

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

GROUP – II**

**REVISION TEST PAPERS

NOVEMBER, 2020**



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

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REVISION TEST PAPER, NOVEMBER, 2020 – OBJECTIVE & APPROACH

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

I Objective of Revision Test Paper

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

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

The primary objectives of the RTP are:

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

RTPs contain the following:

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

Students must bear in mind that the RTP contains a variety of questions based on different sections of the syllabi and thus a comprehensive study of the entire syllabus is a pre-requisite before answering the questions of the RTP. In other words, in order to derive maximum benefit out of the RTPs, it is advised that before proceeding to solve the questions given in the RTP, students ought to have thoroughly read the Study Materials.

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

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

II. Planning and preparing for examination

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

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

Examination tips

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

- Reach the examination hall well in time.
- As soon as you get the question paper, read it carefully and thoroughly. You are given separate 15 minutes for reading the question paper.
- Plan your time so that appropriate time is awarded for each question. Keep sometime for checking the answers as well.
- First impression is the last impression. The question which you can answer in the best manner should be attempted first.
- Always attempt to do all questions. Therefore, it is important that you must finish each question within allocated time.
- Read the question carefully more than once before starting the answer to understand very clearly as to what is required.
- Answer all parts of a question one after the other; do not answer different parts of the same question at different places.

- Write in a neat and legible hand-writing.
- Always be concise and write to the point and do not try to fill pages unnecessarily.
- There must be logical expression of the answer.
- In case a question is not clear, you may state your assumptions and then answer the question.
- Check your answers carefully and underline important points before leaving the examination hall.

III. Subject-wise Guidance – An Overview

PAPER 5: ADVANCED ACCOUNTING

The Revisionary Test Paper (RTP) of Advanced Accounting is divided into two parts viz Part I - Relevant Announcements, Amendments and Notifications for November, 2020 examination and Part II –Questions and Answers.

It may be noted that the July, 2019 edition of the Study Material is relevant for November, 2020 Examination.

Part I of the Revisionary Test Paper consists of the 'Relevant Amendments and Notifications - applicable and not applicable' for November, 2020 examination. It also contains the topics which have been added or removed in the syllabus. The purpose of this information in the RTP is to apprise the students with the latest developments applicable for November, 2020 examination. The brief summary of the same has been given as under:

A. Applicable for November, 2020 examination:

- I. Amendments in Schedule III (Division I) to the Companies Act, 2013
- II. Maintenance of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR)
- III. Enhanced borrowing facility provided to the banks to meet their liquidity shortages till September 30, 2020
- IV. Sale of Securities held in Held to Maturity (HTM) Category
- V. Merging three categories of NBFCs viz. Asset Finance Companies (AFC), Loan Companies (LCs) and Investment Companies (ICs) into a new category called Investment and Credit Company (NBFC-ICC)

B. Not applicable for November, 2020 examination:

- I. Ind ASs issued by the Ministry of Corporate Affairs.

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

Accounting Standards/topics newly included in the curriculum

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

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

Exclusion of topics from the curriculum

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

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

Question No.	Topic
1	Dissolution of partnership firm
2	Limited Liability Partnerships
3	Accounting for ESOPs
4	Buy Back of Securities
5	Equity Shares with Differential Rights
6	Amalgamation of companies
7	Internal Reconstruction of a Company
8	Liquidation of a Company
9	Banking Companies
10	NBFCs
11	Consolidated Financial Statements
12 to 20	Accounting Standards

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

PAPER – 6: AUDITING AND ASSURANCE

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

The Revisionary Test Paper (RTP) of Auditing and Assurance for November, 2020 carries twenty eight descriptive questions along with Integrated Case Scenarios followed by MCQs and standalone MCQs along with their answers. These questions have been taken from the entire syllabus which is divided into thirteen chapters along with engagement and quality control standards etc. discussed in the study material.

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

This RTP of Auditing and Assurance has been divided into two parts viz Part I – Legislative Amendments / Notifications / Circulars / Rules / Guidelines issued by Regulating Authority relevant for November, 2020 examination and Part II – Questions and Answers.

The relevant notified sections of the Companies Act, 2013 and other legislative amendments including relevant Notifications / Circulars / Rules / Guidelines issued by Regulating Authorities up to 30th April, 2020 are applicable for November, 2020 Examination. The questions have been answered in this RTP keeping in view latest amendments as per above mentioned date.

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

The Revision Test Paper on Enterprise Information Systems is a supplementary tool that provides comprehensive view of the entire syllabus which is divided into five chapters. It is based on the study material that is already provided to the students. The chapter-wise questions and answers are provided so that students could test their preparation level for the examination.

The RTP for November 2020 examination contains total 15 questions out of which first 5 questions are Multiple Choice Questions (MCQ). The Questions numbered 1 to 4 are based on Integrated Case Scenario whereas Question number 5 is independent MCQ based to test Analysis and Application skillset of the student. Each MCQ has four options out of which only one option is correct.

Remaining 10 Descriptive questions numbered 6 to 15 are provided chapter-wise with 2 questions from each chapter. These questions have been selected from various topics keeping in view the complete and uniform coverage of the complete syllabus to check the students' preparedness on answering the questions based on different skill levels "Comprehension & Knowledge" as well as "Analysis & Application". The questions provide an insight to the students on evaluate their understanding of the fundamental concepts of Information Systems and Business Process flows, Financial and Accounting Systems, Core Banking Systems and e-Commerce/m-Commerce transactions. Full answer to each descriptive question is provided so that students would be benefited without searching the answers in the study material.

Section – B: Strategic Management

The Revision Test Paper in the subject of Strategic Management for the November, 2020 examination contains twenty two questions. The questions have been selected from all the sections/chapters uniformly to cover whole syllabus. Questions are based on different skill levels, i.e., "Comprehension & Knowledge" as well as "Analysis & Application".

The questions included are of different categories – multiple choice questions based on case scenario, application based and simple multiple choice questions, distinguish between, short notes, descriptive and questions based on practical scenarios. The first question contains multiple choice questions based on case scenario are subdivided into five different parts. Questions from two to six are mixed of application based and simple multiple choice questions. All multiple choice questions are given with four alternatives and the student has to opt the correct option. Subsequently, sixteen different questions have been included to cover all the eight chapters of the syllabus. Chapter names have been mentioned before questions. A descriptive question based on practical scenario has been included from each section. Another descriptive question has also been included from each section of the syllabus.

The students should take up this Revision test paper as a tool to check their preparedness in the subject. Mere reading of Revision Test Paper will not be helpful. To properly self-assess the preparation in the subject, students must attempt the questions on their own. Compare your answers with the suggested answers and hints given to assess the level of preparation and identify areas where more focus is required. Then you may work on these areas to improve the quality of answers that you write.

Work hard and perform well in the examination!

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

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

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

Q. No.	Topic	About the Problem
1.	Ratio Analysis	Preparation of summarised Balance Sheet.
2.	Cost of Capital	Calculation of the weighted average cost of capital.
3.	Capital Structure	Calculation of rate of dividend on preference shares.
4.	Leverage	Calculation of degree of financial leverage, degree of operating leverage at different sales unit.
5.	Investment Decisions	Evaluation of Project.
6.	Receivable Management of working capital	Analyzing credit policies.
7.	Risk Analysis in Capital Budgeting	Evaluation of Project by calculating NPV.
8.	Dividend Decisions	Calculation of market value per share as per Gordon's and Walter's model.
9.	Management of working capital	Preparation of Balance Sheet and Calculation of Working Capital Requirement
10 (a)	Introduction to Financial Management	Agency problem and agency cost
10 (b)	Type of Financing	Financial Lease and Operating Lease

Section B : Economics for Finance

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

The first question relates to simple calculations like finding various components of National Income such as NNPF, NNPM, GNP and GDP and also about how much of the given sale proceeds will be included in national income calculation.

Second question is about estimation of equilibrium level of income and trade balance as well as about how an increase in the marginal propensity to consume impacts consumption expenditure.

Third question relates to three branch taxonomy of the role of government in a market economy. It also asks about why do economists use the word external to describe third-party effects that are harmful or beneficial.

In the fourth question provision of subsidies by the government and concept of price floor with examples have been enquired.

Fifth question relates to the tradable emissions permits.

Sixth question enquires about the influence of different variables on demand for money according to Inventory Theoretic Approach.

Seventh question is concerned about the reflection of the behavior of central bank in economy. Its part b relates to M1 and M2.

In the eighth question, different types of agreements that take place during the negotiations of trade have been asked.

Ninth question relates to Agreement on Trade-Related Investment Measures (TRIMs).

Tenth question requires students to find out (in the question given) which country has absolute advantage and comparative advantage of international trade.

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

PAPER – 5: ADVANCED ACCOUNTING

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

A. Applicable for November, 2020 Examination

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

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

- (A) under the heading “II Assets”, under sub-heading “Non-current assets”, for the words “Fixed assets”, the words “Property, Plant and Equipment” shall be substituted;
- (B) in the “Notes”, under the heading “General Instructions for preparation of Balance Sheet”, in paragraph 6,-
 - (I) under the heading “B. Reserves and Surplus”, in item (i), in sub- item (c), the word “Reserve” shall be omitted;
 - (II) in clause W., for the words “fixed assets”, the words “Property, Plant and Equipment” shall be substituted.

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

Statutory Liquidity Ratio (SLR)

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

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

(v) 18.25 per cent from January 4, 2020

(vi) 18.00 per cent from April 11, 2020

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

Cash Reserve Ratio (CRR)

As per RBI Circular no. DOR.No.Ret.BC.50/12.01.001/2019-20 dated March 27, 2020, the Reserve Bank of India hereby notifies that the average Cash Reserve Ratio (CRR) required to be maintained by every Bank shall be 3.00* per cent of its net demand and time liabilities from the fortnight beginning March 28, 2020 for a period of one year, ending on March 26, 2021.

* Earlier it was 4%.

III. Enhanced borrowing facility provided to the banks to meet their liquidity shortages till September 30, 2020

As per RBI Circular no. RBI/2019-20/259DOR.No.Ret.BC.77/12.02.001/2019-20 applicable for All Scheduled Banks (excluding Regional Rural Banks) dated June 26, 2020 and Statement of Developmental and Regulatory Policies dated March 27, 2020, the borrowing limit of scheduled banks under the Marginal Standing Facility (MSF scheme), by dipping into the prescribed SLR, was increased from 2 per cent to 3 per cent of their Net Demand and Time Liabilities (NDTL) outstanding at the end of the second preceding fortnight with immediate effect. This relaxation was earlier available up to June 30, 2020. It has now been decided to extend this enhanced limit till September 30, 2020.

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

Accounting treatment

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

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

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

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

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

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

B. Not applicable for November, 2020 examination**Non-Applicability of Ind AS for November, 2020 Examination**

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

Change in in the curriculum of Advanced Accounting at Intermediate level w.e.f. May, 2020 Examination**Accounting Standards/topics newly included in the curriculum**

- Application of Accounting Standards: AS 4; AS 5; AS 17 and AS 22
- Dissolution of partnership firms including piecemeal distribution of assets; Amalgamation of partnership firms; Conversion of partnership firm into a company and Sale to a company; Issues related to accounting in Limited Liability Partnership.

Exclusion of topics from the curriculum

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

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

PART – II : QUESTIONS AND ANSWERS**QUESTIONS****Dissolution of partnership firm**

1. Amit, Sumit and Kumar are partners sharing profit and losses in the ratio 2:2:1. The partners decided to dissolve the partnership on 31st March, 2020 when their Balance Sheet was as under:

Liabilities	Amount	Assets	Amount
Capital Accounts:		Land & Building	1,35,000
Amit	55,200	Plant & Machinery	45,000
Sumit	55,200	Furniture	25,500
General Reserve	61,500	Investments	15,000

Kumar's Loan A/c	15,000	Book Debts	60,000	
Loan from D	1,20,000	Less: Prov. for bad debts	(6,000)	54,000
Trade Creditors	30,000	Stock		36,000
Bills Payable	12,000	Bank		13,500
Outstanding Salary	7,500	Capital Withdrawn:		
		Kumar		<u>32,400</u>
Total	<u>3,56,400</u>	Total		<u>3,56,400</u>

The following information is given to you:

- (i) Realization expenses amounted to ₹ 18,000 out of which ₹ 3,000 was borne by Amit.
- (ii) A creditor agreed to takeover furniture of book value ₹ 12,000 at ₹ 10,800. The rest of the creditors were paid off at a discount of 6.25%.
- (iii) The other assets realized as follows:
 - Furniture - Remaining taken over by Kumar at 90% of book value
 - Stock - Realized 120% of book value
 - Book Debts - ₹ 12,000 of debts proved bad, remaining were fully realized
 - Land & Building - Realized ₹ 1,65,000
 - Investments - Taken over by Amit at 15% discount
- (iv) For half of his loan, D accepted Plant & Machinery and ₹ 7,500 cash. The remaining amount was paid at a discount of 10%.
- (v) Bills payable were due on an average basis of one month after 31st March, 2020, but they were paid immediately on 31st March @ 6% discount "per annum".

Prepare the Realization Account, Bank Account and Partners' Capital Accounts in columnar form in the books of Partnership firm.

Limited Liability Partnerships

2. (a) Explain the provisions related with liability of Limited Liability Partnership (LLP) and its partners as per LLP Act, 2008.
- (b) What are circumstances when LLP can be wound up by the Tribunal. Explain in brief.

Accounting for ESOPs

3. Kaushal Ltd. has its share capital divided into equity shares of ₹ 10 each. On 1.1.2020 it granted 5,000 employee stock options at ₹ 30 per share, when the market price was ₹ 50 per share. The options were to be exercised till the month of March, 2020. The employees exercised their options for 3,600 shares only and the remaining options lapsed. Show Journal entries (with narration) as would appear in the books of the company till the

month of March, 2020 relating to ESOPs as the company closes its books on 31st March every year.

Buy Back of Securities

4. Pratham Ltd. (a non-listed company) has the following Capital structure as on 31st March, 2020:

Particulars	₹	₹
Equity Share Capital (shares of ₹ 10 each fully paid)		30,00,000
Reserves & Surplus		
General Reserve	32,50,000	
Security Premium Account	6,00,000	
Profit & Loss Account	4,30,000	
Revaluation Reserve	<u>6,20,000</u>	49,00,000
Loan Funds		42,00,000

You are required to compute by Debt Equity Ratio Test, the maximum number of shares that can be bought back in the light of above information, when the offer price for buy back is ₹ 30 per share.

Equity Shares with Differential Rights

5. (a) What do you mean by equity shares with differential rights. Explain in brief. Can preference shares be also issued with differential rights?
- (b) E, F, G and H hold Equity Capital in Alpha Co. in the proportion of 30:30:20:20. S, T, U and V hold preference share capital in the proportion of 40:30:10:20. If the paid up capital of the company is ₹ 120 Lakh and Preference share capital is ₹ 60 Lakh, You are required to calculate their voting rights in case of resolution of winding up of the company.

Amalgamation of Companies

6. X Ltd. and Y Ltd. give the following information of assets, equity and liabilities as on 31st March, 2018:

	X Ltd. (₹)	Y Ltd. (₹)
Equity and Liabilities		
Equity Shares of ₹ 10 each	30,00,000	9,00,000
9% Preference Shares of ₹ 100 each	3,00,000	-
10% Preference Shares of ₹ 100 each	-	3,00,000
General Reserve	2,10,000	2,10,000
Retirement Gratuity Fund (long term)	1,50,000	60,000

Trade Payables	3,90,000	2,40,000
Assets		
Goodwill	1,50,000	75,000
Land & Buildings	9,00,000	3,00,000
Plant & Machinery	15,00,000	4,50,000
Inventories	7,50,000	5,25,000
Trade Receivables	6,00,000	3,00,000
Cash and Bank	1,50,000	60,000

X Ltd. absorbs Y Ltd. on the following terms:

- (i) 10% Preference Shareholders are to be paid at 10% premium by issue of 9% Preference Shares of X Ltd.
- (ii) Goodwill of Y Ltd. on absorption is to be computed based on two times of average profits of preceding three financial years (2016-17 : ₹ 90,000; 2015-16 : ₹ 78,000 and 2014-15: ₹ 72,000). The profits of 2014 -15 included credit of an insurance claim of ₹ 25,000 (fire occurred in 2013-14 and loss by fire ₹ 30,000 was booked in Profit and Loss Account of that year). In the year 2015 -16, there was an embezzlement of cash by an employee amounting to ₹ 10,000.
- (iii) Land & Buildings are valued at ₹ 5,00,000 and the Plant & Machinery at ₹ 4,00,000.
- (iv) Inventories are to be taken over at 10% less value and Provision for Doubtful Debts is to be created @ 2.5%.
- (v) There was an unrecorded current asset in the books of Y Ltd. whose fair value amounted to ₹ 15,000 and such asset was also taken over by X Ltd.
- (vi) The trade payables of Y Ltd. included ₹ 20,000 payable to X Ltd.
- (vii) Equity Shareholders of Y Ltd. will be issued Equity Shares @ 5% premium.

You are required to:

- (i) Prepare Realisation A/c in the books of Y Ltd.
- (ii) Show journal entries in the books of X Ltd.
- (iii) Prepare the Balance Sheet of X Ltd. after absorption as at 31st March, 2018.

Internal Reconstruction of a Company

7. The following information pertains to Z Limited as on 31st March, 2019:

	Amount in ₹
Share Capital:	
5,00,000 Equity shares of ₹ 10 each fully paid up	50,00,000

9%, 20,000 Preference shares of ₹ 100 each fully paid up	20,00,000
<u>Reserves and Surplus:</u>	
Profit and Loss Account	(14,60,000)
<u>Non-Current Liabilities:</u>	
10% Secured Debentures	16,00,000
<u>Current Liabilities:</u>	
Interest due on Debentures	1,60,000
Trade Payables	5,00,000
Loan from Directors	1,00,000
Bank Overdraft	1,00,000
Provision for Tax	1,00,000
<u>Non-Current Assets:</u>	
<u>(a) Property, Plant and Equipment:</u>	
Land & Buildings	30,00,000
Plant & Machinery	12,50,000
Furniture & Fixtures	2,50,000
<u>(b) Intangible Assets:</u>	
Goodwill	11,00,000
Patents	5,00,000
<u>Current Assets:</u>	
Trade Investments	5,00,000
Trade Receivables	5,00,000
Inventory	10,00,000

Note: Preference dividend is in arrears for last 2 years.

Mr. Y holds 60% of debentures and Mr. Z holds 40% of debentures. Moreover ₹ 1,00,000 and ₹ 60,000 were also payable to Mr. Y and Mr. Z respectively as trade payable.

The following scheme of reconstruction has been agreed upon and duly approved.

- (i) All the equity shares to be converted into fully paid equity shares of ₹ 5.00 each.
- (ii) The Preference shares be reduced to ₹ 50 each and the preference shareholders agreed to forego their arrears of preference dividends, in consideration of which 9% preference shares are to be converted into 10% preference shares.
- (iii) Mr. Y and Mr. Z agreed to cancel 50% each of their respective total debt including interest on debentures. Mr. Y and Mr. Z also agreed to pay ₹ 1,00,000 and ₹ 60,000 respectively in cash and to receive new 12% debentures for the balance amount.

- (iv) Persons relating to trade payables, other than Mr. Y and Mr. Z also agreed to forgo their 50% claims.
- (v) Directors also waived 60% of their loans and accepted equity shares for the balance.
- (vi) Capital commitments of ₹ 3.00 lacs were cancelled on payment of ₹ 15,000 as penalty.
- (vii) Directors refunded ₹ 1,00,000 of the fees previously received by them.
- (viii) Reconstruction expenses paid ₹ 15,000.
- (ix) The taxation liability of the company was settled for ₹ 75,000 and was paid immediately.
- (x) The Assets were revalued as under:

Land and Building	32,00,000
Plant and Machinery	6,00,000
Inventory	7,50,000
Trade Receivables	4,00,000
Furniture and Fixtures	1,50,000
Trade Investments	4,50,000

You are required to pass journal entries for all the above-mentioned transactions including amounts of Goodwill, Patents, Loss in Profit and Loss account to be written off. Also prepare Bank Account and Reconstruction A/c.

Liquidation of Company

8. M. Ltd. resolved on 31st December 2019 that the company be wound up voluntarily. The following was the trial balance extracted from its books as on that date:

	₹	₹
	Dr.	Cr.
Fixed assets	2,00,000	
Inventory	1,20,000	
Book debts	2,40,000	
Cash in hand	40,000	
Profit and loss A/c	3,00,000	
1,000, 6% Preference Shares of ₹ 100 each, fully paid		1,00,000
2,000 Equity shares of ₹ 100 each, fully paid		2,00,000

2,000 Equity shares of ₹ 100 each ₹ 75 paid up		1,50,000
Loan from bank (on security of stock)		1,00,000
Trade Payables		<u>3,50,000</u>
	<u>9,00,000</u>	<u>9,00,000</u>

The assets realized the following amounts (after all costs of realization and liquidator's commission amounting to ₹ 5,000 paid out of cash in hand).

	₹
Fixed assets	1,68,000
Inventory	1,10,000
Trade Receivables	2,30,000

Calls on partly paid shares were made but the amounts due on 200 shares were found to be irrecoverable.

You are required to prepare Liquidator's Final Statement of Receipts and Payments.

Banking Companies

9. (a) State with reason whether the following cash credit accounts are NPA or not:

	Case-1	Case-2
Sanctioned limit	60,00,000	45,00,000
Drawing power	56,00,000	42,00,000
Amount outstanding continuously 01-01-19 to 31-03-19	48,00,000	30,00,000
Total interest debited for the above period	3,84,000	2,40,000
Total credits for the above period	Nil	3,20,000

- (b) The following is an extract from the trial balance of Novel Bank Limited as on 31st March 2019:

Rebate on bills discounted as on 1st April 2018	₹ 78,566 (Cr. bal)
Discount Received	₹ 1,60,572 (Cr. bal)

An analysis of bills discounted is as follows:

Amount ₹	Due Date
2,90,000	01 June 2019
8,75,000	08 June 2019
5,65,000	21 June 2019
8,12,000	01 July 2019
6,50,000	05 July 2019

Find out the amount of discount to be credited to Profit and Loss Account for the year ending on 31st March, 2019 and pass the necessary journal entries. The rate of discount shall be taken at 10% per annum.

NBFCs

10. (a) Write short note on Earning value (Equity share) as per NBFC Prudential Norms (RBI) directions.
- (b) While closing its books of account on 31st March, 2019 a Non-Banking Finance Company has its advances classified as follows:

	₹ in lakhs
Sub-standard assets	2,680
Secured portions of doubtful debts:	
– Up to one year	640
– one year to three years	180
– more than three years	60
Unsecured portions of doubtful debts	194
Loss assets	96

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

Consolidated Financial Statements

11. (a) A Ltd holds 75% of the equity capital and voting power in B Ltd. A Ltd purchases inventories costing ₹ 150 lacs from B Ltd at a price of ₹ 200 lacs. The entire inventories remain unsold with A Ltd at the financial year end i.e. 31 March 2019. Suggest the accounting treatment for this transaction in the consolidated financial statements of A Ltd giving reference of the relevant accounting standard.
- (b) From the following data, determine Minority Interest on the date of acquisition and on the date of consolidation in each case:

Case	Subsidiary Company	% of Share Owned	Cost	Date of Acquisition		Consolidation date	
				01-01-2019		31-12-2019	
				Share Capital	Profit and Loss A/c	Share Capital	Profit and Loss A/c
				₹	₹	₹	₹
Case-A	X	90%	2,00,000	1,50,000	75,000	1,50,000	85,000
Case-B	Y	75%	1,75,000	1,40,000	60,000	1,40,000	20,000

Case-C	Z	70%	98,000	40,000	20,000	40,000	20,000
Case-D	M	95%	75,000	60,000	35,000	60,000	55,000
Case-E	N	100%	1,00,000	40,000	40,000	40,000	65,000

AS 4 Contingencies and Events occurring after the Balance Sheet Date

12. (a) A fire, on 2nd April, 2020, completely destroyed a manufacturing plant of Omega Ltd. whose financial year ended on 31st March, 2020, the financial statements were approved by their approving authority on 15th June, 2020. It was expected that the loss of ₹ 10 million would be fully covered by the insurance company. How will you disclose it in the financial statements of Omega Ltd. for the year ended 31st March, 2020.

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

- (b) The Accountant of Virush Limited has sought your opinion, whether the following transactions will be treated as change in Accounting Policy or not for the year ended 31st March, 2020. Please advise him in the following situations in accordance with the provisions of relevant Accounting Standard;
- Till the previous year the machinery was depreciated on straight line basis over a period of 5 years. From current year, the useful life of furniture has been changed to 3 years.
 - Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.

AS 7 Construction Contracts

13. Uday Constructions undertake to construct a bridge for the Government of Uttar Pradesh. The construction commenced during the financial year ending 31.03.2019 and is likely to be completed by the next financial year. The contract is for a fixed price of ₹ 12 crore with an escalation clause. You are given the following information for the year ended 31.03.2019:

Cost incurred upto 31.03.2019	₹ 4 crore
Further cost estimated to complete the contract	₹ 6 crore

Escalation in cost was by 5%. Hence, the contract price is also increased by 5%.

You are required to ascertain the stage of completion and compute the amount of revenue and profit to be recognized for the year as per AS 7.

AS 9 Revenue Recognition

14. (a) Fashion Limited is engaged in manufacturing of readymade garments. They provide you the following information on 31st March, 2019:

- (i) On 15th January, 2019 garments worth ₹ 4,00,000 were sent to Anand on consignment basis of which 25% garments unsold were lying with Anand as on 31st March, 2019.
- (ii) Garments worth ₹ 1,95,000 were sold to Shine boutique on 25th March, 2019 but at the request of Shine Boutique, these were delivered on 15th April, 2019.

You are required to advise the accountant of Fashion Limited, the amount to be recognised as revenue in above cases in the context of AS 9.

AS 14 Accounting for Amalgamations

- (b) Som Ltd. agreed to takeover Dove Ltd. on 1st April, 2020. The terms and conditions of takeover were as follows:
 - (i) Som Ltd. issued 56,000 equity shares of ₹100 each at a premium of ₹10 per share to the equity shareholders of Dove Ltd.
 - (ii) Cash payment of ₹ 1,00,000 was made to equity shareholders of Dove Ltd.
 - (iii) 20,000 fully paid preference shares of ₹ 70 each issued at par to discharge the preference shareholders of Dove Ltd.

You are required to calculate the amount of purchase consideration as per the provisions of AS 14.

AS 17 Segment Reporting

- 15. (a) A Company has an inter-segment transfer pricing policy of charging at cost less 5%. The market prices are generally 20% above cost. You are required to examine whether the policy adopted by the company for pricing inter-segment transfers at reduced prices is correct or not in line with the provisions of AS 17?

AS 18 Related Party Transactions

- (b) On the basis of provisions of AS 18 'Related Party Disclosures':
 - (i) Identify the related parties in the following cases:
 - X Limited holds 60% shares of Y Limited
 - Y Limited holds 55% shares of W Limited
 - Z Limited holds 35% shares of W Limited
 - (ii) Himalaya Limited sold goods for ₹ 40 Lakhs to Aravalli Limited during financial year ended on March 31, 2019. The Managing Director of Himalaya Limited owns 80% shares of Aravalli Limited. The sales were made to Aravalli Limited at normal selling prices followed by Himalaya Limited. The chief accountant of Himalaya Limited contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per AS 18. You are required to comment on this.

AS 19 Leases

16. (a) Classify the following into either operating or finance lease:
- If Present value (PV) of Minimum lease payment (MLP) = "X" ; Fair value of the asset is "Y" and $X=Y$.
 - Economic life of the asset is 7 years, lease term is 6.5 years, but asset is not acquired at the end of the lease term;
 - Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for use of the lessee.
- (b) Viral Ltd. sold machinery having WDV of ₹ 40 lakhs to Saral Ltd. for ₹ 50 lakhs and the same machinery was leased back by Saral Ltd. to Viral Ltd. The lease back is in nature of operating lease. You are required to explain the treatment in the given cases –
- Fair value is ₹ 45 lakhs and sale price is ₹ 38 lakhs.
 - Fair value is ₹ 40 lakhs and sale price is ₹ 50 lakhs.
 - Fair value is ₹ 46 lakhs and sale price is ₹ 50 lakhs

AS 20 Earnings Per Share

17. A-One Limited supplied the following information. You are required to compute the earnings per share as per AS 20:

Net profit attributable to equity shareholders	Year 2017-18: ₹ 1,00,00,000
	Year 2018-19 : ₹ 1,50,00,000

Number of shares outstanding prior to Right Issue 50,00,000 shares

Right Issue: One new share for each four outstanding shares i.e., 12,50,000 shares
 Right Issue Price - ₹ 96
 Last date of exercising rights - 30-06-2018

Fair value of one equity share immediately prior to exercise of rights on 30-06-2018 was ₹ 101.

AS 22 Accounting for Taxes on Income

18. (a) Write short note on Timing differences and Permanent differences as per AS 22
 (b) Rama Ltd., has provided the following information:

	₹
Depreciation as per accounting records	6,00,000
Depreciation as per income tax records	10,00,000
Unamortized preliminary expenses as per tax record	60,000

There is adequate evidence of future profit sufficiency. You are required to calculate the amount of deferred tax asset/liability to be recognized as transition adjustment assuming Tax rate as 30%.

AS 24 Discontinuing Operations

19. (a) What do you understand by Discontinuing Operations? What are the disclosure and presentation requirements of AS 24 for discontinuing operations? Explain in brief.

AS 26 Intangible Assets

- (b) X Ltd. carried on business of manufacturing of Bakery products. The company has two trademarks "Sun" and "Surya". One month before, the company comes to know through one of the marketing managers that both trademarks have allegedly been infringed by other competitors engaged in the same field. After investigation, legal department of the company informed that it had weak case on trademark "Sun" and strong case in regard to trademark "Surya". X Ltd. incurred additional legal fees to stop infringement on both trademarks. Both trademarks have a remaining legal life of 10 years. How should X Ltd. account for these legal costs incurred relating to the two trademarks?

AS 29 Provisions, Contingent Liabilities and Contingent Assets

20. (a) How will you distinguish contingent assets with Contingent Liabilities. Explain in brief.
- (b) Alpha Ltd. has entered into a sale contract of ₹ 7 crores with Gamma Ltd. during 2018-19 financial year. The profit on this transaction is ₹ 1 crore. The delivery of goods to take place during the first month of 2019-20 financial year. In case of failure of Alpha Ltd. to deliver within the schedule, a compensation of ₹2 crores is to be paid to Gamma Ltd. Alpha Ltd. planned to manufacture the goods during the last month of 2018-19 financial year. As on balance sheet date (31.3.2019), the goods were not manufactured and it was unlikely that Alpha Ltd. will be in a position to meet the contractual obligation. You are required to advise Alpha Ltd. on requirement of provision for contingency in the financial statements for the year ended 31st March, 2019, in line with provisions of AS 29?

SUGGESTED ANSWERS/HINTS

1. Realization Account

To	Land and Building	1,35,000	By	Provision for bad debts	6,000
To	Plant and Machinery	45,000	By	Loan from D	1,20,000

To	Furniture	25,500	By	Trade creditors	30,000
To	Investments	15,000	By	Bills payable	12,000
To	Book debts	60,000	By	Outstanding salary	7,500
To	Stock	36,000	By	Kumar - Furniture taken over (13,500 x .9)	12,150
To	Bank (Realization expenses)	15,000	By	Bank A/c -	
				Stock Realized	43,200
To	Amit- Realization expenses	3,000		Land & Building	1,65,000
				Debtors	<u>48,000</u>
					2,56,200
To	Bank A/c -		By	Amit (Investment taken over)	12,750
	Bill payable	11,940			
	D's Loan	7,500			
	D's Loan	54,000			
	Creditors	18,000			
	Salary	7,500			
To	Profit trs/f to partners' capital Accounts				
	Amit	9,264			
	Sumit	9,264			
	Kumar	<u>4,632</u>			
		<u>23,160</u>			
		4,56,600			<u>4,56,600</u>

Bank Account

		₹			₹
To	Balance b/d		By	Realization A/c (payment of liabilities: 11,940+ 7,500 + 54,000 + 15,000 + 18,000 + 7,500)	
		13,500			1,13,940
To	Realization A/c (assets realized)	2,56,200	By	Amit	79,314
To	Kumar	<u>12,618</u>	By	Sumit	<u>89,064</u>
		2,82,318			2,82,318

Partners' Capital Accounts

		Amit	Sumit	Kumar		Amit	Sumit	Kumar
		₹	₹	₹		₹	₹	₹
To	Balance b/d			32,400	By	Balance b/d	55,200	55,200
To	Realization A/c (Investment taken over)	12,750			By	Kumar's Loan		15,000
To	Realization A/c (Furniture taken over)			12,150	By	General Reserve	24,600	24,600
To	Bank A/c	79,314	89,064		By	Realization A/c (expense)	3,000	
					By	Realization A/c (profit)	9,264	9,264
					By	Bank A/c		12,618
		92,064	89,064	44,550			92,064	89,064
								44,550

Working Notes:**1. Payment for Bills Payable**

Particulars	Amount (₹)
Bills Payable as per Balance Sheet	12,000
Less: Discount for early payment {12,000 x 6% x (1/12)}	<u>60</u>
Amount Paid in Cash	11,940

2. Payment to D's Loan

Particulars	Amount (₹)
D's Loan as per Balance Sheet	<u>120,000.00</u>
50% of Loan adjusted as below:	
Plant & Machinery accepted at Book Value (₹ 45,000) and ₹ 7,500 in cash.	7,500
Balance 50% of Loan adjusted as below:	
In cash after allowing discount of 10% i.e. ₹ 60,000 – ₹ 6,000 = ₹ 54,000.	<u>54,000</u>

3. Payment to Trade Creditors

Particulars	Amount (₹)
Trade Creditors as per Balance Sheet	30,000
Less: Furniture of Book Value ₹ 12,000 accepted at value ₹ 10,800	<u>10,800</u>
	19,200

Less: Discount @ 6.25%	<u>1,200</u>
Amount paid in Cash	18,000

4. Furniture taken over by Kumar

Particulars	Amount
Furniture as per Balance Sheet	25,500
Less: Furniture of Book Value ₹ 12000 accepted by trade creditors	<u>12,000</u>
	13,500
Less: 10% of Book Value	<u>1,350</u>
Value of Furniture taken over by Kumar	12,150

2. (a) Under section 27 (3) of the LLP Act, 2008 an obligation of an LLP arising out of a contract or otherwise, shall be solely the obligation of the LLP. The limitations of liability of an LLP and its partners are as follows:

- ◆ The Liabilities of an LLP shall be met out of the properties of the LLP;
- ◆ A partner is not personally liable, directly or indirectly (for an obligation of an LLP arising out of a contract or otherwise), solely by reason of being a partner in the LLP;
- ◆ An LLP is not bound by anything done by a partner in dealing with a person, if:
 - The partner does not have the authority to act on behalf of the LLP in doing a particular act; and
 - The other person knows that the partner has no authority or does not know or believe him to be a partner in the LLP
- ◆ The liability of the LLP and the partners perpetrating fraudulent dealings shall be unlimited for all or any of the debts or other liabilities of the LLP.

- (b) Under section 64 of the LLP Act, 2008, an LLP may be wound up by the Tribunal:

- If the LLP decides that it should be wound up by the Tribunal;
- If for a period of more than six months, the number of partners of the LLP is reduced below two;
- If the LLP is unable to pay its debts;
- If the LLP has acted against the interests of the integrity and sovereignty of India, the security of the state or public order;

- If the LLP has defaulted in the filing of the Statement of Account and Solvency with the Registrar for five consecutive financial years;

3. Journal Entries in the books of Kaushal Ltd.

			₹	₹
1.3.2020	Bank A/c	Dr.	1,08,000	
to	Employee compensation expense A/c	Dr.	72,000	
31.3.2020	To Equity share capital A/c			36,000
	To Securities premium A/c			1,44,000
	(Being shares issued to the employees against the options vested to them in pursuance of Employee Stock Option Plan)			
31.3.2020	Profit and Loss A/c	Dr.	72,000	
	To Employee compensation expenses A/c			72,000
	(Being transfer of employee compensation expenses transfer to Profit and Loss Account)			

Working Note:

Market Price = ₹ 50 per share and stock option price = ₹ 30, Hence, the difference ₹ 50 – ₹ 30 = ₹ 20 per share is equivalent to employee cost or employee compensation expense and will be charged to P&L Account as such for the number of options exercised i.e. 3,600 shares.

4. Debt Equity Ratio Test

	Particulars	₹
a)	Loan funds	42,00,000
(b)	Minimum equity to be maintained after buy back in the ratio of 2:1 (₹ in crores)	21,00,000
(c)	Present equity shareholders fund (₹ in crores)	72,80,000
(d)	Future equity shareholder fund (₹ in crores) (See Note 2)	59,85,000
		(72,80,000-12,95,000)
(e)	Maximum permitted buy back of Equity (₹ in crores) [(d) – (b)] (See Note 2)	38,85,000 (by simultaneous equation)
(f)	Maximum number of shares that can be bought back @ ₹ 30 per share (shares in crores) (See Note 2)	1,29,500 (by simultaneous equation)

Working Notes:

1. Shareholders' funds

Particulars	₹
Paid up capital	30,00,000
Free reserves (32,50,000 + 6,00,000 + 4,30,000)	<u>42,80,000</u>
	<u>72,80,000</u>

2. As per section 68 of the Companies Act, 2013, amount transferred to CRR and maximum equity to be bought back will be calculated by simultaneous equation method.

Suppose amount equivalent to nominal value of bought back shares transferred to CRR account is 'x' and maximum permitted buy-back of equity is 'y'.

Equation 1 : (Present equity – Nominal value of buy-back transfer to CRR) – Minimum equity to be maintained = Maximum permissible buy-back of equity

$$(72,80,000 - x) - 21,00,000 = y \quad (1)$$

Since $51,80,000 - x = y$

$$\text{Equation 2: } \left(\frac{\text{Maximum buy-back}}{\text{Offer price for buy-back}} \times \text{Nominal Value} \right)$$

= Nominal value of the shares bought back to be transferred to CRR

$$= \left(\frac{y}{30} \times 10 \right) = x$$

$$3x = y \quad (2)$$

$x = ₹ 12,95,000$ crores and $y = ₹ 38,85,000$ crores

5. (a) Equity shares with Differential Rights means the share with dissimilar rights as to dividend, voting or otherwise. No; the preference shares cannot be issued with differential rights.
- (b) E, F, G and H hold Equity capital is held by in the proportion of 30:30:20:20 and S, T, U and V hold preference share capital in the proportion of 40:30:10:20. As the paid up equity share capital of the company is ₹ 120 Lakhs and Preference share capital is ₹ 60 Lakhs (ratio of 2:1), then relative weights in the voting right of equity shareholders and preference shareholders will be 2/3 and 1/3. The respective voting right of various shareholders will be:

$$E = \frac{2}{3} \times \frac{30}{100} = \frac{3}{15}$$

F	=	2/3X30/100	=	3/15
G	=	2/3X20/100	=	2/15
H	=	2/3X20/100	=	2/15
S	=	1/3X40/100	=	2/15
T	=	1/3X30/100	=	1/10
U	=	1/3X10/100	=	1/30
V	=	1/3X20/100	=	1/15

6. **In the Books of Y Ltd.
Realisation Account**

		₹		₹
To Sundry Assets:			By Retirement Gratuity Fund	60,000
Goodwill	75,000			
Land & Building	3,00,000		By Trade payables	2,40,000
Plant & Machinery	4,50,000		By X Ltd. (Purchase Consideration)	15,90,000
Inventory	5,25,000			
Trade receivables	3,00,000			
Bank	<u>60,000</u>	17,10,000		
To Preference Shareholders (Premium on Redemption)		30,000		
To Equity Shareholders (Profit on Realisation)		<u>1,50,000</u>		
		<u>18,90,000</u>		<u>18,90,000</u>

In the Books of X Ltd.

Journal Entries

	Dr.	Cr.
	₹	₹
Business Purchase A/c Dr.	15,90,000	
To Liquidators of Y Ltd. Account		15,90,000
(Being business of Y Ltd. taken over)		

Goodwill Account	Dr.	1,50,000	
Land & Building Account	Dr.	5,00,000	
Plant & Machinery Account	Dr.	4,00,000	
Inventory Account	Dr.	4,72,500	
Trade receivables Account	Dr.	3,00,000	
Bank Account	Dr.	60,000	
Unrecorded assets Account	Dr.	15,000	
To Retirement Gratuity Fund Account			60,000
To Trade payables Account			2,40,000
To Provision for Doubtful Debts Account			7,500
To Business Purchase A/c			15,90,000
(Being Assets and Liabilities taken over as per agreed valuation).			
Liquidators of Y Ltd. A/c	Dr.	15,90,000	
To 9% Preference Share Capital A/c			3,30,000
To Equity Share Capital A/c			12,00,000
To Securities Premium A/c			60,000
(Being Purchase Consideration satisfied as above)			

**Balance Sheet of X Ltd. (after absorption)
as at 31st March, 2018**

Particulars		Notes	₹
Equity and Liabilities			
1	Shareholders' funds		
A	Share capital	1	48,30,000
B	Reserves and Surplus	2	2,70,000
2	Non-current liabilities		
A	Long-term provisions	3	2,10,000
3	Current liabilities		
A	Trade Payables	4	6,10,000
B	Short term provision	5	7,500
	Total		59,27,500
Assets			
1	Non-current assets		
	Property, Plant and Equipment	6	33,00,000
	Intangible assets	7	3,00,000

2	Current assets		
A	Inventories	8	12,22,500
B	Trade receivables	9	8,80,000
C	Other current Assets	10	15,000
D	Cash and cash equivalents	11	<u>2,10,000</u>
	Total		59,27,500

Notes to accounts

	₹
1 Share Capital	
Equity share capital	
4,20,000 Equity Shares of ₹ 10 each fully paid (Out of above 1,20,000 Equity Shares were issued at 5% premium in consideration other than for cash)	42,00,000
Preference share capital	
6,300 9% Preference Shares of ₹ 100 each (Out of above 3,300 Preference Shares were issued in consideration other than for cash)	6,30,000
Total	48,30,000
2 Reserves and Surplus	
Securities Premium	60,000
General Reserve	2,10,000
Total	2,70,000
3 Long-term provisions	
Retirement Gratuity fund	2,10,000
4 Trade payables (3,90,000 + 2,40,000 - 20,000*) * Mutual Owings eliminated.	6,10,000
5 Short term Provisions	
Provision for Doubtful Debts	7,500
6 Property, Plant and Equipment	
Land & Buildings	14,00,000
Plant & Machinery	19,00,000
Total	33,00,000
7 Intangible assets	
Goodwill (1,50,000 + 1,50,000)	3,00,000
8 Inventories (7,50,000 + 4,72,500)	12,22,500

9	Trade receivables (6,00,000 + 3,00,000 - 20,000)	8,80,000
10	Other current Assets	15,000
11	Cash and cash equivalents (1,50,000 + 60,000)	2,10,000

Working Notes:

1. Computation of goodwill

₹

Profit of 2016-17	90,000
Profit of 2015-16 adjusted (₹ 78,000 + 10,000)	88,000
Profit of 2014-15 adjusted (₹ 72,000 – 25,000)	<u>47,000</u>
	<u>2,25,000</u>
Average profit	75,000

Goodwill to be valued at 2 times of average profits = ₹ 75,000 x 2 = ₹ 1,50,000

2.

Purchase Consideration:	₹
Goodwill	1,50,000
Land & Building	5,00,000
Plant & Machinery	4,00,000
Inventory	4,72,500
Trade receivables	3,00,000
Unrecorded assets	15,000
Cash at Bank	<u>60,000</u>
	18,97,500
Less: Liabilities:	
Retirement Gratuity	60,000
Trade payables	2,40,000
Provision for doubtful debts	<u>7,500</u>
	<u>(3,07,500)</u>
Net Assets/ Purchase Consideration	15,90,000
To be satisfied as under:	
10% Preference Shareholders of Y Ltd.	3,00,000
Add: 10% Premium	<u>30,000</u>
9% Preference Shares of X Ltd.	3,30,000
Equity Shareholders of Y Ltd. to be satisfied by issue of 1,20,000 equity Shares of X Ltd. at 5% Premium	
	<u>12,60,000</u>
Total	<u>15,90,000</u>

7. Journal Entries in the Books of Z Ltd.

		Dr.	Cr.
		₹	₹
(i)	Equity Share Capital (₹ 10 each) A/c Dr. 50,00,000 To Equity Share Capital (₹ 5 each) A/c 25,00,000 To Reconstruction A/c 25,00,000 (Being conversion of 5,00,000 equity shares of ₹ 10 each fully paid into same number of fully paid equity shares of ₹ 5 each as per scheme of reconstruction.)		
(ii)	9% Preference Share Capital (₹ 100 each) A/c Dr. 20,00,000 To 10% Preference Share Capital (₹ 50 each) A/c 10,00,000 To Reconstruction A/c 10,00,000 (Being conversion of 9% preference share of ₹ 100 each into same number of 10% preference share of ₹ 50 each and claims of preference dividends settled as per scheme of reconstruction.)		
(iii)	10% Secured Debentures A/c Dr. 9,60,000 Trade payables A/c Dr. 1,00,000 Interest on Debentures Outstanding A/c Dr. 96,000 Bank A/c Dr. 1,00,000 To 12% Debentures A/c 6,78,000 To Reconstruction A/c 5,78,000 (Being ₹ 11,56,000 due to Y (including trade payables) cancelled and 12% debentures allotted for the amount after waving 50% as per scheme of reconstruction.)		
(iv)	10% Secured Debentures A/c Dr. 6,40,000 Trade Payables 60,000 Interest on debentures outstanding A/c 64,000 Bank A/c 60,000 To 12% debentures A/c 4,42,000 To Reconstruction A/c 3,82,000 (Being ₹ 7,64,000 due to Z (including trade payables) cancelled and 12% debentures allotted for the amount after waving 50% as per scheme of reconstruction.)		

(v)	Trade payables A/c To Reconstruction A/c (Being remaining trade payables sacrificed 50% of their claim.)	Dr.	1,70,000	1,70,000
(vi)	Directors' Loan A/c To Equity Share Capital (₹ 5) A/c To Reconstruction A/c (Being Directors' loan claim settled by issuing 12,000 equity shares of ₹ 5 each as per scheme of reconstruction.)	Dr.	1,00,000	40,000 60,000
(vii)	Reconstruction A/c To Bank A/c (Being payment made towards penalty of 5% for cancellation of capital commitments of ₹ 3 Lakhs.)	Dr.	15,000	15,000
(viii)	Bank A/c To Reconstruction A/c (Being refund of fees by directors credited to reconstruction A/c.)	Dr.	1,00,000	1,00,000
(ix)	Reconstruction A/c To Bank A/c (Being payment of reconstruction expenses.)	Dr.	15,000	15,000
(x)	Provision for Tax A/c To Bank A/c To Reconstruction A/c (Being payment of tax liability in full settlement against provision for tax)	Dr.	1,00,000	75,000 25,000
(xi)	Land and Building A/c To Reconstruction A/c (Being appreciation in value of Land & Building recorded)	Dr.	2,00,000	2,00,000
(xii)	Reconstruction A/c To Goodwill A/c To Patent A/c To Profit and Loss A/c To Plant and Machinery A/c To Furniture & Fixture A/c	Dr.	49,85,000	11,00,000 5,00,000 14,60,000 6,50,000 1,00,000

To Trade Investment A/c	50,000
To Inventory A/c	2,50,000
To Trade Receivables A/c	1,00,000
To Capital Reserve (bal. fig.)	7,75,000
(Being writing off of losses and reduction in the value of assets as per scheme of reconstruction, balance of reconstruction A/c transfer to Capital Reserve.)	

Bank Account

	₹		₹
To Reconstruction (Y)	1,00,000	By Balance b/d	1,00,000
To Reconstruction (Z)	60,000	By Reconstruction A/c	15,000
To Reconstruction A/c (refund of earlier fees by directors)	1,00,000	(capital commitment penalty paid)	
		By Reconstruction A/c (reconstruction expenses paid)	15,000
		By Provision for tax A/c (tax paid)	75,000
		By Balance c/d	55,000
	<u>2,60,000</u>		<u>2,60,000</u>

Reconstruction Account

	₹		₹
To Bank (penalty)	15,000	By Equity Share	
To Bank (reconstruction expenses)	15,000	Capital A/c	25,00,000
To Goodwill	11,00,000	By 9% Pref. Share	
To Patent	5,00,000	Capital A/c	10,00,000
To P & L A/c	14,60,000	By Mr. Y (Settlement)	5,78,000
		By Mr. Z (Settlement)	3,82,000
To P & M	6,50,000	By Trade Payables A/c	1,70,000
To Furniture and Fixtures	1,00,000	By Director's loan	60,000
To Trade investment	50,000	By Bank	1,00,000
To Inventory	2,50,000	By Provision for tax	25,000

To Trade Receivables	1,00,000	By Land and Building	2,00,000
To Capital Reserve (bal. fig.)	<u>7,75,000</u>		
	50,15,000		<u>50,15,000</u>

8. **Liquidator's Final Statement of Receipts and Payments A/c**

	₹	₹		₹
To Cash in hand		40,000	By Liquidator's remuneration and expenses	5,000
To Assets realised:			By Trade Payables	3,50,000
Fixed assets	1,68,000		By Preference shareholders	1,00,000
Inventory			By Equity shareholders @ ₹ 10 on 2,000 shares	20,000
(1,10,000 – 1,00,000)	10,000			
Book debts	<u>2,30,000</u>	4,08,000		
To Cash - proceeds of call on 1,800 equity shares @ ₹ 15*		<u>27,000</u>		
		4,75,000		<u>4,75,000</u>

Working Note:

Return per equity share

	₹
Cash available before paying preference shareholders (₹ 4,48,000 – ₹ 3,55,000)	93,000
Add: Notional calls 1,800 shares (2,000-200) × ₹ 25	<u>45,000</u>
	1,38,000
Less: Preference share capital	<u>(1,00,000)</u>
Available for equity shareholders	<u>38,000</u>
Return per share = $\frac{₹ 38,000}{3,800 (4,000 - 200)} = ₹ 10$	
and Loss per Equity Share ₹ (100-10) = ₹ 90	

*Calls to be made @ ₹ 15 per share (₹ 90-75) on 1,800 shares.

9. (a)

	Case 1	Case 2
	₹	₹
Sanctioned limit	60,00,000	45,00,000
Drawing power	56,00,000	42,00,000
Amount outstanding continuously from 1.01.2019 to 31.03.2019	48,00,000	30,00,000

Total interest debited	3,84,000	2,40,000
Total credits	-	320,000
Is credit in the account is sufficient to cover the interest debited during the period or amount is not 'overdue' for a continuous period of 90 days.	No	Yes
	NPA	NOT NPA

- (b) The amount of rebate on bills discounted as on 31st March, 2019 the period which has not been expired upto that day will be calculated as follows:

Discount on ₹ 2,90,000 for 62 days @ 10%	4,926
Discount on ₹ 8,75,000 for 69 days @ 10%	16,541
Discount on ₹ 5,65,000 for 82 days @ 10%	12,693
Discount on ₹ 8,12,000 for 92 days @ 10%	20,467
Discount on ₹ 6,50,000 for 96 days @ 10%	<u>17,096</u>
Total	<u>71,723</u>

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

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

	₹
Transfer from rebate on bills discounted as on 1.4. 2018	78,566
Add: Discount received during the year	<u>1,60,572</u>
	2,39,138
Less: Rebate on bills discounted as on 31.03. 2019 (as above)	<u>(71,723)</u>
	<u>1,67,415</u>

Journal Entries

	₹	₹
Rebate on bills discounted A/c Dr.	78,566	
To Discount on bills A/c		78,566
(Transfer of opening unexpired discount on 31.03. 2018)		
Discount on bills A/c Dr.	71,723	
To Rebate on bills discounted		71,723
(Unexpired discount on 31.03. 2019 taken into account)		
Discount on Bills A/c Dr.	1,67,415	
To P & L A/c		1,67,415
(Discount earned in the year, transferred to P&L A/c)		

10. (a) Earning value means the value of an equity share computed by taking the average of profits after tax as reduced by the preference dividend and adjusted for extra-ordinary and non-recurring items, for the immediately preceding three years and further divided by the number of equity shares of the investee company and capitalized at the following rate:

- in case of predominantly manufacturing company, eight per cent;
- in case of predominantly trading company, ten per cent; and
- in case of any other company, including non-banking financial company, twelve per cent;

Note: If an investee company is a loss making company the earning value will be taken at zero.

- (b) Calculation of provision required on advances as on 31st March, 2019:

	Amount ₹ in lakhs	Percentage of provision	Provision ₹ in lakhs
Sub-standard assets	2,680	10	268.00
Secured portions of doubtful debts			
–up to one year	640	20	128.00
–one year to three years	180	30	54.00
–more than three years	60	50	30.00
Unsecured portions of doubtful debts	194	100	194.00
Loss assets	96	100	96.00
			<u>770.00</u>

11. (a) As per para provisions of AS 21, Intragroup balances and intragroup transactions and resulting unrealized profits should be eliminated in full. Unrealized losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

Intragroup balances and intragroup transactions, including sales, expenses and dividends, are eliminated in full. Unrealised profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full. Unrealised losses resulting from intragroup transactions that are deducted in arriving at the carrying amount of assets are also eliminated unless cost cannot be recovered. One also needs to see whether the intragroup transaction is “upstream” or “down-stream”. Upstream transaction is a transaction in which the subsidiary company sells goods to holding company. While in the downstream transaction, holding company is the seller and subsidiary company is the buyer.

In the case of upstream transaction, since the goods are sold by the subsidiary to holding company; profit is made by the subsidiary company, which is ultimately shared by the holding company and the minority shareholders. In such a transaction, if some goods remain unsold at the balance sheet date, the unrealized profit on such goods should be eliminated from minority interest as well as from consolidated profit on the basis of their share-holding besides deducting the same from unsold inventory.

But in the case of downstream transaction, the whole profit is earned by the holding company, therefore, whole unrealized profit should be adjusted from unsold inventory and consolidated profit and loss account only irrespective of the percentage of the shares held by the parent.

The case given in the question is the case of upstream transaction. In the consolidated profit and loss account for the year ended 31 March 2019, entire transaction of sale and purchase of ₹ 200 lacs each, would be eliminated by reducing both sales and purchases (cost of sales). Further, the unrealized profits of ₹ 50 lacs (i.e. ₹ 200 lacs – ₹ 150 lacs), would be eliminated in the consolidated financial statements for financial year ended 31 March 2019, by reducing the value of closing inventories by ₹ 50 lacs as of 31 March 2019. In the consolidated balance sheet as of 31 March 2019, A Ltd's share of profit from B Ltd will be reduced by ₹ 37.50 lacs (being 75% of ₹ 50 lacs) and the minority's share of the profits of B Ltd would be reduced by ₹ 12.50 lacs (being 25% of ₹ 50 lacs).

(b) Minority Interest = Equity attributable to minorities

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities i.e. in this case, it should be equal to Share Capital + Profit & Loss A/c

A = Share capital on 1.1.2019

B = Profit & loss account balance on 1.1.2019

C = Share capital on 31.12.2019

D = Profit & loss account balance on 31.12.2019

	Minority % Shares Owned [E]	Minority interest as at the date of acquisition [E] x [A + B] ₹	Minority interest as at the date of consolidation [E] X [C + D] ₹
Case A [100-90]	10 %	22,500	23,500
Case B [100-75]	25 %	50,000	40,000
Case C [100-70]	30 %	18,000	18,000
Case D [100-95]	5%	4,750	5,750
Case E [100-100]	NIL	NIL	NIL

12. (a) The event is a non-adjusting event since it occurred after the year-end and does not relate to the conditions existing at the year-end. However, it is necessary to consider the validity of the going concern assumption having regard to the extent of insurance cover. Also, since it is said that the loss would be fully recovered by the insurance company, the fact should be disclosed by way of a note to the financial statements.
- (b) (i) Change in useful life of machinery from 5 years to 3 years is a change in estimate and is not a change in accounting policy.
- (ii) Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is not a change in an accounting policy.

13.

	₹ in crore
Cost of construction of bridge incurred upto 31.3.2019	4.00
Add: Estimated future cost	<u>6.00</u>
Total estimated cost of construction	<u>10.00</u>
Contract Price (12 crore x 1.05)	12.60 crore

Stage of completion

Percentage of completion till date to total estimated cost of construction

$$= (4/10) \times 100 = 40\%$$

Revenue and Profit to be recognized for the year ended 31st March, 2019 as per AS 7:

Proportion of total contract value recognized as revenue

$$= \text{Contract price} \times \text{percentage of completion}$$

$$= ₹ 12.60 \text{ crore} \times 40\% = ₹ 5.04 \text{ crore}$$

Profit for the year ended 31st March, 2019 = ₹ 5.04 crore – ₹ 4 crore = 1.04 crore.

14. (a) As per AS 9 "Revenue Recognition", in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are fulfilled:
- (i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

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

Case (i): 25% goods lying unsold with consignee should be treated as closing inventory and sales should be recognized for ₹ 3,00,000 (75% of ₹ 4,00,000) for the year ended on 31.3.19. In case of consignment sale revenue should not be recognized until the goods are sold to a third party.

Case (ii): The sale is complete but delivery has been postponed at buyer's request. Fashion Ltd. should recognize the entire sale of ₹1,95,000 for the year ended 31st March, 2019.

- (b) As per AS 14, 'Accounting for Amalgamations' consideration for the amalgamation means the aggregate of shares and other securities issued and payment made in form of cash or other assets by the transferee company to the shareholders of the transferor company.

(i) **Computation of Purchase Consideration:**

	₹
(a) Preference Shares:	
20,000 Preference shares in Som Ltd. @ ₹ 70 per share	14,00,000
(b) Cash	1,00,000
(c) Equity shares: 56,000 equity shares in Som Ltd. @ ₹ 110 per share	<u>61,60,000</u>
	<u>76,60,000</u>

15. (a) AS 17 'Segment Reporting' requires that inter-segment transfers should be measured on the basis that the enterprise actually used to price these transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements. Hence, the enterprise can have its own policy for pricing inter-segment transfers and hence, inter-segment transfers may be based on cost, below cost or market price. However, whichever policy is followed, the same should be disclosed and applied consistently. Therefore, in the given case inter-segment transfer pricing policy adopted by the company is correct if followed consistently.

- (b) (i) X Ltd., Y Ltd. & W Ltd. are related to each other. Z Ltd. & W Ltd. are related to each other by virtue of associate relationship. However, neither X Ltd. nor Y Ltd. is related to Z Ltd. and vice versa since neither control nor significant influence exists between them.
- (ii) Himalaya Ltd. and Aravalli Ltd are related parties since key management personnel of Himalaya Ltd. ie. its managing director holds 80% in Aravalli Ltd. and hence disclosure of transaction between them is required irrespective of whether the transaction was done at normal selling price. Hence the contention of Chief Accountant of Himalaya Ltd that these sales require no disclosure under related party transactions, is wrong.
16. (a) (i) The lease is a finance lease if $X = Y$, or if X substantially equals Y.
- (ii) The lease will be classified as a finance lease, since a substantial portion of the life of the asset is covered by the lease term.
- (iii) Since the asset is procured only for the use of lessee, it is a finance lease.
- (b) As per AS 19, where sale and leaseback results in operating lease, then the accounting treatment in different situations is as follows:

Situation 1: Sale price = Fair Value

Profit or loss should be recognized immediately.

Situation 2: Sale Price < Fair Value

Profit should be recognized immediately. The loss should also be recognized immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used.

Situation 3: Sale Price > Fair Value

The excess over fair value should be deferred and amortized over the period for which the asset is expected to be used.

Following will be the treatment in the situations given in the question:

- (i) When fair value of leased machinery is ₹ 45 lakhs & sales price is ₹ 38 lakhs, then loss of ₹ 2 lakhs ($45 - 38$) to be immediately recognized by Viral Ltd. in its books provided loss is not compensated by future lease payment.
- (ii) When fair value is ₹ 40 lakhs & sales price is ₹ 50 lakhs then, profit of ₹ 10 lakhs is to be deferred and amortized over the lease period.

- (iii) When fair value is ₹ 46 lakhs & sales price is ₹ 50 lakhs, profit of ₹ 6 lakhs (46 less 40) to be immediately recognized in its books and balance profit of ₹ 4 lakhs (50-46) is to be amortized/deferred over lease period.

17. Computation of earnings per share

	2017-18 ₹	2018-19 ₹
EPS for the year 2017-18 as originally reported: (₹ 1,00,00,000 / 50,00,000 shares)	2.00	
EPS for the year 2017-18 restated for rights issue: ₹ 1,00,00,000 / (50,00,000 shares x 1.01)*	1.98	
EPS for the year 2018-19 including effects of rights issue Rs. 1,50,00,000 $\frac{(50,00,000 \times 1.01 \times 3/12) + (62,50,000 \times 9/12)}{}$		2.52

*Computation of earnings per share in case of Rights Issue requires computation of adjustment factor which is given as working note.

Working Notes:

1. Computation of theoretical ex-rights fair value per share

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights} + \text{total amount received from exercise}}{\text{Number of shares outstanding prior to exercise} + \text{Number of shares issued in the exercise}}$$

$$\frac{(\text{₹ } 101 \times 50,00,000 \text{ shares}) + (\text{₹ } 96 \times 12,50,000 \text{ shares})}{50,00,000 \text{ shares} + 12,50,000 \text{ shares}}$$

$$= \text{₹ } 62,50,00,000 / 62,50,000 = \text{₹ } 100$$

Therefore, theoretical ex-rights fair value per share is = ₹ 100

2. Computation of adjustment factor

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{\text{₹ } (101)}{\text{₹ } (100)} = 1.01$$

18. (a) Accounting income and taxable income for a period are seldom the same. Permanent differences are those which arise in one period and do not reverse subsequently. For e.g., an income exempt from tax or an expense that is not allowable as a deduction for tax purposes. Timing differences are those which arise in one period and are capable of reversal in one or more subsequent periods. For e.g., Depreciation, Bonus, etc.

(b) Table showing calculation of deferred tax asset / liability

Particulars	Amount	Timing differences	Deferred tax	Amount @ 30%
	₹			₹
Excess depreciation as per tax records (₹ 10,00,000 – ₹ 6,00,000)	4,00,000	Timing	Deferred tax liability	1,20,000
Unamortized preliminary expenses as per tax records	60,000	Timing	Deferred tax asset	(18,000)
Net deferred tax liability				<u>1,02,000</u>

19. (a) As per AS 24 “Discontinuing Operations”, a discontinuing operation is a component of an enterprise:

- a. That the enterprise, pursuant to a single plan, is:
 - (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders or
 - (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually or
 - (iii) Terminating through abandonment and
- b. That represents a separate major line of business or geographical area of operations.
- c. That can be distinguished operationally and for financial reporting purposes.

An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs:

- A description of the discontinuing operation(s);
- The business or geographical segment(s) in which it is reported as per AS 17;
- The date and nature of the initial disclosure event.
- The date or period in which the discontinuance is expected to be completed if known or determinable,
- The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;

- The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period;
 - The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto;
 - The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.
- (b) As per AS 26, subsequent expenditure on an intangible asset after its purchase or its completion should be recognized as an expense. However, if the subsequent expenditure enables the asset to generate future economic benefits in excess of its originally assessed standard of performance or can be measured and attributed to the asset reliably, then such subsequent expenditure should be added to the cost of the intangible asset.

The legal costs incurred for both the trademarks do not enable them to generate future economic benefits in excess of its originally assessed standard of performance. They only ensure to maintain them if the case is decided in favour of the company. Therefore, such legal costs incurred for both trademarks must be recognized as an expense.

20. (a) **A Contingent liability** is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

A present obligation that arises from past events but is not recognized because:

- (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
- (ii) A reliable estimate of the amount of the obligation cannot be made.

An enterprise should not recognize a contingent liability but should be disclosed. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote.

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain. An enterprise should not recognize a contingent asset, since this may result in the recognition of income that may never be realized. However, when the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving

authority (Board of Directors in the case of a company, and, the corresponding approving authority in the case of any other enterprise), where an inflow of economic benefits is probable. Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

- (b) 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 recognized. Alpha Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Alpha Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Alpha Ltd. should provide for the contingency amounting ₹ 2 crores as per AS 29.

PAPER – 6: AUDITING AND ASSURANCE

PART – I : ACADEMIC UPDATE

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

Chapter 9-Audit of Items of Financial Statements

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

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

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

PART – II: QUESTIONS AND ANSWERS

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

Integrated Case Scenario-1

M/s JJ & associates having office in Chennai are statutory auditors under Companies Act, 2013 of a company viz. **Sweet Aroma Private Limited** engaged in business of obtaining and manufacturing rice from paddy catering to both domestic as well as international market mainly in Gulf nations. The company has a huge plant capacity for rice extraction in one of the states in Northern India. Needless to state that inventories are in huge quantity in such type of business consisting of raw material, work in progress and finished goods. The auditors want to obtain sufficient appropriate audit evidence regarding inventories.

In above context, answer the following questions: -

1. Which of the following is most likely correct in relation to obtaining of sufficient appropriate audit evidence regarding existence and condition of inventory?
 - (a) It is mandatory for the auditor to attend physical inventory counting on the date of financial statements in all circumstances.
 - (b) Physical inventory counting may be attended by auditor on the date of financial statement or at a date other than date of financial statements in his discretion mandatorily in all circumstances.

- (c) The attendance of auditors at physical inventory counting is impracticable due to time and costs involved because of auditor's office location vis-à-vis company's plant location. Hence, attendance at physical inventory counting may be skipped and alternative audit procedures may be performed to obtain sufficient appropriate evidence.
 - (d) The auditor shall attend at physical inventory counting unless impracticable. However, issue of time and costs involved because of auditor's office location vis-à-vis company's plant location is not a valid basis for skipping physical inventory counting.
2. Below are given certain cluster of matters which are relevant in planning attendance of auditor at physical inventory counting. Which of the following clusters consists of a likely inappropriate combination?
- (a) Nature of inventory, timing of physical inventory counting and stages of completion of work in progress
 - (b) Nature of inventory, timing of physical inventory counting and valuation method of inventory
 - (c) Nature of inventory, timing of physical inventory counting, considerations regarding maintenance of a perpetual inventory system
 - (d) Risks of material misstatements related to inventory, nature of internal control pertaining to inventory, considerations regarding maintenance of a perpetual inventory system
3. Which of the following is the most likely logical sequence of steps in relation to attendance at physical inventory counting by auditor?
- (a) Observance of performance of management's count procedures, inspection of inventory, performing test counts and evaluation of management's procedures for recording and controlling results of physical inventory counting
 - (b) Observance of performance of management's count procedures, performing test counts, inspection of inventory and evaluation of management's procedures for recording and controlling results of physical inventory counting
 - (c) Performing test counts, inspection of inventory, Observance of performance of management's count procedures and evaluation of management's procedures for recording and controlling results of physical inventory counting
 - (d) Evaluation of management's procedures for recording and controlling results of physical inventory counting, Observance of performance of management's count procedures, inspection of inventory and performing test counts

4. During attendance at physical inventory counting, the auditor inspects inventory. Following outcomes stated as I, II & III are given below of this inspection procedure: -

Outcome I --- Existence of inventory

Outcome II ---- Ownership of inventory

Outcome III ----- Condition of inventory

Which of following statements is most likely true?

- (a) Outcomes I, II and III are all necessarily established after inspection.
 - (b) Only Outcomes I and III are established after inspection and Outcome II is never established.
 - (c) Outcomes I and III are established after inspection. However, outcome II may not be necessarily established.
 - (d) Outcome II and III are established after inspection. However, outcome I may not be necessarily established.
5. It was observed by auditors that, out of total rice physically counted on 31st March, 2020 about 67 quintals of rice belonged to M/s PQR, a proprietary concern which had sent paddy to this company's plant for extraction of rice. What would be treatment of this item in financial statements of company?
- (a) The value of 67 quintals rice would be reflected in company's financial statements as per method of valuation adopted by the company.
 - (b) The value of 67 quintals rice would be reflected in company's financial statements as per method of valuation adopted by the proprietary concern.
 - (c) The value of 67 quintals rice would not be reflected in company's financial statements.
 - (d) The value of 67 quintals rice would be reflected in proprietary concern's financial statements as per method of valuation adopted by the company.

Integrated Case Scenario-2

A partnership firm of Chartered Accountants, YZ and Associates were appointed as auditor of company UV Private Limited. The financial year for which YZ and Associates were to audit books of accounts of UV Private Limited began on 1 April, 2018 and ended on 31 March, 2019.

YZ and Associates consisted of four partners namely Mr. Y, Mr. Z, Mr. G and Mr. H.

While auditing books of accounts of UV Private Limited for the period beginning on 1 April, 2018 and ending on 31 March, 2019, one of the partners of YZ and Associates namely Mr. H took up the expenses part for the purpose of audit.

The management of UV Private Limited had adopted various accounting policies and principles related to expenses which Mr. H as auditor of UV Private Limited was unable to understand. Some of the issues which Mr. H was unable to understand are mentioned as follows:

- (1) Power and Fuel expenses paid for the months of April, 2019 and May, 2019 have been included and shown as Power and Fuel expenses for the period beginning 1 April, 2018 and ending 31 March, 2019.
- (2) Personal Rent Expenses of the son of one of the director, Mr. T of UV Private Limited have been shown as Rent Expenses of business of UV Private Limited.
- (3) Repair and Maintenance Expenses for the months of February 2019 and March 2019 were still outstanding and were not shown in Balance Sheet of UV Private Limited.
- (4) Repair and Maintenance Expenses for the financial year 1 April, 2018 to 31 March, 2019 were very high as compared to financial year 1 April, 2017 to 31 March, 2018. The auditor Mr. H asked the appropriate authority about the reasons for such huge differences in amounts of two financial years.
- (5) While verifying the insurance expenses, the insurance policies were not shown to auditor Mr. H.

The above mentioned five points were some of the issues which Mr. H was unable to understand.

Answer the following questions:

1. As per the point number (1) mentioned in the above case, the Power and Fuel Expenses paid for the months of April 2019 and May 2019 must be shown under asset side of balance sheet of UV Private Limited as on 31 March, 2019 as:
 - (a) Outstanding Power and Fuel Expenses
 - (b) Prepaid Power and Fuel Expenses
 - (c) Power and Fuel Expenses
 - (d) Power and Fuel Expenses Payable
2. As per point number (2) mentioned above in the case, the Personal Rent Expenses of the son of one of the director Mr. T were added to Rent Expenses of business of UV Private Limited. The amount of personal rent expenses of the son of the director Mr. T must be:
 - (a) Subtracted from Rent Expenses of business of UV Private Limited
 - (b) Remain Added to Rent Expenses of business of UV Private Limited
 - (c) Again Added to Rent Expenses of business of UV Private Limited
 - (d) Subtracted twice from Rent Expenses of business of UV Private Limited
3. As per point number (3) mentioned above in the case, the Repair and Maintenance Expenses outstanding for the months of February 2019 and March 2019 must be shown under liability side of balance sheet of UV Private Limited as on 31 March, 2019 as:
 - (a) Prepaid Repair and Maintenance Expenses
 - (b) Repair and Maintenance Expenses

- (c) Repair and Maintenance Expenses paid in advance
 - (d) Repair and Maintenance Expenses Payable
4. As per point number (4) mentioned in the case above, the auditor Mr. H asked the appropriate authority for reasons of huge differences in the amount of two financial years of repair and maintenance expenses. By appropriate authority Mr. H was referring to:
- (a) All employees of UV Private Limited
 - (b) Management of UV Private Limited
 - (c) Members of UV Private Limited
 - (d) Any one director of UV Private Limited
5. As per point number (5) mentioned in the case above, in verifying insurance expenses the insurance policies would provide auditor Mr. H as:
- (a) Invalid Supporting
 - (b) No Supporting
 - (c) Lack of proper Supporting
 - (d) Valid Supporting

MCQ's not based on Case Scenario

1. M/s KYC & Co. is a reputed Audit firm in Mumbai. They are appointed as Statutory Auditors of Blessed Ltd. Which of the below is the responsibility of M/s KYC & Co.
- (a) Preparation of financial statements
 - (b) Designing, implementation and maintenance of internal control system
 - (c) Reporting on true and fair view of financial statements
 - (d) Compliance with the applicable law and regulation
2. Mr. A, auditor and Mr. B, Finance Manager of XYZ Pvt Ltd are friends. Mr. A prepares the audit report according to the wishes and directions of Mr. B. In this situation which essential quality of the auditor has been compromised:
- (a) Professional Competence
 - (b) Independence
 - (c) Professional Skepticism
 - (d) Due care
3. Mr. Salman, is an engagement partner of Khan & co. chartered accountants for an audit of Lava Ltd., he died of a stroke on 30.09.2019 after completing the entire routine audit work of Lava Ltd. Mr. Shoaib, one of the partners of Khan & Co. will be signing the accounts of Lava Ltd. What is the course of action to be taken by Mr. Shoaib?

- (a) Sign the accounts of Lava Ltd without reviewing the work of his partner
 - (b) Sign the balance sheet after reviewing the work of his partner
 - (c) Withdraw the audit as the person who has performed the audit is no more
 - (d) Issue an adverse report
4. Auditor Compares Gross Profit Ratio with that of Previous year and it is discovered that there has been a fall in the ratio. This is an example of :
- (a) Analytical Procedure
 - (b) Test of Controls
 - (c) Walk Through Test
 - (d) Audit Sampling
5. While conducting the audit of Saraswati Ltd, a packaged water making company, it was found that a purchase of motor car was made in the name of the company. Your Article Assistant has performed the following audit procedures. Identify which of the following procedure is incorrect.
- (a) Ascertain whether the purchase of car has been properly authenticated.
 - (b) Check invoice of the car dealer to confirm the purchase price
 - (c) Examine registration with Transport Authorities to verify the ownership
 - (d) Ensure that the motor car has been included in the Closing inventory of goods

PART II B – DESCRIPTIVE QUESTIONS

1. State with reason (in short) whether the following statements are true or false:
- (i) Overall audit plan sets the scope, timing and direction of the audit, and guides the development of the more detailed audit strategy.
 - (ii) The Constitution of India contains no specific provisions regarding the appointment, salary and duties and powers of the C&AG. Moreover, the constitution does not guarantee the independence of the C&AG of India.
 - (iii) 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.
 - (iv) If an entity has a known number of employees at fixed rates of pay throughout the period, there would be more need to perform tests of details on the payroll.
 - (v) The term “**relative**”, as defined under the Companies Act, 2013, means anyone who is closely related to another.
 - (vi) 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 passing a Board resolution.

- (vii) In considering the qualitative aspects of the entity's accounting practices, the auditor may not become aware of possible bias in management's judgments.
- (viii) One of the key principles of accrual basis of accounting requires that an asset's cost is proportionally expensed based on the period over which the asset is expected to be used.

Chapter 1- Nature, Objective and Scope of Audit

- 2. (a) **Professional skepticism** refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. Explain giving examples.
- (b) Both accounting and auditing are closely related with each other. Explain
- 3. (a) As per SA 220 "Quality Control for an Audit of Financial Statements", the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. Explain clearly stating the meaning of engagement partner and also the actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement.
- (b) The firm should **establish policies and procedures** designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

Explain the purpose of monitoring compliance with quality control policies and procedures

Chapter 2- Audit Strategy, Audit Planning and Audit Programme

- 4. (a) The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors. Explain giving examples.
- (b) **The auditor shall document** the overall audit strategy, the audit plan and any significant changes made to the overall audit strategy or the audit plan. Explain in detail giving examples.
- 5. (a) Evolving one audit programme applicable to all business under all circumstances is not practicable. Explain clearly stating in detail the meaning of audit programme.

- (b) In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. An auditor picks up evidence from a variety of fields. Analyse and explain with the help of examples.

Chapter 3- Audit Documentation and Audit Evidence

- 6. (a) An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Explain stating clearly the examples of significant matters.
- (b) Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement and also by the quality of such audit evidence. Obtaining more audit evidence, however, may not compensate for its poor quality. Explain also stating the factors affecting auditor's judgment as to sufficiency of audit evidence.
- 7. (a) There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements.

Explain in detail stating clearly the auditor's responsibility in the above context.

- (b) The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. Explain with the help of examples.
- 8. (a) A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls. Explain and also state when will the auditor design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls.
- (b) When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Discuss the matters the auditor may consider in determining the extent of test of controls.

Chapter 4- Risk Assessment and Internal Control

- 9. (a) The risks of material misstatement may exist at the financial statement level and assertion level. Explain the two levels.
- (b) For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall identify risks throughout the process of obtaining an understanding of the entity and its environment. Explain in detail along with other relevant points.

10. (a) Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority.

Explain with the help of examples.

- (b) Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Explain in detail.

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

11. Explain what an auditor is expected to do if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit.
12. As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

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

Explain the manner of reporting the matter to the Central Government in the above context.

Chapter 6- Audit in an Automated Environment

13. With the increasing adoption of information technology, business today relies on software systems and applications more than ever. Many of these IT systems generate and process data that is used in the preparation of financial statements of a company. The auditors also often rely on the data and reports that are generated from these systems. Explain stating clearly the meaning of Automated environment with example.
14. When a business operates in a more automated environment it is likely that we, as auditors, will see several business functions and activities happening within the systems. Explain which of the aspect you will consider relevant as an auditor.

Chapter 7 - Audit Sampling

15. Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk leads to erroneous conclusions. Explain in detail distinguishing it from non-sampling risk with examples.
16. Explain the factors that should be considered for deciding upon the extent of checking on a sampling plan.

Chapter 8 - Analytical Procedures

17. In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk. Explain
18. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment. Explain

Chapter 9 - Audit of Items of Financial Statements

19. How will you vouch/verify the following?
 - (a) Trademarks and copyrights
 - (b) Investments income in the case of charitable institutions
 - (c) Contingent liabilities
 - (d) Leasehold rights
20. A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, etc. as at the end of the reporting period under audit. Explain the audit procedure in this context.

Chapter 10 - The Company Audit

21. Rule 3 of CAAR, 2014 prescribes the manner and procedure of selection and appointment of auditors. Explain that procedure in detail.
22. At the AGM of HDB Pvt. Ltd., Mr. R was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to pursue his career in banking sector. The Board of Director has appointed Mr. L as the statutory auditor in board meeting within 30 days. Comment on the matter with reference to the provisions of Companies Act, 2013.
23. M/s. ABC & Co. is an Audit firm, having partners CA. A, CA. B and CA. C. The firm has been offered the appointment as an Auditor of XYZ Ltd. for the Financial Year 2019-20. Mr. D, the relative of CA. A, is holding 25,000 shares (face value of ₹ 10 each) in XYZ Ltd. having market value of ₹ 90,000. Are M/s. ABC & Co. qualified to be appointed as Auditors of XYZ Ltd.?

Chapter 11 - Audit Report

24. Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?
25. The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section.

Chapter 12- Bank Audit

26. Distinguish between Primary Security and Collateral Security with reference to audit of Banks. Also give examples of most common types of securities accepted by the Banks.
27. Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien. Explain with specific reference to Audit of Banks.

Chapter 13- Audit of Different Types of Entities

28. (a) Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. Analyse and Explain
- (b) The auditor of a Govt Company has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. Explain

SUGGESTED ANSWERS / HINTS**ANSWERS - MULTIPLE CHOICE QUESTIONS- Integrated Case Scenario-1**

1. (d)
2. (b)
3. (d)
4. (c)
5. (c)

ANSWERS - MULTIPLE CHOICE QUESTIONS- Integrated Case Scenario-2

1. (b)
2. (a)
3. (d)
4. (b)
5. (d)

General MCQ's

- 1 (c)
- 2 (b)
- 3 (b)
- 4 (a)
- 5 (d)

DESCRIPTIVE ANSWERS

1. (i) **Incorrect:** Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.
- (ii) **Incorrect:** The Constitution of India contains specific provisions regarding the appointment, salary and duties and powers of the C&AG. The constitution guarantees the independence of the C&AG of India by prescribing that he shall be appointed by the President of India and shall not be removed from office except on the ground of proven mis-behaviour or incapacity.
- (iii) **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.
- (iv) **Incorrect:** If an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.
- (v) **Incorrect:** The term “relative”, as defined under the Companies Act, 2013, means anyone who is related to another as members of a Hindu Undivided Family; husband and wife; Father (including step- father), Mother (including step-mother), Son (including step- son), Son’s wife, Daughter, Daughter’s husband, Brother (including step- brother), Sister (including step-sister).
- (vi) **Incorrect:** According to **Section 140(1)**, the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per **Rule 7 of CAAR, 2014**
- (vii) **Incorrect:** 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.

(viii) **correct:** One of the key principles of accrual basis of accounting requires that an asset's cost is proportionally expensed based on the period over which the asset is expected to be used. Both depreciation and amortization are methods that are used to prorate the cost of a specific type of asset over its useful life. Depreciation represents systematic allocation of the depreciable value of an item of PPE over its useful life while amortisation represents systematic allocation of the depreciable amount of an intangible asset over its useful life.

2. (a) The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

Professional skepticism includes being alert to, for example:

- ◆ Audit evidence that contradicts other audit evidence obtained.
- ◆ Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- ◆ Conditions that may indicate possible fraud.
- ◆ Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
- ◆ Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:
- ◆ Overlooking unusual circumstances.
- ◆ Over generalising when drawing conclusions from audit observations.
- ◆ Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

- (b) Both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process. It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements. In fact, auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities. To begin with, it may be noted that the discipline of auditing itself is a logical construct and everything done in auditing must be bound by the rules of logic. Ethical precepts are the basis on which the foundation of the entire accounting profession rests. The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work.

3. (a) As per SA 220 “Quality Control for an Audit of Financial Statements”, the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

- (a) The importance to audit quality of:
 - (i) Performing work that complies with professional standards and regulatory and legal requirements;
 - (ii) Complying with the firm’s quality control policies and procedures as applicable;
 - (iii) Issuing auditor’s reports that are appropriate in the circumstances; and
 - (iv) The engagement team’s ability to raise concerns without fear of reprisals; and
- (b) The fact that quality is essential in performing audit engagements.

Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor’s report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

- (b) The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:
- (a) Adherence to professional standards and regulatory and legal requirements;
 - (b) Whether the quality control system has been appropriately designed and effectively implemented; and
 - (c) Whether the firm’s quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

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

4. (a) The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

1. The size and complexity of the entity.
2. The area of the audit.

3. The assessed risks of material misstatement

Example

An increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work.

4. The capabilities and competence of the individual team members performing the audit work.

Example

We may have identified a problem related to the production process that raised concerns about inventory obsolescence. After obtaining an understanding of the entity's process that raised concerns about inventory obsolescence (which we had identified as a significant class of transactions), we concluded that additional tests of details were required. Therefore, the senior will likely take part, along with the team, in the discussions with management about the provision for obsolescence and examine related documentation supporting the provision, rather than just reading the memo on file. These procedures should be completed as the work is being performed rather than as an after the fact review. The extent of the senior's involvement requires judgement, taking into consideration the complexity of the area and the experience of the team.

(b) The auditor shall document:

- (a) the overall audit strategy;
- (b) the audit plan; and
- (c) any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

Example

The auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.

The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Example

The following things should form part of auditor's documentation:

- ◆ A summary of discussions with the entity's key decision makers.
- ◆ Documentation of audit committee pre-approval of services, where required.
- ◆ Audit documentation access letters.
- ◆ Other communications or agreements with management or those charged with governance regarding the scope, or changes in scope, of our services.
- ◆ Auditor's report on the entity's financial statements.
- ◆ Other reports as specified in the engagement agreement (e.g., debt covenant compliance letter).

5. (a) Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. However, it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

It is desirable that in respect of each audit and more particularly for bigger audits an audit programme should be drawn up. Audit programme is a list of examination and verification steps to be applied and set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client.

Definition : An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements.

In other words, an audit programme is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

- (b) In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.

An auditor picks up evidence from a variety of fields and it is generally of the following broad types:

- (a) Documentary examination,
- (b) Physical examination,
- (c) Statements and explanation of management, officials and employees,
- (d) Statements and explanations of third parties,
- (e) Arithmetical calculations by the auditor,
- (f) State of internal controls and internal checks,
- (g) Inter-relationship of the various accounting data,
- (h) Subsidiary and memorandum records,
- (i) Minutes,
- (j) Subsequent action by the client and by others.

Example

- 1. For cash in hand, the best evidence is 'count'
- 2. For investment pledged with a bank, the banker's certificate.
- 3. For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion.

The auditor, however, has to place appropriate weight on each piece of evidence and accordingly should prescribe the priority of verification. It is true that in all cases one procedure may not bring the highest satisfaction and it may be dangerous for the auditor to ignore any evidence that is available. By the word "available" we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.

6. (a) Judging the significance of a matter requires an objective analysis of the facts and circumstances.

Examples of significant matters include:

- ◆ Matters that give rise to significant risks.
- ◆ Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- ◆ Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- ◆ Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report.

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgement exercised in performing the work and evaluating the results. Documentation of the professional judgements made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgement. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

- (b) Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. **Auditor's judgement as to sufficiency may be affected by the factors such as:**

- (i) Materiality
- (ii) Risk of material misstatement
- (iii) Size and characteristics of the population.

(a) **Materiality** may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.

(2) **Risk of material misstatement** may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of

two components described as follows at the assertion level (a) Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls. (b) Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control. Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand if assertions have a higher risk of material misstatement, more evidence would be required.

- (c) **Size of a population** refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

7. (a) There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements.

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances.

The auditor needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

- (a) Achieve a true and fair presentation ; or
- (b) Are not misleading (for compliance frameworks).

In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether fraud risk factors are present as required by SA 240. This is because fraud may be more easily committed through related parties.

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- ◆ Management may be unaware of the existence of all related party relationships.
- ◆ Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

Planning and performing the audit with professional skepticism as required by SA 200 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

- (b) The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

- 8. (a) Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

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

- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
- (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

- (b) When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Matters the auditor may consider in determining the extent of test of controls include the following:
 1. The frequency of the performance of the control by the entity during the period.
 2. The length of time during the audit period that the auditor is relying on the

operating effectiveness of the control.

3. The expected rate of deviation from a control.
4. The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
5. The extent to which audit evidence is obtained from tests of other controls related to the assertion.

9. (a) Risks of Material Misstatement at Two levels

The risks of material misstatement may exist at two levels:

- (i) **The overall financial statement level-** Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.
- (ii) **The assertion level for classes of transactions, account balances, and disclosures-** Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

(b) For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall:

- (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
- (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
- (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

10. (a) **Inquiries of Management and Others Within the Entity:** Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority.

Examples

- ◆ Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
 - ◆ Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
 - ◆ Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
 - ◆ Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
 - ◆ Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
 - ◆ Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
 - ◆ Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system- related risks.
- (b) Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

11. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:
 - (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
 - (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and
 - (c) If the auditor withdraws:
 - (i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
 - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.
12. The manner of reporting the matter to the Central Government is as follows:
 - (a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;
 - (b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;
 - (c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

- (d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;
 - (e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and
 - (f) the report shall be in the form of a statement as specified in Form ADT-4.
13. With the increasing adoption of information technology, business today relies on software systems and applications more than ever. Many of these IT systems generate and process data that is used in the preparation of financial statements of a company. The auditors also often rely on the data and reports that are generated from these systems. In this context, it is critical to understand the IT specific risks that could potentially impact the integrity and reliability of financial transactions and data flowing through a company's systems.

An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems. Nowadays, it is very common to see computer systems being used in almost every type of business.

Example

Think about how banking transactions are carried out using ATMs (Automated Teller Machines), or how tickets can be purchased using “apps” on mobile phones, etc. In these examples, you can see how these computer systems enable us to transact business at any time and any day.

14. When a business operates in a more automated environment it is likely that we, as auditors, will see several business functions and activities happening within the systems. As an auditor, there is a need to consider the following aspects :
- ◆ Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).
 - ◆ Accounting entries are posted automatically (for example, sub-ledger to GL postings are automatic).
 - ◆ Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).
 - ◆ Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).

- ◆ User access and security are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively).

15. Sampling Risk. The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

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

Non-Sampling Risk. The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Example

Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.

Sources of Non Sampling risk are :

Human Mistakes	Misinterpreting the sample results
Applying audit procedures not appropriate to the objectives of audit	
Relying on erroneous information e.g. erroneous confirmation	

Non sampling risk can never be mathematically measured.

- 16.** The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:
- (i) Size of the organisation under audit.
 - (ii) State of the internal control.
 - (iii) Adequacy and reliability of books and records.
 - (iv) Tolerable error range.
 - (v) Degree of the desired confidence.

17. In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.
18. The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

19. (a) Trademarks and Copyrights:
- (i) Obtain schedule of Trade Marks and Copyrights duly signed by the responsible officer and scrutinise the same and confirm that all of them are shown in the Balance Sheet.
 - (ii) Examine the written agreement in case of assignment of Copyrights and Assignment Deed in case of transfer of trade marks. Also ensure that trademarks and copyrights have been duly registered.
 - (iii) Verify existence of copyright by reference to contract between the author & the entity and note down the terms of payment of royalty.
 - (iv) See that the value has been determined properly and the costs incurred for the purpose of obtaining the trademarks and copyrights have been capitalised.
 - (v) Ascertain that the legal life of the trademarks and copyrights has not expired.
 - (vi) Ensure that amount paid for both the intangible assets is properly amortised having regard to appropriate legal and commercial considerations, as per the principles enunciated under AS 26 on Intangible Assets.
- (b) Investment Income in the case of Charitable Institution:
- (i) Vouching the amounts received with the dividend and interest counterfoils.
 - (ii) Checking the calculations of interest received on securities bearing fixed rates of interest.

- (iii) Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.
- (iv) Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

(c) Contingent liabilities:

- (i) Inspect the minute books of the company to ascertain all contingent liabilities known to the company.
- (ii) Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating therefrom.
- (iii) Scrutinise the lawyer's bills to track unreported contingent liabilities.
- (iv) Examine bank letters in respect of bills discounted and not matured.
- (v) Examine bank letters to ascertain guarantees on behalf of other companies or individuals.
- (vi) Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.
- (vii) Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.
- (viii) Ensure that proper disclosure has been made as per Schedule III to the Companies Act, 2013 and AS 29, "Provisions, Contingent Liabilities and Contingent Assets".

(d) Leasehold Rights:

- (i) Inspect the lease or assignment thereof to ascertain the amount of premium, if any, for securing the lease, and its terms and conditions; and that the lease has been duly registered. A lease exceeding one year is not valid unless it has been granted by a registered instrument.
- (ii) Ascertain that all the conditions, the failure to comply with which might result in the forfeiture or cancellation of the lease, e.g., payment of ground rent on the due dates, insurance of property, its maintenance in a satisfactory state of repairs, etc. prescribed by the lease, are being duly complied with.
- (iii) Examine the counterpart of the tenants' agreements, if part of the leasehold property has been sublet.
- (iv) Make certain that due provisions for any claim that might arise under the dilapidation clause on the expiry of the lease has been made, and, if no such provision has been made, draw the client's attention to the matter.

- (v) Ensure that the outlay as well as any legal expenses incurred to acquire the leases which are shown as an asset in the Balance Sheet is being written off at a rate which could completely wipe off the asset over the unexpired term of the lease.

20. Direct confirmation procedure

- A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, restrictive use accounts like dividend, escrow accounts as of the end of the reporting period under audit. This should necessarily be done for all account balances as at the period-end.
- The Company should be asked to investigate and reconcile the discrepancies, if any, including seeking written explanations/ clarifications from the banks/ financial institutions on any unresolved queries.
- The auditor should emphasize for confirmation of 100% of bank account balances. In remote situations, where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include:
 - Agreeing the balance to bank statement received by the Company or internet/ online login to account in auditor's personal presence;
 - Sending the audit team member to the bank branch along with the entity's personal to obtain balance confirmation from the bank directly.

21. Rule 3 of CAAR, 2014 prescribes the following manner and procedure of selection and appointment of auditors-

- (1) In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

It may be noted that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.

- (2) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.
- (3) Subject to the provisions of sub-rule (1), where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall

consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.

- (4) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.
 - (5) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.
 - (6) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.
 - (7) The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.
22. 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, be filled by the Board of Directors within 30 days.

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

Further, as per section 140(2) the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form with the company and the Registrar. In the instant case, R resigned after three months of his appointment as statutory auditor as he wanted to pursue his career in banking sector.

Therefore, the board of director has appointed Mr. L as the statutory auditor with in 30 days is in order subject to such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board. Further, it is also the duty of the auditor to file, within a period of 30 days from the date of resignation, a statement in the prescribed Form with the company and the Registrar in compliance with section 140(2) of the Companies Act, 2013.

23. As per section 141(3)(d)(i), a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the instant case, M/s ABC & Co. is an audit firm having partners CA. A, CA. B and CA. C. Mr. D is a relative of CA. A and he is holding shares in XYZ Ltd. of face value of ₹ 2,50,000 (25,000 shares x rupees 10 per share). Market value of ₹ 90,000 would not be relevant.

Therefore, M/s ABC & Co. is disqualified for appointment as an auditors of XYZ Ltd. as the relative of CA. A (i.e. partner of M/s ABC & Co.) is holding the securities in XYZ Ltd. which is exceeding the limit mentioned in proviso to section 141(3)(d)(i) of the Companies Act, 2013.

24. **Emphasis of Matter paragraph:** 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.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (i) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
 - (ii) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
 - (iii) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.
25. **Basis for Opinion:** The auditor's report shall include a section, directly following the Opinion section, with the heading "**Basis for Opinion**", that:
- (a) States that the audit was conducted in accordance with Standards on Auditing;
 - (b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
 - (c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.
 - (d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

26. A. **Primary security** refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.
- B. **Collateral security** is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following:

- Personal Security of Guarantor
 - Goods/Stocks/Debtors/Trade Receivables
 - Gold Ornaments and Bullion
 - Immovable Property
 - Plantations (For Agricultural Advances)
 - Third Party Guarantees
 - Banker's General Lien
 - Life Insurance Policies
 - Stock Exchange Securities and Other Instruments
27. Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien.
- (i) **Mortgage:** Mortgage are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage.
- **Registered Mortgage** can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security.
 - **Equitable mortgage**, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.
- (ii) **Pledge:** A pledge thus involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge.
- (iii) **Hypothecation:** The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favour of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank.

The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

- (iv) **Assignment:** Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favour of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

An assignment gives the assignee absolute right over the moneys/debts assigned to him.

- (v) **Set-off** Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same).

For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

- (vi) **Lien:** Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

28. (a) **Audit against Rules & Orders** - Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

- (i) Rules and orders regulating the powers to incur and sanction expenditure from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);
- (ii) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and
- (iii) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that

these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

- (a) they are not inconsistent with any provisions of the Constitution or any laws made thereunder;
- (b) they are consistent with the essential requirements of audit and accounts as determined by the C&AG;
- (c) they do not come in conflict with the orders of, or rules made by, any higher authority; and
- (d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C&AG.

- (b) **Audit of sanctions** - The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. The audit of sanctions is directed both in respect of ensuring that the expenditure is properly covered by a sanction, and also to satisfy that the authority sanctioning it is competent for the purpose by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made thereunder, or by the rules of delegation of financial powers made by an authority competent to do so.

PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC MANAGEMENT

SECTION – A: ENTERPRISE INFORMATION SYSTEMS



QUESTIONS

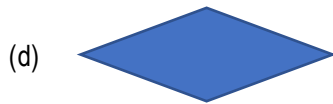
Multiple Choice Questions

Q. No (s) 1 to 4 are based on the Case Scenario. Question No. 5 is independent.

Sweet & Sour is an established food chain with five branches at different locations within Delhi. In 2018, the management decided to start a tiffin services with 24x7 availability on regular basis. To do so, they decided to acquire a software which would be an online assistant to its customers by providing them a complete detail about their services. The Management asked its manager to present them a report mentioning the benefits, risks, control objectives and above all highlighting any changes that are required in the working of food chain.

The management settled on a plan to benefit all its customers by providing them discounted coupons in case they recommend their services to others and customer ensuring to provide the food chain of three new customers. Also, the management decided for a centralized billing system that mandatorily requires customer's name and phone number to be filled for each bill that system generates. To maintain these necessary details of its customers, the data management team of Sweet & Sour implemented major changes in the database design of its billing software. Subsequently, the security and database maintenance has become essential to protect the system against any unlawful activity as the database now contains the personal details of its customers.

1. The software which food chain decided to buy, to help their customer and provide them online help, falls under which of the following technology?
 - (a) Artificial Intelligence
 - (b) Data Mining
 - (c) Cloud Computing
 - (d) Mobile Computing
2. The Manager of the food chain prepared a document wherein he depicted various business processes of the food chain in diagrammatic form. Which of the following diagram will he use to present pre-defined process?
 - (a) 
 - (b) 



3. The data management team of Sweet & Sour food chain was working to implement changes in database design of its billing software. Which of the following person will carry out routine data maintenance and monitor this task?
 - (a) Database Administrator
 - (b) Database Architect
 - (c) Database Analyst
 - (d) Database Advisor
4. The management of Sweet & Sour has shown its concern what would happen if any of its employees dishonestly make use of personal information of customer. Which of the following Section of IT Act, 2000 will help Sweet & Sour to deal with this situation?
 - (a) Section 43A
 - (b) Section 43
 - (c) Section 66E
 - (d) Section 66B
5. The Management Information System of SVE Ltd. enterprise develops MIS reports only when required. It does not generate MIS reports for each and every day. Identify from following the type of MIS report generated by SVE Ltd.
 - (a) Off Demand MIS Reports
 - (b) Demand MIS Reports
 - (c) Required MIS Reports
 - (d) On-Demand MIS Reports

Descriptive Questions

Chapter 1: Automated Business Process

6. ERM framework identifies risks and opportunities to protect the business and create the value for stakeholders, including owners, customer, regulators and society overall. Briefly explain all the components of ERM framework.

7. An E-commerce site has the following cash back offers.
- (i) If purchase mode is via website, an initial discount of 5% is given on bill amount.
 - (ii) If purchase mode is via phone app, an initial discount of 10% is given on bill amount.
 - (iii) If done via any other purchase mode, the customer is not eligible for any discount.
- Every purchase eligible to discount is given 10 reward points.
- (a) If the reward points are between 100 and 200 points, the customer is eligible for a further 20% discount on the bill amount after initial discount.
 - (b) If the reward points exceed 200 points, the customer is eligible for a further 25% discount on the bill amount after initial discount.

Taking purchase mode, bill amount and number of purchases as input; draw a flowchart to calculate and display the total reward points and total bill amount payable by the customer after all the discount calculation.

Chapter 2: Financial and Accounting Systems

- 8. A medium sized enterprise ABC Ltd. wants to acquire Financial Accounting System not through its own IT infrastructure but rather through outsourcing its IT functions using cloud-based application. Enlist the characteristics of cloud-based application on various parameters that would help ABC company.
- 9. Identify the functional module of ERP that controls the business flow in an organization and facilitates coordinating, monitoring and optimizing all processes in an organization and elaborate the key features of this module.

Chapter 3: Information Systems and its Components

- 10. Share & Care is a multinational FMCG company having various branches in different cities across the country. The company used a centralized Data warehouse to store data of all branches at its headquarters in Mumbai. Elaborate the benefits of Data Warehouse that may be availed by Share & Care company.
- 11. In Information Systems, Logical Access Controls ensure the access to system, data, and program. Discuss various technical exposures on which logical access controls can be implemented.

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

- 12. Ms. Nisha has setup a home tiffin service along with her business partner Ms. Seema. Though Nisha is not convinced, her business partner Ms. Seema is certain to adopt the digital mode of payment than traditional method in their business. To convince Nisha about the same, Ms. Seema jotted down the advantages and disadvantages of digital payment. Identify the points she would have prepared.


13. Mr. R as an IT manager of a financial company, advised his management to allow their senior employees to use their own computing devices for official work under Bring Your Own Device (BYOD) policy. The management wishes to know about the risks associated with BYOD. Briefly explain the classification of BYOD risks.

Chapter 5: Core Banking Systems

14. Agro development bank is a corporate bank with two branches in Jaipur city. The bank has decided to implement Core Banking Systems (CBS) in both branches for better inter-connectivity between its branches and also to facilitate management of deposit, loan and credit processing. Explain the various stages involved in deployment and implementation of CBS.
15. Explain the Section 43 of IT Act, 2000 related to penalty and compensation for damage to computer and computer system.

SUGGESTED ANSWERS/HINTS

Multiple Choice Answers

1. (a) Artificial Intelligence
2. (c) 
3. (c) Database Analyst
4. (a) Section 43A
5. (d) On-Demand MIS Reports

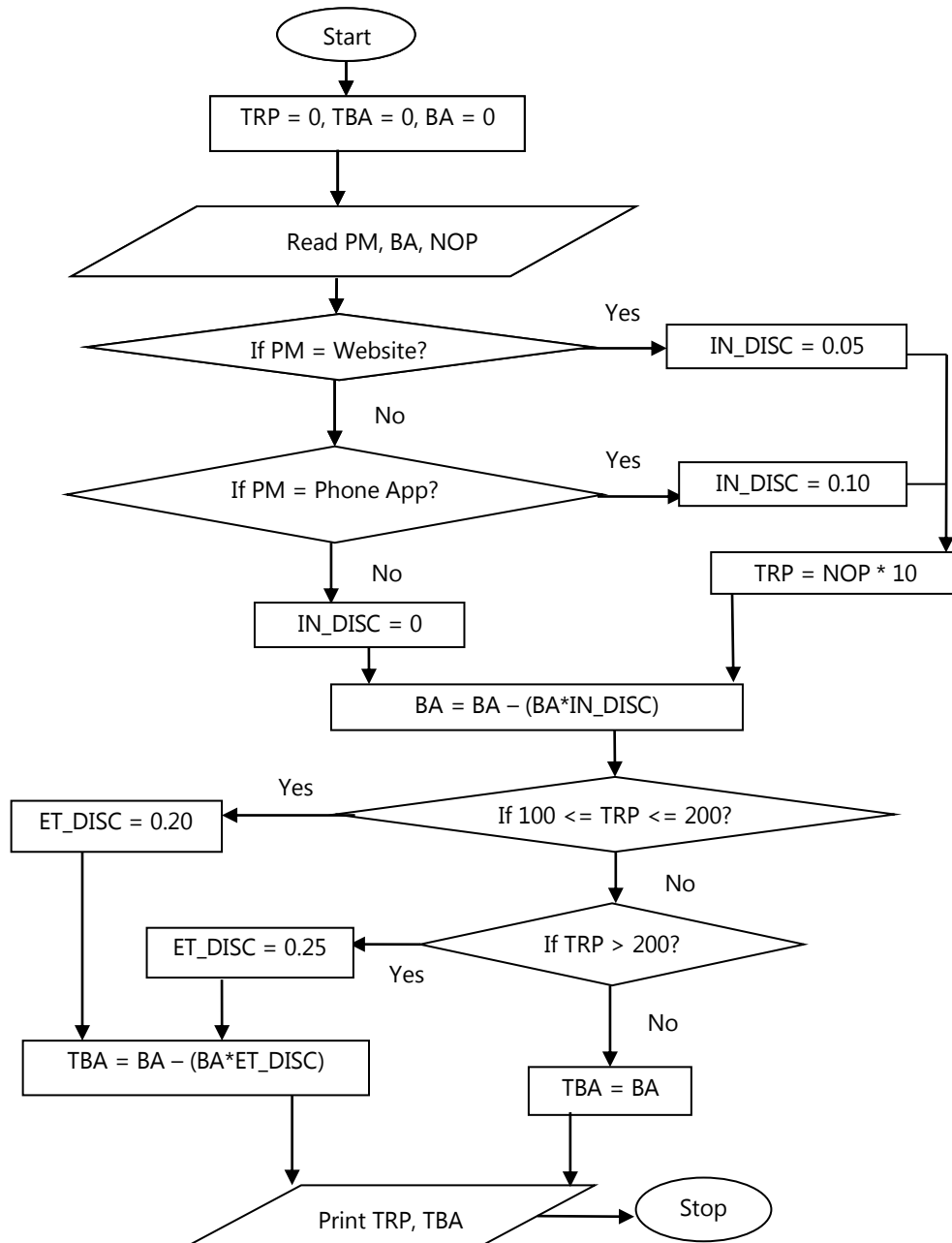
Descriptive Answers

6. ERM framework consists of eight interrelated components that are derived from the way management runs a business and are integrated with the management process. These components are as follows:
 - (i) **Internal Environment:** The internal environment encompasses the tone of an organization and sets the basis for how risk is viewed and addressed by an entity's people, including risk management philosophy and risk appetite, integrity and ethical values, and the environment in which they operate. Management sets a philosophy regarding risk and establishes a risk appetite. The internal environment sets the foundation for how risk and control are viewed and addressed by an entity's people. The core of any business is its people – their individual attributes, including integrity, ethical values and competence – and the environment in which they operate. They are the engine that drives the entity and the foundation on which everything rests.

- (ii) **Objective Setting:** Objectives should be set before management can identify events potentially affecting their achievement. ERM ensures that management has a process in place to set objectives and that the chosen objectives support and align with the entity's mission/vision and are consistent with the entity's risk appetite.
 - (iii) **Event Identification:** Potential events that might have an impact on the entity should be identified. Event identification includes identifying factors – internal and external – that influence how potential events may affect strategy implementation and achievement of objectives. It includes distinguishing between potential events that represent risks, those representing opportunities and those that may be both. Opportunities are channelled back to management's strategy or objective-setting processes. Management identifies inter-relationships between potential events and may categorize events to create and reinforce a common risk language across the entity and form a basis for considering events from a portfolio perspective.
 - (iv) **Risk Assessment:** Identified risks are analyzed to form a basis for determining how they should be managed. Risks are associated with related objectives that may be affected. Risks are assessed on both an inherent and a residual basis, and the assessment considers both risk likelihood and impact. A range of possible results may be associated with a potential event, and management needs to consider them together.
 - (v) **Risk Response:** Management selects an approach or set of actions to align assessed risks with the entity's risk tolerance and risk appetite, in the context of the strategy and objectives. Personnel identify and evaluate possible responses to risks, including avoiding, accepting, reducing and sharing risk.
 - (vi) **Control Activities:** Policies and procedures are established and executed to help ensure that the risk responses that management selected, are effectively carried out.
 - (vii) **Information and Communication:** Relevant information is identified, captured and communicated in a form and time frame that enable people to carry out their responsibilities. Information is needed at all levels of an entity for identifying, assessing and responding to risk. Effective communication also should occur in a broader sense, flowing down, across and up the entity. Personnel need to receive clear communications regarding their role and responsibilities.
 - (viii) **Monitoring:** The entire ERM process should be monitored, and modifications made as necessary. In this way, the system can react dynamically, changing as conditions warrant. Monitoring is accomplished through ongoing management activities, separate evaluations of the ERM processes or a combination of the both.
7. Let us define the variables first:
- | | | |
|---------------------------------|---------------------------------|----------------------------------|
| PM: Purchase Mode | BA: Bill Amount | TBA: Total Bill Amount |
| NOP: Number of Purchases | TRP: Total Reward Points | IN_DISC: Initial Discount |

ET_DISC: Extra Discount on purchases eligible to Initial Discount

N: Counter (to track the no. of purchases)



8. The characteristics of Cloud-based application on various parameters that would help ABC company are as follows:
- **Installation and Maintenance:** Installation on user computer is not required. Update and maintenance are defined responsibility of service provider.
 - **Accessibility:** As software is available through online access, to use the software a browser and an internet connection is needed. It can be used from any computer in the world. Access to the software becomes very easy. Also, it can be used 24 x 7.
 - **Mobile Application:** Mobile application becomes very easy as data is available 24x7. As technology evolves mobile technology is becoming an industry norm. That makes cloud-based application future oriented.
 - **Data Storage:** Data is not stored in the user's server computer. It is stored on a web server. Ownership of data is defined in Service Level Agreement (SLA). SLA defines the rights, responsibilities and authority of both service provider and service user.
 - **Data Security:** Data security is a challenge in case of cloud-based application as the data is not in control of the user or owner of data. As time evolves; SLAs provides for details of back-up, disaster recovery alternatives being used by service provider.
 - **Performance:** Access is dependent on speed of internet. Slow internet slows access to information and may slow operations.
 - **Flexibility:** The success of cloud-based applications is that they allow flexibility against both capital expenditure (CAPEX) and Operating Expense (OPEX) to the user. User can scale up operations as per need.
9. In ERP, the **Controlling Module** controls the business flow in an organization and facilitates coordinating, monitoring, and optimizing all the processes in an organization. This module helps in analysing the actual figures with the planned data and in planning business strategies.

Key features of Controlling module are as under.

- **Cost Element Accounting:** This component provides overview of the costs and revenues that occur in an organization. The cost elements are the basis for cost accounting and enable the user the ability to display costs for each of the accounts that have been assigned to the cost element. Examples of accounts that can be assigned are Cost Centres, Internal Orders, WBS (work breakdown structures).
- **Cost Centre Accounting:** This provides information on the costs incurred by the business. Cost Centres can be created for such functional areas as Marketing, Purchasing, Human Resources, Finance, Facilities, Information Systems, Administrative Support, Legal, Shipping/Receiving, or even Quality. Some of the benefits of Cost Centre Accounting are that the Managers can set Budget/Cost

Centre targets; Planning; Availability of Cost allocation methods; and Assessments/Distribution of costs to other cost objects.

- **Activity-Based-Accounting:** This analyze cross-departmental business processes and allows for a process-oriented and cross-functional view of the cost centres.
- **Internal Orders:** Internal Orders provide a means of tracking costs of a specific job, service, or task. These are used as a method to collect those costs and business transactions related to the task. This level of monitoring can be very detailed but allows management the ability to review Internal Order activity for better decision-making purposes.
- **Product Cost Controlling:** This calculates the costs that occur during the manufacture of a product or provision of a service and allows the management the ability to analyse their product costs and to make decisions on the optimal price(s) to market their products.
- **Profitability Analysis:** This allows the management to review information with respect to the company's profit or contribution margin by individual market segment; and
- **Profit Centre Accounting:** This evaluates the profit or loss of individual, independent areas within an organization.

10. Benefits of Data Warehouse are as follows:

- The process of developing a data warehouse forces an organization to better understand the data that it is currently collecting and, equally important, what data is not being collected.
- A data warehouse provides a centralized view of all data being collected across the enterprise and provides a means for determining data that is inconsistent.
- Once all data is identified as consistent, an organization can generate one version of the truth. This is important when the company wants to report consistent statistics about itself, such as revenue or number of employees.
- By having a data warehouse, snapshots of data can be taken over time. This creates a historical record of data, which allows for an analysis of trends.
- A data warehouse provides tools to combine data, which can provide new information and analysis.

11. The various technical exposures on which Logical Access Controls can be implemented are as follows:

- ◆ **Data Diddling:** This involves the change of data before or after they entered the system. A limited technical knowledge is required to data diddle and the worst part with this is that it occurs before computer security can protect the data.

- ◆ **Bomb:** Bomb is a piece of bad code deliberately planted by an insider or supplier of a program. An event, which is logical, triggers a bomb or time based. The bombs explode when the conditions of explosion get fulfilled causing the damage immediately. However, these programs cannot infect other programs. Since, these programs do not circulate by infecting other programs; chances of a widespread epidemic are relatively low.
- ◆ **Christmas Card:** It is a well-known example of Trojan and was detected on internal E-mail of IBM system. On typing the word 'Christmas', it will draw the Christmas tree as expected, but in addition, it will send copies of similar output to all other users connected to the network. Because of this message on other terminals, other users cannot save their half-finished work.
- ◆ **Worm:** A worm does not require a host program like a Trojan to relocate itself. Thus, a Worm program copies itself to another machine on the network. Since, worms are stand-alone programs, and they can be detected easily in comparison to Trojans and computer viruses. Examples of worms are Existential Worm, Alarm clock Worm etc. The Alarm Clock worm places wake-up calls on a list of users. It passes through the network to an outgoing terminal while the sole purpose of existential worm is to remain alive. Existential worm does not cause damage to the system, but only copies itself to several places in a computer network.
- ◆ **Rounding Down:** This refers to rounding of small fractions of a denomination and transferring these small fractions into an authorized account. As the amount is small, it gets rarely noticed.
- ◆ **Salami Techniques:** This involves slicing of small amounts of money from a computerized transaction or account. A Salami technique is slightly different from a rounding technique in the sense a fix amount is deducted. For example, in the rounding off technique, ₹ 21,23,456.39 becomes ₹ 21,23,456.40, while in the Salami technique the transaction amount ₹ 21,23,456.39 is truncated to either ₹ 21,23,456.30 or ₹ 21,23,456.00, depending on the logic.
- ◆ **Trap Doors:** Trap doors allow insertion of specific logic, such as program interrupts that permit a review of data. They also permit insertion of unauthorized logic.
- ◆ **Spoofing:** A spoofing attack involves forging one's source address. One machine is used to impersonate the other in spoofing technique. Spoofing occurs only after a particular machine has been identified as vulnerable. A penetrator makes the user think that s/he is interacting with the operating system. For example, a penetrator duplicates the login procedure, captures the user's password, attempts for a system crash and makes user login again.

12. The **advantages** of Digital payment are as follows:

- (i) **Easy and convenient:** Digital payments are easy and convenient. Person does not need to take loads of cash with themselves.
- (ii) **Pay or send money from anywhere:** With digital payment modes, one can pay from anywhere anytime.
- (iii) **Discounts from taxes:** Government has announced many discounts to encourage digital payments. User get 0.75% discounts on fuels and 10% discount on insurance premiums of government insurers.
- (iv) **Written record:** User often forgets to note down his / her spending, or even if nothing is done it takes a lot of time. These are automatically recorded in passbook or inside E-Wallet app. This helps to maintain record, track spending and budget planning.
- (v) **Less Risk:** Digital payments have less risk if used wisely. If user loses mobile phone or debit / credit card or Aadhar card, no need to worry a lot. No one can use anyone else's money without MPIN, PIN or fingerprint in the case of Aadhar. It is advised that user should get card blocked, if lost.

The **disadvantages** of Digital Payments are as follows:

- (i) **Difficult for a Non-technical person:** As most of the digital payment modes are based on mobile phone, the internet and cards. These modes are somewhat difficult for non-technical persons such as farmers, workers etc.
- (ii) **The risk of data theft:** There is a big risk of data theft associated with the digital payment. Hackers can hack the servers of the bank or the E-Wallet a customer is using and easily get his/her personal information. They can use this information to steal money from the customer's account.
- (iii) **Overspending:** One keeps limited cash in his/her physical wallet and hence thinks twice before buying anything. But if digital payment modes are used, one has access to all his/her money that can result in overspending.

13. Bring Your Own Device (BYOD) risks can be classified into four areas that are as follows:

- ◆ **Network Risks:** It is normally exemplified and hidden in 'Lack of Device Visibility'. When company-owned devices are used by all employees within an organization, the organization's IT practice has complete visibility of the devices connected to the network. This helps to analyze traffic and data exchanged over the Internet. As BYOD permits employees to carry their own devices (smart phones, laptops for business use), the IT practice team is unaware about the number of devices being connected to the network. As network visibility is of high importance, this lack of visibility can be hazardous. For example, if a virus hits the network and all the devices connected to the network need be scanned, it is probable that some of the

devices would miss out on this routine scan operation. In addition to this, the network security lines become blurred when BYOD is implemented.

- ◆ **Device Risks:** It is normally exemplified and hidden in 'Loss of Devices'. A lost or stolen device can result in an enormous financial and reputational embarrassment to an organization as the device may hold sensitive corporate information. Data lost from stolen or lost devices ranks as the top security threats as per the rankings released by Cloud Security Alliance. With easy access to company emails as well as corporate intranet, company trade secrets can be easily retrieved from a misplaced device.
 - ◆ **Application Risks:** It is normally exemplified and hidden in 'Application Viruses and Malware'. A related report revealed that most employees' phones and smart devices that were connected to the corporate network weren't protected by security software. With an increase in mobile usage, mobile vulnerabilities have increased concurrently. Organizations are not clear in deciding that 'who is responsible for device security – the organization or the user'.
 - ◆ **Implementation Risks:** It is normally exemplified and hidden in 'Weak BYOD Policy'. The effective implementation of the BYOD program should not only cover the technical issues mentioned above but also mandate the development of a robust implementation policy. Because corporate knowledge and data are key assets of an organization, the absence of a strong BYOD policy would fail to communicate employee expectations, thereby increasing the chances of device misuse. In addition to this, a weak policy fails to educate the user, thereby increasing vulnerability to the above-mentioned threats.
14. The various stages involved in deployment and implementation of Core Banking Systems (CBS) are as follows:
- **Planning:** Planning for implementing the CBS should be done as per strategic and business objectives of bank.
 - **Approval:** The decision to implement CBS requires high investment and recurring costs and will impact how banking services are provided by the bank. Hence, the decision must be approved by the board of directors.
 - **Selection:** Although there are multiple vendors of CBS, each solution has key differentiators. Hence, bank should select the right solution considering various parameters as defined by the bank to meet their specific requirements and business objectives.
 - **Design and develop or procured:** CBS solutions used to be earlier developed in-house by the bank. Currently, most of the CBS deployments 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.

15. Section 43: Penalty and compensation for damage to computer, computer system, etc.

If any person without permission of the owner or any other person who is in-charge of a computer, computer system or computer network -

- (a) accesses or secures access to such computer, computer system or computer network [or computer resource];
- (b) downloads, copies or extracts any data, computer database or information from such computer, computer system or computer network including information or data held or stored in any removable storage medium;
- (c) introduces or causes to be introduced any computer contaminant or computer virus into any computer, computer system or computer network;
- (d) damages or causes to be damaged any computer, computer system or computer network, data, computer database or any other programs residing in such computer, computer system or computer network;
- (e) disrupts or causes disruption of any computer, computer system or computer network;
- (f) denies or causes the denial of access to any person authorized to access any computer, computer system or computer network by any means;

- (g) provides any assistance to any person to facilitate access to a computer, computer system or computer network in contravention of the provisions of this Act, rules or regulations made there under;
- (h) charges the services availed of by a person to the account of another person by tampering with or manipulating any computer, computer system, or computer network;
- (i) destroys, deletes or alters any information residing in a computer resource or diminishes its value or utility or affects it injuriously by any means;
- (j) steals, conceals, destroys or alters or causes any person to steal, conceal, destroy or alter any computer source code used for a computer resource with an intention to cause damage, he shall be liable to pay damages by way of compensation to the person so affected.

SECTION – B: STRATEGIC MANAGEMENT**Multiple Choice Questions**

1. Connect Private Limited, a Mumbai based company is launching a smartphone, under the brand name of Poppy. The company recognizes plethora of options that customers have from Chinese manufacturers flooding the smartphone landscape. With recent COVID-19 pandemic hurting the global sentiment towards Chinese products, the company plans to play on the patriotic card and advertise Poppy as the “Desi” smartphone of India.

Strategic Arm of the company undertook an industry analysis and reported, that, budget phone segment was overtaken by the Chinese brands completely; however, the low segment of smartphones was still open for exploration. Thus, the company planned to enter the market with two models, Poppy A and Poppy B, priced at ₹ 4,499 and ₹ 5,499.

The company is also aware that their product can easily be imitated at same costing as well as pricing, and thus the very essence of their product can be lost. A team of marketing professionals was hired to tackle this issue. The solution they suggested was to take the first mover advantage by spending huge sums in advertising and promotion.

Based on sound consciousness of the competition from huge money backed international players, the company decided to manufacture smartphone covers and accessories with the same “Desi” tag, along with Poppy smartphones. This shall help them mitigate the risk of being completely thrown out of business. Consequently, they invested a fairly good amount in manufacturing of these accessories.

The investors made it an objective for the team to reach an annual sales volume of 15,000 handsets and 70,000 pieces of accessories. The accessories sales surpassed the expectations by a fairly good margin. However, Poppy A and Poppy B did not receive the much anticipated response and the leadership decided to reduce the scope and focus purely on accessories business going forward.

With a new focus on accessories production, the “Desi” tag will still play an important part in the success. However, they need to ensure creation of strong barriers to entry for domestic players, and for that, they have plans to increase the production to enormous levels. This shall reduce their unit cost, thus, eliminating the new entrants due to extremely competitive pricing.

Based on the above case scenario, answer the multiple choice questions which are as follows:

- (i) Connect Private Limited, entered a saturated market of smartphones, after a due market study of understanding the competitive landscape. Put the below steps in correct sequence of understanding the competitive landscape.
- (I) Understanding the competitors
 - (II) Determining strengths and weaknesses of the competitors
 - (III) Identify the competitors

- (IV) Put all information gathered together
 - (a) (I),(III),(II),(IV)
 - (b) (III),(I),(II),(IV)
 - (c) (II),(III),(IV),(I)
 - (d) (I),(III),(II),(IV)
- (ii) Annual sales volume as an objective by the investors was crucial to establish the company in the market. In which stage of strategic management are such annual objectives especially important?
 - (a) Formulation
 - (b) Control
 - (c) Evaluation
 - (d) Implementation
- (iii) Following the sales numbers reported at the end of year, the leadership took a serious strategic stand point to move forward and shift to a new core business which was more profitable. Under which of the following category of business strategy can this decision be categorized?
 - (a) Retrenchment strategy
 - (b) Strategic alliance
 - (c) Diversification strategy
 - (d) Market development
- (iv) After getting results from the market, accessories business of the company can be classified under which category of BCG's growth share matrix?
 - (a) Star
 - (b) Question mark
 - (c) Cash cow
 - (d) Dog
- (v) In the second phase of shifting the business focus to peripheral accessories production, Connect Private Limited has planned setting up entries to barrier for its potential competitors. Which of the following barrier have they planned to implement?
 - (a) Capital requirement

- (b) Product differentiation
 - (c) Access to distribution channels
 - (d) Economies of scale
2. Velvet Limited is a full-service airline. The company is making the following decisions:
- (i) Should a 'no-frills', 'low-fare' subsidiary be set-up?
 - (ii) If it is set-up, how should the cabin staff be recruited?
- Which of the above decisions will be taken by corporate level managers?
- (a) Only (i)
 - (b) Only (ii)
 - (c) Both (i) & (ii)
 - (d) Neither (i) nor (ii)
3. Training company operates a network of accounting training centres throughout Europe, the US and Australia. The business intends to enter developing markets in order to drive growth and has now decided to enter India which is 7,500 kilometres from the Training Co.'s UK headquarters. The Board has suggested that it will require externally focused management information to move into India. Which of the following is an external factor(s) that the Board should consider while implementing its strategy?
- (a) Key local rivals and their strengths and weaknesses
 - (b) Courses are suitable for this market
 - (c) Timing of the courses (Public holidays, religious festivals, etc to be avoided)
 - (d) All of the above
4. GetWellSoon Limited is a health provider and has only large edge of town hospitals. It is considering setting-up additional small city centre clinics capable of treating less-serious day cases. Which of the following will fall under "Strategy Implementation"?
- (1) Acquiring and fitting out clinics
 - (2) Hiring and/or transferring staff
 - (3) Publicity, so that patients know where and when to go
 - (4) Liaison with general practitioners and the main hospitals
- (a) Only (d)
 - (b) (b) & (d)
 - (c) (a), (b) & (d)
 - (d) (a), (b), (c) & (d)

5. A person who searched for business opportunity and starts a new enterprise to make use of that opportunity called
- (a) Employee
 - (b) Entrepreneur
 - (c) Intrapreneur
 - (d) Investor
6. The Niche strategy is the best way to enter a:
- (a) New market
 - (b) Growing market
 - (c) Matured market
 - (d) None of the above

Descriptive Questions

Chapter 1-Introduction to Strategic Management

7. Ramesh Sharma has fifteen stores selling consumer durables in Delhi Region. Four of these stores were opened in last three years. He believes in managing strategically and enjoyed significant sales of refrigerator, televisions, washing machines, air conditioners and like till four years back. With shift to the purchases to online stores, the sales of his stores came down to about seventy per cent in last four years.
- Analyse the position of Ramesh Sharma in light of limitations of strategic management.
8. "Strategy is partly proactive and partly reactive." Discuss.

Chapter 2-Dynamics of Competitive Strategy

9. 'Speed' is a leading retail chain, on account of its ability to operate its business at low costs. The retail chain aims to further strengthen its top position in the retail industry. The Chief executive of the retail chain is of the view that to achieve the goals they should focus on lowering the costs of procurement of products. Highlight and explain the core competence of the retail chain.
10. Write a short note on the role of ADL Matrix in assessing competitive position of a firm.

Chapter 3-Strategic Management Process

11. Mr. Raj has been hired as a CEO by XYZ Ltd a FMCG company that has diversified into affordable cosmetics. The company intends to launch Feelgood brand of cosmetics. XYZ wishes to enrich the lives of people with its products that are good for skin and are produced in ecologically beneficial manner using herbal ingredients. Draft vision and mission statement that may be formulated by Raj.
12. What is strategic decision making? What tasks are performed by a strategic manager?

Chapter 4-Corporate Level Strategies

13. General public is discerning from buying air conditioning units based on the Health Ministry guidelines regarding emergence of a contagious viral pandemic. Consequently, Nebula Pvt. Ltd, a manufacturer of evaporation coils used in air conditioning units has faced significant loss in working capital due to sharp fall in demand. The company conducted financial assessment and developed a workable action plan based on short and long term financial needs. But for immediate needs, an emergency plan has been implemented. It includes selling scrap, asset liquidation and overheads cost reduction. Further, to avoid any such untoward event in future, they plan to diversify into newer business areas along with its core business. Identify and explain the strategy opted by M/s. Nebula Pvt. Ltd.?
14. What is Divestment strategy? When is, it adopted?

Chapter 5-Business Level Strategies

15. Airlines industry in India is highly competitive with several players. Businesses face severe competition and aggressively market themselves with each other. Luxury Jet is a private Delhi based company with a fleet size of 9 small aircrafts with seating capacity ranging between 6 seats to 9 seats. These aircrafts are chartered by big business houses and high net worth individuals for their personalised use. With customised tourism packages their aircrafts are also often hired by foreigners. Identify and explain the Michael Porter's Generic Strategy followed by Luxury Jet.
16. Distinguish between Cost Leadership and Differentiation Strategies.

Chapter 6-Functional Level Strategies

17. Mr. Vicky Verma, a Gwalior based entrepreneur, has entered into an exclusive-retail deal with an Italian company selling 'Fantasy-3D', a Hologram LED Fan, which is being used for advertising at public places. Mr. Verma procured a total of 500 units of the product and paid upfront as per the seller's policy. This resulted in blocking of his working capital significantly and the shipment is expected in a month. Meanwhile his continued efforts of establishing relations with the marketing heads of corporates resulted in a series of meetings, where he demonstrated his specialist product knowledge by changing the hologram images to personalise basis specifications of the customer. The management of a big automotive company was impressed with the quality and adaptability of the product, and awarded a contract of 125 units to be displayed in the auto-maker's showrooms. Identify and explain the product promotion strategy adopted by Mr. Verma.
18. How would you argue that Research and Development Personnel are important for effective strategy implementation?

Chapter 7-Organisation and Strategic Leadership

19. Delta is an organization specializing in Information Technology enabled Services (ITeS) and Communications business. Previous year the organization had successfully integrated an Artificial Intelligence (AI) tool named 'Zeus' into the existing ERP system.

The AI tool using Deep Learning technique provided a digital leap transformation in various business processes and operations. It has significantly diminished the role played by specialist managers of the middle management. This technological tool in addition to saving organisational costs by replacing many tasks of the middle management, has also served as a link between top and bottom levels in the organization and assists in faster decision making. The skewed middle level managers now perform cross-functional duties. Which type of organisational structure is the company transitioning into?

20. How can you differentiate between transformational and transactional leaders?

Chapter 8-Strategy Implementation and Control

21. The Audit Committee of Theta Ltd on observing a sluggish growth has advised a radical internal digital transformation. A strategy audit was proposed to identify problem areas and correct the strategic approaches that have not been effective so far. The strategy auditor while measuring organisational performance has identified gaps in flow between order booking by the sales department and the dispatch of product by the delivery department, which amounts to success of one department means failure for another. With reference to Richard Rumelt's criteria for strategy audit, identify and explain the correct evaluation criteria to be adopted.
22. Discuss three methods for reassigning new patterns of behavior as proposed by H.C. Kellman.

SUGGESTED ANSWERS/HINTS

1. (i) b (ii) d (iii) a (iv) c (v) d
2. a
3. d
4. d
5. b
6. c
7. Ramesh Sharma is facing declining sales on account of large scale shift of customers to online stores. While he is using the tools of strategic management, they cannot counter all hindrances and always achieve success. There are limitations attached to strategic management as follows:
 - ◆ Environment under which strategies are made is highly complex and turbulent. Entry of online stores, a new kind of competitor brought a different dimension to selling consumer durables. Online stores with their size power could control the market and offer stiff competition to traditional stores.

- ◆ Another limitation of strategic management is that it is difficult to predict how things will shape-up in future. Ramesh Sharma, although managing strategically failed to see how online stores will impact the sales.
 - ◆ Although, strategic management is a time-consuming process, he should continue to manage strategically. The challenging times require more efforts on his part.
 - ◆ Strategic management is costly. Ramesh Sharma may consider engaging experts to find out preferences of the customers and attune his strategies to better serve them in a customized manner. Such customized offerings may be difficult to match by the online stores.
 - ◆ The stores owned by Ramesh Sharma are much smaller than online stores. It is very difficult for him to visualize how online stores will be moving strategically.
8. Strategy is partly proactive and partly reactive. In proactive strategy, organizations will analyze possible environmental scenarios and create strategic framework after proper planning and set procedures and work on these strategies in a predetermined manner. However, in reality no company can forecast both internal and external environment exactly. Everything cannot be planned in advance. It is not possible to anticipate moves of rival firms, consumer behaviour, evolving technologies and so on.
- There can be significant deviations between what was visualized and what actually happens. Strategies need to be attuned or modified in the light of possible environmental changes. There can be significant or major strategic changes when the environment demands. Reactive strategy is triggered by the changes in the environment and provides ways and means to cope with the negative factors or take advantage of emerging opportunities.
9. A core competence is a unique strength of an organization which may not be shared by others. Core competencies are those capabilities that are critical to a business achieving competitive advantage. In order to qualify as a core competence, the competency should differentiate the business from any other similar businesses. A core competency for a firm is whatever it does is highly beneficial to the organisation. 'Speed' is the leader on account of its ability to keep costs low. The cost advantage that 'Value for Money' has created for itself has allowed the retailer to price goods lower than competitors. The core competency in this case is derived from the company's ability to generate large sales volume, allowing the company to remain profitable with low profit margin.
10. The ADL matrix has derived its name from Arthur D. Little which is a portfolio analysis method based on product life cycle. The approach forms a two dimensional matrix based on stage of industry maturity and the firm's competitive position, environmental assessment and business strength assessment. The role of ADL matrix is to assess the competitive position of a firm based on an assessment of the following criteria:
- ◆ **Dominant:** This is a comparatively rare position and in many cases is attributable either to a monopoly or a strong and protected technological leadership.

- ◆ **Strong:** By virtue of this position, the firm has a considerable degree of freedom over its choice of strategies and is often able to act without its market position being unduly threatened by its competitors.
- ◆ **Favourable:** This position, which generally comes about when the industry is fragmented and no one competitor stand out clearly, results in the market leaders a reasonable degree of freedom.
- ◆ **Tenable:** Although the firms within this category are able to perform satisfactorily and can justify staying in the industry, they are generally vulnerable in the face of increased competition from stronger and more proactive companies in the market.
- ◆ **Weak:** The performance of firms in this category is generally unsatisfactory although the opportunities for improvement do exist.

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

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

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

Mr Raj may identify mission in the following lines:

- ◆ To be in the business of cosmetics to enhance the lives of people, give them confidence to lead.
- ◆ To protect skin from harmful elements in environment and sun rays.
- ◆ To produce herbal cosmetics using natural ingredients.

12. Decision making is a managerial process of selecting the best course of action out of several alternative courses for the purpose of accomplishment of the organizational goals. Decisions may be operational i.e., which relate to general day-to-day operations. They may also be strategic in nature. According to Jauch and Glueck "**Strategic decisions encompass the definition of the business, products to be handled, markets to be served, functions to be performed and major policies needed for the organisation to execute these decisions to achieve the strategic objectives.**"

The primary task of the strategic manager is conceptualizing, designing and executing company strategies. For this purpose, his tasks include:

- ◆ Defining the mission and goals of the organization.
- ◆ Determining what businesses it should be in.
- ◆ Allocating resources among the different businesses.

- ◆ Formulating and implementing strategies that span individual businesses.
 - ◆ Providing leadership for the organization.
13. M/s. Nebula Pvt Ltd has opted Turnaround Strategy as the company while facing serious working capital crunch persistently conducted an assessment of current problem and developed a workable action plan based on short and long term financial needs and strategic issues. A workable action plan for turnaround would involve:
- Stage One – Assessment of current problems:** In the first step, assess the current problems and get to the root causes and the extent of damage.
- Stage Two – Analyze the situation and develop a strategic plan:** Identify major problems and opportunities, develop a strategic plan with specific goals and detailed functional actions.
- Stage Three – Implementing an emergency action plan:** If the organization is in a critical stage, an appropriate action plan must be developed to stop the bleeding and enable the organization to survive.
- Stage Four – Restructuring the business:** If the core business is irreparably damaged, then the outlook for the entire organization may be bleak. Efforts to be made to position the organization for rapid improvement.
- Stage Five – Returning to normal:** In the final stage of turnaround strategy process, the organization should begin to show signs of profitability, return on investments and enhancing economic value-added.
14. Divestment strategy involves the sale or liquidation of a portion of business, or a major division, profit centre or SBU. For a multiple product company, divestment could be a part of rehabilitating or restructuring plan called turnaround.
- ◆ A divestment strategy may be adopted due to various reasons:
 - ◆ When a turnaround has been attempted but has proved to be unsuccessful.
 - ◆ A business that had been acquired proves to be a mismatch and cannot be integrated within the company.
 - ◆ Persistent negative cash flows from a particular business create financial problems for the whole company.
 - ◆ Severity of competition and the inability of a firm to cope with it.
 - ◆ Technological upgradation is required if the business is to survive but where it is not possible for the firm to invest in it.
 - ◆ A better alternative may be available for investment.
15. The Airlines industry faces stiff competition. However, Luxury Jet has attempted to create a niche market by adopting focused differentiation strategy. A focused differentiation strategy requires offering unique features that fulfil the demands of a narrow market.

Luxury Jet compete in the market based on uniqueness and target a narrow market which provides business houses, high net worth individuals to maintain strict schedules. The option of charter flights provided several advantages including, flexibility, privacy, luxury and many a times cost saving. Apart from conveniences, the facility will provide time flexibility. Travelling by private jet is the most comfortable, safe and secure way of flying your company's senior business personnel.

Chartered services in airlines can have both business and private use. Personalized tourism packages can be provided to those who can afford it.

16. Cost leadership emphasizes producing standardized products at a very low per-unit cost for consumers who are price-sensitive. Differentiation is a strategy aimed at producing products and services considered unique industry wide and directed at consumers who are relatively price-insensitive.

A primary reason for pursuing forward, backward, and horizontal integration strategies is to gain cost leadership benefits. But cost leadership generally must be pursued in conjunction with differentiation. Different strategies offer different degrees of differentiation. A differentiation strategy should be pursued only after a careful study of buyers' needs and preferences to determine the feasibility of incorporating one or more differentiating features into a unique product. A successful differentiation strategy allows a firm to charge a higher price for its product and to gain customer loyalty.

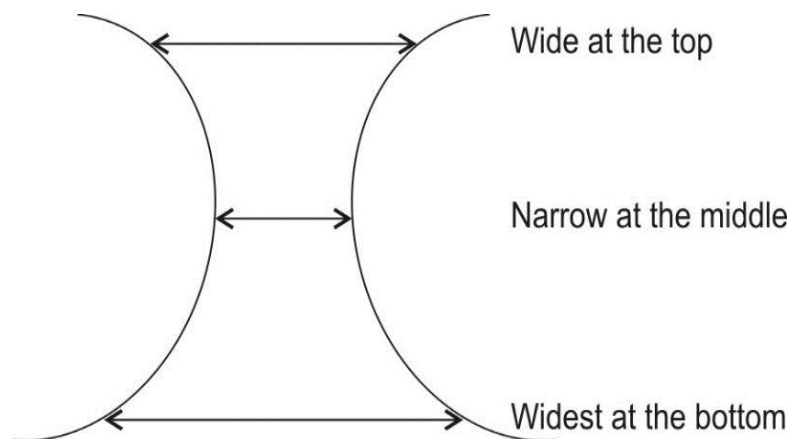
17. Mr. Vicky Verma established personal contacts with potential buyers of the product and persuaded the marketing department over several physical meetings, and was finally able to make sales. The personal relation establishment and physical demonstration, indicates that Mr. Verma used the Personal Selling method of Promotion. Modern marketing is highly promotional oriented and include personal selling, advertising, publicity and sales promotion. Personal selling involves face to face interaction of sales persons with the prospective customers and provides a high degree of personal attention. It involves working with one customer at a time and hence not cost effective. The intention of oral communication is sale.

18. Research and Development (R&D) personnel can play an integral part in strategy implementation. These individuals are generally charged with developing new products and improving old products in a way that will allow effective strategy implementation. R&D employees and managers perform tasks that include transferring complex technology, adjusting processes to local raw materials, adapting processes to local markets, and altering products to particular tastes and specifications.

Strategies such as product development, market penetration, and concentric diversification require that new products be successfully developed and that old products be significantly improved. But the level of management support for R&D is often constrained by resource availability.

19. The company Delta is transitioning into the Hourglass organization structure because it has used technological tools to transform various business processes and operations and has significantly diminished the role played by specialist managers of the middle

management. The technological tool in addition to savings organisational costs by replacing many tasks of the middle management has also served as a link between top and bottom levels in the organization and assists in faster decision making. The skewed middle level managers now perform cross-functional duties. All these factors indicate towards Hourglass organization structure.



20. Difference between transformational and transactional leadership:

1. Transformational leadership style uses charisma and enthusiasm to inspire people to exert them for the good of organization. Transactional leadership style uses the authority of its office to exchange rewards such as pay, status symbols etc.
 2. Transformational leadership style may be appropriate in turbulent environment, in industries at the very start or end of their cycles, poorly performing organisations, when there is a need to inspire a company to embrace major changes. Transactional leadership style can be appropriate in static environment, in growing or mature industries and in organisations that are performing well.
 3. Transformational leaders inspire employees by offering excitement, vision, intellectual stimulation and personal satisfaction. Transactional leaders prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement and non-achievement. Transactional leaders focus mainly to build on existing culture and enhance current practices.
- 21. Richard Rumelt's criteria for strategy audit proposes four criteria namely, consistency, consonance, feasibility and advantage. In the present scenario, the strategy auditor while measuring organisational performance has identified a gap which amounts to success of one department means failure for another. This can be clearly identified as a consistency criterion as the current organisational strategies are inconsistent.**

Three guidelines help determine if organizational problems are due to inconsistencies in strategy:

- ◆ If managerial problems continue despite changes in personnel and if they tend to be issue-based rather than people-based, then strategies may be inconsistent.
 - ◆ If success for one organizational department means, or is interpreted to mean, failure for another department, then strategies may be inconsistent.
 - ◆ If policy problems and issues continue to be brought to the top for resolution, then strategies may be inconsistent.
22. H.C. Kellman has proposed three methods for reassigning new patterns of behaviour. These are compliance, identification and internalisation.
- ◆ **Compliance:** It is achieved by strictly enforcing the reward and punishment strategy for good or bad behaviour. Fear of punishment, actual punishment or actual reward seems to change behaviour for the better.
 - ◆ **Identification:** Identification occurs when members are psychologically impressed upon to identify themselves with some given role models whose behaviour they would like to adopt and try to become like them.
 - ◆ **Internalization:** Internalization involves some internal changing of the individual's thought processes in order to adjust to a new environment. They have given freedom to learn and adopt new behaviour in order to succeed in the new set of circumstances.

PAPER – 8: FINANCIAL MANAGEMENT & ECONOMICS FOR FINANCE

PART A: FINANCIAL MANAGEMENT

QUESTIONS

Ratio Analysis

1. Following information has been provided from the books of M/s Laxmi & Co. for the year ending on 31st March, 2020:

Net Working Capital	₹ 4,80,000
Bank overdraft	₹ 80,000
Fixed Assets to Proprietary ratio	0.75
Reserves and Surplus	₹ 3,20,000
Current ratio	2.5
Liquid ratio (Quick Ratio)	1.5

You are required to PREPARE a summarised Balance Sheet as at 31st March, 2020.

Cost of Capital

2. CALCULATE the WACC using the following data by using:
- (a) Book value weights
 - (b) Market value weights

The capital structure of the company is as under:

Particulars	(₹)
Debentures (₹ 100 per debenture)	5,00,000
Preference shares (₹ 100 per share)	5,00,000
Equity shares (₹ 10 per share)	10,00,000
	20,00,000

The market prices of these securities are:

Debentures	₹ 105 per debenture
Preference shares	₹ 110 per preference share
Equity shares	₹ 24 each.

Additional information:

- (i) ₹ 100 per debenture redeemable at par, 10% coupon rate, 4% floatation costs, 10-year maturity.

- (ii) ₹ 100 per preference share redeemable at par, 5% coupon rate, 2% floatation cost and 10-year maturity.
- (iii) Equity shares has ₹ 4 floatation cost and market price ₹ 24 per share.

The next year expected dividend is ₹ 1 with annual growth of 5%. The firm has practice of paying all earnings in the form of dividend.

Corporate tax rate is 30%. Use YTM method to calculate cost of debentures and preference shares.

Capital Structure

3. Xylo Ltd. is considering two alternative financing plans as follows:

Particulars	Plan – A (₹)	Plan – B (₹)
Equity shares of ₹ 10 each	8,00,000	8,00,000
Preference Shares of ₹ 100 each	-	4,00,000
12% Debentures	4,00,000	-
	12,00,000	12,00,000

The indifference point between the plans is ₹ 4,80,000. Corporate tax rate is 30%. CALCULATE the rate of dividend on preference shares.

Leverage

4. The capital structure of PS Ltd. for the year ended 31st March, 2020 consisted as follows:

Particulars	Amount in ₹
Equity share capital (face value ₹ 100 each)	10,00,000
10% debentures (₹ 100 each)	10,00,000

During the year 2019-20, sales decreased to 1,00,000 units as compared to 1,20,000 units in the previous year. However, the selling price stood at ₹ 12 per unit and variable cost at ₹ 8 per unit for both the years. The fixed expenses were at ₹ 2,00,000 p.a. and the income tax rate is 30%.

You are required to CALCULATE the following:

- The degree of financial leverage at 1,20,000 units and 1,00,000 units.
- The degree of operating leverage at 1,20,000 units and 1,00,000 units.
- The percentage change in EPS.

Investment Decisions

5. A large profit making company is considering the installation of a machine to process the waste produced by one of its existing manufacturing process to be converted into a marketable product. At present, the waste is removed by a contractor for disposal on payment by the company of ₹ 150 lakh per annum for the next four years. The contract can be terminated upon installation of the aforesaid machine on payment of a compensation of ₹ 90 lakh before the processing operation starts. This compensation is not allowed as deduction for tax purposes.

The machine required for carrying out the processing will cost ₹ 600 lakh to be financed by a loan repayable in 4 equal instalments commencing from end of the year 1. The interest rate is 14% per annum. At the end of the 4th year, the machine can be sold for ₹ 60 lakh and the cost of dismantling and removal will be ₹ 45 lakh.

Sales and direct costs of the product emerging from waste processing for 4 years are estimated as under:

(₹ In lakh)

Year	1	2	3	4
Sales	966	966	1,254	1,254
Material consumption	90	120	255	255
Wages	225	225	255	300
Other expenses	120	135	162	210
Factory overheads	165	180	330	435
Depreciation (as per income tax rules)	150	114	84	63

Initial stock of materials required before commencement of the processing operations is ₹ 60 lakh at the start of year 1. The stock levels of materials to be maintained at the end of year 1, 2 and 3 will be ₹ 165 lakh and the stocks at the end of year 4 will be nil. The storage of materials will utilise space which would otherwise have been rented out for ₹ 30 lakh per annum. Labour costs include wages of 40 workers, whose transfer to this process will reduce idle time payments of ₹ 45 lakh in the year - 1 and ₹ 30 lakh in the year - 2. Factory overheads include apportionment of general factory overheads except to the extent of insurance charges of ₹ 90 lakh per annum payable on this venture. The company's tax rate is 30%.

Present value factors for four years are as under:

Year	1	2	3	4
PV factors @14%	0.877	0.769	0.674	0.592

ADVISE the management on the desirability of installing the machine for processing the waste. All calculations should form part of the answer.

Management of Receivables (Debtors)

6. A company wants to follow a more prudent policy to improve its sales for the region which is ₹ 9 lakhs per annum at present, having an average collection period of 45 days. After certain researches, the management consultant of the company reveals the following information:

Credit Policy	Increase in collection period	Increase in sales	Present default anticipated
W	15 days	₹ 60,000	1.5%
X	30 days	₹ 90,000	2%
Y	45 days	₹ 1,50,000	3%
Z	70 days	₹ 2,10,000	4%

The selling price per unit is ₹ 3. Average cost per unit is ₹ 2.25 and variable costs per unit are ₹ 2. The current bad debt loss is 1%. Required return on additional investment is 20%. (Assume 360 days year)

ANALYSE which of the above policies would you recommend for adoption?

Risk Analysis in Capital Budgeting

7. A&R Ltd. is considering one of two mutually exclusive proposals, Projects - X and Y, which require cash outlays of ₹ 42,50,000 and ₹ 41,25,000 respectively. The certainty-equivalent (C.E) approach is used in incorporating risk in capital budgeting decisions. The current yield on government bonds is 5.5% and this is used as the risk-free rate. The expected net cash flows and their certainty equivalents are as follows:

Project X			Project Y	
Year-end	Cash Flow (₹)	C.E.	Cash Flow (₹)	C.E.
1	16,50,000	0.8	16,50,000	0.9
2	15,00,000	0.7	16,50,000	0.8
3	15,00,000	0.5	15,00,000	0.7
4	20,00,000	0.4	10,00,000	0.8
5	21,00,000	0.6	8,00,000	0.9

The Present value (PV) factor @ 5.5% is as follows:

Year	0	1	2	3	4	5
PV factor	1	0.947	0.898	0.851	0.807	0.765

Required:

DETERMINE the project that should be accepted?

Dividend Decisions

8. The following information is given for QB Ltd.

Earnings per share ₹ 120

Dividend per share ₹ 36

Cost of capital 15%

Internal Rate of Return on investment 20%

CALCULATE the market price per share using

(a) Gordon's formula

(b) Walter's formula

Management of working Capital

9. The following figures and ratios are related to a company:

(i) Sales for the year (all credit)	₹ 90,00,000
(ii) Gross Profit ratio	35 percent
(iii) Fixed assets turnover (based on cost of goods sold)	1.5
(iv) Stock turnover (based on cost of goods sold)	6
(v) Liquid ratio	1.5:1
(vi) Current ratio	2.5:1
(vii) Receivables (Debtors) collection period	1 month
(viii) Reserves and surplus to Share capital	1:1.5
(ix) Capital gearing ratio	0.7875
(x) Fixed assets to net worth	1.3 : 1

You are required to PREPARE:

- (a) Balance Sheet of the company on the basis of above details.
- (b) The statement showing working capital requirement, if the company wants to make a provision for contingencies @ 15 percent of net working capital.

Miscellaneous

10. (a) EXPLAIN agency problem and agency cost. How to address the issues of the same.
- (b) COMPARE between Financial Lease and Operating Lease.

SUGGESTED HINTS/ANSWERS

1. Working notes:

(i) Current Assets and Current Liabilities computation:

$$\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{2.5}{1}$$

$$\text{Or Current assets} = 2.5 \text{ Current liabilities}$$

$$\text{Now, Working capital} = \text{Current assets} - \text{Current liabilities}$$

$$\text{Or ₹ 4,80,000} = 2.5 \text{ Current liability} - \text{Current liability}$$

$$\text{Or } 1.5 \text{ Current liability} = ₹ 4,80,000$$

$$\therefore \text{Current Liabilities} = ₹ 3,20,000$$

$$\text{So, Current Assets} = ₹ 3,20,000 \times 2.5 = ₹ 8,00,000$$

(ii) Computation of stock

$$\text{Liquid ratio} = \frac{\text{Liquid assets}}{\text{Current liabilities}}$$

$$\text{Or } 1.5 = \frac{\text{Current assets} - \text{Inventories}}{₹ 3,20,000}$$

$$\text{Or } 1.5 \times ₹ 3,20,000 = ₹ 8,00,000 - \text{Inventories}$$

$$\text{Or Inventories} = ₹ 8,00,000 - ₹ 4,80,000$$

$$\text{Or Stock} = ₹ 3,20,000$$

(iii) Computation of Proprietary fund; Fixed assets; Capital and Sundry creditors

$$\text{Fixed Asset to Proprietary ratio} = \frac{\text{Fixed assets}}{\text{Proprietary fund}} = 0.75$$

$$\therefore \text{Fixed Assets} = 0.75 \text{ Proprietary fund (PF)} [\text{FA} + \text{NWC} = \text{PF}]$$

$$\text{or NWC} = \text{PF} - \text{FA} [(i.e. .75 \text{ PF})]$$

$$\text{and Net Working Capital (NWC)} = 0.25 \text{ Proprietary fund}$$

$$\text{Or } ₹ 4,80,000 / 0.25 = \text{Proprietary fund}$$

$$\text{Or Proprietary fund} = ₹ 19,20,000$$

$$\text{and Fixed Assets} = 0.75 \text{ proprietary fund}$$

$$= 0.75 \times ₹ 19,20,000 = ₹ 14,40,000$$

Capital	=	Proprietary fund – Reserves & Surplus
	=	₹ 19,20,000 – ₹ 3,20,000 = ₹ 16,00,000
Sundry Creditors	=	(Current liabilities – Bank overdraft)
	=	(₹ 3,20,000 – ₹ 80,000) = ₹ 2,40,000

Balance Sheet as at 31st March, 2020

Liabilities	₹	Assets	₹
Capital	16,00,000	Fixed Assets	14,40,000
Reserves & Surplus	3,20,000	Stock	3,20,000
Bank overdraft	80,000	Other Current Assets	4,80,000
Sundry creditors	<u>2,40,000</u>		<u> </u>
	<u>22,40,000</u>		<u>22,40,000</u>

2. (i) Cost of Equity (K_e)

$$= \frac{D_1}{P_0 - F} + g = \frac{₹ 1}{₹ 24 - ₹ 4} + 0.05 = 0.1 \text{ or } 10\%$$

(ii) Cost of Debt (K_d)

Current market price (P_0) – floatation cost = $I(1-t) \times PVAF(r,10) + RV \times PVIF(r,10)$

$$₹ 105 - 4\% \text{ of } ₹ 105 = ₹ 10 (1-0.3) \times PVAF(r,10) + ₹ 100 \times PVIF(r,10)$$

Calculation of NPV at discount rate of 5% and 7%

Year	Cash flows (₹)	Discount factor @ 5%	Present Value	Discount factor @ 7%	Present Value (₹)
0	100.8	1.000	(100.8)	1.000	(100.8)
1 to 10	7	7.722	54.05	7.024	49.17
10	100	0.614	61.40	0.508	50.80
NPV			+14.65		-0.83

Calculation of IRR

$$IRR = 5\% + \frac{14.65}{14.65 - (-0.83)}(7\% - 5\%) = 5\% + \frac{14.65}{15.48}(7\% - 5\%) = 6.89\%$$

Cost of Debt (K_d) = 6.89%

(iii) Cost of Preference shares (K_p)

Current market price (P_0) – floatation cost = $PD \times PVAF(r,10) + RV \times PVIF(r,10)$

₹ 110 – 2% of ₹ 110 = ₹ 5 × $PVAF(r,10) + ₹ 100 \times PVIF(r,10)$

Calculation of NPV at discount rate of 3% and 5%

Year	Cash flows (₹)	Discount factor @ 3%	Present Value	Discount factor @ 5%	Present Value (₹)
0	107.8	1.000	(107.8)	1.000	(107.8)
1 to 10	5	8.530	42.65	7.722	38.61
10	100	0.744	74.40	0.614	61.40
NPV			+9.25		-7.79

Calculation of IRR

$$IRR = 3\% + \frac{9.25}{9.25 - (-7.79)} (5\% - 3\%) = 3\% + \frac{9.25}{17.04} (5\% - 3\%) = 4.08\%$$

Cost of Preference Shares (K_p) = 4.08%

(a) Calculation of WACC using book value weights

Source of capital	Book Value	Weights	After tax cost of capital	WACC (K_o)
	(₹)	(a)	(b)	(c) = (a) × (b)
10% Debentures	5,00,000	0.25	0.0689	0.01723
5% Preference shares	5,00,000	0.25	0.0408	0.0102
Equity shares	10,00,000	0.50	0.10	0.05000
	20,00,000	1.00		0.07743

WACC (K_o) = 0.07743 or 7.74%

(b) Calculation of WACC using market value weights

Source of capital	Market Value	Weights	After tax cost of capital	WACC (K_o)
	(₹)	(a)	(b)	(c) = (a) × (b)
10% Debentures (₹ 105 × 5,000)	5,25,000	0.151	0.0689	0.0104
5% Preference shares	5,50,000	0.158	0.0408	0.0064

(₹ 110 × 5,000)				
Equity shares (₹ 24 × 1,00,000)	24,00,000	0.691	0.10	0.0691
	34,75,000	1.000		0.0859

WACC (K_o) = 0.0859 or 8.59%

3. Computation of Rate of Preference Dividend

$$\begin{aligned}
 \frac{(\text{EBIT} - \text{Interest})(1 - t)}{\text{No. of Equity Shares } (N_1)} &= \frac{(\text{EBIT}(1 - t) - \text{Preference Dividend})}{\text{No. of Equity Shares } (N_2)} \\
 \frac{(\text{₹ } 4,80,000 - \text{₹ } 48,000) \times (1 - 0.30)}{80,00,000 \text{ shares}} &= \frac{\text{₹ } 4,80,000(1 - 0.30) - \text{Preference Dividend}}{80,00,000 \text{ shares}} \\
 \frac{\text{₹ } 3,02,400}{80,00,000 \text{ shares}} &= \frac{\text{₹ } 3,36,000 - \text{Preference Dividend}}{80,00,000 \text{ shares}} \\
 \text{₹ } 3,02,400 &= \text{₹ } 3,36,000 - \text{Preference Dividend} \\
 \text{Preference Dividend} &= \text{₹ } 3,36,000 - \text{₹ } 3,02,400 = \text{₹ } 33,600 \\
 \text{Rate of Dividend} &= \frac{\text{Preference Dividend}}{\text{Preference share capital}} \times 100 \\
 &= \frac{\text{₹ } 33,600}{4,00,000} \times 100 = 8.4\%
 \end{aligned}$$

4.

Sales in units	1,20,000 (₹)	1,00,000 (₹)
Sales Value	14,40,000	12,00,000
Variable Cost	(9,60,000)	(8,00,000)
Contribution	4,80,000	4,00,000
Fixed expenses	(2,00,000)	(2,00,000)
EBIT	2,80,000	2,00,000
Debenture Interest	(1,00,000)	(1,00,000)
EBT	1,80,000	1,00,000
Tax @ 30%	(54,000)	(30,000)
Profit after tax (PAT)	1,26,000	70,000

(i) Financial Leverage = $\frac{\text{EBIT}}{\text{EBT}}$	$= \frac{₹ 2,80,000}{₹ 1,80,000} = 1.56$	$= \frac{₹ 2,00,000}{₹ 1,00,000} = 2$
(ii) Operating leverage = $\frac{\text{Contribution}}{\text{EBIT}}$	$= \frac{₹ 4,80,000}{₹ 2,80,000} = 1.71$	$= \frac{₹ 4,00,000}{₹ 2,00,000} = 2$
(iii) Earnings per share (EPS)	$\frac{₹ 1,26,000}{₹ 10,000} = ₹ 12.6$	$\frac{₹ 70,000}{₹ 10,000} = ₹ 7$
Decrease in EPS	$= ₹ 12.6 - ₹ 7 = ₹ 5.6$	
% decrease in EPS	$\frac{5.6}{12.6} \times 100 = 44.44\%$	

5. Statement of Operating Profit from processing of waste (₹ in lakh)

Year	1	2	3	4
Sales :(A)	966	966	1,254	1,254
Material consumption	90	120	255	255
Wages	180	195	255	300
Other expenses	120	135	162	210
Factory overheads (insurance only)	90	90	90	90
Loss of rent on storage space (opportunity cost)	30	30	30	30
Interest @14%	84	63	42	21
Depreciation (as per income tax rules)	150	114	84	63
Total cost: (B)	744	747	918	969
Profit (C)=(A)-(B)	222	219	336	285
Tax (30%)	66.6	65.7	100.8	85.5
Profit after Tax (PAT)	155.4	153.3	235.2	199.5

Statement of Incremental Cash Flows (₹ in lakh)

Year	0	1	2	3	4
Material stock	(60)	(105)	-	-	165
Compensation for contract	(90)	-	-	-	-
Contract payment saved	-	150	150	150	150
Tax on contract payment	-	(45)	(45)	(45)	(45)
Incremental profit	-	222	219	336	285
Depreciation added back	-	150	114	84	63
Tax on profits	-	(66.6)	(65.7)	(100.8)	(85.5)

Loan repayment	-	(150)	(150)	(150)	(150)
Profit on sale of machinery (net)	-	-	-	-	15
Total incremental cash flows	(150)	155.4	222.3	274.2	397.5
Present value factor	1.00	0.877	0.769	0.674	0.592
Present value of cash flows	(150)	136.28	170.95	184.81	235.32
Net present value	577.36				

Advice: Since the net present value of cash flows is ₹ 577.36 lakh which is positive the management should install the machine for processing the waste.

Notes:

- (i) Material stock increases are taken in cash flows.
- (ii) Idle time wages have also been considered.
- (iii) Apportioned factory overheads are not relevant only insurance charges of this project are relevant.
- (iv) Interest calculated at 14% based on 4 equal instalments of loan repayment.
- (v) Sale of machinery- Net income after deducting removal expenses taken. Tax on Capital gains ignored.
- (vi) Saving in contract payment and income tax thereon considered in the cash flows.

6. A. Statement showing the Evaluation of Debtors Policies (Total Approach)

(Amount in ₹)

Particulars		Present Policy 45 days	Proposed Policy W 60 days	Proposed Policy X 75 days	Proposed Policy Y 90 days	Proposed Policy Z 115 days
I. Expected Profit:						
(a) Credit Sales		9,00,000	9,60,000	9,90,000	10,50,000	11,10,000
(b) Total Cost other than Bad Debts						
(i) Variable Costs [Sales × 2/ 3]		6,00,000	6,40,000	6,60,000	7,00,000	7,40,000
(ii) Fixed Costs		75,000	75,000	75,000	75,000	75,000
		6,75,000	7,15,000	7,35,000	7,75,000	8,15,000
(c) Bad Debts		9,000	14,400	19,800	31,500	44,400
(d) Expected Profit [(a) – (b) – (c)]		2,16,000	2,30,600	2,35,200	2,43,500	2,50,600

II.	Opportunity Cost of Investments in Receivables	16,875	23,833	30,625	38,750	52,069
III.	Net Benefits (I – II)	1,99,125	2,06,767	2,04,575	2,04,750	1,98,531

Recommendation: The Proposed Policy W (i.e. increase in collection period by 15 days or total 60 days) should be adopted since the net benefits under this policy are higher as compared to other policies.

Working Notes:

- (i) **Calculation of Fixed Cost** = [Average Cost per unit – Variable Cost per unit] × No. of Units sold

$$= [₹ 2.25 - ₹ 2.00] \times (₹ 9,00,000/3)$$

$$= ₹ 0.25 \times 3,00,000 = ₹ 75,000$$

(ii) **Calculation of Opportunity Cost of Average Investments**

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

$$\text{Present Policy} = 6,75,000 \times \frac{45}{360} \times \frac{20}{100} = 16,875$$

$$\text{Policy W} = 7,15,000 \times \frac{60}{360} \times \frac{20}{100} = 23,833$$

$$\text{Policy X} = 7,35,000 \times \frac{75}{360} \times \frac{20}{100} = 30,625$$

$$\text{Policy Y} = 7,75,000 \times \frac{90}{360} \times \frac{20}{100} = 38,750$$

$$\text{Policy Z} = 8,15,000 \times \frac{115}{360} \times \frac{20}{100} = 52,069$$

- B. Another method of solving the problem is **Incremental Approach**. Here we assume that sales are all credit sales. **(Amount in ₹)**

Particulars		Present Policy 45 days	Proposed Policy W 60 days	Proposed Policy X 75 days	Proposed Policy Y 90 days	Proposed Policy Z 115 days
I.	Incremental Expected Profit:					
	(a) Incremental Credit Sales	0	60,000	90,000	1,50,000	2,10,000
	(b) Incremental Costs					
	(i) Variable Costs	6,00,000	40,000	60,000	1,00,000	1,40,000
	(ii) Fixed Costs	75,000	-	-	-	-

(c) Incremental Bad Debt Losses	9,000	5,400	10,800	22,500	35,400
(d) Incremental Expected Profit (a – b – c)]		14,600	19,200	27,500	34,600
II. Required Return on Incremental Investments:					
(a) Cost of Credit Sales	6,75,000	7,15,000	7,35,000	7,75,000	8,15,000
(b) Collection period	45	60	75	90	115
(c) Investment in Receivable (a × b/360)	84,375	1,19,167	1,53,125	1,93,750	2,60,347
(d) Incremental Investment in Receivables	-	34,792	68,750	1,09,375	1,75,972
(e) Required Rate of Return (in %)		20	20	20	20
(f) Required Return on Incremental Investments (d × e)	-	6,958	13,750	21,875	35,194
III. Net Benefits (I – II)	-	7,642	5,450	5,625	(594)

Recommendation: The Proposed Policy W should be adopted since the net benefits under this policy are higher than those under other policies.

C. Another method of solving the problem is by computing the **Expected Rate of Return**.

$$\text{Expected Rate of Return} = \frac{\text{Incremental Expected Profit}}{\text{Incremental Investment in Receivables}} \times 100$$

$$\text{For Policy W} = \frac{\text{₹ } 14,600}{\text{₹ } 34,792} \times 100 = 41.96\%$$

$$\text{For Policy X} = \frac{\text{₹ } 19,200}{\text{₹ } 68,750} \times 100 = 27.93\%$$

$$\text{For Policy Y} = \frac{\text{₹ } 27,500}{\text{₹ } 1,09,375} \times 100 = 25.14\%$$

$$\text{For Policy Z} = \frac{\text{₹ } 34,600}{\text{₹ } 1,75,972} \times 100 = 19.66\%$$

Recommendation: The Proposed Policy W should be adopted since the Expected Rate of Return (41.96%) is more than the Required Rate of Return (20%) and is highest among the given policies compared.

7. **Calculation of Net Present Value (NPV) of Project X**

Year end	Cash Flow (₹) (a)	C.E. (b)	Adjusted Cash flow (₹) (c) = (a) × (b)	Present value factor at 5.5% (d)	Total Present value (₹) (e) = (c) × (d)
1	16,50,000	0.8	13,20,000	0.947	12,50,040
2	15,00,000	0.7	10,50,000	0.898	9,42,900
3	15,00,000	0.5	7,50,000	0.851	6,38,250
4	20,00,000	0.4	8,00,000	0.807	6,45,600
5	21,00,000	0.6	12,60,000	0.765	9,63,900
PV of total cash inflows					44,40,690
Less: Initial Investment					(42,50,000)
Net Present Value					1,90,690

Calculation of Net Present Value (NPV) of Project Y

Year end	Cash Flow (₹) (a)	C.E. (b)	Adjusted Cash flow (₹) (c) = (a) × (b)	Present value factor at 5.5% (d)	Total Present value (₹) (e) = (c) × (d)
1	16,50,000	0.9	14,85,000	0.947	14,06,295
2	16,50,000	0.8	13,20,000	0.898	11,85,360
3	15,00,000	0.7	10,50,000	0.851	8,93,550
4	10,00,000	0.8	8,00,000	0.807	6,45,600
5	8,00,000	0.9	7,20,000	0.765	5,50,800
PV of total cash inflows					46,81,605
Less: Initial Investment					(41,25,000)
Net Present Value					5,56,605

Project Y has NPV of ₹ 5,56,605/- which is higher than the NPV of Project X. Thus, A&R Ltd. should accept Project Y.

8. (a) As per **Gordon's Model**, Price per share is computed using the formula:

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

Where,

P_0 = Price per share

E_1 = Earnings per share

b = Retention ratio; ($1 - b$ = Pay-out ratio)

K_e = Cost of capital

r = IRR

br = Growth rate (g)

Applying the above formula, price per share

$$P_0 = \frac{120(1-0.7)}{0.15 - 0.70 \times 0.2} = \frac{36}{0.01} = ₹ 3,600$$

- (b) As per **Walter's Model**, Price per share is computed using the formula:

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

Where,

P = Market Price of the share.

E = Earnings per share.

D = Dividend per share.

K_e = Cost of equity/ rate of capitalization/ discount rate.

r = Internal rate of return/ return on investment

Applying the above formula, price per share

$$P = \frac{36 + \frac{0.20}{0.15}(120-36)}{0.15}$$

$$\text{Or, } P = \frac{36 + 112}{0.15} = ₹ 986.67$$

9. Working Notes:

- (i) Cost of Goods Sold = Sales – Gross Profit (35% of Sales)
= ₹ 90,00,000 – ₹ 31,50,000

- $= ₹ 58,50,000$
- (ii) Closing Stock $= \text{Cost of Goods Sold} / \text{Stock Turnover}$
 $= ₹ 58,50,000 / 6 = ₹ 9,75,000$
- (iii) Fixed Assets $= \text{Cost of Goods Sold} / \text{Fixed Assets Turnover}$
 $= ₹ 58,50,000 / 1.5$
 $= ₹ 39,00,000$
- (iv) Current Assets:
 Current Ratio $= 2.5$ and Liquid Ratio $= 1.5$
 Inventories (Stock) $= 2.5 - 1.5 = 1$
 Current Assets $= \text{Amount of Inventories (Stock)} \times 2.5/1$
 $= ₹ 9,75,000 \times 2.5/1 = ₹ 24,37,500$
- (v) Liquid Assets (Receivables and Cash)
 $= \text{Current Assets} - \text{Inventories (Stock)}$
 $= ₹ 24,37,500 - ₹ 9,75,000$
 $= ₹ 14,62,500$
- (vi) Receivables (Debtors) $= \text{Sales} \times \text{Debtors Collection period} / 12$
 $= ₹ 90,00,000 \times 1/12$
 $= ₹ 7,50,000$
- (vii) Cash $= \text{Liquid Assets} - \text{Receivables (Debtors)}$
 $= ₹ 14,62,500 - ₹ 7,50,000 = ₹ 7,12,500$
- (viii) Net worth $= \text{Fixed Assets} / 1.3$
 $= ₹ 39,00,000 / 1.3 = ₹ 30,00,000$
- (ix) Reserves and Surplus
 Reserves and Share Capital $= \text{Net worth}$
 Net worth $= 1 + 1.5 = 2.5$
 Reserves and Surplus $= ₹ 30,00,000 \times 1/2.5$
 $= ₹ 12,00,000$
- (x) Share Capital $= \text{Net worth} - \text{Reserves and Surplus}$
 $= ₹ 30,00,000 - ₹ 12,00,000$

$$= ₹ 18,00,000$$

(xi) Current Liabilities = Current Assets/ Current Ratio
 $= ₹ 24,37,500/2.5 = ₹ 9,75,000$

(xii) Long-term Debts

Capital Gearing Ratio = Long-term Debts / Equity Shareholders' Fund

Long-term Debts = ₹30,00,000 × 0.7875 = ₹23,62,500

(a) **Balance Sheet of the Company**

Particulars	Figures as at 31-03-2020 (₹)	Figures as at 31-03-2019 (₹)
I. EQUITY AND LIABILITIES		
Shareholders' funds		
(a) Share capital	18,00,000	-
(b) Reserves and surplus	12,00,000	-
Non-current liabilities		
(a) Long-term borrowings	23,62,500	-
Current liabilities	9,75,000	-
TOTAL	63,37,500	-
II. ASSETS		
Non-current assets		
Fixed assets	39,00,000	-
Current assets		
Inventories	9,75,000	-
Trade receivables	7,50,000	-
Cash and cash equivalents	7,12,500	-
TOTAL	63,37,500	-

(b) **Statement Showing Working Capital Requirement**

Particulars	(₹)	(₹)
A. Current Assets		
(i) Inventories (Stocks)		9,75,000
(ii) Receivables (Debtors)		7,50,000
(iii) Cash in hand & at bank		7,12,500
Total Current Assets		24,37,500

B. Current Liabilities:		
Total Current Liabilities		9,75,000
Net Working Capital (A – B)		14,62,500
Add: Provision for contingencies (15% of Net Working Capital)		2,19,375
Working capital requirement		16,81,875

10. (a) Though in a sole proprietorship firm, partnership etc., owners participate in management but in corporates, owners are not active in management so, there is a separation between owner/ shareholders and managers. In theory managers should act in the best interest of shareholders, however, in reality, managers may try to maximise their individual goal like salary, perks etc., so there is a **principal agent relationship between managers and owners, which is known as Agency Problem**. In a nutshell, Agency Problem is the chances that managers may place personal goals ahead of the goal of owners. Agency Problem leads to Agency Cost. Agency cost is the additional cost borne by the shareholders to monitor the manager and control their behaviour so as to maximise shareholders wealth. Generally, Agency Costs are of four types (i) monitoring (ii) bonding (iii) opportunity (iv) structuring

Addressing the agency problem

The agency problem arises if manager's interests are not aligned to the interests of the debt lender and equity investors. The agency problem of debt lender would be addressed by imposing negative covenants i.e. the managers cannot borrow beyond a point. This is one of the most important concepts of modern day finance and the application of this would be applied in the Credit Risk Management of Bank, Fund Raising, Valuing distressed companies.

Agency problem between the managers and shareholders can be addressed if the interests of the managers are aligned to the interests of the shareholders. It is easier said than done.

However, following efforts have been made to address these issues:

- ◆ Managerial compensation is linked to profit of the company to some extent and also with the long term objectives of the company.
- ◆ Employee is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors.
- ◆ Effecting monitoring can be done.

(b)

	Finance Lease	Operating Lease
1.	The risk and reward incident to ownership are passed on to the lessee. The lessor only remains the legal owner of the asset.	The lessee is only provided the use of the asset for a certain time. Risk incident to ownership belong wholly to the lessor.
2.	The lessee bears the risk of obsolescence.	The lessor bears the risk of obsolescence.
3.	The lessor is interested in his rentals and not in the asset. He must get his principal back along with interest. Therefore, the lease is non-cancellable by either party.	As the lessor does not have difficulty in leasing the same asset to other willing lessor, the lease is kept cancelable by the lessor.
4.	The lessor enters into the transaction only as financier. He does not bear the cost of repairs, maintenance or operations.	Usually, the lessor bears cost of repairs, maintenance or operations.
5.	The lease is usually full payout, that is, the single lease repays the cost of the asset together with the interest.	The lease is usually non-payout, since the lessor expects to lease the same asset over and over again to several users.

SECTION: B: ECONOMICS FOR FINANCE

QUESTIONS

1. (a) From the following data, calculate NNP_{FC} , NNP_{MP} , GNP_{MP} and GDP_{MP} .

Items	In Cr.
Operating surplus	2000
Mixed income of self-employed	1100
Rent	550
Profit	800
Net indirect tax	450
Consumption of fixed capital	400
Net factor income from abroad	-50
Compensation of employees	1000

- (b) A sells a used car to B and receives Rs. 60,000. How much of the sale proceeds will be included in national income calculation?
2. (a) An economy is characterized by the following equation-
- Consumption $C = 60 + 0.9Y_d$
- Investment $I = 10$
- Government expenditure $G = 10$
- Tax $T = 0$
- Exports $X = 20$
- Imports $M = 10 + 0.05 Y$
- Find equilibrium income and trade balance.
- (b) Explain (with the aid of a diagram) how an increase in the marginal propensity to consume impacts consumption expenditure.
3. (a) According to Richard Musgrave, there are three branch taxonomy of the role of government in a market economy? Explain them.
- (b) Why do economists use the word external to describe third-party effects that are harmful or beneficial?

4. (a) Explain why do governments provide subsidies? Illustrate a few examples of subsidies.
(b) Describe the concept of price floors with examples.
5. The tradable emissions permits are claimed to have certain advantages. Explain.
6. Examine the influence of different variables on demand for money according to Inventory Theoretic Approach?
7. (a) How is the behaviour of central bank in economy reflected? Explain.
(b) Distinguish between M_1 and M_2 . Find out M_1 when a country has the following monetary asset information as of March 2020:

Components	₹ in million
Cash in hands of the public	300
Demand Deposits	400
Savings Type accounts	2000
Money Market Mutual Funds	1000
Traveller's checks	50
Small Time Deposits	500
Large Time Deposits	450
Other Checkable Deposits	150

8. Describe the different types of agreements that take place during the negotiations of trade?
9. (a) Into how many parts are FDIs categorized according to the nature of foreign investment? Describe them.
(b) What does the Agreement on Trade-Related Investment Measures (TRIMs) stipulate?
10. Countries Rose Land and Daisy land have a total of 4000 hours each of labour available each day to produce shirts and trousers. Both countries use equal number of hours on each good each day. Rose Land produces 800 shirts and 500 trousers per day. Daisy land produces 500 shirts and 250 trousers per day.
In the absence of trade:
 - i. Which country has absolute advantage in producing shirts or trousers?
 - ii. Which country has comparative advantage in producing shirts or trousers?

SUGGESTED ANSWERS/ HINTS

1. (a) $GDP_{MP} = \text{Compensation of employees} + \text{mixed income of self-employed} + \text{operating surplus} + \text{depreciation} + \text{net indirect taxes}$
 $= 1000 \text{ crores} + 1100 \text{ crores} + 2000 \text{ crores} + 400 \text{ crores} + 450 \text{ crores} = 4950 \text{ crores}$
 $GNP_{MP} = GDP_{MP} + NFIA$
 $= 4950 \text{ crores} + (-50) \text{ crores} = 4900 \text{ crores}$
 $NNP_{MP} = GNP_{MP} - \text{consumption of fixed capital}$
 $= 4900 \text{ crores} - 400 \text{ crores} = 4500 \text{ crores}$
 $NNP_{FC} \text{ or NI} = NNP_{MP} - NIT$
 $= 4500 \text{ crores} - 450 \text{ crores} = 4050 \text{ crores}$
- (b) National income is a flow measure of output per time period—for example, per year—and includes only those goods and services currently produced i.e. produced during the time interval under consideration. The value of market transactions such as exchange of goods which already exist or are previously produced, do not enter into the calculation of national income. No part of the used car sales proceeds of Rs 60,000 will be included in national income calculation because sale of a used car represents transfer of existing asset which was produced during some earlier year and was accounted in the national income calculation of that year.
2. (a) $Y = C + I + G + (X - M)$
 $= 60 + 0.9(Y - 0) + 10 + 10 + (20 - 10 - 0.05Y)$
 $= 60 + 0.9Y + 30 - 0.05Y$
 $Y = 600$
 $\text{Trade Balance} = X - M = -20$
 Thus trade balance is in deficit.
- (b) An increase in marginal propensity to consume implies that the proportion of income that is spent on consumption increases with an increase in income. In other words, except for an income level of zero, at each income level, the level of consumption spending is higher. The vertical intercept is unchanged as autonomous consumption remains unchanged; but the slope of the consumption curve would be higher and it will spin upwards. For example, if consumption function $20 + .6Y$ changes to $20 + .8Y$, for an income of 200, consumption rises from 140 to 180.
 (The students need to draw diagram to illustrate the same).

3. (a) Richard Musgrave, in his classic treatise 'The Theory of Public Finance' (1959), introduced the three-branch taxonomy of the role of government in a market economy namely, resource allocation, income redistribution and macroeconomic stabilization. The allocation and distribution functions are primarily microeconomic functions, while stabilization is a macroeconomic function. The allocation function aims to correct the sources of inefficiency in the economic system while the distribution role ensures that the distribution of wealth and income is fair. Monetary and fiscal policy, the problems of macroeconomic stability, maintenance of high levels of employment and price stability etc. fall under the stabilization function.
- (b) Economists use the word 'external' to describe third-party effects that are harmful or beneficial because sometimes, the actions of either consumers or producers result in costs or benefits that do not reflect as part of the market price. Such costs or benefits which are not accounted for by the market price are called externalities because they are "external" to the market. Or in other words, externalities are costs or benefits that result from an activity or transaction and affect a third party who did not choose to incur the cost or benefit. Externalities are either positive or negative depending on the nature of the impact on the third party.
4. (a) Subsidy is market-based policy and involves the government paying part of the cost to the firms in order to promote the production of goods having positive externalities. Or in other words, a subsidy on a good which has substantial positive externalities would reduce its cost and consequently price, shift the supply curve to the right and increase its output. A higher output that would equate marginal social benefit and marginal social cost is socially optimal. There are many forms of subsidies given out by the government. Two of the most common types of individual subsidies are welfare payments and unemployment benefits. The objective of these types of subsidies is to help people who are temporarily suffering economically. Other subsidies, such as subsidized interest rates on student loans, are given to encourage people to further their education.
- (b) Price floor is defined as an intervention to raise market prices if the government feels the price is too low. In this case, since the new price is higher, the producers benefit. For a price floor to be effective, the minimum price has to be higher than the equilibrium price. For example, many governments intervene by establishing price floors to ensure that farmers make enough money by guaranteeing a minimum price at which their goods can be sold for. The most common example of a price floor is the minimum wage. This is the minimum price that employers can pay workers for their labour.
5. Tradable emissions permits are marketable licenses to emit limited quantities of pollutants and can be bought and sold by polluters. Under this method, each firm has permits specifying the number of units of emissions that the firm is allowed to generate. A firm that generates emissions above what is allowed by the permit is penalized with substantial monetary sanctions. These permits are transferable, and therefore different pollution

levels are possible across the regulated entities. Permits are allocated among firms, with the total number of permits so chosen as to achieve the desired maximum level of emissions. By allocating fewer permits than the free pollution level, the regulatory agency creates a shortage of permits which then leads to a positive price for permits. This establishes a price for pollution, just as in the tax case. The high polluters have to buy more permits, which increases their costs, and makes them less competitive and less profitable. The low polluters receive extra revenue from selling their surplus permits, which makes them more competitive and more profitable. Therefore, firms will have an incentive not to pollute. India is experimenting with tradable emissions permits in the form of Perform, Achieve & Trade (PAT) scheme and carbon tax in the form of a cess on coal. The advantages claimed for tradable permits are that the system allows flexibility and reward efficiency and it is administratively cheap and simple to implement and ensures that pollution is minimised in the most cost-effective way. It also provides strong incentives for innovation and consumers may benefit if the extra profits made by low pollution firms are passed on to them in the form of lower prices.

The main argument in opposition to the employment of tradable emission permits is that they do not in reality stop firms from polluting the environment; they only provide an incentive to them to do so. Moreover, if firms have monopoly power of some degree along with a relatively inelastic demand for its product, the extra cost incurred for procuring additional permits so as to further pollute the atmosphere, could easily be compensated by charging higher prices to consumers.

6. Inventory-theoretical approach assumes that there are two media for storing value: money and an interest-bearing alternative financial asset. There is a fixed cost of making transfers between money and the alternative assets e.g. broker charges. While relatively liquid financial assets other than money (such as, bank deposits) offer a positive return, the above said transaction cost of going between money and these assets justifies holding money.

Baumol used Business Inventory approach to analyse the behaviour of individuals. Just as businesses keep money to facilitate their business transactions, people also hold cash balance which involves an opportunity cost in terms of lost interest. Therefore, they hold an optimum combination of bonds and cash balance, i.e., an amount that minimizes the opportunity cost.

Baumol's propositions in his theory of transaction demand for money hold that receipt of income, say Y takes place once per unit of time but expenditure is spread at a constant rate over the entire period of time. Excess cash over and above what is required for transactions during the period under consideration will be invested in bonds or put in an interest-bearing account. Money holdings on an average will be lower if people hold bonds or other interest yielding assets.

The higher the income, the higher is the average level or inventory of money holdings. The level of inventory holding also depends also upon the carrying cost, which is the interest forgone by holding money and not bonds, net of the cost to the individual of making a transfer between money and bonds, say for example brokerage fee. The individual will choose the number of times the transfer between money and bonds takes place in such a way that the net profits from bond transactions are maximized.

The average transaction balance (money) holding is a function of the number of times the transfer between money and bonds takes place. The more the number of times the bond transaction is made, the lesser will be the average transaction balance holdings. In other words, the choice of the number of times the bond transaction is made determines the split of money and bond holdings for a given income.

The inventory-theoretic approach also suggests that the demand for money and bonds depend on the cost of making a transfer between money and bonds e.g. the brokerage fee. An increase the brokerage fee raises the marginal cost of bond market transactions and consequently lowers the number of such transactions. The increase in the brokerage fee raises the transactions demand for money and lowers the average bond holding over the period. This result follows because an increase in the brokerage fee makes it more costly to switch funds temporarily into bond holdings. An individual combines his asset portfolio of cash and bond in such proportions that his cost is minimized.

7. (a) The behaviour of the central bank which controls the issue of currency is reflected in the supply of the nominal high-powered money. Money stock is determined by the money multiplier and the monetary base is controlled by the monetary authority. If the behaviour of the public and the commercial banks remains unchanged over time, the total supply of nominal money in the economy will vary directly with the supply of the nominal high-powered money issued by the central bank.
- (b) M_1 is composed of currency and coins with the people, demand deposits of banks (current and saving accounts) and other deposits with the RBI whereas M_2 includes M_1 as well as savings deposits with post office savings banks.

$$M_1 = 300 + 400 + 150 + 50 = \text{Rs } 900 \text{ Millions}$$

8. Trade negotiations result in different types of agreements. These agreements are-

Unilateral trade agreements- under which an importing country offers trade incentives in order to encourage the exporting country to engage in international economic activities. E.g. Generalized System of Preferences.

Bilateral agreements- agreements which set rules of trade between two countries, two blocs or a bloc and a country. These may be limited to certain goods and services or certain types of market entry barriers. E.g. EU-South Africa Free Trade Agreement; ASEAN-India Free Trade Area.

Regional Preferential Trade Agreements- agreements that reduce trade barriers on a reciprocal and preferential basis for only the members of the group. E.g. Global System of Trade Preferences among Developing Countries (GSTP).

Trading bloc- A group of countries that have a free trade agreement between themselves and may apply a common external tariff to other countries. Example: Arab League (AL), European Free Trade Association (EFTA).

Free-trade area- is a group of countries that eliminate all tariff barriers on trade with each other and retains independence in determining their tariffs with non-members. Example: NAFTA.

Customs union -A group of countries that eliminate all tariffs on trade among themselves but maintain a common external tariff on trade with countries outside the union (thus technically violating MFN). E.g. EC, MERCOSUR.

Common market- A common market deepens a customs union by providing for the free flow of factors of production (labor and capital) in addition to the free flow of outputs. The member countries attempt to harmonize some institutional arrangements and commercial and financial laws and regulations among themselves. There are also common barriers against non-members (E.g., EU, ASEAN).

In an *Economic and Monetary Union*- members share a common currency and macroeconomic policies. For E.g., the European Union countries implement and adopt a single currency.

9. (a) Based on the nature of foreign investments, FDI may be categorized into three parts as horizontal, vertical or conglomerate.
- (i) A *horizontal direct investment* is said to take place when the investor establishes the same type of business operation in a foreign country as it operates in its home country, for example, a cell phone service provider based in the United States moving to India to provide the same service.
 - (ii) A *vertical investment* is one under which the investor establishes or acquires a business activity in a foreign country which is different from the investor's main business activity yet in some way supplements its major activity. For example; an automobile manufacturing company may acquire an interest in a foreign company that supplies parts or raw materials required for the company.
 - (iii) A *conglomerate type of foreign direct investment* is one where an investor makes a foreign investment in a business that is unrelated to its existing business in its home country. This is often in the form of a joint venture with a foreign firm already operating in the industry as the investor has no previous experience.

- (b) Agreement on TRIMS establishes discipline governing investment measures in relation to cross-border investments by stipulating that countries receiving foreign investments shall not impose investment measures such as requirements, conditions and restrictions inconsistent with the provisions of the principle of national treatment and general elimination of quantitative restrictions.

10. Goods produced by each country

Country	Shirts	Trousers
Rose Land	800	500
Daisy Land	500	250

Each country has 4000 hours of labour and uses 2000 hours each for both the goods. Therefore, the number of hours spent per unit on each good

Country	Shirts	Trousers
Rose Land	2.5	4
Daisy Land	4	8

Since Rose Land produces both goods in less time, it has absolute advantage in both shirts and trousers.

Comparative advantage; comparing the opportunity costs of both goods we have

Rose Land

Opportunity cost of Shirts $2.5/4 = 0.625$

Opportunity cost of Trousers $4/2.5 = 1.6$

Daisy Land

Opportunity cost of Shirts $4/8 = 0.5$

Opportunity cost of Trousers $8/4 = 2$

For producing shirts

Daisy Land has lower opportunity cost for producing shirts, therefore Daisy Land has comparative advantage

For producing Trousers

Rose Land has lower opportunity cost for producing Trousers, therefore Rose Land has comparative advantage.

**Applicability of Standards/Guidance Notes/Legislative Amendments etc. for November,
2020 Examination - Intermediate Level (New Course)**

Paper 5: Advanced Accounting

List of Applicable Accounting Standards

- AS 4: Contingencies and Events Occurring After the Balance Sheet Date
- AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
- AS 7: Construction Contracts
- AS 9: Revenue Recognition
- AS 14: Accounting for Amalgamations
- AS 17: Segment Reporting
- AS 18: Related Party Disclosures
- AS 19: Leases
- AS 20: Earnings Per Share
- AS 22: Accounting for Taxes on Income
- AS 24: Discontinuing Operations
- AS 26: Intangible Assets
- AS 29: Provisions, Contingent Liabilities and Contingent Assets.

Applicability of the Companies Act, 2013 and other Legislative Amendments for November, 2020 Examination

The relevant notified Sections of the Companies Act, 2013 and legislative amendments including relevant Notifications / Circulars / Rules / Guidelines issued by Regulating Authorities up to 30th April, 2020 will be applicable for November, 2020 Examination.

Non-Applicability of Ind AS

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

Paper 6: Auditing and Assurance
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List of topic-wise inclusion in the syllabus**I. List of applicable Engagements and Quality Control Standards on Auditing for November, 2020 Examination**

S.No.	SA	Title of Standard on Auditing
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
3	SA 210	Agreeing the Terms of Audit Engagements
4	SA 220	Quality Control for Audit of Financial Statements
5	SA 230	Audit Documentation
6	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements
7	SA 250	Consideration of Laws and Regulations in An Audit of Financial Statements
8	SA 299	Joint Audit of Financial Statements(Revised)
9	SA 300	Planning an Audit of Financial Statements
10	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
11	SA 320	Materiality in Planning and Performing an Audit
12	SA 500	Audit Evidence
13	SA 501	Audit Evidence - Specific Considerations for Selected Items
14	SA 505	External Confirmations
15	SA 510	Initial Audit Engagements-Opening Balances
16	SA 520	Analytical Procedures
17	SA 530	Audit Sampling
18	SA 550	Related Parties
19	SA 560	Subsequent Events
20	SA 570	Going Concern (Revised)
21	SA 580	Written Representations
22	SA 610	Using the Work of Internal Auditors (Revised)

23	SA 700	Forming an Opinion and Reporting on Financial Statements(Revised)
24	SA 701	Communicating Key Audit Matters in the Independent Auditor's Report (New)
25	SA 705	Modifications to the Opinion in the Independent Auditor's Report (Revised)
26	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report (Revised)
27	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements

II. Applicability of the Companies Act, 2013 and other Legislative Amendments for November, 2020 Examination

- (i) The **July 2019 Edition of the Study Material** on Intermediate Paper 6: Auditing and Assurance [comprising of 2 Modules – Modules 1 – 2] is relevant for November, 2020 Examinations. **This is an integrated Study Material cum Practice Manual.**

Students are expected to be updated with the notifications, circulars and other legislative amendments made upto 6 months prior to the examination. **For instance, for November, 2020 examination, significant notifications and circulars issued upto 30th April, 2020 would be relevant.**

The relevant notified Sections of the Companies Act, 2013 and legislative amendments including relevant Notifications / Circulars / Rules / Guidelines issued by Regulating Authority up to 30th April, 2020 will be applicable for November, 2020 Examination. **It may be noted that the significant notifications and circulars issued up to 30th April, 2020, which are not covered in the July 2019 Edition of the Study Material, would be given as Academic Update in the Revision Test Paper for November, 2020 Examination.**

- (ii) Companies (Auditor's Report) Order, 2016 issued by Ministry of Corporate Affairs on 29th March, 2016 is applicable for November, 2020 Examination.

List of topic-wise exclusion in the syllabus

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

(1)	(2)	(3)
S.No.	SA	Exclusions
1	SA 260	Communication with Those Charged with Governance (Revised)
2	SA 265	Communicating Deficiencies in Internal Control to Those Charged

		with Governance and Management
3	SA 330	The Auditor's Responses to Assessed Risks
4	SA 402	Audit Considerations Relating to an Entity Using a Service Organization
5	SA 450	Evaluation of Misstatements Identified during the Audits
6	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
7	SA 600	Using the Work of Another Auditor
8	SA 620	Using the Work of an Auditor's Expert
9	SA 720	The Auditor's Responsibilities Relating to Other Information

III. Following Guidance Notes are excluded:

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