
 - d. Management
- (xiii) Anything that a firm does especially well compared to rival firms is referred to as _____.
- a. Competitive advantage
 - b. Comparative advantage
 - c. Opportunity cost
 - d. Sustainable advantage

- (xiv) An important activity in _____ is taking corrective action.
- Strategy evaluation
 - Strategy implementation
 - Strategy formulation
 - Strategy leadership
- (xv) A firm successfully implementing a differentiation strategy would expect:
- Customers to be sensitive to price increases.
 - To charge premium prices.
 - Customers to perceive the product as standard.
 - To automatically have high levels of power over suppliers. **(15 x 1 = 15 Marks)**
2. Infant care is a successful store chain that caters products for expectant mothers and new moms. They offer everything from nursing classes to strollers, toys, infant clothes, diapers and baby furniture. Due to a one-stop shop for infants, they are charging a premium for its products.
Identify and explain how the strategy adopted by infant care. **(5 Marks)**
3. (a) The presence of strategic management cannot counter all hindrances and always achieve success for an organisation. What are the limitations attached to strategic management? **(5 Marks)**
- (b) Dinesh Yadav is the owner of a beverage-based private company in Sonapat, Haryana. His unit is producing fruit juices, cold drinks, soda and lime. While its products have significant market share in the northern part of country, the sales are on decline in last couple of years. He seeks help of a management expert who advises him to first understand the competitive landscape.
Explain the steps to be followed by Dinesh Yadav to understand competitive landscape. **(5 Marks)**
4. (a) To convert strategic plans into actions and results, a manager must be able to direct organizational change, motivate people, build and strengthen company competencies and competitive capabilities, create a strategy-supportive work climate, and meet or beat performance targets.
Explain the principal aspects of strategy-execution process. **(5 Marks)**
- (b) Leatherite Ltd., was started as a leather company to manufacture footwear. Currently, they are in the manufacturing of footwears for males and females. The top management desires to expand the business in the leather manufacturing goods. To expand they decided to purchase more machines to manufacture leather bags for males and females.
Identify and explain the strategy opted by the top management of Leatherite Ltd. **(5 Marks)**
5. (a) Explain Porter's five forces model as to how businesses can deal with the competition. **(5 Marks)**
- (b) Distinguish between Logistic Management and Supply Chain Management. **(5 Marks)**
6. (a) How can a corporate culture be both strength and weakness of an organisation? **(5 Marks)**
- (b) Write a short note on Implementation Control. **(5 Marks)**

MOCK TEST PAPER - 1
INTERMEDIATE (NEW): GROUP – II
PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC MANAGEMENT
SECTION – A: ENTERPRISE INFORMATION SYSTEMS

ANSWERS

MULTIPLE CHOICE QUESTIONS

1. (a) Business Process Automation
2. (c) Integration Testing
3. (a) Design
4. (b) Today itself based on past years' experience and future projected increase
5. (b) Internet of Things (IoT)
6. (a) Confidentiality
7. (b) Data
8. (d) Walkie - Talkie
9. (b) Weakness of controls
10. (d) Auditor Suggesting Controls

DESCRIPTIVE QUESTIONS

1. (a) **Role-Based Access Control (RBAC):** In computer systems security, RBAC also referred as Role-Based Security is an approach to restricting system access to authorized users. It is used by most enterprises and can implement mandatory access control or discretionary access control. RBAC is a policy neutral access control mechanism defined around roles and privileges. The components of RBAC such as role-permissions, user-role and role-role relationships make it simple to perform user assignments. RBAC can be used to facilitate administration of security in large organizations with hundreds of users and thousands of permissions. Roles for staff are defined in organization and access to the system can be given according to the role assigned. E.g. a junior accountant in accounting department is assigned a role of recording basic accounting transactions, an executive in human resource department is assigned a role of gathering data for salary calculations on monthly basis, etc.
- (b) The key technology components of Core Banking System (CBS) are as follows:
 - Database Environment
 - Application Environment
 - Web Environment
 - Security solution
 - Connectivity to the Corporate Network and the Internet
 - Data Centre and Disaster Recovery Centre
 - Network Solution architecture to provide total connectivity
 - Enterprise Security architecture
 - Branch and Delivery channel environment
 - Online Transaction monitoring for fraud risk management

2. (a) **Power Spikes:** This is caused due to a very short pulse of energy in a power line.

Controls for Environmental Exposures: Some of the major ways of protecting the installation against power spikes as follows:

- ◆ The risk of damage due to power spikes can be reduced using Electrical Surge Protectors that are typically built into the Un-interruptible Power System (UPS).
- ◆ **Un-interruptible Power System (UPS)/Generator:** In case of a power failure, the UPS provides the back up by providing electrical power from the battery to the computer for a certain span of time. Depending on the sophistication of the UPS, electrical power supply could continue to flow for days or for just a few minutes to permit an orderly computer shutdown.
- ◆ Voltage regulators and circuit breakers protect the hardware from temporary increase or decrease of power.
- ◆ **Emergency Power-Off Switch:** When the need arises for an immediate power shut down during situations like a computer room fire or an emergency evacuation, an emergency power-off switch at the strategic locations would serve the purpose. They should be easily accessible and yet secured from unauthorized people.

Water Damage: Water damage to a computer installation can be the outcome of water pipes burst. Water damage may also result from other resources such as cyclones, tornadoes, floods etc

Controls for Environmental Exposures: Some of the major ways of protecting the installation against water damage are as follows:

- ◆ Wherever possible have waterproof ceilings, walls and floors;
- ◆ Ensure an adequate positive drainage system exists;
- ◆ Install alarms at strategic points within the installation;
- ◆ In flood areas have the installation above the upper floors but not at the top floor;
- ◆ Water proofing; and
- ◆ Water leakage Alarms

- (b) The success of any Business Process Automation shall only be achieved when BPA ensures the following:

- ◆ **Confidentiality:** To ensure that data is only available to persons who have right to see the same;
- ◆ **Integrity:** To ensure that no un-authorized amendments can be made in the data;
- ◆ **Availability:** To ensure that data is available when asked for; and
- ◆ **Timeliness:** To ensure that data is made available in at the right time.

To ensure that all the above parameters are met, BPA needs to have appropriate internal controls put in place.

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

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

- a. **Accounting Master Data** – This includes names of ledgers, groups, cost centres, accounting voucher types, etc. E.g. Capital Ledger is created once and not expected to change frequently. Similarly, all other ledgers like, sales, purchase, expenses and income ledgers are created once and not expected to change again and again. Opening balance carried forward from previous year to next year is also a part of master data and not expected to change.
- b. **Inventory Master Data** – This includes stock items, stock groups, godowns, inventory voucher types, etc. Stock item is something which bought and sold for business purpose, a trading goods. E.g. If a person is into the business of dealing in white goods, stock items shall be Television, Fridge, Air Conditioner, etc. For a person running a medicine shop, all types of medicines shall be stock items for him/her.
- c. **Payroll Master Data** – Payroll is another area connecting with Accounting Systems. Payroll is a system for calculation of salary and recoding of transactions relating to employees. Master data in case of payroll can be names of employees, group of employees, salary structure, pay heads, etc. These data are not expected to change frequently. E.g. Employee created in the system will remain as it is for a longer period of time, his/her salary structure may change but not frequently, pay heads associated with his/her salary structure will be relatively permanent.
- d. **Statutory Master Data** – This is a master data relating to statute/law. It may be different for different type of taxes. E.g. Goods and Service Tax (GST), Nature of Payments for Tax Deducted at Source (TDS), etc. This data also shall be relatively permanent. We don't have any control on this data as statutory changes are made by Government and not by us. In case of change in tax rates, forms, categories, we need to update/change our master data.

All business process modules must use common master data.

(b) Various benefits of an e-commerce transaction to Customer / Individual / User are as follows:

- ◆ **Convenience:** Every product at the tip of individual's fingertips on internet.
- ◆ **Time saving:** Number of operations that can be performed both by potential buyers and sellers increase.
- ◆ **Various Options:** There are several options available for customers which are not only being easy to compare but are provided by different players in the market.
- ◆ **Easy to find reviews:** There are often reviews about a site or product from the previous customers which provides valuable feedback.
- ◆ **Coupon and Deals:** There are discount coupons and reward points available for customers to encourage online transaction.
- ◆ **Anytime Access:** Even midnight access to the e commerce platforms is available which brings in customer suitability.

4. (a) The deployment and implementation of Core Banking Systems(CBS) should be controlled at various stages to ensure that banks automation objectives are achieved:

- **Planning:** Planning for implementing the CBS should be done as per strategic and business objectives of bank.
- **Approval:** The decision to implement CBS requires high investment and recurring costs and will impact how banking services are provided by the bank. Hence, the decision must be approved by the board of directors.
- **Selection:** Although there are multiple vendors of CBS, each solution has key differentiators. Hence, bank should select the right solution considering various parameters as defined by the bank to meet their specific requirements and business objectives.

- **Design and Develop/ Procure:** CBS solutions used to be earlier developed in-house by the bank. Currently, most of the CBS deployment are procured. There should be appropriate controls covering the design or development or procurement of CBS for the bank.
 - **Testing:** Extensive testing must be done before the CBS is live. The testing is to be done at different phases at procurement stage to test suitability to data migration to ensure all existing data is correctly migrated and testing to confirm processing of various types of transactions of all modules produces the correct results.
 - **Implementation:** CBS must be implemented as per pre-defined and agreed plan with specific project milestones to ensure successful implementation.
 - **Maintenance:** CBS must be maintained as required. E.g. program bugs fixed, version changes implemented, etc.
 - **Support:** CBS must be supported to ensure that it is working effectively.
 - **Updation:** CBS modules must be updated based on requirements of business processes, technology updates and regulatory requirements.
 - **Audit:** Audit of CBS must be done internally and externally as required to ensure that controls are working as envisaged.
- (b) In an e-business environment, controls are necessary for all persons in the chain that include the following-
- **Users:** This is important to ensure that the genuine user is using the e-commerce/ m-commerce platform. There is risk if user accounts are hacked and hackers buy products / services.
 - **Sellers / Buyers / Merchants:** These people need to proper framework in place to ensure success of business. Many e-commerce businesses have lost huge amount of money as they did not have proper controls put in place. These include controls on Product catalogues; Price catalogues; Discounts and promotional schemes; Product returns and Accounting for cash received through Cash on Delivery mode of sales.
 - **Government:** Governments across the world and in India have few critical concerns vis-à-vis electronic transactions, namely Tax accounting of all products / services sold and all products/ services are sold.
 - **Network Service Providers:** They need to ensure availability and security of network. Any downtime of network can be disastrous for business.
 - **Technology Service Providers:** These include all other service provider other than network service provider, for example, cloud computing back-ends, applications back-ends and like. They are also prone to risk of availability and security.
 - **Logistics Service Providers:** Success or failure of any e-commerce / m-commerce venture finally lies here. Logistics service providers are the ones who are finally responsible for timely product deliveries.
 - **Payment Gateways:** E-commerce vendors' business shall run only when their payment gateways are efficient, effective and foolproof.

Each participant needs to put in place controls in an e-commerce environment.

5. (a) Given below is a list of the controls for the Purchase to Pay cycle, which is broken down to four main components:
- ◆ **Purchases:** When an employee working in a specific department (i.e., marketing, operations, sales, etc.) wants to purchase something required for carrying out the job, he/she will submit a Purchase Requisition (PR) to a manager for approval. Based on the approved PR, a

Purchase Order (PO) is raised. The PO may be raised manually and then input into the computer system or raised directly by the computer system.

- ◆ **Goods Receipt:** The PO is then sent to the vendor, who will deliver the goods as per the specifications mentioned in the PO. When the goods are received at the warehouse, the receiving staff checks the delivery note, PO number etc. and acknowledges the receipt of the material. Quantity and quality are checked and any unfit items are rejected and sent back to the vendor. A Goods Receipt Note (GRN) is raised indicating the quantity received. The GRN may be raised manually and then input into the computer system or raised directly by computer system.
 - ◆ **Invoice Processing:** The vendor sends the invoice to the accounts payable department who will input the details into the computer system. The vendor invoice is checked with the PO to ensure that only the goods ordered have been invoiced and at the negotiated price. Further the vendor invoice is checked with the GRN to ensure that the quantity ordered has been received.
 - ◆ **Payment:** If there is no mismatch between the PO, GRN and vendor invoice; the payment is released to the vendor based on the credit period negotiated with the vendor.
- (b) Subversive Attacks and Piggybacking are the types of Asynchronous Attacks. However, they differ in following aspects:

Subversive Attacks: These can provide intruders with important information about messages being transmitted and the intruder may attempt to violate the integrity of some components in the sub-system.

Piggybacking: This is the act of following an authorized person through a secured door or electronically attaching to an authorized telecommunication link that intercepts and alters transmissions. This involves intercepting communication between the operating system and the user and modifying them or substituting new messages.

MOCK TEST PAPER
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SECTION – B: STRATEGIC MANAGEMENT
SUGGESTED ANSWERS/HINTS

1.

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

2. Infant care is opting for differentiation strategy. A one-stop shop is a benefit for this type of customers, seeking convenience in a time. Infant care is catering the products only related to infants that is perceived by the customers as unique. Because of differentiation, the Infant care is charging a premium for its product.

3. (a) The presence of strategic management cannot counter all hindrances and always achieve success as there are limitations attached to strategic management. These can be explained in the following lines:

- ◆ Environment is highly complex and turbulent. It is difficult to understand the complex environment and exactly pinpoint how it will shape-up in future. The organisational estimate about its future shape may awfully go wrong and jeopardise all strategic plans. The environment affects as the organisation has to deal with suppliers, customers, governments and other external factors.
- ◆ Strategic Management is a time-consuming process. Organisations spend a lot of time in preparing, communicating the strategies that may impede daily operations and negatively impact the routine business.
- ◆ Strategic Management is a costly process. Strategic management adds a lot of expenses to an organization. Expert strategic planners need to be engaged, efforts are made for analysis of external and internal environments devise strategies and properly implement. These can be really costly for organisations with limited resources particularly when small and medium organisation create strategies to compete.
- ◆ In a competitive scenario, where all organisations are trying to move strategically, it is difficult to clearly estimate the competitive responses to the strategies.

(b) Steps to understand the competitive landscape:

- (i) **Identify the competitor:** The first step to understand the competitive landscape is to identify the competitors in the firm's industry and have actual data about their respective market share.
- (ii) **Understand the competitors:** Once the competitors have been identified, the strategist can use market research report, internet, newspapers, social media, industry reports, and various other sources to understand the products and services offered by them in different markets.
- (iii) **Determine the strengths of the competitors:** What are the strength of the competitors? What do they do well? Do they offer great products? Do they utilize marketing in a way that comparatively reaches out to more consumers. Why do customers give them their business?
- (iv) **Determine the weaknesses of the competitors:** Weaknesses (and strengths) can be

identified by going through consumer reports and reviews appearing in various media. After all, consumers are often willing to give their opinions, especially when the products or services are either great or very poor.

- (v) **Put all of the information together:** At this stage, the strategist should put together all information about competitors and draw inference about what they are not offering and what the firm can do to fill in the gaps. The strategist can also know the areas which need to be strengthened by the firm.

4. (a) In most situations, strategy-execution process includes the following principal aspects:

- ◆ Developing budgets that steer ample resources into those activities critical to strategic success.
- ◆ Staffing the organization with the needed skills and expertise, consciously building and strengthening strategy-supportive competencies and competitive capabilities, and organizing the work effort.
- ◆ Ensuring that policies and operating procedures facilitate rather than impede effective execution.
- ◆ Using the best-known practices to perform core business activities and pushing for continuous improvement.
- ◆ Installing information and operating systems that enable company personnel to better carry out their strategic roles day in and day out.
- ◆ Motivating people to pursue the target objectives energetically.
- ◆ Creating a company culture and work climate conducive to successful strategy implementation and execution.
- ◆ Exerting the internal leadership needed to drive implementation forward and keep improving strategy execution. When the organization encounters stumbling blocks or weaknesses, management has to see that they are addressed and rectified quickly.

Good strategy execution involves creating strong “fits” between strategy and organizational capabilities, between strategy and the reward structure, between strategy and internal operating systems, and between strategy and the organization’s work climate and culture.

- (b) Leatherite Ltd. is currently manufacturing footwears for males and females and its top management has decided to expand its business by manufacturing leather bags for males and females. Both the products are similar in nature within the same industry. The strategic diversification that the top management of Leatherite Ltd. has opted is concentric in nature. They were in business of manufacturing leather footwears and now they will manufacture leather bags as well. They will be able to use existing infrastructure and distribution channel. Concentric diversification amounts to related diversification.

In concentric diversification, the new business is linked to the existing businesses through process, technology or marketing. The new product is a spin-off from the existing facilities and products/processes. This means that in concentric diversification too, there are benefits of synergy with the current operations.

5. (a) To gain a deep understanding of a company’s industry and competitive environment, managers do not need to gather all the information they can find and waste a lot of time digesting it. Rather, the task is much more focused. A powerful and widely used tool for systematically diagnosing the significant competitive pressures in a market and assessing the strength and importance of each is the Porter’s five-forces model of competition. This model holds that the state of competition in an industry is a composite of competitive pressures operating in five areas of the overall market:

- Competitive pressures associated with the market manoeuvring and jockeying for buyer patronage that goes on among rival sellers in the industry.
- Competitive pressures associated with the threat of new entrants into the market.

- Competitive pressures coming from the attempts of companies in other industries to win buyers over to their own substitute products.
 - Competitive pressures stemming from supplier bargaining power and supplier-seller collaboration.
 - Competitive pressures stemming from buyer bargaining power and seller-buyer Collaboration.
- (b) Supply chain management is an extension of logistic management. However, there are differences between the two. Logistical activities typically include management of inbound and outbound goods, transportation, warehousing, handling of material, fulfillment of orders, inventory management and supply/demand planning. Although these activities also form part of supply chain management, the latter is much broader. Logistic management can be termed as one of its part that is related to planning, implementing, and controlling the movement and storage of goods, services and related information between the point of origin and the point of consumption.

Supply chain management is an integrating function of all the major business activities and business processes within and across organisations. Supply Chain Management is a systems view of the linkages in the chain consisting of different channel partners – suppliers, intermediaries, third-party service providers and customers. Different elements in the chain work together in a collaborative and coordinated manner. Often it is used as a tool of business transformation and involves delivering the right product at the right time to the right place and at the right price.

6. (a) The most important phenomenon which often distinguishes one organisation with another is its corporate culture. Corporate culture refers to a company's values, beliefs, business principles, traditions, and ways of operating and internal work environment. Every corporation has a culture that exerts powerful influences on the behaviour of managers.
- (i) **As a strength:** Culture can facilitate communication, decision making and control and instil cooperation and commitment. An organization's culture could be strong and cohesive when it conducts its business according to clear and explicit set of principles and values, which the management devotes considerable time to communicating to employees and which values are shared widely across the organisation.
- (ii) **As a weakness:** Culture, as a weakness can obstruct the smooth implementation of strategy by creating resistance to change. An organization's culture could be characterised as weak when many sub-cultures exists, few values and behavioural norms are shared and traditions are rare. In such organizations, employees do not have a sense of commitment, loyalty and sense of identity.
- (b) **Implementation control:** Managers implement strategy by converting major plans into concrete, sequential actions that form incremental steps. Implementation control is directed towards assessing the need for changes in the overall strategy in light of unfolding events and results associated with incremental steps and actions.

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

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

MOCK TEST PAPER – 1
INTERMEDIATE: GROUP – II

PAPER – 8: FINANCIAL MANAGEMENT & ECONOMICS FOR FINANCE

Time Allowed – 3 Hours

Maximum Marks – 100

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.

Maximum Marks – 60

1. Answer the following:

(a) With the help of following figures CALCULATE the market price of a share of a company by using:

- (i) Walter's formula
(ii) Dividend growth model (Gordon's formula)

Earnings per share (EPS)	Rs. 10
Dividend per share (DPS)	Rs. 6
Cost of capital (k)	20%
Internal rate of return on investment	25%
Retention Ratio	60%

(b) From the following details of X Ltd., PREPARE the Income Statement for the year ended 31st March, 20X8:

Financial Leverage	2
Interest	Rs. 5,000
Operating Leverage	3
Variable cost as a percentage of sales	75%
Income tax rate	30%

(c) Using the following information, PREPARE and complete the Balance Sheet given below:

- (i) Total debt to net worth : 1 : 2
(ii) Total assets turnover : 2
(iii) Gross profit on sales : 30%
(iv) Average collection period : 40 days
(Assume 360 days in a year)
(v) Inventory turnover ratio based on cost of goods sold and year-end inventory : 3
(vi) Acid test ratio : 0.75

**Balance Sheet
as on March 31, 20X8**

Liabilities	Rs.	Assets	Rs.
Equity Shares Capital	4,00,000	Plant and Machinery and other Fixed Assets	—
Reserves and Surplus	6,00,000		
Total Debt:		Current Assets:	
Current Liabilities	—	Inventory	—
		Debtors	—
	-	Cash	—

- (d) Determine the risk adjusted net present value of the following projects:

	X	Y	Z
Net cash outlays (Rs.)	2,10,000	1,20,000	1,00,000
Project life	5 years	5 years	5 years
Annual Cash inflow (Rs.)	70,000	42,000	30,000
Coefficient of variation	1.2	0.8	0.4

The Company selects the risk-adjusted rate of discount on the basis of the coefficient of variation:

Coefficient of Variation	Risk-Adjusted Rate of Return	P.V. Factor 1 to 5 years At risk adjusted rate of discount
0.0	10%	3.791
0.4	12%	3.605
0.8	14%	3.433
1.2	16%	3.274
1.6	18%	3.127
2.0	22%	2.864
More than 2.0	25%	2.689

[4 × 5 = 20 Marks]

2. (a) LIST the factors determining the dividend policy of a company. **[3 Marks]**
- (b) A bank is analysing the receivables of J Ltd. in order to identify acceptable collateral for a short-term loan. The company's credit policy is 2/10 net 30. The bank lends 80 percent on accounts where customers are not currently overdue and where the average payment period does not exceed 10 days past the net period. A schedule of J Ltd.'s receivables has been prepared. ANALYSE, how much will the bank lend on pledge of receivables, if the bank uses a 10 per cent allowance for cash discount and returns?

Account	Amount Rs.	Days Outstanding in days	Average Payment Period historically
74	25,000	15	20
91	9,000	45	60
107	11,500	22	24
108	2,300	9	10

114	18,000	50	45
116	29,000	16	10
123	14,000	27	48
	1,08,800		

[7 Marks]

3. X Ltd. is considering to select a machine out of two mutually exclusive machines. The company's cost of capital is 15 per cent and corporate tax rate is 30 per cent. Other information relating to both machines is as follows:

Machine – I	Machine – II
Cost of Machine	Rs. 30,00,000 Rs. 40,00,000
Expected Life	10 years. 10 years.
Annual Income (Before Tax and Depreciation)	Rs. 12,50,000 Rs. 17,50,000

Depreciation is to be charged on straight line basis:

You are required to CALCULATE:

- Discounted Pay Back Period
- Net Present Value
- Profitability Index

The present value factors of Re.1 @ 15% are as follows:

Year	01	02	03	04	05
PV factor @ 15%	0.870	0.756	0.658	0.572	0.497.

[10 Marks]

4. A Company earns a profit of Rs.6,00,000 per annum after meeting its interest liability of Rs.1,20,000 on 12% debentures. The Tax rate is 50%. The number of Equity Shares of Rs.10 each are 80,000 and the retained earnings amount to Rs.18,00,000. The company proposes to take up an expansion scheme for which a sum of Rs.8,00,000 is required. It is anticipated that after expansion, the company will be able to achieve the same return on investment as at present. The funds required for expansion can be raised either through debt at the rate of 12% or by issuing equity shares at par.

Required:

- COMPUTE the Earnings per Share (EPS), if:
 - The additional funds were raised as debt
 - The additional funds were raised by issue of equity shares.
- ADVISE the company as to which source of finance is preferable. [10 Marks]

5. A company needs Rs.31,25,000 for the construction of a new plant. The following three plans are feasible:
- The company may issue 3,12,500 equity shares at Rs. 10 per share.
 - The company may issue 1,56,250 equity shares at Rs. 10 per share and 15,625 debentures of Rs. 100 denomination bearing a 8% rate of interest.
 - The company may issue 1,56,250 equity shares at Rs. 10 per share and 15,625 cumulative preference shares at Rs. 100 per share bearing a 8% rate of dividend.

- (i) if the company's earnings before interest and taxes are Rs. 62,500, Rs. 1,25,000, Rs. 2,50,000, Rs. 3,75,000 and Rs. 6,25,000, DETERMINE earnings per share under each of three financial plans? Assume a corporate income tax rate of 40%.
- (ii) IDENTIFY which alternative would you recommend and why?
- (iii) DETERMINE the EBIT-EPS indifference points by formulae between Financing Plan I and Plan II and Plan I and Plan III. **[10 Marks]**
6. (a) EXPLAIN the difference between Business risk and Financial risk
- (b) EXPLAIN as to how the wealth maximisation objective is superior to the profit maximisation objective What is the cost of these sources?
- (c) DISCUSS the dividend-price approach to estimate cost of equity capital **[4 + 4+ 2 =10 Marks]**

PAPER – 8 SECTION B : ECONOMICS FOR FINANCE

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.

Maximum Marks - 40

7. (a) What do you understand by the term 'final good'? **(2 Marks)**
- (b) How would each of the following affect money multiplier and money supply?
- (i) Fearing shortage of money in ATMs, people decides to hoard money.
- (ii) Banks open large number of ATMs all over country.
- (iii) During the festival season, people decide to use ATMs very often. **(3 Marks)**
- (c) The table below shows the number of labour hours required to produce wheat and cloth in two countries X and Y.

Commodity	Country X	Country Y
1 unit of cloth	4	1.0
1 unit of wheat	2	2.5

- (i) Compare the productivity of labour in both countries in respect of both commodities
- (ii) Which country has absolute advantage in the production of wheat?
- (iii) Which country has absolute advantage in the production of cloth? **(3 Marks)**
- (d) What is meant by Crowding out? **(2 Marks)**
8. (a) The equilibrium level of income of an economy is Rs. 2,000 crores. The autonomous consumption expenditure is equal to Rs.100 crores and investment expenditure is Rs.500 crores. Calculate.
- (i) Consumption expenditure level of National Income.
- (ii) Marginal propensity to save and Marginal propensity to consume
- (iii) Break-even level of Income. **(5 Marks)**
- (b) (i) Describe rationale for the stabilisation function of government policy. **(3 Marks)**
- (ii) Explain the concept of Demand for Money **(2 Marks)**
9. (a) (i) What is the crux of Heckscher-Ohlin theory of International Trade **(3 Marks)**
- (ii) Define common resources? Why are they over used? **(2 Marks)**
- (b) (i) Define Foreign Direct Investment (FDI). Mention two arguments made in favor of FDI to developing economies like India? **(3 Marks)**
- (ii) What is the nature of relationship between investment and income according to Keynes? **(2 Marks)**

10. (a) (i) Explain the term Contractionary Fiscal Policy. What are the measures under taken in a contractionary fiscal policy? **(3 Marks)**
- (ii) Explain the functioning of SLR? **(2 Marks)**
- (b) (i) Explain why government imposes price ceilings **(3 Marks)**
- (ii) What is Arbitrage? What is the outcome of Arbitrage **(2 Marks)?**
11. (a) (i) Outline different components of monetary policy framework for India? **(3 Marks)**
- (ii) Write a note on two major components of Reserve Money **(2 Marks)**
- (b) (i) Define aggregate demand. How do you derive the Keynesian aggregate demand schedule? **(3 Marks)**
- (ii) What is mean by Anti-dumping duties? **(2 Marks)**
- OR
- Explain the term on market failure **(2 Marks)**

MOCK TEST PAPER – 1
INTERMEDIATE (IPC): GROUP – II
PAPER – 8: FINANCIAL MANAGEMENT & ECONOMICS FOR FINANCE
8A : FINANCIAL MANAGEMENT

Suggested Answers/Hints

1. (a) Market price per share by

(i) **Walter's formula:**
$$P = \frac{D + \frac{r}{K_e}(E - D)}{K_e}$$

$$P = \frac{6 + \frac{0.25}{0.20}(10 - 6)}{0.20}$$

$P = \text{Rs.}55$

(ii) **Gordon's formula (Dividend Growth model):** When the growth is incorporated in earnings and dividend, the present value of market price per share (P_0) is determined as follows:

Gordon's theory:

$$P_0 = \frac{E_1(1-b)}{K_e - br}$$

Where,

P_0 = Price per share

E_1 = Earnings per share

b = Retention ratio; ($1 - b$ = Payout ratio)

K_e = Cost of capital

r = IRR

br = Growth rate (g)

$$P_0 = \frac{10(1-0.60)}{0.20 - (0.60 \times 0.25)} = \text{Rs.} \frac{4}{0.05} = \text{Rs.}80$$

(b) **Workings:**

(i) Financial Leverage = $\frac{\text{EBIT}}{\text{EBIT} - \text{Interest}}$ Or, $2 = \frac{\text{EBIT}}{\text{EBIT} - \text{Rs.}5,000}$

Or, $\text{EBIT} = \text{Rs.}10,000$

(ii) Operating Leverage = $\frac{\text{Contribution}}{\text{EBIT}}$

Or, $3 = \frac{\text{Contribution}}{\text{Rs.}10,000}$

Or, Contribution = $\text{Rs.}30,000$

$$(iii) \text{ Sales} = \frac{\text{Contribution}}{\text{P/V Ratio}} = \frac{\text{Rs.30,000}}{25\%} = \text{Rs.1,20,000}$$

$$(iv) \text{ Fixed Cost} = \text{Contribution} - \text{Fixed cost} = \text{EBIT}$$

$$= \text{Rs.30,000} - \text{Fixed cost} = \text{Rs.10,000}$$

$$\text{Or, Fixed cost} = \text{Rs. 20,000}$$

Income Statement for the year ended 31st March, 20X8

Particulars	Amount (Rs.)
Sales	1,20,000
Less: Variable Cost (75% of Rs.1,20,000)	(90,000)
Contribution	30,000
Less: Fixed Cost (Contribution - EBIT)	(20,000)
Earnings Before Interest and Tax (EBIT)	10,000
Less: Interest	(5,000)
Earnings Before Tax (EBT)	5,000
Less: Income Tax @ 30%	(1,500)
Earnings After Tax (EAT or PAT)	3,500

(c) Net worth = Capital + Reserves and surplus
= 4,00,000 + 6,00,000 = Rs.10,00,000

$$\frac{\text{Total Debt}}{\text{Networth}} = \frac{1}{2}$$

∴ Total debt = Rs. 5,00,000

Total Liability side = Rs. 4,00,000 + Rs. 6,00,000 + Rs. 5,00,000
= Rs. 15,00,000

= Total Assets

Total Assets Turnover = $\frac{\text{Sales}}{\text{Total assets}}$

$$2 = \frac{\text{Sales}}{\text{Rs.15,00,000}}$$

∴ Sales = Rs. 30,00,000

Gross Profit on Sales: 30% i.e. Rs. 9,00,000

∴ Cost of Goods Sold (COGS) = Rs. 30,00,000 – Rs. 9,00,000
= Rs. 21,00,000

Inventory turnover = $\frac{\text{COGS}}{\text{Inventory}}$

$$3 = \frac{\text{Rs.21,00,000}}{\text{Inventory}}$$

∴ Inventory = Rs. 7,00,000

$$\text{Average collection period} = \frac{\text{Average debtors}}{\text{Sales / day}}$$

$$40 = \frac{\text{Debtors}}{\text{Rs.30,00,000 / 360}}$$

$$\therefore \text{Debtors} = \text{Rs.3,33,333.}$$

$$\text{Acid test ratio} = \frac{\text{Current Assets - Stock (Quick Asset)}}{\text{Current liabilities}}$$

$$0.75 = \frac{\text{Current Assets - Rs.7,00,000}}{\text{Rs.5,00,000}}$$

$$\therefore \text{Current Assets} = \text{Rs.10,75,000.}$$

$$\begin{aligned} \therefore \text{Fixed Assets} &= \text{Total Assets} - \text{Current Assets} \\ &= \text{Rs.15,00,000} - \text{Rs.10,75,000} = \text{Rs.4,25,000} \end{aligned}$$

$$\begin{aligned} \text{Cash and Bank balance} &= \text{Current Assets} - \text{Inventory} - \text{Debtors} \\ &= \text{Rs.10,75,000} - \text{Rs.7,00,000} - \text{Rs.3,33,333} = \text{Rs.41,667} \end{aligned}$$

Balance Sheet as on March 31, 20X8

Liabilities	Rs.	Assets	Rs.
Equity Share Capital	4,00,000	Plant and Machinery and other	
Reserves & Surplus	6,00,000	Fixed Assets	4,25,000
Total Debt:		Current Assets:	
Current liabilities	5,00,000	Inventory	7,00,000
		Debtors	3,33,333
		Cash	41,667
	15,00,000		15,00,000

(d) Statement showing the determination of the risk adjusted net present value

Projects	Net cash outlays	Coefficient of variation	Risk adjusted discount rate	Annual cash inflow	PV factor 1-5 years	Discounted cash inflow	Net present value
	(Rs.)			(Rs.)		(Rs.)	(Rs.)
(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii) = (v) × (vi)	(viii) = (vii) – (ii)
X	2,10,000	1.20	16%	70,000	3.274	2,29,180	19,180
Y	1,20,000	0.80	14%	42,000	3.433	1,44,186	24,186
Z	1,00,000	0.40	12%	30,000	3.605	1,08,150	8,150

2. (a) Factors Determining the Dividend Policy of a Company

- (i) Liquidity: In order to pay dividends, a company will require access to cash. Even very profitable companies might sometimes have difficulty in paying dividends if resources are tied up in other forms of assets.
- (ii) Repayment of debt: Dividend payout may be made difficult if debt is scheduled for repayment.

- (iii) Stability of Profits: Other things being equal, a company with stable profits is more likely to pay out a higher percentage of earnings than a company with fluctuating profits.
- (iv) Control: The use of retained earnings to finance new projects preserves the company's ownership and control. This can be advantageous in firms where the present disposition of shareholding is of importance.
- (v) Legal consideration: The legal provisions lay down boundaries within which a company can declare dividends.
- (vi) Likely effect of the declaration and quantum of dividend on market prices.
- (vii) Tax considerations and
- (viii) Others such as dividend policies adopted by units similarly placed in the industry, management attitude on dilution of existing control over the shares, fear of being branded as incompetent or inefficient, conservative policy Vs non-aggressive one.
- (ix) Inflation: Inflation must be taken into account when a firm establishes its dividend policy.

(b) Analysis of the receivables of J Ltd. by the bank in order to identify acceptable collateral for a short-term loan:

(i) **The J Ltd.'s credit policy is 2/10 net 30.**

The bank lends 80 per cent on accounts where customers are not currently overdue and where the average payment period does not exceed 10 days past the net period i.e. thirty days. From the schedule of receivables of J Ltd. Account No. 91 and Account No. 114 are currently overdue and for Account No. 123 the average payment period exceeds 40 days. Hence Account Nos. 91, 114 and 123 are eliminated. Therefore, the selected Accounts are Account Nos. 74, 107, 108 and 116.

(ii) Statement showing the calculation of the amount which the bank will lend on a pledge of receivables if the bank uses a 10 per cent allowances for cash discount and returns

Account No.	Amount (Rs.)	90 per cent of amount (Rs.)	80% of amount (Rs.)
	(a)	(b) = 90% of (a)	(c) = 80% of (b)
74	25,000	22,500	18,000
107	11,500	10,350	8280
108	2,300	2,070	1,656
116	29,000	26,100	20,880
Total loan amount			48,816

3. Working Notes:

$$\text{Depreciation on Machine - I} = \frac{30,00,000}{10} = \text{Rs. } 3,00,000$$

$$\text{Depreciation on Machine - II} = \frac{40,00,000}{10} = \text{Rs. } 4,00,000$$

Particulars	Machine-I (Rs.)	Machine - II (Rs.)
Annual Income (before Tax and Depreciation)	12,50,000	17,50,000
Less: Depreciation	3,00,000	4,00,000
Annual Income (before Tax)	9,50,000	13,50,000
Less: Tax @ 30%	(2,85,000)	(4,05,000)

Annual Income (after Tax)	6,65,000	9,45,000
Add: Depreciation	3,00,000	4,00,000
Annual Cash Inflows	9,65,000	13,45,000

Year	Machine - I				Machine - II		
	PV of Re 1 @ 15%	Cash flow	PV	Cumulative PV	Cash flow	PV	Cumulative PV
1	0.870	9,65,000	8,39,550	8,39,550	13,45,000	11,70,150	11,70,150
2	0.756	9,65,000	7,29,540	15,69,090	13,45,000	10,16,820	21,86,970
3	0.658	9,65,000	6,34,970	22,04,060	13,45,000	8,85,010	30,71,980
4	0.572	9,65,000	5,51,980	27,56,040	13,45,000	7,69,340	38,41,320
5	0.497	9,65,000	4,79,605	32,35,645	13,45,000	6,68,465	45,09,785

(i) Discounted Payback Period

Machine - I

$$\text{Discounted Payback Period} = 4 + \frac{(30,00,000 - 27,56,040)}{4,79,605}$$

$$= 4 + \frac{2,43,960}{4,79,605} = 4 + 0.5087 = 4.5087 \text{ years or } 4 \text{ years } 6.10 \text{ months}$$

Machine - II

$$\text{Discounted Payback Period} = 4 + \frac{(40,00,000 - 38,41,320)}{6,68,465}$$

$$= 4 + \frac{1,58,680}{6,68,465} = 4 + 0.2374 = 4.2374 \text{ years or } 4 \text{ years } 2.85 \text{ months}$$

(ii) Net Present Value (NPV)

Machine - I

$$\text{NPV} = 32,35,645 - 30,00,000 = \text{Rs. } 2,35,645$$

Machine - II

$$\text{NPV} = 45,09,785 - 40,00,000 = \text{Rs. } 5,09,785$$

(iii) Profitability Index

Machine - I

$$\text{Profitability Index} = \frac{32,35,645}{30,00,000} = 1.08$$

Machine - II

$$\text{Profitability Index} = \frac{45,09,785}{40,00,000} = 1.13$$

Conclusion:

Method	Machine - I	Machine - II	Rank
Discounted Payback Period	4.51 years	4.24 years	II
Net Present Value	Rs. 2,35,645	Rs. 5,09,785	II
Profitability Index	1.08	1.13	II

4. Working Notes:**1. Capital employed before expansion plan:**

	(Rs.)
Equity shares (Rs.10 × 80,000 shares)	8,00,000
Debentures {(Rs.1,20,000/12) × 100}	10,00,000
Retained earnings	18,00,000
Total capital employed	36,00,000

2. Earnings before the payment of interest and tax (EBIT):

	(Rs.)
Profit (EBT)	6,00,000
Add: Interest	1,20,000
EBIT	7,20,000

3. Return on Capital Employed (ROCE):

$$\text{ROCE} = \frac{\text{EBIT}}{\text{Capital employed}} \times 100 = \frac{\text{Rs.7,20,000}}{\text{Rs.36,00,000}} \times 100 = 20\%$$

4. Earnings before interest and tax (EBIT) after expansion scheme:

$$\begin{aligned} \text{After expansion, capital employed} &= \text{Rs.36,00,000} + \text{Rs.8,00,000} \\ &= \text{Rs.44,00,000} \end{aligned}$$

$$\text{Desired EBIT} = 20\% \times \text{Rs.44,00,000} = \text{Rs.8,80,000}$$

(i) Computation of Earnings Per Share (EPS) under the following options:

	Present situation (Rs.)	Expansion scheme Additional funds raised as	
		Debt (Rs.)	Equity (Rs.)
Earnings before Interest and Tax (EBIT)	7,20,000	8,80,000	8,80,000
Less: Interest - Old capital	1,20,000	1,20,000	1,20,000
- New capital	--	96,000 (Rs.8,00,000 × 12%)	--
Earnings before Tax (EBT)	6,00,000	6,64,000	7,60,000
Less: Tax (50% of EBT)	3,00,000	3,32,000	3,80,000
PAT	3,00,000	3,32,000	3,80,000
No. of shares outstanding	80,000	80,000	1,60,000

Earnings per Share (EPS)	3.75	4.15	2.38
	$\left(\frac{\text{Rs.}3,00,000}{80,000} \right)$	$\left(\frac{\text{Rs.}3,32,000}{80,000} \right)$	$\left(\frac{\text{Rs.}3,80,000}{1,60,000} \right)$

(ii) **Advise to the Company:** When the expansion scheme is financed by additional debt, the EPS is higher. Hence, the company should finance the expansion scheme by raising debt.

5. (i) **Computation of EPS under three-financial plans.**

Plan I: Equity Financing

	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)
EBIT	62,500	1,25,000	2,50,000	3,75,000	6,25,000
Interest	0	0	0	0	0
EBT	62,500	1,25,000	2,50,000	3,75,000	6,25,000
Less: Tax @ 40%	25,000	50,000	1,00,000	1,50,000	2,50,000
PAT	37,500	75,000	1,50,000	2,25,000	3,75,000
No. of equity shares	3,12,500	3,12,500	3,12,500	3,12,500	3,12,500
EPS	0.12	0.24	0.48	0.72	1.20

Plan II: Debt – Equity Mix

	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)
EBIT	62,500	1,25,000	2,50,000	3,75,000	6,25,000
Less: Interest	1,25,000	1,25,000	1,25,000	1,25,000	1,25,000
EBT	(62,500)	0	1,25,000	2,50,000	5,00,000
Less: Tax @ 40%	25,000*	0	50,000	1,00,000	2,00,000
PAT	(37,500)	0	75,000	1,50,000	3,00,000
No. of equity shares	1,56,250	1,56,250	1,56,250	1,56,250	1,56,250
EPS	(Rs. 0.24)	0	0.48	0.96	1.92

* The Company can set off losses against the overall business profit or may carry forward it to next financial years.

Plan III: Preference Shares – Equity Mix

	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)
EBIT	62,500	1,25,000	2,50,000	3,75,000	6,25,000
Less: Interest	0	0	0	0	0
EBT	62,500	1,25,000	2,50,000	3,75,000	6,25,000
Less: Tax @ 40%	25,000	50,000	1,00,000	1,50,000	2,50,000
PAT	37,500	75,000	1,50,000	2,25,000	3,75,000
Less: Pref. dividend	1,25,000*	1,25,000*	1,25,000	1,25,000	1,25,000
PAT after Pref. dividend.	(87,500)	(50,000)	25,000	1,00,000	2,50,000
No. of Equity shares	1,56,250	1,56,250	1,56,250	1,56,250	1,56,250
EPS	(0.56)	(0.32)	0.16	0.64	1.60

* In case of cumulative preference shares, the company has to pay cumulative dividend to preference shareholders, when company earns sufficient profits.

(ii) From the above EPS computations tables under the three financial plans we can see that when EBIT is Rs. 2,50,000 or more, Plan II: Debt-Equity mix is preferable over the Plan I and Plan III, as rate of EPS is more under this plan. On the other hand an EBIT of less than Rs.2,50,000, Plan I:

Equity Financing has higher EPS than Plan II and Plan III. Plan III Preference share-Equity mix is not acceptable at any level of EBIT, as EPS under this plan is lower.

The choice of the financing plan will depend on the performance of the company and other macro-economic conditions. If the company is expected to have higher operating profit Plan II: Debt – Equity Mix is preferable. Moreover, debt financing gives more benefit due to availability of tax shield.

(iii) EBIT – EPS Indifference point : Plan I and Plan II

$$\frac{\text{EBIT}_1 \times (1-t)}{\text{No. of equity shares (N}_1)} = \frac{(\text{EBIT}_2 - \text{Interest}) \times (1-t)}{\text{No. of equity shares (N}_2)}$$

$$\frac{\text{EBIT}(1-0.40)}{3,12,500 \text{ shares}} = \frac{(\text{EBIT} - \text{Rs. } 1,25,000) \times (1-0.40)}{1,56,250 \text{ shares}}$$

$$0.6 \text{ EBIT} = 1.2 \text{ EBIT} - \text{Rs. } 1,50,000$$

$$\text{EBIT} = \frac{\text{Rs. } 1,50,000}{0.6} = \text{Rs. } 2,50,000$$

Indifference points between Plan I and Plan II is Rs. 2,50,000

EBIT – EPS Indifference Point: Plan I and Plan III

$$\frac{\text{EBIT}_1 \times (1-t)}{\text{No. of equity shares (N}_1)} = \frac{\text{EBIT}_3 \times (1-t) - \text{Pr ef. dividend}}{\text{No. of equity shares (N}_3)}$$

$$\frac{\text{EBIT}_1(1-0.40)}{3,12,500 \text{ shares}} = \frac{\text{EBIT}_3(1-0.40) - \text{Rs. } 1,25,000}{1,56,250 \text{ shares}}$$

$$0.6 \text{ EBIT} = 1.2 \text{ EBIT} - \text{Rs. } 2,50,000$$

$$\text{EBIT} = \frac{\text{Rs. } 2,50,000}{0.6} = \text{Rs. } 4,16,667$$

Indifference points between Plan I and Plan III is Rs. 4,16,667.

6. (a) Business Risk and Financial Risk

Business risk refers to the risk associated with the firm's operations. It is an unavoidable risk because of the environment in which the firm has to operate and the business risk is represented by the variability of earnings before interest and tax (EBIT). The variability in turn is influenced by revenues and expenses. Revenues and expenses are affected by demand of firm's products, variations in prices and proportion of fixed cost in total cost.

Whereas, Financial risk refers to the additional risk placed on firm's shareholders as a result of debt use in financing. Companies that issue more debt instruments would have higher financial risk than companies financed mostly by equity. Financial risk can be measured by ratios such as firm's financial leverage multiplier, total debt to assets ratio etc.

(b) A firm's financial management may often have the following as their objectives:

- (i) The maximisation of firm's profit.
- (ii) The maximisation of firm's value / wealth.

The maximisation of profit is often considered as an implied objective of a firm. To achieve the aforesaid objective various type of financing decisions may be taken. Options resulting into maximisation of profit may be selected by the firm's decision makers. They even sometime may adopt policies yielding exorbitant profits in short run which may prove to be unhealthy for the

growth, survival and overall interests of the firm. The profit of the firm in this case is measured in terms of its total accounting profit available to its shareholders.

The value/wealth of a firm is defined as the market price of the firm's stock. The market price of a firm's stock represents the focal judgment of all market participants as to what the value of the particular firm is. It takes into account present and prospective future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock.

The value maximisation objective of a firm is superior to its profit maximisation objective due to following reasons.

1. The value maximisation objective of a firm considers all future cash flows, dividends, earning per share, risk of a decision etc. whereas profit maximisation objective does not consider the effect of EPS, dividend paid or any other returns to shareholders or the wealth of the shareholder.
2. A firm that wishes to maximise the shareholders wealth may pay regular dividends whereas a firm with the objective of profit maximisation may refrain from dividend payment to its shareholders.
3. Shareholders would prefer an increase in the firm's wealth against its generation of increasing flow of profits.
4. The market price of a share reflects the shareholders expected return, considering the long-term prospects of the firm, reflects the differences in timings of the returns, considers risk and recognizes the importance of distribution of returns.

The maximisation of a firm's value as reflected in the market price of a share is viewed as a proper goal of a firm. The profit maximisation can be considered as a part of the wealth maximisation strategy.

- (c) In dividend price approach, cost of equity capital is computed by dividing the expected dividend by market price per share. This ratio expresses the cost of equity capital in relation to what yield the company should pay to attract investors. It is computed as:

$$K_e = \frac{D_1}{P_0}$$

Where,

D_1 = Dividend per share in period 1

P_0 = Market price per share today.

PAPER – 8B: ECONOMICS FOR FINANCE

SUGGESTED ANSWERS/HINTS

7. (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.
- (b) (i) When people hold more money, it increases the currency-deposit ratio; reduces money multiplier; money supply declines.
- (ii) ATMs let people to withdraw cash from the bank as and when needed, reduces cost of conversion of deposits to cash and makes deposits relatively more convenient. People hold less cash and more deposits, thus reducing the currency-deposit ratio; increasing the money multiplier causing the money supply to increase.
- (iii) If people, for any reason, are expected to withdraw money from ATMs with more frequency, then banks will want to keep more reserves. This will raise the reserve ratio, and lower the money multiplier. As a result, money supply will decline.
- (c) (i) Productivity of labour (output per labour hour = the volume of output produced per unit of labour input)

$$= \text{output} / \text{input of labour hours}$$

Output of commodity	Units in Country X	Units in Country Y
Cloth	0.25	1.0
Wheat	0.50	0.4

- (ii) A country has an absolute advantage in producing a good over another country if it requires fewer resources to produce that good. Since one hour of labour time produces 0.5 units of wheat in country X against 0.4 units in country Y. Therefore, Country X has absolute advantage in production of wheat.
- (iii) Since one hour of labour time produces 1.0 units of rice in country Y against 0.25 units in country X. Therefore, Country Y has absolute advantage in production of cloth.
- (d) A decline in private spending may be partially or completely offset the expansion of demand resulting from an increase in government expenditure. Crowding out effect is the negative effect fiscal policy may generate when money from the private sector is 'crowded out' to the public sector. Private investments, especially the ones which are interest –sensitive, will be reduced if interest rates rise due to increased spending by government.
8. (a) (i) Consumption expenditure at equilibrium level of National Income
 $Y = C + I$ [$AD = C + I$]
 Putting the value of Investment Expenditure (I) = Rs.500 Crores and Income (Y) = Rs. 2000 crores, we get $C = 2,000 - 500$
 $C = \text{Rs.1500 Crores}$
- (ii) Marginal Propensity to Save (MPS)
 Consumption function is given by
 $C = a + bY$
 $1500 = 100 + 2000b$
 $2000b = 1400$

$$\text{MPC} = 0.7$$

$$\text{MPS} = 1 - \text{MPC} = 1 - 0.7 = 0.3$$

(iii) Break-even level of Income attained at break-even point = $C = Y$

Putting $Y = C$

$$Y = 100 + 0.7Y$$

$$0.3Y = 100$$

$$Y = 333.33$$

- (b) (i) Stabilization function is one of the key functions of fiscal policy and aims at eliminating macroeconomic fluctuations arising from suboptimal allocation. The stabilization function is concerned with the performance of the aggregate economy in terms of labour employment and capital utilization, overall output and income, general price levels, economic growth and balance of international payments. Government's stabilization intervention may be through monetary policy as well as fiscal policy. Monetary policy has a singular objective of controlling the size of money supply and interest rate in the economy, while fiscal policy aims at changing aggregate demand by suitable changes in government spending and taxes.
- (ii) The demand for money is a decision about how much of one's given stock of wealth should be held in the form of money rather than as other assets such as bonds. Demand for money is actually demand for liquidity and a demand to store value.
9. (a) (i) The Heckscher-Ohlin theory of trade, also referred to as Factor-Endowment Theory of Trade or Modern Theory of Trade, states that comparative advantage in cost of production is explained exclusively by the differences in factor endowments.
- A country tends to specialize in the export of a commodity whose production requires intensive use of its abundant resources and imports a commodity whose production requires intensive use of its scarce resources.
- Accordingly, a capital abundant country will produce and export capital intensive goods relatively more cheaply and a labour-abundant country will produce and export labour intensive goods relatively more cheaply than another country.
- (ii) Common access resources or common pool resources are a special class of impure public goods which are non-excludable as people cannot be excluded from using them. These are rival in nature and their consumption lessens the benefits available for others. This rival nature of common resources is what distinguishes them from pure public goods, which exhibit both non-excludability and non-rivalry in consumption. They are generally available free of charge. Some important natural resources fall into this category.
- Examples of common access resources are fisheries, common pastures, rivers, sea, backwaters biodiversity etc. The earth's atmosphere is perhaps the best example. Emissions of carbon dioxide and other greenhouse gases have led to the depletion of the ozone layer endangering environmental sustainability. Although nations are aware of the fact that reduced global warming would benefit everyone, they have an incentive to free ride, with the result that nothing positive is likely to be done to correct the problem.
- (b) (i) Foreign direct investment is defined as a process whereby the resident of one country (i.e. home country) acquires ownership of an asset in another country (i.e. the host country) and such movement of capital involves ownership, control as well as management of the asset in the host country. Direct investments are real investments in factories, assets, land, inventories etc. and have three components, viz., equity capital, reinvested earnings and other direct capital in the form of intra-company loans. Foreign direct investment also includes all subsequent investment transactions between the investor and the enterprise and among affiliated enterprises, both incorporated and unincorporated. FDI involves long term

relationship and reflects a lasting interest and control. According to the IMF and OECD definitions, the acquisition of at least ten percent of the ordinary shares or voting power in a public or private enterprise by non-resident investors makes it eligible to be categorized as FDI. FDI may be categorized as horizontal, vertical, conglomerate and two-way direct foreign investments which are reciprocal investments.

Benefits of Foreign Direct Investment

Following are the benefits ascribed to foreign investments:

- (i) Entry of foreign enterprises usually fosters competition and generates a competitive environment in the host country.
 - (ii) International capital allows countries to finance more investment than can be supported by domestic savings resulting in higher productivity and enhanced output.
- (ii) Keynes argued that, in the short run, investment is best viewed as an autonomous expenditure, that is, it is independent of people's income. The Keynesian model assumes that the planned level of investment expenditure is constant with respect to current income. Investment is determined by factors other than income such as business expectations and economic policy.
- 10. (a) (i)** When aggregate demand rises beyond what the economy can potentially produce by fully employing its given resources; it gives rise to inflationary pressures in the economy. The aggregate demand may rise due to large increase in consumption demand by households or investment expenditure by entrepreneurs, or government expenditure. In these circumstances inflationary gap occurs which tends to bring about rise in prices. Under such circumstances, a contractionary fiscal policy will have to be used.

Contractionary fiscal policy refers to the deliberate policy of government applied to curtail aggregate demand and consequently the level of economic activity. In other words, it is fiscal policy aimed at eliminating an inflationary gap. This is achieved by adopting policy measures that would result in the aggregate demand curve (AD) shift to the left so the equilibrium may be established at the full employment level of real GDP.

This can be achieved either by:

- Decrease in government spending.
 - Increase in personal income taxes and/or business taxes.
 - A combination of decrease in government spending and increase in personal income taxes and/or business taxes.
- (ii) Changes in SLR chiefly influence the availability of resources in the banking system for lending. A rise in SLR -during periods of high liquidity - to lock up a rising fraction of a bank's assets in the form of eligible instruments – reduces the credit creation capacity of banks. A reduction in SLR during periods of economic downturn has the opposite effect.
- (b) (i)** When prices of certain essential commodities rise excessively, government may resort to controls in the form of price ceilings (also called maximum price) for making a resource or commodity available to all at reasonable prices. For example: maximum prices of food grains and essential items are set by government during times of scarcity. A price ceiling which is set below the prevailing market clearing price will generate excess demand over supply.

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

- (ii) Arbitrage refers to the practice of making risk-less profits by intelligently exploiting price differences of an asset at different dealing places. On account of arbitrage, regardless of physical location, at any given moment, all markets tend to have the same exchange rate for a given currency
11. (a) (i) The central bank in its execution of monetary policy, functions within an articulated monetary policy framework which comprises of:
- **the objectives of monetary policy**, such as maintenance of price stability (or controlling inflation) and achievement of economic growth
 - **the analytics of monetary policy** which focus on the transmission mechanisms, or the ways in which monetary policy actions get transmitted to the real economy and
 - **the operating procedure** which relates to all aspects of implementation of monetary policy namely, choosing the operating target, choosing the intermediate target, and choosing the policy instruments.
- (ii) Reserve money has two major components – currency in circulation and reserves. Currency in circulation comprises currency with the public and cash in hand with banks. Reserves are bank deposits with the central bank
- (b) (i) Aggregate demand is the total quantity of finished goods and services that all sectors (consumers, firms, government and the rest of the world) together wish to buy under different conditions. The components of aggregate demand are consumption demand, investment demand, government spending and net exports at each level of income. While consumption demand is a function of the level of disposable income, the demand for investment, government spending and net exports are autonomous, i.e. these are determined outside the model and are specifically assumed to be independent of income.

The Keynesian aggregate demand schedule is obtained by vertically adding the demand for consumption, investment demand, government spending and net exports at each level of income.

$$AD = C + I + G + NX$$

- (ii) Anti-dumping measures consist of imposition of additional import duties to offset the effects of dumping. These measures are initiated as safeguards to offset the foreign firm's unfair price advantage. This is justified only if the domestic industry is seriously injured by import competition, and protection is in the national interest (that is, the associated costs to consumers would be less than the benefits that would accrue to producers).

OR

- (ii) Market failure is a situation in which the free market fails to allocate resources efficiently in the sense that there is either overproduction or underproduction of particular goods and services leading to less than optimal market outcomes.