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FOR CA INTERMEDIATE EXAM PREPARATION

CA Intermediate 2022 Suggested Answers · Group II (All Papers) (Old Scheme)

EXAM	YEAR	TYPE
CA Intermediate	2022	Suggested Answers

SUBJECT	DATE
Group II (All Papers) (Old Scheme)	November 2022

SUGGESTED ANSWERS TO QUESTIONS SET AT THE

INTERMEDIATE EXAMINATION

GROUP II

NOVEMBER, 2022

BOARD OF STUDIES

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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PAPER – 5: ADVANCED ACCOUNTING

*Question No.**1** is compulsory.*

*Candidates are also required to answer any **four** questions from the remaining **five** questions.*

Working notes should form part of the respective answers.

Wherever necessary, candidates are permitted to make suitable assumptions which should be disclosed by way of a note.

Question 1

(a) The Accountant of Shiva Limited had sought your opinion with relevant reasons, whether the following transactions will be treated as change in Accounting Policies or change in Accounting Estimates for the year ended 31st March, 2021. Please advise him in the following situations in accordance with the provisions of AS 5:

(i) Provision for doubtful debts was created @3% till 31st March, 2020. From the Financial year 2020-2021, the rate of provision has been changed to 4%.

(ii) During the year ended 31st March,2021, the management has introduced a formal gratuity scheme in place of ad-hoc ex-gratia payments to employees on retirement.

(iii) Till 31st March, 2020 the furniture was depreciated on straight line basis over a period of 5 years. From the Financial year 2020-2021, the useful life of furniture has been changed to 3 years.

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

(v) During the year ended 31st March 2021, there was change in cost formula in measuring the cost of inventories.

(b) The following information is furnished in respect of Mohit Limited for the year ending 31st March,2022.

(i) Depreciation as per accounting records ₹ 56,000

Depreciation for income tax records ₹ 38,000

The above depreciation does not include depreciation on new addition.

(ii) A new machinery purchased on 1st April, 2021 costing ₹ 24,000 on which 100% depreciation in allowed in the 1st Year for income tax purpose, whereas straight line method of depreciation is considered appropriate for accounting purpose with a life estimation of 4 years.

(ii) The company has made a profit of ₹ 1,28,000 before depreciation and taxes.

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(iv) *Donation to private trust during the year is ₹ 15,000 (not allowed under Income tax laws.)*

(v) *Corporate tax is 40%.*

Prepare relevant extract of statement of Profit & Loss for the year ending 31st March, 2022. Also show the effect of the above items on Deferred Tax Liability/Assets as per AS 22.

(c) *The following information is provided to you:*

Net profit for the year 2022:	*₹ 72,00,000*
Weighted average number of equity shares outstanding during the year 2022:	*30,00,000 shares*
Average Fair value of one equity share during the year 2022:	*₹ 25.00*
Weighted average number of shares under option during the year 2022:	*6,00,000 shares*
Exercise price for shares under option during the year 2022:	*₹ 20.00*

You are required to compute Basic and Diluted Earnings Per Share as per AS 20.

(d) *MN Limited operates its business into various segments. Its financial year ended on 31st March, 2022 and financial statements were approved by their approving authority on 15th June, 2022. The following material events took place:*

(i) *On 7th April, 2022, a fire completely destroyed a manufacturing plant of the entity. It was expected that the loss of ₹ 15 crores would be fully covered by the insurance company.*

(ii) *A claim for damage amounting to ₹ 12 crores for breach of patent had been received by the entity prior to the year end. It is the director's opinion, backed by legal advice that the claim will ultimately prove to be baseless. But it is still estimated that it would involve a considerable expenditure on legal fees.*

(iii) *A major property was sold (it was included in the balance sheet at ₹ 37,50,000) for which contracts had been exchanged on 15th March, 2022. The sale was completed on 15th May, 2022 at a price of ₹ 39,75,000.*

You are required to state with reasons, how each of the above items should be dealt with in the financial statements of MN Limited for the year ended 31st March, 2022 as per AS 4.

(4 Parts x 5 Marks= 20 Marks)

Answer

(a) (i) In the given case, company has created 3cer% provision for doubtful debts till 31st March, 2020. Subsequently from 1st April, 2020, the company revised the estimates based on the changed circumstances and wants to create 4% provision. Thus, change in rate of provision of doubtful debt is change in estimate and is not

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change in accounting policy. This change will affect only current year.

(ii) As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy. Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is a transaction which is substantially different from the previous transaction, will neither be treated as change in an accounting policy nor change in accounting estimate.

(iii) Change in useful life of furniture from 5 years to 3 years is a change in accounting estimate and is not a change in accounting policy.

(iv) Adoption of a new accounting policy for events or transactions which did not occur previously should not be treated as a change in an accounting policy. Hence the introduction of new pension scheme is neither a change in accounting policy nor a change in accounting estimate.

(v) Change in cost formula used in measurement of cost of inventories is a change in accounting policy.

(b) Statement of profit and Loss for the year ended 31st March, 2022 (An Extract)

	₹
Profit before taxes and depreciation	1,28,000
Less: Depreciation (56,000+ 6,000)	62,000
Profit before tax	66,000
Less: Current tax (W.N)	(32,400)
Deferred Tax	Nil
Profit after tax	33,600

Working Note:

Computation of taxable income

	₹
Profit before taxes and depreciation	1,28,000
Less: Depreciation (38,000+ 24,000)	(62,000)
	66,000
Add: Donation*	15,000
	81,000
Current tax (40%)	32,400

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Note: The profit of ₹ 1,28,000 given in the question is before depreciation and taxes. It has been considered that this amount is after making adjustment of donation amounting ₹ 15,000.

Impact of various items in terms of deferred tax liability/deferred tax asset

Transactions	*Nature of difference*	*Effect*	*Amount*
(1) Difference in depreciation (old machinery)	Timing difference	Reversal of DTL	₹ 18,000 (56,000 – 38,000) × 40% = (+) ₹ 7,200
(2) Depreciation on new machinery	Timing difference	Creation of DTL	₹ 18,000 (24,000 – 6,000) x 40% = (-) ₹ 7,200
(3) Donation to private trusts	Permanent difference	Not applicable	--
Net Effect of Deferred Tax			NIL

(c) Computation of Basic earnings per share

	Earnings ₹	*Shares*	*Earnings/ Share* ₹
Net profit for the year 2022	72,00,000		
Weighted average no. of shares during year 2022		30,00,000	
Basic earnings per share (72,00,000/30,00,000)			2.40

Computation of Diluted earnings per share

	Earnings ₹	*Shares*	*Earnings/Share* ₹
Net profit for the year 2022	72,00,000		
Weighted average no. of shares during year 2022		30,00,000	
Number of shares under option		6,00,000	
Number of shares that would have been issued at fair value (6,00,000 x 20.00)/25.00		(4,80,000)	
Diluted earnings per share	72,00,000	31,20,000	2.31 (rounded-off)

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Note: The earnings have not been increased as the total number of shares has been increased only by the number of shares (1,20,000) deemed for the purpose of the computation to have been issued for no consideration.

To the extent that partly paid shares are not entitled to participate in dividends during the reporting period they are considered the equivalent of options.

(d) Treatment as per AS 4 'Contingencies and Events Occurring After the Balance Sheet Date'

(i) 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 note in the financial statements.

(ii) On the basis of evidence provided, the claim against the company will not succeed. Thus, 12 crores should not be provided in the account but should be disclosed by means of a contingent liability with full details of the facts as per AS 29. Provision can be made for legal fee expected to be incurred to the extent that they are not expected to be recovered if the amount can be ascertained.

(iii) The sale of property should be treated as an adjusting event since contracts had been exchanged prior to the year-end. The effect of the sale would be reflected in the financial statements ended on 31.3.2022 and the profit on sale of property ₹ 2,25,000 would be considered.

Question 2

The following is the Balance Sheet of Purple Limited as at 31st March, 2022:

Particulars	*Notes*	*Amount in ₹*
I. Equity and Liabilities		
(1) Shareholders' Funds		
(a) Share Capital	*1*	*15,00,000*
(b) Reserves & Surplus	*2*	*(3,00,000)*
(2) Current Liabilities		
(a) Trade Payables		*2,20,000*
(b) Short Term Borrowings – Bank Overdraft		*2,00,000*
Total		*16,20,000*

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II.	*Assets*		
	(1) Non-Current Assets		
	(a) Property, Plant and Equipment	*3*	*10,20,000*
	(b) Intangible Assets	*4*	*1,20,600*
	(2) Current Assets		
	(a) Inventories		*1,70,000*
	(b) Trade Receivables		*3,01,800*
	(c) Cash and cash equivalents		*7,600*
	Total		*16,20,000*

Notes to Accounts

	₹	₹
(1) Share Capital		
90,000 Equity Shares of ₹10 each fully paid	*9,00,000*	
6% Preference Share Capital	*6,00,000*	*15,00,000*
(2) Reserves & Surplus		
Profit & Loss account		*(3,00,000)*
(3) Property, Plant and Equipment		
Land and Building	*5,40,000*	
Plant and Machinery	*4,80,000*	*10,20,000*
(4) Intangible Assets		
Goodwill	*84,600*	
Patents	*36,000*	*1,20,600*

Dividends on preference shares are in arrears for 3 years.

On the above date, the company adopted the following scheme of reconstruction:

(i) The preference shares are converted from 6% to 8% but revalued in a manner in which the total return on them remains unaffected.

(ii) The value of equity shares is brought down to ₹8 per share.

(iii) The arrears of dividend on preference shares are cancelled.

(iv) The debit balance of Goodwill account is written off entirely.

(v) Land and Building and Plant and Machinery are revalued at 85% and 80% of their respective book values.

(vi) Book debts amounting to ₹14,400 are to be treated as bad and hence to be written off.

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(vii) The company expects to earn a profit at the rate of ₹ 90,000 per annum from the current year which would be utilized entirely for reducing the debit balance of Profit and loss accounts for 3 years. The remaining balance of the said account would be written off at the time of capital reduction process.

(viii) The balance of total capital reduction is to be utilized in writing down Patents.

(ix) A secured loan of ₹ 4,80,000 bearing interest at 12% per annum is to be obtained by mortgaging tangible fixed assets for repayment of bank overdraft and for providing additional funds for working capital.

You are required to give journal entries incorporating the above scheme of reconstruction, capital reduction account and prepare the reconstructed Balance Sheet. ***(20 Marks)***

Answer

Journal Entries In the books of Purple Ltd.

	Particulars		*Debit (₹)*	*Credit (₹)*
1.	6% Preference share capital A/c	Dr.	6,00,000	
	To 8% Preference share capital A/c			4,50,000
	To Capital reduction A/c			1,50,000
	(Being 6% preference shares converted to 8% preference shares so that return to pref. shareholders remains unaffected)			
2.	Equity share capital A/c (₹ 10)	Dr.	9,00,000	
	To Equity share capital A/c (₹ 8)			7,20,000
	To Capital reduction A/c			1,80,000
	(Being equity capital reduced to nominal value of ₹ 8 each)			
3.	Capital Reduction A/c	Dr.	3,30,000	
	To Goodwill A/c			84,600
	To Land and Building A/c			81,000
	To Plant and Machinery A/c			96,000
	To Trade Receivables A/c (Book debts)			14,400
	To Patents A/c (Bal. fig.)			24,000
	To Profit and loss A/c			30,000
	(Being losses and assets written off to the extent required)			

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4.	Bank A/c	Dr.	4,80,000	
	To Bank Loan A/c			4,80,000
	(Being Loan taken)			
5.	Bank overdraft A/c	Dr.	2,00,000	
	To Bank A/c			2,00,000
	(Being Bank overdraft repaid)			

Capital Reduction Account

	Particulars	₹		Particulars	₹
To	Goodwill A/c	84,600	By	Equity Share Capital A/c	1,80,000
To	Land & Building A/c	81,000	By	6% Preference Share Capital A/c	1,50,000
To	Plant and Machinery A/c	96,000			
To	Trade receivables (Book Debts) A/c	14,400			
To	Profit & Loss A/c	30,000			
To	Patents A/c (Bal. fig.)	24,000			
		3,30,000			3,30,000

Balance Sheet of Purple Ltd. (and reduced)

as at 31.3.2022

		Particulars	*Notes*	₹
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	11,70,000
	b	Reserves and surplus	2	(2,70,000)
2		**Current liabilities**		
	a	Short term borrowings (Secured Bank Loan)		4,80,000
	b	Trade Payables		2,20,000
		Total		16,00,000
		Assets		
1		**Non-current assets**		
	a	Property, plant and equipment	3	8,43,000
	b	Intangible assets	4	12,000

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2		**Current Assets**		
	a	Inventory		1,70,000
	b	Trade receivables	5	2,87,400
	c	Cash and cash equivalents (7,600+4,80,000-2,00,000)		2,87,600
		Total		16,00,000

Notes to Accounts:

			₹
1.	Share Capital		
	Authorized		
	Issued, subscribed and paid up:		
	90,000 equity shares of ₹ 8 each fully paid	7,20,000	
	8% Preference share capital*	4,50,000	11,70,000
2.	Reserves and Surplus		
	Profit and Loss Account (Dr. balance)		(2,70,000)
3.	Property plant and equipment		
	Land and Building	4,59,000	
	Plant and Machinery	3,84,000	8,43,000
4.	Intangible assets		
	Patent ₹(36,000 - 24,000)		12,000
5.	Trade Receivables		
	Sundry Debtors	3,01,800	
	Less: Bad debts	(14,400)	2,87,400

Note: *Face value of preference share is not given in the question (pre and post reconstruction) and hence any suitable value of preference share may be assumed.

Working Notes:

1. Calculation of new Preference Shares

Rate of return : 6% on Preference Shares

Dividend : (6/100) x ₹ 6,00,000 = ₹ 36,000

Rate of return : 8% on Preference Shares

Dividend : (8/100) x X = ₹ 36,000

X = (36,000/8) x 100 = ₹ 4,50,000

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New Preference Share Capital	=	₹ 4,50,000
Old Preference Share Capital	=	₹ 6,00,000
(6,00,000 – 4,50,000)	=	₹ 1,50,000 Amount taken to Capital Reduction A/c.

2. Since the company expects to earn a profit of ₹ 90,000 p.a. consecutively for three years and it shall be used to write-off debit balance of P & L account, hence ₹ 2,70,000 being loss shall be shown in the Balance Sheet under Reserve & Surplus head and ₹ 30,000 shall be written-off from Capital Reduction A/c.

3. Calculation of Amount written off on Land & Building and Plant & Machinery

Land & Building	= (85/100) x 5,40,000	= ₹ 4,59,000
Plant & Machinery	= (80/100) x 4,80,000	= ₹ 3,84,000
Reduced by:		
Land & Building	= (5,40,000 - 4,59,000)	= ₹ 81,000
Plant & Machinery	= (4,80,000 - 3,84,000)	= ₹ 96,000

Question 3

(a) H Ltd. and S Ltd. provide the following information as at 31st March,2022:

	H Ltd.₹	*S Ltd.₹*
Property, Plant and Equipment	*2,00,000*	*2,60,000*
Investments (14,000 Equity Shares of S Ltd.)	*2,52,000*	*-*
Current Assets	*1,48,000*	*1,40,000*
Share capital (Fully paid equity shares of ₹10 each)	*3,00,000*	*2,00,000*
Profit and loss account	*1,00,000*	*80,000*
Trade Payables	*2,00,000*	*1,20,000*

Additional information:

H Ltd. acquired the shares of S Ltd. on 1st July, 2021 and Balance of profit and loss account of S Ltd. on 1st April, 2021 was ₹60,000. Prepare consolidated balance sheet of H Ltd. and its subsidiary as at 31st March, 2022. ***(15 Marks)***

(b) DS Finance Limited is a non-banking financial company. It provides you with the following information regarding its outstanding amount, ₹ 100 lakhs of which instalments are overdue on:

- *400 accounts for last one month (amount overdue ₹20 lakhs),*
- *24 accounts for two months (amount overdue ₹12 lakhs),*

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- *10 accounts for more than 30 months (amount overdue ₹10 lakhs)*
- *4 accounts for more than 3 years (amounts overdue ₹10 lakhs - already identified as sub-standard assets)*
- *1 account of ₹5 lakhs which has been identified as non- recoverable by management.*
- *Out of 10 accounts overdue for more than 30 months, 6 accounts are already identified as sub-standard (amount ₹3 lakhs) for more than 12 months and others are identified as sub-standard assets for a period of less than twelve months.*

Classify the assets of the company in line with Non-Banking Financial Company-Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016. ***(5 Marks)***

Answer

(a) Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd.

as at 31st March, 2022

		Note No	Amount (₹)
	I **Equity and Liabilities**		
1	Shareholders' Fund:		
	(a) Share Capital	1	3,00,000
	(b) Reserve and Surplus	2	1,10,500
2	Minority interest	3	84,000
3	Current Liabilities		
	Trade payables	4	3,20,000
	Total		8,14,500
	II **Assets**		
1	Non-Current Assets:		
	Property, plant and equipment	5	4,60,000
	Intangible Asset	6	66,500
2	Current Assets	7	2,88,000
	Total		8,14,500

Notes to Accounts

		Amount (₹)
1	Share capital 30,000 Equity Shares @ ₹10 each	3,00,000

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2	Reserve and Surplus Profit and loss account (₹ 1,00,000 + 70% of 9/12 x 20,000 i.e. ₹ 10,500)	1,10,500
3	Minority Interest (W/N 2)	84,000
4	Trade payables H Ltd. S Ltd.	2,00,000 1,20,000 3,20,000
5	Property, plant and equipment H Ltd. S Ltd.	2,00,000 2,60,000 4,60,000
6	Intangible Asset: Goodwill (W/N 3)	66,500
7	Current Assets H Ltd. S Ltd.	1,48,000 1,40,000 2,88,000

Working Notes:

1. **Percentage of holding**

		No. of Shares	Percentage
Holding Co.	:	14,000	(70%)
Minority shareholders	:	6,000	(30%)
Total Shares	:	20,000	

2. **Calculation of Minority Interest**

Share capital (30% of ₹ 2,00,000)	60,000	
Share in Profit and loss account (₹ 80,000 X 30%)	24,000	84,000

3. **Calculation of Cost of Control (Goodwill)**

Cost of Investment	2,52,000
Less: Paid up value of shares (70% of ₹ 2,00,000)	(1,40,000)
Share in pre-acquisition profits 70% of [60,000+3/12(80,000-60,000)]	(45,500)
	66,500

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

		(₹ in lakhs)
Standard Assets:		
Accounts (Balancing figure)	43.00	
400 accounts overdue for a period of 1 month	20.00	
24 accounts overdue for a period of 2 months	12.00	75.00
Sub-Standard Assets:		
4 accounts identified as sub-standard asset for a period less than 12 months		7.00
Doubtful Debts:		
6 accounts identified as sub-standard for a period more than 12 months		3.00
4 accounts identified as sub-standard for a period more than 3 years		10.00
Loss Assets		
1 account identified by management as loss asset		5.00
Total overdue		100.00

Question 4

(a) M, N and O were in partnership sharing profits and losses in the ratio of 3:2: 1. There was no provision in the agreement for interest on capitals or drawings.

M died on 31st March, 2021 and on that date, the partners' balances were as under:

Capital Account: M- ₹75,000 (Cr); N- ₹50,000 (Cr); O- ₹25,000 (Cr)

Current Account: M- ₹50,000 (Cr); N- ₹37,500 (Cr); O- ₹ 12,500 (Dr)

By the partnership agreement, the sum due to M's estate was required to be paid within a period of 3 years, and minimum instalment of ₹37,500 each were to be paid, the first such instalment falling due immediately after death and the subsequent instalments at half-yearly intervals. Interest @ 6% was to be credited half-yearly.

In ascertaining M's share, Goodwill (not recorded in the books) was to be valued at ₹1,12,500 and the assets, excluding the Joint Assurance Policy (mentioned below) were valued at ₹75,000 in excess of the book values.

No Goodwill account was raised and no alteration was made to the book values of fixed assets. The Joint Assurance Policy shown in the books at ₹50,000 matured on 01.04.2021, realizing ₹65,000; payment of ₹37,500 each were made to M's Executors on 01.04.2021, 30.09.2021 and 31.03.2022. N and O continued trading on the same terms and conditions

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as previously and the net profit for the year ending 31.03.2022 (before charging the interest due to M's estate) amounted to ₹ 65,000. During that period, the partners' drawings were N -₹ 18,750 and O -₹ 10,000.

On 01.04.2022, the partnership was dissolved and an offer to purchase the business as a going concern for ₹ 2,25,000 was accepted on that day. A cheque for that sum was received on 30.06.2022.

The balance due to M's estate, including interest, was paid on 30.06.2022 and on that day, N and O received the sums due to them.

You are required to write-up the Partners' Capital Accounts and Partners' Current Accounts from 01.04.2021 to 30.06.2022. Show also the account of executors of M. ***(15 Marks)***

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

(i) Applicable Law

(ii) Perpetual Succession

(iii) Ownership of Assets

(iv) Liability of Partners / Members

(v) Principal-Agent Relationship ***(5 Marks)***

Answer

(a) Partners' Current Accounts

Particulars		M ₹	N ₹	O ₹	Particulars		M ₹	N ₹	O ₹
31.3.2021					*31.3.2021*				
To	Balance b/d	-	-	12,500	By	Balance b/d	50,000	37,500	-
To	M's Current A/c– goodwill	-	37,500	18,750	By	N's Current A/c –goodwill	37,500	-	-
To	M's Current A/c– Revaluation Profit	-	25,000	12,500	By	O's Current A/c – goodwill	18,750	-	-
To	M's Capital A/c– transfer	1,51,250	-	-	By	N's Current A/c– Revaluation profit	25,000	-	-
					By	O's Current A/c – Revaluation profit	12,500		

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				By Joint assurance policy	7,500	5,000	2,500
				By Balance c/d		20,000	41,250
	1,51,250	62,500	43,750		1,51,250	62,500	43,750
1.4.21				31.3.22			
To Balance b/d		20,000	41,250	By Profit & Loss Appropriation A/c (43,920)		29,280	14,640
31.3.22							
To Drawings A/c		18,750	10,000	By Balance c/d		9,470	36,610
		38,750	51,250			38,750	51,250
1.4.22				1.4.22			
To Balance b/d		9,470	36,610	By Realization A/c -profit		38,137	19,068
To N's Capital A/c-transfer		28,667	-	By O's Capital A/c - transfer		-	17,542
		38,137	36,610			38,137	36,610

Partners' Capital Accounts

Particulars	*M* ₹	*N* ₹	*O* ₹	*Particulars*	*M* ₹	*N* ₹	*O* ₹
31.3.21				31.3.21			
To M's Executors A/c	2,26,250	----	---	By Balance b/d	75,000	50,000	25,000
To Balance c/d	---	50,000	25,000	By M's Current A/c	1,51,250	--	--
	2,26,250	50,000	25,000		2,26,250	50,000	25,000
31.3.22				1.4.21			
To Balance c/d		50,000	25,000	By Balance b/d		50,000	25,000
		50,000	25,000			50,000	25,000
1.4.22				1.4.22			
To O's Current A/c – transfer		---	17,542	By Balance b/d		50,000	25,000
30.6.22							
To Bank A/c		78,667	7,458	By N's Current A/c – transfer		28,667	---
		78,667	25,000			78,667	25,000

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M's Executor's Account

Date	Particulars	Amount	Date	Particulars	Amount
31.3.2021	To Balance c/d	2,26,250	31.3.2021	By M's Capital A/c	2,26,250
		2,26,250			2,26,250
1.4.2021	To Bank	37,500	1.4.2021	By Balance b/d	2,26,250
30.9.2021	To Bank	37,500	30.9.2021	By Interest A/c	11,325
30.9.2021	To Balance c/d	1,62,575		(12% p.a. for 6 months)	----------
		2,37,575			2,37,575
31.3.2022	To Bank	37,500	1.10.2021	By Balance b/d	1,62,575
31.3.2022	To Balance c/d	1,34,830	31.3.2022	By Interest A/c	9,755
				(12% p.a. for 6 months)	----------
		1,72,330			1,72,330
30.6.2022	To Bank	1,38,875	1.4.2022	By Balance b/d	1,34,830
			30.6.2022	By Interest	4,045
		----------		(12% p.a. for 3 months)	----------
		1,38,875			1,38,875

Working Notes:

(1) Adjustment in regard to Goodwill

Partners		*M*	*N*	*O*
Share of goodwill before death	(₹)	56,250	37,500	18,750
Share of goodwill after death	(₹)	-	75,000	37,500
Gain (+)/Sacrifice (-)	(₹)	(56,250)	37,500	18,750
		Cr.	Dr.	Dr.

(2) Adjustment in regard to revaluation of assets

Partners		*M*	*N*	*O*
Share of profit on revaluation credited to all the partners (75,000 in 3:2:1)	(₹)	37,500	25,000	12,500
Debited to the continuing partners	(₹)	-	50,000	25,000
	(₹)	(37,500)	25,000	12,500
		Cr.	Dr.	Dr.

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(3) Ascertainment of Profit for the year ended 31.3.22

	₹	₹
Profit before charging interest on balance due to M's executors		65,000
Less: Interest payable to M's executors:		
From 1.4.21 to 30.9.21	11,325	
From 1.10.21 to 31.3.22	9,755	(21,080)
Balance of profit to be shared by N and O in 2:1		43,920

(4) Ascertainment of Sundry Assets as on 31.3.22

Liabilities	₹	*Assets*	₹
Capital Account – N	50,000	Sundry Assets (balancing figure)	1,63,750
Capital Account – O	25,000	Partner's Current A/c – N	9,470
M's Executors A/c	1,34,830	Partner's Current A/c- O	36,610
	2,09,830		2,09,830

(5) Realization Account

		₹			₹
To	Sundry Assets A/c	1,63,750	By	Bank A/c (purchase consideration)	2,25,000
To	Interest A/c– M's Executors	4,045			
To	Partner's Current A/c – N	{38,137			
To	Partner's Current A/c – O	19,068}			
		2,25,000			2,25,000

(6) Bank Account

		₹			₹
To	Purchase consideration	2,25,000	By	M's Executors A/c	1,38,875
			By	Partner's Capital - N	78,667
			By	Partner's Capital - O	7,458
		2,25,000			2,25,000

Note:

1. As per the information given in the question, Interest @ 6% was to be credited half-yearly to M's executor's account. Hence the rate of 12% per annum has been considered in the solution while working the interest computations.

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2. Interest computations have been rounded off.

(b) Distinction between an ordinary partnership firm and an LLP

	Basis	LLP	Partnership firm
1.	Applicable law	The Limited Liability Partnership Act, 2008.	The Indian Partnership Act, 1932.
2.	Perpetual succession	The death, insanity, retirement or insolvency of the partner(s) does not affect its existence of LLP. Members may join or leave but its existence continues forever.	The death, insanity, retirement or insolvency of the partner(s) may affect its existence. It has no perpetual succession.
3	Ownership of assets	The LLP as an independent entity can own assets	Firm cannot own any assets. The partners own the assets of the firm
4.	Liability of Partners/ Members	Liability of each partner is limited to the extent to agreed contribution except in case of willful fraud.	Liability of each partner is unlimited. Partners are severally and jointly liable for actions of other partners and the firm and their liability extends to personal assets
5.	Principal-agent relationship	Partners are agents of the firm only and not of other partners.	Partners are the agents of the firm and of each other

Question 5

(a) Following information of RJS Bank Limited for the year ended 31st March, 2022 are as under:

Particulars	*₹ in '000*
Total interest earned and received on term loans	*6375.00*
Interest earned on term loans classified as NPA	*1827.50*
Interest received on term loans classified as NPA	*595.00*
Total interest earned on cash credits and overdrafts	*14157.50*
Interest earned but not received on cash credits and overdrafts treated as NPA	*2307.50*
Interest on Deposits	*10300.00*
Commission, exchange and brokerage	*502.50*
Profit on sale of Investments	*4690.00*

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Profit on revaluation of Investments	*855.00*
Income from Investments	*5435.00*
Payment to and provision for employees	*6862.50*
Rent, Taxes and Lighting	*962.50*
Printing and Stationery	*155.00*
Director's fees, allowances and expenses	*782.50*
Repairs and Maintenance	*140.00*
Depreciation on Bank's property	*247.50*
Insurance	*107.50*

Classification of Assets:

Particulars	*₹*
Standard [including advances to Commercial Real Estate (CRE) sector ₹17,50,000]	*11,750*
Sub-standard (fully secured)	*4,750*
Doubtful Assets not covered by security	*1,000*
Doubtful Assets covered by security for 1 year	*100*
Loss Assets	*750*

You are required to prepare Profit and Loss account of RJS Bank Limited including Schedules for the year ended 31st March, 2022 and calculate provision required to be made on Risk Assets. ***(15 Marks)***

(b) *Proud Limited is being wound up by the tribunal. All the assets of the company have been charged to the company's banker to whom the company owes ₹10 crores. The company owes the following amounts to others:*

(i) Dues to workers-₹2,50,00,000

(ii) Taxes payable to Government-₹60,00,000

(iii) Unsecured Creditors-₹1,20,00,000

You are required to compute with the reference to the provisions of the Companies Act, 2013 the amount each kind of creditors is likely to get if the amount realized by the official liquidator from the secured assets and available for distribution among creditors is only ₹8,00,00,000. ***(5 Marks)***

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Answer

(a)

RJS Bank
Profit and Loss Account
For the year ended 31st March, 2022

	Particulars	Schedule	(₹'000') Year ended 31-3-2022
I	Income		
	Interest earned	13	23,660.00
	Other income	14	6,047.50
			29,707.50
II	Expenditure		
	Interest expended	15	10,300.00
	Operating expenses	16	9,257.50
	Provisions and Contingencies (refer W.N)		2,545
			22,102.50
III	Profit/Loss		7,605.00

Schedule 13 - Interest Earned

			Year ended 31-3-2022 (₹'000')
I	Interest/discount on advances/bills		
	Interest on term loans *		6,375.00
	Interest on cash credits and overdrafts	(14157.50-2307.50)	11,850.00
II	Income on investments		5,435.00
			23,660.00

Schedule 14 - Other Income

	Year ended 31-3-2022 (₹'000')
Commission, exchange and brokerage	502.50

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Profit on sale of investments	4690
Profit on revaluation of investments	855
	6047.50

Schedule 15 - Interest Expended

	Year ended 31-3-2022
I Interest on Deposits	10,300

Schedule 16 - Operating Expenses

		Year Ended 31-3-2022
I	Payment and provision for employees	
	Salaries, allowances and bonus	6862.50
II	Rent, taxes and lighting	962.50
III	Printing & stationery	155.00
IV	Director's fee, allowances and expenses	782.50
V	Depreciation on the Bank's Property	247.50
VI	Repairs & maintenance	140.00
VII	Insurance	107.50
		9,257.50

Working Note:

Calculation of Provisions amount on risk assets		*(₹'000)*
Provision for NPA:		
Standard (excluding advances to Commercial Real Estate (CRE) Sector 11,750-1,750)	10,000 × 0.40%	40
Standard - advances to Commercial Real Estate (CRE)	1,750 x 1%	17.5
Sub-standard- fully secured	4750 × 15%	712.5
Doubtful assets not covered by security	1,000 × 100%	1000
Doubtful covered by security for one year	100 × 25%	25
Loss Assets	750 × 100%	750
		2,545

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Note: *The amount of total interest earned and received on term loans amounting ₹ 63,75,000 is given in the question. It has been assumed in the given answer that this amount does not include any amount of interest earned but not received on term loans (classified as NPA). Hence no adjustment for the amount of interest earned but not received on term loans (classified as NPA) has been done. Alternatively, it may be assumed that the amount of total interest earned and received on term loans amounting ₹ 63,75,000 is inclusive of interest amount earned but not received on term loans classified as NPA. In this case, the Profit and Loss Account and Schedule 13 will be changed and will be given as follows (Schedules 14 to 16 and Working Note will remain same):

RJS Bank

Profit and Loss Account

For the year ended 31st March, 2022

	Particulars	Schedule	*Year ended 31-3-2022 (₹'000')*
I	Income		
	Interest earned	13	22,427.50
	Other income	14	6,047.50
			28,475
II	Expenditure		
	Interest expended	15	10,300.00
	Operating expenses	16	9,257.50
	Provisions and Contingencies (refer W.N)		2,545
			22,102.50
III	Profit/Loss		6,372.50

Schedule 13 - Interest Earned

		Year ended 31-3-2022 (₹'000')
I	Interest/discount on advances/bills	
	Interest on term loans [6375- (1827.50-595)]	5,142.50
	Interest on cash credits and overdrafts (14157.50-2307.50)	11,850.00
II	Income on investments	5,435.00
		22,427.50

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Interest on NPA is recognized on cash basis, hence excess reduced.

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

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

$$= \frac{8,00,00,000 \text{ X } 2,50,00,000}{2,50,00,000 + 10,00,00,000}$$

$$8,00,00,000 \text{ X } \frac{1}{5}$$

Workman's Share to Secured Assets = ₹1,60,00,000

Amount available to secured creditor is ₹ 800 Lakhs – ₹160 Lakhs = ₹ 640 Lakhs

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

Question 6

*Answer any **four** of the following:*

(a) Indicate in each case whether revenue can be recognized and when it will be recognized as per AS-9.

(i) Delivery is delayed at buyer's request but buyer takes title and accepts billing.

(ii) Instalment Sales.

(iii) Trade discounts and volume rebates.

(iv) Insurance agency commission for rendering services.

(v) Advertising commission.

(b) PG Limited furnishes the following Balance Sheet as at 31st March,2022:

	Particulars	*Notes*	*₹ (in Lakhs)*
1.	*Equity and Liabilities*		
	Shareholders' funds		
	(a) Share Capital	*1*	*12,000*
	(b) Reserves and Surplus	*2*	*8,100*
2	*Current liabilities*		
	(a) Trade Payables		*7,450*

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	(b) Other Current Liabilities		1,950
	Total		29,500
	Assets		
1	Non-current assets		
	(a) Property, Plant and Equipment		12,760
	(b) Non-current Investments		740
2.	Current assets		
	(a) Inventories		6,000
	(b) Trade receivables		2,600
	(c) Cash and cash equivalents		7,400
	Total		29,500

Notes to accounts:

	Particulars	₹ (in Lakhs)
1.	Share Capital	
	Authorized, issued and subscribed capital	
	Equity share capital (fully paid up shares of ₹ 10 each)	12,000
2.	Reserves and Surplus	
	Securities premium	1,750
	General reserve	2,650
	Capital redemption reserve	2,000
	Profit and Loss account	1,700
	Total	8,100

On 1st April, 2022, the company announced the buy-back of 25% of its Equity Shares @ ₹ 15 per share. For this purpose, it sold all of is investments for ₹ 750 lakhs.

On 5th April, 2022, the company achieved the target of buy-back You are required to pass necessary journal entries for the above transactions.

(c) *At the beginning of year 1, an enterprise grants 1,000 stock options to a senior executive, conditional upon the executive remaining in the employment of the enterprise until the end of year 3. The exercise price is ₹ 400. However, the exercise price drops to ₹ 300 if the earnings of the enterprise increase by at-least an average of 10 percent per year over the three-year period.*

On the grant date, the enterprise estimates that the fair value of the stock options, with an exercise price of ₹ 300, is ₹ 160 per option. If the exercise price is ₹ 400, the enterprise estimates that the stock options have a fair value of ₹ 120 per option.

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During year 1, the earnings of the enterprise increased by 12 percent, and the enterprise expects that earnings will continue to increase at this rate over the next two years. The enterprise, therefore, expects that the earnings target will be achieved, and hence the stock options will have an exercise price of ₹ 300.

During year 2, the earnings of the enterprise increased by 13 percent, and the enterprise continues to expect that the earnings target will be achieved.

During year 3, the earnings of the enterprise increased by only 3 percent, and therefore the earnings target was not achieved. The executive completes three years' service, and therefore satisfies the service condition. Because the earnings target was not achieved, the 1,000 vested stock options have an exercise price of ₹ 400, You are required to calculate the amount to be charged to Profit and Loss Account every year on account of compensation expenses.

(d) *At the end of the financial year ending on 31st March, 2022, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:*

Particulars	Probability	Loss (₹)
In respect of five cases (Win)	100%	-
Next ten cases (Win)	50%	-
Lose (Low damages)	40%	12,00,000
Lose (High damages)	10%	20,00,000
Remaining five cases Win	50%	-
Lose (Low damages)	30%	10,00,000
Lose (High damages)	20%	21,00,000

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof as per AS - 29.

(e) *Star Limited agreed to take over Moon Limited on 1st April,2022. The terms and conditions of takeover were as follows:*

(i) *Star Limited issued 70,000 Equity shares of ₹ 100 each at a premium of ₹ 10 per share to the equity shareholders of Moon Limited.*

(ii) *Cash payment of ₹ 1,25,000 was made to the equity shareholders of Moon Limited.*

(iii) *25,000 fully paid Preference shares of ₹ 70 each issued at par to discharge the preference shareholders of Moon Limited.*

You are required:

(i) *to give the meaning of "consideration for the amalgamation' as per AS-14, and*

(ii) *Calculate the amount of purchase consideration.* ***(4 parts x 5 Marks = 20 Marks)***

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Answer

(a) (i) Delivery is delayed at buyer's request and buyer takes title and accepts billing: Revenue should be recognized notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognized rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

(ii) Instalment sales: When the consideration is receivable in instalments, revenue attributable to the sales price exclusive of interest should be recognized at the date of sale. The interest element should be recognized as revenue, proportionately to the unpaid balance due to the seller.

(iii) Trade discounts and volume rebates: Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

(iv) Insurance agency commissions for rendering services: Insurance agency commissions should be recognized on the effective commencement or renewal dates of the related policies.

(v) Advertising commission: Revenue should be recognized when the service is completed. For advertising agencies, media commissions will normally be recognized when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission, which will be recognized when the project is completed.

(b) In the books of PG Limited

Journal Entries

Date	*Particulars*		*Dr.*	*Cr.*
2022			*(₹ in lakhs)*	
April 1	Bank A/c	Dr.	750	
	To Investment A/c			740
	To P& L A/c (Profit on sale of investment)			10
	(Being investment sold on profit)			
April 5	Equity share capital A/c	Dr.	3,000	
	Premium payable on buy-back A/c	Dr.	1,500	
	To Equity shares buy-back A/c			4,500
	(Being the amount due to equity shareholders on buy-back)			

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	Securities Premium A/c	Dr.	1,500	
	To Premium payable on buy-back A/c			1,500
	(Being the amount of premium charged from securities premium account)			
	Equity shares buy-back A/c	Dr.	4,500	
	To Bank A/c			4,500
	(Being the payment made on account of buy-back of 30 Lakh Equity Shares)			
April 5	Profit and Loss A/c	Dr.	1,700	
	General reserve A/c	Dr.	1,300	
	To Capital redemption reserve A/c			3,000
	(Being amount equal to nominal value of buy-back shares from free reserves transferred to capital redemption reserve account as per the law)			

Note: 1. In the last entry given in the solution, it is possible to adjust transfer to Capital Redemption Reserve Account from different combinations of amounts from Securities Premium, General Reserve and Profit and Loss Account to the extent available.

2. Calculation of amount of Buy Back of Share: ₹12,000/10 X 25% X ₹ 15 = ₹ 4,500 Lakhs

(c) Since the exercise price varies depending on the outcome of a performance condition which is not a market condition, the effect of that performance condition (i.e. the possibility that the exercise price might be ₹400 and the possibility that the exercise price might be ₹300) is not considered when estimating the fair value of the stock options at the grant date. Instead, the enterprise estimates the fair value of the stock options at the grant date under each scenario and revises the transaction amount to reflect the outcomes of that performance condition at the end of every year based on the information available at that point of time.

Calculation of compensation expense to be charged every year:

Year	*Calculation*	*Cumulative expense (₹)*	*Expense for the year (₹)*
1	1,000 x ₹ 160 x 1/3	53,333	53,333
2	1,000 x ₹ 160 x 2/3	1,06,667	(1,06,667 - 53,333) 53,334
3	1,000 x ₹ 120 x 3/3	1,20,000	(1,20,000 - 1,06,667) 13,333

(d) According to AS 29 (Revised) 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:

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(i) There is a present obligation arising out of past events but not recognized as provision.

(ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

(iii) The possibility of an outflow of resources embodying economic benefits is not remote.

(iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 50% and for remaining five cases is 50%. As per AS 29 (Revised), we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is remote, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in next ten cases	=	40% of ₹ 12,00,000 + 10% of ₹ 20,00,000
	=	₹ 4,80,000 + ₹ 2,00,000
	=	6,80,000
Expected loss in remaining five cases	=	30% of ₹ 10,00,000 + 20% of ₹ 21,00,000
	=	₹ 3,00,000 + ₹ 4,20,000
	=	₹ 7,20,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of 1,04,00,000 (₹ 6,80,000 × 10 + ₹ 7,20,000 × 5) as contingent liability.

(e) ***Consideration*** for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

Computation of Purchase consideration	***(₹)***	***Form***
For Preference Shareholders of Moon Ltd. (25,000 × ₹ 70)	17,50,000	25,000 Preference
For equity shareholders of Moon Ltd. (70,000 × ₹ 110)	77,00,000	70,000 Equity shares of Star Ltd.
	1,25,000	Cash
Total Purchase consideration	95,75,000	

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PAPER – 6 : AUDITING AND ASSURANCE

*Question No.**1** is compulsory.*

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

Question 1

State with reasons whether the following statements are correct or incorrect:(Answer any Seven)

(a) In an automated environment, the relationship between the application controls and the General IT controls over IT systems are not interrelated.

(b) Historical financial information relates to financial information based on assumptions about occurrence of future events and possible actions by an entity.

(c) The auditor shall assemble the audit documentation in the audit file and complete the administrative process of assembling the final audit file before the date of the auditor's report.

(d) Where a firm is appointed as the auditor of a company, the report is signed only in the personal name of the partner signing the report.

(e) The term "Analytical Procedures" means evaluation of financial information through analysis of plausible relationships among financial data and non-financial data.

(f) A company should disclose in its Annual Report, the shares in the company held by each shareholder holding more than 10 percent shares specifying the number of shares held.

(g) As per SA 240, the primary responsibility of an auditor is to detect fraud and error in the financial statements.

(h) Mr. T, the director of A Ltd., has purchased an old car belonging to the company against the cooling equipment belonging to the director, which is given to the company as consideration for the car. The auditor is not required to include this in his CARO report.

(7 x 2 = 14 Marks)

Answer

(a) Incorrect: The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems. These two categories of control over IT systems are interrelated.

(b) Incorrect: Historical financial information relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. Whereas financial information based on assumptions about occurrence of future events and possible actions by an entity relates to prospective financial information.

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(c) **Incorrect:** The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.

Alternative reason: An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

(d) **Incorrect:** Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

Alternative Solution:

As per section 145 of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company. Whereas if a firm is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

The partner signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

(e) **Correct:** As per Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

(f) **Incorrect:** Schedule III to the Companies Act, 2013 requires the company to disclose- "shares in the company held by each shareholder holding more than **5 per cent** shares specifying the number of shares held" in notes to accounts.

(g) **Incorrect:** As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

(h) **Incorrect:** The auditor is required to report the same as per clause (xv) of Paragraph 3 of CARO, 2020, "whether the company has entered into any non-cash transactions with

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directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with".

Question 2

(a) S& Co., Chartered Accountants, are appointed as the auditors of ABC Ltd. CA S, the engagement partner, has come across the following while verifying equity share capital of the company:

(i) He noticed that some of the equity shares are held by promoters.

(ii) Some shares are issued as sweat equity shares to the employees.

What is the meaning of sweat equity shares?

What are the disclosure requirements of such promoter's shareholding? ***(4 Marks)***

(b) CA P is appointed as an auditor of XYZ Limited for the F.Y. 2021-22. The management of XYZ Limited has requested the auditor to change the terms of original engagement as the company has diversified its business and few new products have been introduced by the company. Can CA P agree to the request made by the management? Under which circumstances can the client make a request to the auditor for a change in the terms of engagement? ***(4 Marks)***

(c) What are the matters that the auditor shall consider while designing an audit sample?

(3 Marks)

(d) In an automated environment, General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. One such area is access security. What is the objective of access security and what are the activities included in it? ***(3 Marks)***

Answer

(a) Meaning of Sweat Equity & Disclosure of shares held by Promotors:

Meaning Sweat Equity Shares: According to Section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares".

"Sweat Equity Shares" mean equity shares issued by the company to **employees or directors** at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

Disclosure requirements of such promoter's shareholding: A company shall disclose Shareholding of Promoters* as below:

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Shares held by promoters at the end of the year				% Change during the year***
S. No.	Promoter Name	No. of shares	% of total shares**	

* Promoter here means promoter as defined in the Companies Act, 2013.

** Details shall be given separately for each class of shares.

*** percentage change shall be computed with respect to the number at the beginning of the year or if issued during the year for the first time then with respect to the date of issue.]

(b) Acceptance of a Change in Engagement:

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, **a significant change in nature or size of the entity's business is one of the factors** which may make it appropriate to revise the terms of the audit engagement.

In the given situation, XYZ Limited has diversified its business and few new products have also been introduced by the Company which is indicative of significant change in nature or size of the entity's business. In view of above, CA. P can agree to the request made by the management to change the terms of the audit engagement. Therefore, request of Management to change the terms of audit engagement is appropriate.

A request from the client for the auditor to change the engagement may result from-

1. a change in circumstances affecting the need for the service,
2. a misunderstanding as to the nature of an audit or related service originally requested.
3. a restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

(c) Matters to be considered while designing an Audit Sample:

As per SA 530, "Audit Sampling",

(i) When designing an audit sample, the auditor shall consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn.

(ii) When designing an audit sample, the auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

(iii) When designing an audit sample, the auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

(iv) When designing an audit sample, the auditor shall determine that sample selected must be representative of the population.

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(v) When designing an audit sample, the auditor's consideration includes the *specific purpose* to be achieved and the *combination of audit procedures* that is likely to best achieve that purpose.

(vi) When designing an audit sample, Consideration of the *nature of the audit evidence* sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.

(vii) In fulfilling the requirement of **SA 500 "Audit Evidence**", when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

(d) Access Security in Automated Environment:

Objective of access security: The objective of Access Security is to ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

Activities:

(i) Security Organization & Management

(ii) Security Policies & Procedures

(iii) Application Security

(iv) Data Security

(v) Operating System Security

(vi) Network Security – internal network, perimeter network

(vii) Physical Security – access controls, environment controls

(viii) System Administration & Privileged Accounts – Sysadmins, DBAs, Super users

Question 3

(a) The objective of auditing is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. This can be obtained by performing which procedures? Name the types of audit procedures the auditor can perform to obtain audit evidence? ***(4 Marks)***

(b) M/s SS & Associates have been appointed as statutory auditors of Green Limited, a company engaged in the business of manufacturing of hardware products. They are analyzing the monthly trends for other expenses like rent, power and fuel, repairs, etc. and are also verifying attributes of such types of expenses. List down the attributes for verifying such expenses. ***(4 Marks)***

(c) While auditing books of accounts of SOLAR Ltd., you observed that an amount due from a debtor for invoice issued on 31.03.2022 has not been recognized in the books of

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accounts. As an auditor, you want to ensure that all trade receivable balances that are supposed to be recorded have been recognized in the financial statements. How will you achieve the stated objective? ***(3 Marks)***

(d) A Ltd. has traded for 50.00 Lacs in "TETRA", a virtual currency, during the F.Y. 2021-2022 and earned a profit of 20.00 Lacs on it. What disclosure requirements are prescribed for such type of transactions done by the company? ***(3 Marks)***

Answer

(a) Audit Procedures to Obtain Audit Evidence: Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(I) Risk assessment procedures; and

(II) Further audit procedures, which comprise:

i. Test of controls, when required by the SAs or when the auditor has chosen to do so; and

ii. Substantive procedures, including tests of details and substantive analytical procedures.

Audit procedures to obtain audit evidence can include

(a) Inspection

(b) Observation

(c) External Confirmation

(d) Recalculation

(e) Reperformance

(f) Analytical Procedures

(g) Inquiry

(b) Attributes for verifying other expenses like Power and Fuel, Repair etc.:

An entity in addition to making purchases and incurring employee benefit expenses, also incurs other expenditures like rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc., that are essential and incidental to running of business operations.

While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify following attributes:

(a) Whether the expenditure pertained to current period under audit;

(b) Whether the expenditure qualified as a revenue and not capital expenditure;

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(c) Whether the expenditure had a valid supporting document like travel tickets, insurance policy, third party invoice etc.;

(d) Whether the expenditure has been classified under the correct expense head;

(e) Whether the expenditure was authorised as per the delegation of authority matrix;

(f) Whether the expenditure was in relation to the entity's business and not a personal expenditure.

(c) Audit of Trade Receivable:

All Trade receivable balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS): The auditor needs to satisfy himself of the cut-offs. Without a cut-off, sales could be understated or overstated, hence there is a need to perform the following cut off procedure:

(a) For the invoices issued during the last few days (last 5 days of the reporting year) i.e. cut-off date and which have been included in the debtors; check that the goods should have been dispatched and not lying with the Company;

(b) Ensure that all goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis;

(c) Ensure that no goods dispatched after the year- end have been invoiced and included in debtors for the period under audit.

(d) Disclosure of Crypto Currency or Virtual Currency:

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:

(a) profit or loss on transactions involving Crypto currency or Virtual Currency

(b) amount of currency held as at the reporting date,

(c) deposits or advances from any person for the purpose of trading or investing in Crypto Currency/ virtual currency.

Question 4

(a) Z Ltd. is a manufacturer of ready-made garments. During the year 2021-22, they have opened two new branches and there is a substantial increase in their sales. The management has appointed CA R to review the internal control system of the company as they feel that there are lapses in the control environment of the company. What is included in the control environment and what will the auditor evaluate in order obtain an understanding of the control environment? ***(4 Marks)***

(b) HMB Limited's business has grown from one state of India to various countries of the world. Since the business has increased manifold, the management decided to appoint joint auditors for conducting the statutory audit of the company. They appointed three CA firms for it. For which audit work the joint auditors will be jointly & severally responsible? ***(4 Marks)***

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(c) ABC Ltd. has many divisions and branches across the country. They have an internal control system which is well established maintained by the management on a regular basis. Explain the meaning of internal control as per SA-315 and also state the benefits of understanding the internal controls of a company. ***(3 Marks)***

(d) As per the Standard on Auditing (SA) 520 "Analytical Procedures", what are the examples of analytical procedures having consideration of relationships? ***(3 Marks)***

Answer

(a) Control Environment:

The control environment includes:

i. the governance and management functions and

ii. the attitudes, awareness, and actions of those charged with governance and management.

iii. the control environment sets the tone of an organization, influencing the control consciousness of its people.

The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

(a) Management has created and maintained a culture of honesty and ethical behavior; and

(b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

(b) Joint Audit of Financial Statements:

As per SA 299, "Joint Audit of Financial Statements", all the joint auditors shall be jointly and severally responsible for:

i. the audit work which is not divided among the joint auditors and is carried out by all joint auditors;

ii. decisions taken by all the joint auditors under audit planning in respect of common audit areas;

iii. matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;

iv. examining that the financial statements of the entity comply with the requirements of the relevant statutes;

v. presentation and disclosure of the financial statements as required by the applicable financial reporting framework;

vi. ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

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(c) Meaning and benefits of understanding Internal Control:

Meaning of Internal Control: As per SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the internal control may be defined as "the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control."

Benefits of Understanding of Internal Control: An understanding of internal control assists the auditor in:

i. identifying types of potential misstatements;

ii. identifying factors that affect the risks of material misstatement, and

iii. designing the nature, timing, and extent of further audit procedures.

(d) Examples of Analytical Procedure having consideration of relationship:

As per the Standard on Auditing (SA) 520 "Analytical Procedures", examples of Analytical Procedures having consideration of relationships are:

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

ii. Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Question 5

(a) NG Ltd. appointed CA N as the statutory auditor for the F.Y. 2021-2022. Previous year's auditor gave a qualified opinion on the Comparative Financial Statements for the year ended 31.03.2021. What will be the reporting responsibility casted on CA N when he forms an opinion and prepares audit report on the Comparative Financial Statements for the F.Y. 2021-2022? ***(4 Marks)***

(b) M/s RAP & Co., a firm of Chartered Accountants, has three partners, namely Mr. R, Mr. A and Mr. P. Mr. R is also in whole time employment elsewhere and Mr. A & Mr. P do not hold any audits in their personal capacity or as partners of other firms. The Firm, currently, has statutory audit of 40 public companies. They are offered the statutory audit of a public company XYZ Ltd. Whether M/s. RAP & Co. can accept the audit of XYZ Ltd.? ***(4 Marks)***

(c) CAM is the engagement partner of S Ltd. He has instructed his audit team to maintain proper audit documentation. The audit team members are not sure about the purpose for which the documentation should be made. Explain the various purposes of audit documentation with reference to SA 230. ***(3 Marks)***

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(d) You notice a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit. As a Statutory Auditor, how you will deal with this situation? ***(3 Marks)***

Answer

(a) Prior Period Financial Statements Audited by a Predecessor Auditor: As per SA 710, if the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, CA. N, the auditor of NG Limited shall state in an Other Matter paragraph:

(a) That the financial statements of the prior period were audited by a predecessor auditor;

(b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and

(c) The date of that report, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

(b) Eligibility to be appointed as an auditor of a company: Section 141(3(g) of Companies Act, 2013 states that a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies shall be disqualified from being appointed as auditor of the company.

In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

The above said ceiling applies per partner of the firm. In the given case, M/s. RAP & Co., a firm of Chartered Accountants, having 3 partners CA. R, CA. A and CA. P, is offered appointment of statutory audit of a public company XYZ Limited. CA. R is in whole time employment elsewhere, therefore, for computation of ceiling limit only CA. A and CA. P (two partners) will be considered. Therefore, entitlement of firm is 40 company audits(20X2) only.

Since, M/s. RAP & Co.is already having statutory audit of 40 public companies, therefore, RAP & Co. cannot accept audit of XYZ Limited.

(c) Purpose of Audit Documentation: As per SA 230, "Audit Documentation", the following are the purpose of Audit documentation:

1. Assisting the engagement team to plan and perform the audit.
2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
3. Enabling the engagement team to be accountable for its work.

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4. Retaining a record of matters of continuing significance to future audits.
5. Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

(d) Inability of auditor to continue the engagement: 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.

Question 6

(a) TS Ltd. has raised funds by issuing fully convertible debentures. These funds were raised for the expansion and diversification of the business. However, the company utilised these funds for repayment of long-term loans and advances. What are the reporting requirements under CARO 2020 in this case?

OR

M/s PQ & Co., Chartered Accountants have been appointed as statutory auditor of CBD Multiplex Cinema Ltd. The audit team started the audit and verified the ledger and other books of accounts for the F.Y 2021-2022. However, one of the team members is of the view that the internal control mechanism of the company should also be verified. Can you guide the audit team about the areas that will be covered in verifying the internal control mechanism? ***(4 Marks)***

(b) CARD Ltd. is into the banking business and handles large amount of loans and advances of different kinds. Non-performing assets are on the rise since last two quarters. The management is concerned with correct provisioning for the same. CA R is appointed to

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check whether correct provisioning of NPA's is being made by the bank or not. What are the aspects that will be verified by CA R for this purpose? ***(4 Marks)***

(c) *CA Sevak is appointed as an auditor of a Municipal Corporation of a big smart city. He wants to verify various expenditures of the Municipality. Define the term "Municipality" and state what are the heads under which expenditures incurred by the Municipalities and Corporations can be broadly classified?* ***(3 Marks)***

(d) *Ban LLP is formed during the year 2021-22. They are not sure about the type of books of accounts to be maintained. What are the books of accounts that the LLP is required to maintain?* ***(3 Marks)***

Answer

(a) Reporting Requirements under CARO 2020 for raising funds: As per clause (x)(b) of Para 3 of CARO, 2020, the auditor of a company has to report whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance.

In the present case, TS Ltd. has raised funds by issuing fully convertible debentures for expansion and diversification of the business. However, the company used the funds for repayment of long-term loans and advances instead of utilisation of the same for the purpose for which the funds were raised i.e. expansion and diversification of business.

Here, the auditor should report the fact in his report that the funds were used for the purpose other than the purpose for which the funds were raised, as per clause (x)(b) of Para 3 of CARO, 2020.

OR

(a) Areas to be covered while verifying the Internal Control Mechanism in Multiplex: Audit Team of M/s PQ & Co. should cover the following areas to verify the internal control mechanism of CBD Multiplex Cinema Ltd.-

i. that entrance to the cinema-hall during show is only through printed tickets;

ii. that they are serially numbered and bound into books;

iii. that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;

iv. that for advance booking a separate series of tickets is issued; and

v. that the inventory of tickets is kept in the custody of a responsible official.

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(b) Provisioning of Non-performing Assets: CA R should verify that the classification of NPAs into sub-standard assets, doubtful assets and loss assets is done depending upon prudential norms as per the RBI Guidelines. Further he should also ensure that provision is being made for the same in accordance with the given table:

Categories of Non-Performing Assets:	Provision required
Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
Doubtful Assets: Would be one, which has remained in the substandard category for a period of 12 months.	
Sub-categories:	
• Doubtful up to 1 Year (D1)	(Secured + Unsecured) 25% + 100%
• Doubtful 1 to 3 Years (D2)	40% + 100%
• Doubtful more than 3 Years (D3)	100% + 100%
Loss Assets: Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Alternative Answer 1:

Aspects to be verified by CA R to check correct provisioning of NPAs: CA R should verify following aspects while checking whether correct provisioning of NPAs is being made by bank: -

1. It should be verified whether classification of NPAs is in accordance with RBI guidelines. Such guidelines require classification of NPAs into sub-standard assets, doubtful assets and loss assets depending upon different criteria. Each classification requires different percentage of provisions. Therefore, proper classification of NPAs would ensure that provisioning is correct.
2. It should be verified that doubtful assets have been further properly classified in D1, D2 and D3 categories. These three different categories require provision of 25%, 40% and 100% respectively of secured portions of outstanding amount.
3. It should be verified that secured and unsecured portion in doubtful assets have been arrived at properly. Unsecured portion of liability entails provision of 100%. Therefore, it is important to verify that break-up of doubtful assets into secured and unsecured portions is proper.

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4. As different kinds of loans and advances are handled by the bank, it should be ensured that loan classification according to its purpose is properly made in the system. NPA norms vary for cash credit accounts, term loans, bills purchased and agricultural loans. Any wrong classification can lead to incorrect provisioning. For example, if an agricultural loan is wrongly classified, it would lead to incorrect provisions.

Alternative Answer 2:

Aspects to be verified by CA R to check correct provisioning of NPAs:

1. For audit of Provisions, the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
2. The auditor should obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets.
3. The auditor may verify the loan classification on a sample basis.
4. The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.

(c) **Definition of Municipality & Expenditure incurred by it: Definition:** A **Municipality** can be defined as a unit of local self-government in an urban area. By the term 'local self-government' is ordinarily understood the administration of a locality – a village, a town, a city or any other area smaller than a state – by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.

Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads:

(a) general administration and revenue collection,

(b) public health,

(c) public safety,

(d) education,

(e) public works, and

(f) others such as interest payments, etc.

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(d) Books of Accounts Ban LLP is required to maintain: An LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. LLPs are required to maintain books of accounts which shall contain-

1. Particulars of all sums of money received and expended by the LLP and the matters in respect of which the receipt and expenditure takes place,
2. A record of the assets and liabilities of the LLP,
3. Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,
4. Any other particulars which the partners may decide.

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PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC MANAGEMENT

SECTION – A: ENTERPRISE INFORMATION SYSTEMS

*Question No. **1** is compulsory.*

*Answer any **three** questions from the rest.*

Question 1

(a) In a conventional sense, 'data' is a raw entity whereas 'information' is a processed entity. An Information System (IS) model converts data into information, so that it is meaningful to the end user. What are those steps involved in accomplishing this in an IS model?

(3 Marks)

(b) Information Systems Audit is the process of attesting objectives that focus on asset safeguarding, data integrity and management objectives that include effectiveness and efficiency. List the objectives of Information Systems audit. ***(2 Marks)***

Answer

(a) The steps involved in an Information System model are as follows:

- **Input:** Data is collected from an organization or from external environments and converted into suitable format required for processing.
- **Processing:** A process is a series of steps undertaken to achieve desired outcome or goal. Information Systems are becoming more and more integrated with organizational processes, bringing more productivity and better control to those processes.
- **Output:** The system processes the data by applying the appropriate procedure on it and the information thus produced is stored for future use or communicated to user.
- **Storage:** The storage of data shall be done at the most detailed level possible. Regular backups should be stored in a geographically different locations to avoid impact on both the original data storage and the backup data storage due to any major disasters such as flooding or fires etc.
- **Feedback:** Apart from these activities, information system also needs feedback that is returned to appropriate members of the enterprises to help them to evaluate at the input stage.

(b) The objectives of Information Systems Audit are as follows:

- Improved Safeguarding of Assets
- Improved Data Integrity

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- Improved System Effectiveness
- Improved System Efficiency

Question 2

(a) In the modern era, the business gets well developed by using the automation technique with a greater customer satisfaction of services and products, where customer-oriented supply chain is playing a vital role. In this context, explain the benefits of automating business processes. ***(6 Marks)***

(b) Many organizations are moving towards cloud based technology for storage and thus providing many benefits to the users. Explain any four reasons for cloud based applications comparing to installed applications. ***(4 Marks)***

Answer

(a) The benefits of automating business processes are as follows:

- **Quality and Consistency:** The automation ensures that every action is performed identically resulting in high quality and reliable results and stakeholders will consistently experience the same level of service.
- **Time Saving:** Automation reduces the number of tasks the employees would otherwise need to do, manually. It frees up time to work on items that add genuine value to the business, allowing innovation and increasing employees' levels of motivation.
- **Visibility:** The automated processes are controlled, and they consistently operate accurately within the defined timeline. It gives visibility of the process status to the organization.
- **Improved Operational Efficiency:** The automation reduces the time it takes to achieve a task, the effort required to undertake it and the cost of completing it successfully. Automation not only ensures that systems run smoothly and efficiently, but also that errors are eliminated and that best practices are constantly leveraged.
- **Governance and Reliability:** The consistency of automated processes means stakeholders can rely on business processes to operate and offer reliable services to customers, thus, maintaining a competitive advantage.
- **Reduced Turnaround Time:** The automation eliminates unnecessary tasks and realigns process steps to optimize the flow of information throughout production, service, billing, and collection. This adjustment of processes distils operational performance and reduces the turnaround time for both staff and external customers.
- **Reduced Costs:** The manual tasks, given that they are performed one-at-a-time and

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at a slower rate than an automated task, will cost more. The automation allows to accomplish more by utilizing fewer resources.

(b) The reasons for Cloud based applications compared to Installed applications are as follows:

Particulars	Cloud Based Application	Installed Application
Installation and Maintenance	Installation on user computer is not required. Update and maintenance are defined responsibility of service provider.	As software is installed on hard disc of the user's computer, it needs to be installed on every computer one by one. This may take lot of time. Also, maintenance and updating of software may take lot of time and efforts.
Accessibility	As software is available through online access, to use the software a browser and an internet connection are 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.	As software is installed on the hard disc of the user's computer, user needs to go to the computer in which the software is installed to use the software. It cannot be used from any other computer.
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.	Using the software through mobile application is difficult in this case.
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 is physically stored in the premises of the user, i.e. on the hard disc of the user's server computer. Hence user will have full control over the data.
Data Security	Data security is a challenge in case of cloud based application as the data is not in	As the data is in physical control of the user, user shall have the full physical control over the

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	control of the user or owner of data. As time evolves; SLAs provide for details of back-up, disaster recovery alternatives being used by service provider.	data and he/she can ensure that it is not accessed without proper access.
Performance	Access is dependent on speed of internet. Slow internet slows access to information and may slow operations.	A well written installed application shall always be faster than web application, reason being data is picked from local server without internet.
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.	It shall have more flexibility and controls as compared to web application. It is very easy to write desktop applications that take advantage of the user's hardware (such as: scanners, cameras, Wi-Fi, serial ports, network ports, etc.). Installed applications have the dis-advantage of higher Capital Expenditure (CAPEX) in comparison to cloud-based application.

Question 3

(a) We have been using Emails and Google Drive's applications for our personal use, which are free versions of cloud computing. However, it makes a major impact in business organizations. Nowadays, why companies are migrating their business operations to cloud computing environment? Give reasons by highlighting its advantages. ***(6 Marks)***

(b) Fixed assets process is used to ensure that the immovable assets of an enterprise are traced for financial accounting related purposes. In order to accomplish those tasks, what are the typical steps of fixed assets process to follow? ***(4 Marks)***

Answer

(a) The advantages of Cloud Computing are as follows:

- **Achieve economies of scale:** In cloud computing; computational resources, storage, and services are shared between multiple customers. This results in achieving efficient utilization of resources and that too at reduced cost. Volume output or productivity can be increased even with fewer systems and thereby reduce the cost per unit of a project or product.

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- **Reduce spending on technology infrastructure:** Data and information can be accessed with minimal upfront spending in a pay-as-you-go approach, which is based on demand. With the increased dependency of business organizations on IT, huge investment is required for acquiring IT resources. By using cloud computing, the organization can avoid purchasing hardware, software, and licensing fees. Moreover, cloud service providers are paid based on actual usage of resources, which is based on demand.
- **Globalize the workforce:** Cloud computing allows users to globalize their workforce and improve accessibility while shortening training time and new employee learning curves.
- **Streamline business processes:** Cloud Service Providers (CSPs) manage underlying infrastructure to enable organizations to focus on application development in less time with less resources.
- **Reduce capital costs:** Cloud computing users worldwide can access the cloud with Internet connection that subsequently does not require them to spend on technology infrastructure, hardware, software, or licensing fees.
- **Easy access to information/applications:** One can access information and applications as utilities anytime and anywhere, over the internet using any smart computing device.
- **Pervasive accessibility:** Data and applications can be accessed anytime, anywhere, using any smart computing device, making our life so much easier.
- **Backup and Recovery:** It is relatively much easier to backup and restore data stored in cloud. Even if one hard disk fails, data will be safe and will continue to be available automatically on another one.
- **Monitor projects more effectively:** It is feasible to confine within budgetary allocations and can be ahead of completion cycle times.
- **Less personnel training is needed:** It takes fewer people to do more work on a cloud with a minimal learning curve on hardware and software issues.
- **Minimize maintenance and licensing software:** As there is not much of non-premise computing resources, maintenance becomes simple, and updates and renewals of software systems rely on the cloud vendor or provider.
- **Load balancing:** Load balancing is defined as the process of distributing workloads across multiple servers to prevent any single server from getting overloaded and possibly breaking down. It plays an important role in maintaining the availability of

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cloud-based applications to customers, business partners, and end users, thus making it more reliable.

- **Improved flexibility:** Cloud users can make fast changes in their work environment without serious issues at stake to scale services to fit their needs.

(b) Typical steps of Fixed Assets process are as follows:

i. **Procuring an asset:** An asset is most often entered into the accounting system when the invoice for the asset is entered into the accounts payable or purchasing module of the system.

ii. **Registering or adding an asset:** Most of the information needed to set up the asset for depreciation is available at the time, the invoice is entered. Information entered at this stage could include acquisition date, placed-in-service date, description, asset type, cost basis, depreciable basis etc.

iii. **Adjusting the Assets:** Adjustments to existing asset information is often needed to be made. Events may occur that can change the depreciable basis of an asset. Further, there may be improvements or repairs made to asset that either adds value to the asset or extend its economic life.

iv. **Transferring the Assets:** A fixed asset may be sold or transferred to another subsidiary, reporting entity, or department within the company. These inter-company and intra-company transfers may result in changes that impact the asset's depreciable basis, depreciation, or other asset data. This needs to be reflected accurately in the fixed assets management system.

v. **Depreciating the Assets:** The decline in an asset's economic and physical value is called Depreciation. Depreciation is an expense which should be periodically accounted on a company's books, and allocated to the accounting periods, to match income and expenses. Sometimes, the revaluation of an asset, may also result in appreciation of its value.

vi. **Disposing the Assets:** When a fixed asset is no longer in use, becomes obsolete, or is beyond repair; the asset is typically disposed. When an asset is taken out of service, depreciation cannot be charged on it. There are multiple types of disposals such as abandonments, sales, and trade-ins. Any difference between the book value and realized value is reported as a gain or loss.

Question 4

(a) ABC Bank, one of the largest public sector banks, is planning to deploy and implement Core Banking System (CBS) to all its branches. As an IT consultant, suggest the deployment and implementation of CBS at various stages to ensure that bank's automation objectives are achieved. ***(6 Marks)***

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(b) In recent times, new modes of money transfer have replaced the traditional methods of funds transfer. Most of the banks have now introduced digital mode of remittance, called Electronic Fund Transfer (EFT) which facilitates almost instantaneous transfer of funds. Define EFT and explain its types. ***(4 Marks)***

Answer

(a) The deployment and implementation of Core Banking System (CBS) should be controlled at various stages to ensure that banks automation objectives are achieved, 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 which is scalable and where different interfaces are readily available 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. For example - 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.

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(b) **Electronic Funds Transfer (EFT)** is another mode of remittance which facilitates almost instantaneous transfer of funds between two centres electronically. Most of the banks have introduced digital mode of remittance which makes remittance possible online and on mobile devices directly by the customer in a few clicks.

New modes of money transfer include the following:

- **Real Time Gross Settlement (RTGS)** is an electronic form of funds transfer where the transmission takes place on a real-time basis. In India, transfer of funds with RTGS is done for high value transactions, the minimum amount being Rs. 2 lakh. The beneficiary account receives the funds transferred, on a real- time basis.
- **National Electronic Funds Transfer (NEFT)** is a nation-wide payment system facilitating one-to-one funds transfer. Under this scheme, individuals can electronically transfer funds from any bank branch to any individual having an account with any other bank branch in the country participating in the scheme.
- **Immediate Payment Service (IMPS)** is an instant payment inter-bank electronic funds transfer system in India. IMPS offers an inter-bank electronic fund transfer service through mobile phones. Unlike NEFT and RTGS, the service is available 24x7 throughout the year including bank holidays.

Question 5

(a) Computers are used extensively to process data and to provide Information for decision making. However, uncontrolled use of computers can have a widespread impact on a society. Explain the factors influencing the need for control and audit of information systems. ***(6 Marks)***

(b) Today's ERP systems can cover a wide range of functions such as Human Resources, Supply Chain Management, Customer Relationship Management, Financials, etc. and integrating them into one unified database. As an IT consultant of a company, how will you influence the Management to migrate their activities to ERP system by explaining its benefits. ***(4 Marks)***

OR

One of the major problems of doing online business is the question of security. Then, how do you protect your e-commerce business from intrusion?

Answer

(a) The factors influencing the need for control and audit of Information Systems are as follows:

- **Organizational costs of data loss:** Data is a critical resource of an organization for its present and future processes. If the data is accurate, its ability to adapt and survive in a changing environment increases significantly. If such data is lost, an organization can incur substantial losses.

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- **Cost of incorrect decision making:** Making high-quality decisions are dependent on both – the quality of the data and quality of the decision rules that exist within computer-based information systems. While making strategic decisions, some errors may be allowed by management considering the long-run nature of strategic planning decisions whereas highly accurate data would be required while making operational control decisions by the managers. These operational controls taken by managers involve detection, investigations, and correction of the processes. Incorrect data can also have adverse impact on the other stakeholders having an interest in the organization.
- **Costs of computer abuse:** Computer abuse is defined as any incident associated with computer technology in which the user suffered or could have suffered loss and a perpetrator by intention made or could have made gain. Unauthorized access to computer systems, malwares, unauthorized physical access to computer facilities, unauthorized copies of sensitive data, viruses, and hacking can lead to destruction of assets like hardware, software, data, information etc.
- **Value of computer hardware, software, and personnel:** These are critical resources of an organization, which has a credible impact on its infrastructure and business competitiveness. The intentional or unintentional loss of hardware, the destructions or corruption of software, and non-availability of skilled computer professionals in some countries; an organization might be unable to continue their operations seamlessly.
- **High costs of computer error:** In a computerized enterprise environment where many critical business processes are performed, a data error during entry or process would cause great damage. For example - small data error during an operational flight can lead to loss of human lives; an error in any financial system can make an organization liable for penalty etc.
- **Maintenance of privacy:** Nowadays, data collected in a business process contains private information about an individual too. These data were also collected before computers but now, there are many instances in which privacy of individuals has been eroded beyond acceptable levels.
- **Controlled evolution of computers' use:** Use of Technology and reliability of complex computer systems cannot be guaranteed and the consequences of using unreliable systems can be destructive. Governments, professional bodies, pressure groups, organizations, and individual persons all must be concerned with evaluating and monitoring how we deploy computer technology.

(b) The benefits of an Enterprise Resource Planning (ERP) System are as follows:

- **Information integration:** The reason ERP systems are called integrated is because they possess the ability to automatically update data between related business functions and components. For example - one needs to only update the status of an

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order at one place in the order-processing system and all the other components will automatically get updated.

- **Reduction of Lead-time:** The elapsed time between placing an order and receiving it is known as the Lead-time. The ERP Systems by virtue of their integrated nature with many modules like Finance, Manufacturing, Material Management Module etc.; the use of the latest technologies like EFT (Electronic Fund Transfer), EDI (Electronic Data Interchange) reduce the lead times and make it possible for the organizations to have the items at the time they are required.
- **On-time shipment:** Since the different functions involved in the timely delivery of the finished goods to the customers - purchasing, material management production, production planning, plant maintenance, sales and distribution are integrated, and the procedures are automated; the chances of errors are minimal, and the production efficiency is high. Thus, by integrating the various business functions and automating the procedures and tasks, the ERP system ensures on-time delivery of goods to the customers.
- **Reduction in Cycle Time:** The Cycle time is the time between placement of the order and delivery of the product. In an ERP System, all the data updated to the minute, is available in the centralized database and all the procedures are automated. Almost all these activities are done without human intervention. This efficiency of the ERP systems helps in reducing the cycle time.
- **Improved resource utilization:** The efficient functioning of different modules in the ERP system like manufacturing, material management, plant maintenance, sales and distribution ensures that the inventory is kept to a minimum level, the machine down time is minimum, the goods are produced only as per the demand and the finished goods are delivered to the customer in the most efficient way. Thus, the ERP systems help an organization in drastically improving the capacity and resource utilization.
- **Better customer satisfaction:** Customer satisfaction means meeting or exceeding customers' requirement for a product or service. With the help of web-enabled ERP systems, customers can place an order, track the status of the order, and make the payment while sitting at home. Since all the details of the product and the customer are available to the person at the technical support department also, the company can better support the customer.
- **Improved supplier performance:** ERP systems provide vendor management and procurement support tools designed to coordinate all aspect of the procurement process. They support an organization in its efforts to effectively negotiate, monitor and control procurement costs and schedules while assuring superior product quality. The supplier management and control processes are comprised of features that will help the organization in managing supplier relations, monitoring vendor activities, and managing supplier quality.

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- **Increased flexibility:** ERP Systems help the companies to remain flexible by making the company's information available across the departmental barriers and automating most of the processes and procedures, thus enabling the company to react quickly to the changing market conditions.
- **Reduced quality costs:** Quality is defined in many different ways - excellence, conformance to specifications, fitness for use, value for the price and so on. An ERP System's central database eliminates redundant specifications and ensures that a single change to standard procedures takes effect immediately throughout the organization. It also provides tools for implementing total quality management programs within an organization.
- **Better analysis and planning capabilities:** Another advantage provided by ERP Systems is the boost to the planning functions. By enabling the comprehensive and unified management of related business functions such as production, finance, inventory management etc. and their data; it becomes possible to utilize fully many types of Decision Support Systems (DSS) and simulation functions, what-if analysis and so on; thus, enabling the decision-makers to make better and informed decisions.
- **Improved information accuracy and decision-making capability:** The three fundamental characteristics of information are Accuracy, Relevancy and Timeliness. The information needs to be accurate, relevant for the decision-maker and available to the decision-makers when she/he requires it. The strength of ERP Systems-integration and automation help in improving the information accuracy and help in better decision-making.
- **Use of latest technology:** ERP packages are adapted to utilize the latest developments in Information Technology such as open systems, client/server technology, Cloud computing, Mobile computing etc. It is this adaptation of ERP packages to the latest changes in IT that makes the flexible adaptation to changes in future development environments possible.

OR

The ways to protect any e-Commerce business from intrusion are as follows:

- **Viruses:** The business website should be checked daily for viruses, the presence of which can result in the loss of valuable data. Virus protection gains greater significance in e-commerce operations primarily because most of the users of e-commerce infrastructure are either unknown or are not under the control of business enterprise. These users have their own virus protection environment that may not be secure.
- **Hackers:** Software packages to carry out regular assessments of how vulnerable their website is to hackers.

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- **Passwords:** Employees should ensure that they change their passwords regularly and that passwords set by former employees of an organization are defunct.
- **Regular software updates:** A business website should always be up to date with the newest versions of security software. If it is not done regularly, the website may become vulnerable to attack.
- **Sensitive data:** Financial information and other confidential data should be encrypted using encryption software. Hackers or third parties will not be able to access encrypted data without a key. This is particularly relevant for any e-commerce sites that use a shopping cart system.
- Know the details of your payment service providers' contract.

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PAPER 7 - SECTION – B: STRATEGIC MANAGEMENT

Question paper comprises of 5 questions, Answer Question No. 6 which is compulsory and any 3 out of the remaining 4 questions.

Question 6

Quick N Sturdy Inc., a multinational company, is undergoing feasibility study to introduce new luxury and sports car for specific group of customers. The product is meant for customers with distinctive preferences and special requirements. The product is not a standard one and as such the target market is also narrow. Company knows that demand for the product is large enough to be profitable for the company, but small enough to be ignored by other major industry players. The company wants to position itself in the niche market with the prime consideration to offer unique features in the product for the target market.

In the given situation, identify the generic strategy as suggested by Michael Porter. Also state the advantages and disadvantages of such strategy. ***(1 + 2 + 2 = 5 Marks)***

Answer

Quick N Sturdy Inc. has adopted **Focused Differentiation Strategy** which is one of the Michael Porter's Generic strategies. A focused differentiation strategy requires offering unique features that fulfil the demands of a narrow market. Some firms using a focused differentiation strategy concentrate their efforts on a particular sales channel, such as selling over the internet only. Others target particular demographic groups. ***Firms that compete based on uniqueness and target a narrow market are following a focused differentiation strategy.***

Advantages of Focused Strategy

1. Premium prices can be charged by the organisations for their focused product/services.
2. Due to the tremendous expertise in the goods and services that the organisations following focus strategy offer, rivals and new entrants may find it difficult to compete.

Disadvantages of Focused Strategy

1. The firms lacking in distinctive competencies may not be able to pursue focus strategy.
2. Due to the limited demand of product/services, costs are high, which can cause problems.
3. In the long run, the niche could disappear or be taken over by larger competitors by acquiring the same distinctive competencies.

Question 7

(a) "The strategic management cannot counter all hindrances and always achieve success for an organization." Do you agree with this statement? Give arguments in support of your answer. ***(1+ 4 = 5 Marks)***

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(b) You have been appointed as a Chief Executive Officer (CEO) in a company which is facing many difficulties in proper execution of its strategy. Explain the leadership roles which you should play in pushing for good strategy execution. ***(5 Marks)***

Answer

(a) **Yes,** it is true that the presence of strategic management cannot counter all hindrances and always achieve success for an organization. This is on account of complex multiple forces acting on business organization and limiting its success.

These limitations are on account of following factors:

- **Environment is highly complex and turbulent.** It is difficult to understand the complex environment and exactly pinpoint how it will shape-up in future. The organisational estimate about its future shape may awfully go wrong and jeopardise all strategic plans.
- **Strategic management is a time-consuming process.** Organisations spend a lot of time in preparing, communicating the strategies that may impede daily operations and negatively impact the routine business.
- **Strategic management is a costly process.** Strategic management adds a lot of expenses to an organization – particularly to small and medium organisations. Expert strategic planners need to be engaged, efforts are made for analysis of external and internal environments devise strategies and properly implement.
- **Competition is unpredictable.** In a competitive scenario, where all organisations are trying to move strategically, it is difficult to clearly estimate the competitive responses to the strategies.

(b) A Chief Executive Officer (CEO) has many different leadership roles to play: visionary, chief entrepreneur and strategist, chief administrator, culture builder, resource acquirer and allocator, capabilities builder, process integrator, crisis solver, spokesperson, negotiator, motivator, arbitrator, policy maker, policy enforcer, and head cheerleader. Managers have five leadership roles to play in pushing for good strategy execution:

1. Staying on top of what is happening, closely monitoring progress, working through issues and obstacles.
2. Promoting a culture that mobilizes and energizes organizational members to execute strategy and perform at a high level.
3. Keeping the organization responsive to changing conditions, alert for new opportunities and remain ahead of rivals in developing competitively valuable competencies and capabilities.
4. Ethical leadership and insisting that the organization conduct its affairs like a model corporate citizen.

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5. Pushing corrective actions to improve strategy execution and overall strategic performance.

Question 8

(a) A company started its operation in 2015 with Product Alpha. In early 2021, with intent to have its better presence in the market, the company diversifies by acquiring a company with product Beta. After sometime, it was observed that product Beta is not faring well. Aggressive competition was therein market for the product. It was also revealed that though customers are not price sensitive, but product was not keeping pace with the fast changing unique features as expected by its customers.

Company has tried one of the retrenchment strategies by putting efforts to improve its internal efficiency, but could not get desired results. In the situation, company is of a considered view to remain and grow in product alpha and to decouple with product Beta from its portfolio.

As a strategist, suggest the retrenchment strategy to be adopted by the company. Also delineate reasons why a company should adopt such strategy? ***(1+ 4 = 5 Marks)***

(b) What is cost leadership strategy? Under what circumstances an organization can gain competitive advantages from cost leadership strategy? Is there any risk in pursuing cost leadership strategy? ***(1+ 3 + 1 = 5 Marks)***

Answer

(a) As per the facts of the case, company had tried to improve its internal efficiency. In other words, had tried turnaround strategy but could not get the desired results.

Company does not want to go for complete close down of business. Rather it wants to continue and grow in its original business i.e. product Alpha.

As a strategist, it is advisable that the company should adopt **divestment strategy**. In the given situation where the business of product Beta is not faring well and became unprofitable and unviable due to aggressive competition in the market, the best option for the company is to divest the product Beta which is loss-making business.

Retrenchment may be done either internally or externally. Turnaround strategy is adopted in case of internal retrenchment where emphasis is laid on improving internal efficiency of the organization, while divestment strategy is adopted when a business turns unprofitable and unviable due to some external factors. In view of the above, the company should go for divestment strategy.

A divestment strategy may be adopted due to various reasons:

1. A business that had been acquired proves to be a mismatch and cannot be integrated within the company.
2. Persistent negative cash flows from a particular business create financial problems for the whole company, creating the need for divestment of that business.

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3. Severity of competition and the inability of a firm to cope with it may cause it to divest.
4. It is not possible for the business to do Technological up-gradation that is required for the business to survive, a preferable option would be to divest.
5. A better alternative may be available for investment, causing a firm to divest a part of its unprofitable business.

(b) **Cost leadership strategy** emphasizes producing standardized products at a very low per-unit cost for consumers who are price-sensitive. It frequently results from productivity increases and aggressive pursuit of cost reduction throughout the development, production, marketing, and distribution processes. It allows a firm to earn higher profits than its competitors.

The circumstances in which an organization can gain competitive advantages from cost leadership strategy are:

- when the market is composed of many price-sensitive buyers.
- when there are few ways to achieve product differentiation.
- when buyers do not care much about differences from brand to brand.
- when there are a large number of buyers with significant bargaining power.

The basic idea is to underprice competitors and thereby gain market share driving some of the competitors out of the market.

Some risks of pursuing cost leadership are:

- that competitors may imitate the strategy, therefore driving overall industry profits down
- that technological breakthroughs in the industry may make the strategy ineffective; or that buyer interests may swing to other differentiating features besides price.

Question 9

(a) "The TOWS Marix is a tool for generating strategic options/choices." Do you agree with this statement? How it can help a strategist in decision making? ***(1 + 4 = 5 Marks)***

(b) "Strategic intent provides the framework within which the firm would adopt a predetermined direction and would operate to achieve strategic objectives." In the light of this statement, discuss the elements of strategic intent. ***(5 Marks)***

Answer

(a) **Yes,** TOWS Matrix is a relatively simple tool for generating strategic options. Through TOWS matrix four distinct alternative kinds of strategic choices can be identified.

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SO (Maxi-Maxi): Aggressive strategy - SO is a position that any firm would like to achieve. The strengths can be used to capitalize or build upon existing or emerging opportunities.

ST (Maxi-Mini): Conservative strategy - ST is a position in which a firm strives to minimize existing or emerging threats through its strengths.

WO (Mini-Maxi): Competitive strategy - The strategies developed need to overcome organizational weaknesses if existing or emerging opportunities are to be exploited to maximum.

WT (Mini-Mini): Defensive strategy - WT is a position that any firm will try to avoid. An organization facing external threats and internal weaknesses may have to struggle for its survival.

The matrix is outlined below:

Internal External	**Strengths – S** List Strengths	**Weaknesses – W** List Weaknesses
Opportunities – O List Opportunities	**SO Strategies** Use strengths to take advantage of opportunities	**WO Strategies** Overcoming weaknesses by taking advantage of opportunities
Threats – T List Threats	**ST Strategies** Use strengths to avoid threats	**WT Strategies** Minimize weaknesses and avoid threats

Figure: The TOWS Matrix

By using TOWS Matrix, a strategist can look intelligently at how he can best take advantage of the opportunities open to him, at the same time that he can minimize the impact of weaknesses and protect himself against threats. Used after detailed analysis of threats, opportunities, strength and weaknesses, it helps the strategist to consider how to use the external environment to his strategic advantage, and so he can identify some of the strategic options available to him.

(b) Strategic intent can be understood as the philosophical base of strategic management. It implies the purposes, which an organization endeavours to achieve. It is a statement that provides a perspective. Strategic intent gives an idea of what the organization desires to attain in future. Strategic intent provides the framework within which the firm would adopt a predetermined direction and would operate to achieve strategic objectives.

Elements of strategic management are as follows:

(i) **Vision:** Vision implies the blueprint of the company's future position. It describes where the organisation wants to land. It depicts the organisation's aspirations and

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provides a glimpse of what the organization would like to become in future. Every sub system of the organization is required to follow its vision.

(ii) Mission: Mission delineates the firm's business, its goals and ways to reach the goals. It explains the reason for the existence of the firm in the society. A mission statement helps to identify, 'what business the company undertakes.' It defines the present capabilities, activities, customer focus and role in society.

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

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

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

Question 10

(a) The growth rate of A & B Ltd. growth rate was around 10% per annum during the last decade. But thereafter its growth rate started falling and presently the growth rate of the company is very low around 1%. The company is facing twin problems, one the strategy is not implemented as planned; and two the results produced by the strategy are not in conformity with intended goals.

You being a strategy consultant, advise the tool for audit of management performance. Also explain the need of such tool and its basic activities. ***(1 + 2 + 2 = 5 Marks)***

(b) "A well designed strategic management system can fail if insufficient attention is given to the human resource dimension." ·Elucidate this statement. ***(5 Marks)***

OR

Write short note on Strategic Business Unit (SBU).

Answer

(a) A & B Ltd. reviews its business plans and strategies on regular basis to identify weaknesses and shortcomings to enable a successful development plan. A strategy audit is an examination and evaluation of areas affected by the operation of a strategic management process within an organization. The audit of management performance with

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regard to its strategies helps an organization identify problem areas and correct the strategic approaches that have not been effective.

Strategy audit is needed under the following conditions:

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

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

Strategy Audit includes three basic activities:

1. Examining the underlying bases of a firm's strategy,
2. Comparing expected results with actual results, and
3. Taking corrective actions to ensure that performance conforms to plans.

(b) A well-designed strategic-management system can fail if insufficient attention is given to the human resource dimension. Human resource problems that arise when a business implements strategies can usually be traced to one of three causes: (1) disruption of social and political structures, (2) failure to match individuals' aptitudes with implementation tasks, and (3) inadequate top management support for implementation activities.

i. Disruption of social and political structures: Strategy implementation poses a threat to many managers and employees in an organization. New power and status relationships are anticipated and realized. New formal and informal groups' values, beliefs, and priorities may be largely unknown. Managers and employees may become engaged in resistance behaviour as their roles, prerogatives, and power in the firm change. Disruption of social and political structures that accompany strategy execution must be anticipated and considered during strategy formulation and managed during strategy implementation.

ii. Failure to match individuals' aptitudes with implementation tasks: A concern in matching managers with strategy is that jobs have specific and relatively static responsibilities, although people are dynamic in their personal development. Commonly used methods that match managers with strategies to be implemented

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include transferring managers, developing leadership workshops, offering career development activities, promotions, job enlargement, and job enrichment.

It is surprising that so often during strategy formulation; individual values, skills, and abilities needed for successful strategy implementation are not considered. It is rare that a firm selecting new strategies or significantly altering existing strategies possesses the right line and staff personnel in the tight positions for successful strategy implementation. The need to match individual aptitudes with strategy-implementation tasks should be considered in strategy choice.

iii. **Inadequate top management support for implementation activities**: Inadequate support from strategists for implementation activities often undermines organizational success. Chief executive officers, small business owners, and government agency heads must be personally committed to strategy implementation and express this commitment in highly visible ways. Strategists' formal statements about the importance of strategic management must be consistent with actual support and rewards given for activities completed and objectives reached. Otherwise, stress created by inconsistency can cause uncertainty among managers and employees at all levels.

OR

SBU is a part of a large business organization that is treated separately for strategic management purposes. It is separate part of large business serving product markets with readily identifiable competitors. It is created by adding another level of management in a divisional structure after the divisions have been grouped under a divisional top management authority based on the common strategic interests.

Very large organizations, particularly those running into several products, or operating at distant geographical locations that are extremely diverse in terms of environmental factors, can be better managed by creating strategic business units. SBU structure becomes imperative in an organization with increase in number, size and diversity.

The three most important characteristics of a SBU are:

- It is a single business or a collection of related businesses which offer scope for independent planning and which might feasibly standalone from the rest of the organization.
- It has its own set of competitors.
- It has a manager who has responsibility for strategic planning and profit performance, and who has control of profit-influencing factors.

Benefits of SBUs:

1. Establishing coordination between divisions having common strategic interest.
2. Facilitate strategic management and control.

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3. Determine accountability at the level of distinct business units.
4. Allow strategic planning to be done at the most relevant level within the total enterprise.
5. Make the task of strategic review by top executives more objective and more effective.
6. Help to allocate resources to areas with better opportunities.

Thus, an SBU structure with its set of advantages would be most suitable for the company with the given diverse businesses having separate identifiable competitors, but a common organizational goal.

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PAPER – 8 : FINANCIAL MANAGEMENT AND ECONOMICS FOR FINANCE

SECTION – A: FINANCIAL MANAGEMENT

*Question No. **1** is compulsory.*

*Attempt any **four** questions out of the remaining **five** questions.*

In case, any candidate answers extra question(s)/ sub-question(s) over and above the required number, then only the requisite number of questions first answered in the answer book shall be valued and subsequent extra question(s) answered shall be ignored.

Working notes should form part of the respective answers.

Question 1

(a) *K Ltd. has a Quarterly cash outflow of ₹ 9,00,000 arising uniformly during the Quarter. The company has an Investment portfolio of Marketable Securities. It plans to meet the demands for cash by periodically selling marketable securities. The marketable securities are generating a return of 12% p.a. Transaction cost of converting investments to cash is ₹ 60. The company uses Baumol model to find out the optimal transaction size for converting marketable securities into cash.*

Consider 360 days in a year.

You are required to calculate

(i) Company's average cash balance,

(ii) Number of conversions each year and

(iii) Time interval between two conversions. ***(5 Marks)***

(b) *The following figures are related to the trading activities of M Ltd.*

Total assets	*₹ 10,00,000*
Debt to total assets	*50%*
Interest cost	*10% per year*
Direct Cost	*10 times of the interest cost*
Operating Exp.	*₹ 1,00,000*

The goods are sold to customers at a margin of 50% on the direct cost

Tax Rate is 30%

You are required to calculate

(i) Net profit margin

(ii) Net operating profit margin

(iii) Return on assets

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(iv) Return on owner's equity **(5 Marks)**

(c) The following is the extract of the Balance Sheet of M/s KD Ltd.:

Particulars	Amount (₹)
Ordinary shares (Face Value ₹ 10/- per share)	5,00,000
Share Premium	1,00,000
Retained Profits	6,00,000
8% Preference Shares (Face Value ₹ 25/- per share)	4,00,000
12% Debentures (Face value ₹ 100/- each)	6,00,000
	22,00,000

The ordinary shares are currently priced at ₹ 39 ex-dividend and preference share is priced at ₹ 18 cum-dividend. The debentures are selling at 120 percent ex-interest. The applicable tax rate to KD Ltd. is 30 percent. KD Ltd.'s cost of equity has been estimated at 19 percent. Calculate the WACC (weighted average cost of capital) of KD Ltd. on the basis of market value. **(5 Marks)**

(d) Determine the Risk Adjusted Net Present Value of the following projects:

	A	B	C
Net cash outlays (₹)	70,000	1,20,000	2,20,000
Project life	5 years	5 years	5 years
Annual cash inflow (₹)	30,000	42,000	70,000
Coefficient of Variation	2.2	1.6	1.2

The company selects the risk-adjusted discount rate on the basis of the Coefficient of variation.

Coefficient of Variation	Applicable Risk adjusted discount rate (i)	PVIFA (i,5)
0	10%	3.791
0.4.	12%	3.605
0.8	14%	3.433
1.2	16%	3.274
1.6	18%	3.127
2	22%	2.864
>2.0	25%	2.689

Which project should be selected by the company based on Risk Adjusted NPV?

(5 Marks)

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Answer

(a) (i) Computation of Average Cash balance:

Annual cash outflow (U) = 9,00,000 x 4 = ₹ 36,00,000

Fixed cost per transaction (P) = ₹ 60

Opportunity cost of one rupee p.a. (S) = $\frac{12}{100}$ = 0.12

Optimum cash balance (C) = $\sqrt{\frac{2UP}{S}} = \sqrt{\frac{2\times 36,00,000\times 60}{0.12}}$ = ₹ 60,000

∴ Average Cash balance = $\frac{(0 + 60,000)}{2}$ = ₹ 30,000

(ii) Number of conversions p.a.

Annual cash outflow = ₹ 36,00,000

Optimum cash balance = ₹ 60,000

∴ No. of conversions p.a. = $\frac{36,00,000}{60,000}$ = 60

(iii) Time interval between two conversions

No. of days in a year = 360

No. of conversions p.a. = 60

∴ Time interval = $\frac{360}{60}$ = 6 days

(b) (i) Computation of Net Profit Margin

Debt = (10,00,000 x 50%) = ₹ 5,00,000

Interest cost = 5,00,000 x $\left(\frac{10}{100}\right)$ = ₹ 50,000

Direct cost = 50,000 x 10 = ₹ 5,00,000

Sales = 5,00,000 x 150% = ₹ 7,50,000

	(₹)
Gross profit = 7,50,000 – 5,00,000	= 2,50,000
Less: Operating expenses	= 1,00,000
∴ EBIT	= 1,50,000
Less: Interest	= 50,000

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∴ EBT	= 1,00,000
Less: Tax @ 30%	= 30,000
∴ PAT	= 70,000

Net profit margin $= \left(\frac{70,000}{7,50,000}\right) \times 100 = 9.33\%$

(ii) Net Operating Profit margin

Net operating profit margin $= \left(\frac{EBIT}{Sales}\right) \times 100$

$= \left(\frac{1,50,000}{7,50,000}\right) \times 100 = 20\%$

(iii) Return on Assets

Return on Assets $= \left[\left(\frac{PAT + Interest}{Total\ Assets}\right)\right] \times 100$

$= \left[\left(\frac{1,20,000}{10,00,000}\right)\right] \times 100] = 12\%$

(OR)

Return on Assets $= \frac{EBIT}{Assets} \times 100$

$= \frac{1,50,000}{10,00,000} \times 100 = 15\%$

(OR)

$= \frac{70,000}{10,00,000} \times 100 = 7\%$

(OR)

$= \left[\frac{1,50,000(1-0.3)}{10,00,000}\right] \times 100 = 10.5\%$

(iv) Return on owner's equity

Return $= \left(\frac{PAT}{Owner's\ equity}\right) \times 100$

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$$= \left(\frac{70,000}{5,00,000}\right) \times 100 = 14\%$$

(c) Computation of WACC on the basis of market value

W.N. 1

Cum-dividend price of Preference shares = ₹ 18

Less: Dividend (8/100) x 25 = ₹ 2

∴ Market Price of Preference shares = ₹ 16

$K_p = \frac{2}{16} = 0.125$ (or) 12.5%

No. of Preference shares $= \left(\frac{4,00,000}{25}\right) = 16,000$

W.N. 2

Market price of Debentures $= \left(\frac{120}{100}\right) \times 100 = ₹120$

$K_d = \left[\frac{12\ (1 - 0.3)}{120}\right] = 0.07$ (or) 7%

No. of Debentures $= \left(\frac{6,00,000}{100}\right) = 6,000$

W.N.3

Market Price of Equity shares = ₹39

K_e (given) = 19% or 0.19

No. of Equity shares $= \frac{5,00,000}{10} = 50,000$

Sources	Market Value (₹)	Nos.	Total Market value (₹)	Weight	Cost of Capital	Product
Equity Shares	39	50,000	19,50,000	0.6664	0.19	0.1266
Preference Shares	16	16,000	2,56,000	0.0875	0.125	0.0109
Debentures	120	6,000	7,20,000	0.2461	0.07	0.0172
					WACC =	0.1547

WACC = 0.1547 or 15.47%

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(d) Selection of project on the basis of Risk Adjusted Net Present Value

Particulars	A	B	C
Co efficient of Variation	2.2	1.6	1.2
Applicable discount rate (%)	25	18	16
Annual cash inflow (₹)	30,000	42,000	70,000
Relevant PVIFA	2.689	3.127	3.274
PV of cash inflow (₹)	**80,670**	**1,31,334**	**2,29,180**
Less: Cash outflow (₹)	70,000	1,20,000	2,20,000
Risk adjusted NPV (₹)	**10,670**	**11,334**	**9,180**

Conclusion: Project B should be selected as its Risk adjusted NPV is high.

Question 2

The following information is available for SS Ltd.

Profit volume (PV) ratio	*30%*
Operating leverage	*2.00*
Financial leverage	*1.50*
Loan	*₹ 1,25,000*
Post-tax interest rate	*5.6%*
Tax rate	*30%*
Market Price per share (MPS)	*₹ 140*
Price Earnings Ratio (PER)	*10*

You are required to:

(1) Prepare the Profit-Loss statement of SS Ltd. and

(2) Find out the number of equity shares. ***(10 Marks)***

Answer

(1) Preparation of Profit – Loss Statement

Working Notes:

1. Post tax interest	5.60%
Tax rate	30%
Pre tax interest rate = (5.6/70) x 100	8%
Loan amount	₹ 1,25,000
Interest amount = 1,25,000 x 8%	₹ 10,000

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Financial Leverage (FL) = $\left(\frac{EBIT}{EBT}\right) = \left\lfloor\frac{EBIT}{(EBIT - Interest)}\right\rfloor = \left\lfloor\frac{EBIT}{(EBIT - 10,000)}\right\rfloor$

$1.5 = \left\lfloor\frac{EBIT}{(EBIT - 10,000)}\right\rfloor$

1.5 EBIT -15000 = EBIT

1.5 EBIT – EBIT = 15,000

0.5 EBIT = 15,000

∴ EBIT = ₹ 30,000

EBT = EBIT – Interest = 30,000 – 10,000 = ₹ 20,000

2. Operating Leverage (OL) = $\frac{Contribution}{EBIT}$

$2 = \frac{Contribution}{30,000}$

Contribution = ₹ 60,000

3., **Fixed cost** = Contribution – Profit

= 60,000 – 30,000 = **₹ 30,000**

4., Sales = $\frac{Contribution}{PV\ Ratio}$

= $\frac{60,000}{30\%}$ = **₹ 2,00,000**

5. If PV ratio is 30%, then the variable cost is 70% on sales.

∴ **Variable cost** = 2,00,000 x 70% = **₹ 1,40,000**

Profit – Loss Statement

Particulars	**₹**
Sales	2,00,000
Less: Variable cost	1,40,000
Contribution	60000
Less: Fixed cost	30,000
EBIT	30,000
Less: Interest	10,000

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EBT	20,000
Less: Tax @ 30%	6,000
EAT	**14,000**

(2) Calculation of no. of Equity shares

Market Price per Share (MPS) = ₹140

Price Earnings Ratio (PER) = 10

WKT,

$$\textbf{EPS} = \frac{\text{MPS}}{\text{PER}} = \frac{140}{10} = \textbf{₹ 14}$$

Total earnings (EAT) = ₹ 14,000

∴ No. of Equity Shares = 14,000 / 14 = **1000**

Question 3

A firm is in need of a small vehicle to make deliveries. It is intending to choose between two options. One option is to buy a new three wheeler that would cost ₹ 1,50,000 and will remain in service for 10 years.

The other alternative is to buy a second hand vehicle for ₹ 80,000 that could remain in service for 5 years. Thereafter the firm, can buy another second hand vehicle for ₹ 60,000 that will last for another 5 years.

The scrap value of the discarded vehicle will be equal to it written down value (WDV). The firm pays 30% tax and is allowed to claim depreciation on vehicles @ 25% on WDV basis.

The cost of capital of the firm is 12%.

You are required to advise the best option.

Given:

t	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
PVIF (t,12%)	*0.892*	*0.797*	*0.711*	*0.635*	*0.567*	*0.506*	*0.452*	*0.403*	*0.360*	*0.322*

(10 Marks)

Answer

Selection of Investment Decision

Tax shield on Purchase of New vehicle			
Year	WDV	Dep. @ 25%	Tax shield @ 30%
1	1,50,000	37,500	11,250

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2	1,12,500	28,125	8,437
3	84,375	21,094	6,328
4	63,281	15,820	4,746
5	47,461	11,865	3,560
6	35,596	8,899	2,670
7	26,697	6,674	2,002
8	20,023	5,006	1,502
9	15,017	3,754	1,126
10	11,263	2,816	845
11	8,447	Scrap value	

Tax shield on Purchase of Second hand vehicles

Year	WDV	Dep. @ 25%	Tax shield @ 30%	
1	80,000	20,000	6,000	
2	60,000	15,000	4,500	
3	45,000	11,250	3,375	
4	33,750	8,437	2,531	
5	25,313	6,328	1,898	Scrap value = ₹ 18,985
6	60,000	15,000	4,500	
7	45,000	11,250	3,375	
8	33,750	8,437	2,531	
9	25,313	6,328	1,898	
10	18,985	4,746	1,424	Scrap value = ₹ 14,239

Calculation of PV of Net outflow of New Vehicle

Year	Cash OF/IF	PV Factor	PV of OF/IF
0	1,50,000	1	1,50,000
1	(11,250)	0.892	(10,035)
2	(8,437)	0.797	(6,724)
3	(6,328)	0.711	(4,499)
4	(4,746)	0.635	(3,014)
5	(3,560)	0.567	(2,018)
6	(2,670)	0.506	(1,351)
7	(2,002)	0.452	(905)

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8	(1,502)	0.403	(605)
9	(1,126)	0.360	(405)
10	(845 + 8447)	0.322	(2,992)
		PVNOF	**1,17,452**

Calculation of PV of Net outflow of Second hand Vehicles

Year	Cash OF/IF	PV Factor	PV of OF/IF
0	80,000	1	80,000
1	(6,000)	0.892	(5,352)
2	(4,500)	0.797	(3,587)
3	(3,375)	0.711	(2,400)
4	(2,531)	0.635	(1,607)
5	(60000 – 18985 – 1898) = 39,117	0.567	22,179
6	(4,500)	0.506	(2,277)
7	(3,375)	0.452	(1,525)
8	(2,531)	0.403	(1,020)
9	(1,898)	0.360	(683)
10	(1424 + 14239) = (15,663)	0.322	(5,043)
		PVNOF	**78,686**

Advise: The PV of net outflow is low in case of buying the second hand vehicles. Therefore, it is advisable to buy second hand vehicles.

Question 4

A hospital is considering to purchase a diagnostic machine costing ₹ 80,000. The projected life of the machine is 8 years and has an expected salvage value of ₹ 6,000 at the end of 8 years. The annual operating cost of the machine is ₹ 7,500. It is expected to generate revenues of ₹ 40,000 per year for eight years. Presently, the hospital is outsourcing the diagnostic work and is earning commission income of ₹ 12,000 per annum.

Consider tax rate of 30% and Discounting Rate as 10%.

Advise:

Whether it would be profitable for the hospital to purchase the machine?

Give your recommendation as per Net Present Value method and Present Value Index method under below mentioned two situations:

(i) If Commission income of ₹ 12,000 p.a. is before taxes.

(ii) If Commission income of ₹ 12,000 p.a. is net of taxes.

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Given:

t	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*
PVIF (t, 10%)	*0.909*	*0.826*	*0.751*	*0.683*	*0.621*	*0.564*	*0.513*	*0.467*

(10 Marks)

Answer

Analysis of Investment Decisions

Determination of Cash inflows	**Situation-(i) Commission Income before taxes**	**Situation-(ii) Commission Income after taxes**
Cash flow up-to 7th year:		
Sales Revenue	40,000	40,000
Less: Operating Cost	(7,500)	(7,500)
	32,500	32,500
Less: Depreciation (80,000 – 6,000) ÷ 8	(9,250)	(9,250)
Net Income	23,250	23,250
Tax @ 30%	(6,975)	(6,975)
Earnings after Tax (EAT)	16,275	16,275
Add: Depreciation	9,250	9,250
Cash inflow after tax per annum	25,525	25,525
Less: Loss of Commission Income	(8,400)	(12,000)
Net Cash inflow after tax per annum	17,125	13,525
In 8th Year:		
Net Cash inflow after tax	17,125	13,525
Add: Salvage Value of Machine	6,000	6,000
Net Cash inflow in year 8	**23,125**	**19,525**

Calculation of Net Present Value (NPV) and Profitability Index (PI)

	Particulars	**PV factor @10%**	**Situation-(i) [Commission Income before taxes]**	**Situation-(ii) [Commission Income after taxes]**
A	Present value of cash inflows (1st to 7th year)	4.867	83,347.38 (17,125 × 4.867)	65,826.18 (13,525 × 4.867)

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B	Present value of cash inflow at 8th year	0.467	10,799.38 (23,125 × 0.467)	9,118.18 (19,525 × 0.467)
C	PV of cash inflows		94,146.76	74,944.36
D	*Less:* Cash Outflow	1.00	(80,000)	(80,000)
E	**Net Present Value (NPV)**		**14,146.76**	**(5,055.64)**
F	**PI = (C÷D)**		**1.18**	**0.94**

Recommendation: The hospital may consider purchasing of diagnostic machine in situation (i) where commission income is 12,000 before tax as NPV is positive and PI is also greater than 1. Contrary to situation (i), in situation (ii) where the commission income is net of tax, the recommendation is reversed to not purchase the machine as NPV is negative and PI is also less than 1.

Question 5

(a) The following are the costs and values for the firms A and B according to the traditional approach.

	Firm A	*Firm B*
Total value of firm, V (in ₹)	*50,000*	*60,000*
Market value of debt, D (in ₹)	*0*	*30,000*
Market value of equity, E (in ₹)	*50,000*	*30,000*
Expected net operating income (in ₹)	*5,000*	*5,000*
Cost of debt (in ₹)	*0*	*1,800*
Net Income (in ₹)	*5,000*	*3,200*
Cost of equity, Ke = NI/V	*10.00%*	*10.70%*

(i) Compute the Equilibrium value for Firm A and B in accordance with the M-M approach. Assume that (a) taxes do not exist and (b) the equilibrium value of Ke is 9.09%.

(ii) Compute Value of Equity and Cost of Equity for both the firms. ***(4 Marks)***

(b) MR Ltd. is having the following capital structure, which is considered to be optimum as on 31.03.2022.

Equity share capital (50,000 shares)	*₹ 8,00,000*
12% Pref. share capital	*₹ 50,000*
15% Debentures	*₹ 1,50,000*
	₹ 10,00,000

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The earnings per share (EPS) of the company were ₹ 2.50 in 2021 and the expected growth in equity dividend is 10% per year. The next year's dividend per share (DPS) is 50% of EPS of the year 202I. The current market price per share (MPS) is ₹ 25.00. The 15% new debentures can be issued by the company. The company's debentures are currently selling at ₹ 96 per debenture. The new 12% Pref. share can be sold at a net price of ₹ 91.50 (face value ₹ 100 each). The applicable tax rate is 30%.

You are required to calculate

(a) After tax cost of

(i) New debt,

(ii) New pref. share capital and

(iii) Equity shares assuming that new equity shares come from retained earnings.

(b) Marginal cost of capital,

How much can be spent for capital investment before sale of new equity shares assuming that retained earnings for next year investment is 50% of 2021? ***(6 Marks)***

Answer

(a) (i) Computation of Equilibrium value of Firms A & B under MM Approach:

As per MM approach K_O is equal to K_{eu}

$\therefore K_O = K_{eu} (1 - t) = 9.09 (1 - 0) = 9.09$

Particulars	A	B
EBIT (NOI) (₹)	5000	5000
$K_{O\ (\%)}$	9.09	9.09
Equilibrium value (₹) (NOI/Ko) X 100	55005.5	55005.5
	$\frac{5,000}{9.09} \times 100$	$\frac{5,000}{9.09} \times 100$

(ii) Computation of value of equity and cost of equity of Firms A & B

Particulars	A	B
Equilibrium value (₹)	55,005.5	55,005.5
Less: Value of Debt	-	30,000
Value of Equity	55,005.5	25,005.5

Cost of Equity of Firm A (unlevered) = 9.09

Cost of Debt of Firm B (K_d) (levered) = (1800/30000) x 100 = 6%

Cost of Equity of Firm B (Levered) $= K_O + (K_O - K_d) \times (Debt / Equity)$

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= 9.09 + (9.09 – 6) x (30000/25005.5)

= 9.09 + 3.09 x 1.2 = 9.09 + 3.71 = **12.80%**

(OR)

Cost of Equity of Firm B (Levered) = $\left(\frac{\text{NI}}{\text{Value of Equity}}\right)$ x 100

= $\left(\frac{3200}{25005.5}\right)$ x 100 = **12.8%**

(b) (a) (i) After tax cost of new Debt:

$K_d = I\ \frac{(1-t)}{P_1} = 15\ \frac{(1-0.3)}{96}$

= 0.1094 (or) **10.94%**

(ii) After tax cost of New Preference share capital:

$K_p = \frac{PD}{P_O} = \left(\frac{12}{91.5}\right) = 0.1311$ (or) **13.11%**

(iii) After tax cost of Equity shares:

$K_e = \left(\frac{D_1}{P_O}\right) + g = \left[\frac{(2.50 \times 50\%)}{25}\right] + 0.10$

= **0.15 (or) 15%**

(b) Marginal Cost of Capital

Type of capital	Proportions	Specific cost	Product
Equity Shares	0.80	0.15	0.12
Preference Shares	0.05	0.1311	0.0066
Debentures	0.15	0.1094	0.0164
∴ Marginal cost of capital			**0.1430**

(c) Amount that can be spend for capital investment

Retained earnings = 50% of EPS x No. of outstanding Equity shares

= 1.25 x 50,000

= ₹ 62,500

Proportion of equity (Retained earnings here) capital is 80% of total capital. Therefore,

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₹ 62,500 is 80% of total capital.

$\therefore$ Amount of Capital Investment = $\frac{62,500}{0.80}$ = **₹ 78,125**

Question 6

(a) These bonds are issued by non-US Banks and non-US corporations in US. What this bond is called and what are the other features of this Bond? ***(4 Marks)***

(b) Elucidate the fundamental tasks of treasury department of a firm. ***(4 Marks)***

(c) The firm has more capital than its requirements. What is this situation called? Give two consequences of it. ***(2 Marks)***

OR

What are the important factors considered for deciding the source and quantum of capital? ***(2 Marks)***

Answer

(a) The Bond is called as Yankee Bond.

Features of the bond:

- These bonds are denominated in Dollars
- Bonds are to be registered in SEC (Securities and Exchange Commission)
- Bonds are issued in tranches
- Time taken can be up to 14 weeks

(b) Fundamental tasks of treasury department of a firm:

(i) Cash management: It involves efficient cash collection process and managing payment of cash both inside the organization and to third parties. Treasury will also manage surplus funds in an investment portfolio.

(ii) Currency management: The treasury department manages the foreign currency risk exposure of the company. In a large multi-national company, the first step will usually be to set off intra-group indebtedness. The use of matching receipts and payments in the same currency will save transaction costs and will save the organization from any unfavorable exchange movement.

(iii) Fund management: Treasury department is responsible for planning and sourcing the company's short, medium and long-term cash needs. It also facilitates temporary investment of surplus funds by mapping the time gap between funds inflow and outflow.

(iv) Banking: It is important that a company maintains a good relationship with its bankers. Treasury department carry out negotiations with bankers with respect to

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interest rates, foreign exchange rates etc. and act as the initial point of contact with them.

(v) Corporate finance: Treasury department is involved with both acquisition and divestment activities within the group. In addition, it will often have responsibility for investors' relations.

(c) The situation is called as Over Capitalization.

Consequences of Over Capitalization:

- Considerable reduction in the rate of dividend and interest payments.
- Reduction in the market price of shares
- Resorting to "Window dressing"
- Some companies may opt for reorganization. However, sometimes the matter gets worse and the company may go into liquidation.

(OR)

The source and quantum of capital is decided keeping in mind the following factors:

(i) Control: Capital structure should be designed in such a manner that existing shareholders continue to hold majority stake

(ii) Risk: Capital structure should be designed in such a manner that financial risk of a company does not increase beyond tolerable limit.

(iii) Cost: Overall cost of capital remains minimum.

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SECTION – B: ECONOMICS FOR FINANCE

*Question No. **7** is compulsory.*

*Answer any **three** from the rest.*

Question 7

(a) The equilibrium level of income (Y) of an economy is ₹ 2,000 crores.

The autonomous consumption expenditure (a) is equal to ₹ 100 crores and investment expenditure (I) is ₹ 500 crores.

You are required to calculate:

(i) Consumption expenditure at equilibrium level of National Income.

(ii) Marginal Propensity to Consume (MPC) and Marginal Propensity to Save (MPS).

(iii) Equilibrium level of income if saving function is S = - 10 + 0.2Y. ***(3 Marks)***

(b) What are the two forms, through which foreign capital may flow into an economy, as an investment? ***(2 Marks)***

(c) Define 'Money Multiplier'. Use of e-wallets is increasing at fast pace nowadays. How this enhanced use of e-wallets is affecting money multiplier and money supply? ***(3 Marks)***

(d) What is the difference between price ceiling and price floor? ***(2 Marks)***

Answer

(a) (i) Consumption expenditure at equilibrium level:

Y = C + I

C = Y-I

By putting value, we get

= ₹ 2000 – ₹ 500

C = ₹ 1500 Crores

(ii) MPC and MPS:

C = a + bY

1500 = 100 + b×2000

b = 1400 ÷ 2000

= 0.7

MPC (b) = 0.7

MPS = 1- MPC

= 1-0.7

MPS = 0.3

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(iii) Equilibrium level of income

S = Y – C		S = I
-10 + 0.2Y = Y – C		-10 + 0.2Y = 500
0.2Y – Y = -C + 10	**(OR)**	0.2Y = 500 + 10
-0.8Y = -1500 + 10		0.2Y = 510
0.8Y = 1490		Y = 510/0.2
Y = 1490/0.8 = **₹ 1862.5 crores**		**Y = ₹2550 crores**

(b) Forms of foreign capital into an economy

The two forms through which foreign capital may flow into an economy as investments are:

Foreign portfolio investment (FPI) in bonds, stocks and securities, and **Foreign direct investment** (FDI) in industrial, commercial, and similar other enterprises.

Foreign direct investment is defined as a process whereby the resident of one country (i.e., home country) acquires ownership of an asset in another country (i.e., the host country) and such movement of capital involves ownership, control as well as management of the asset in the host country.

Foreign portfolio investment is the flow of 'financial capital' with stake in a firm at below 10 percent and does not involve manufacture of goods or provision of services, ownership management or control of the asset on the part of the investor.

(c) Money multiplier:

Money multiplier *m* is defined as a **ratio that relates the changes in the money supply to a given change in the monetary base.** It is the ratio of the stock of money to the stock of high-powered money. It denotes by how much the money supply will change for a given change in high-powered money.

Money multiplier (m) = Money Supply / Monetary base

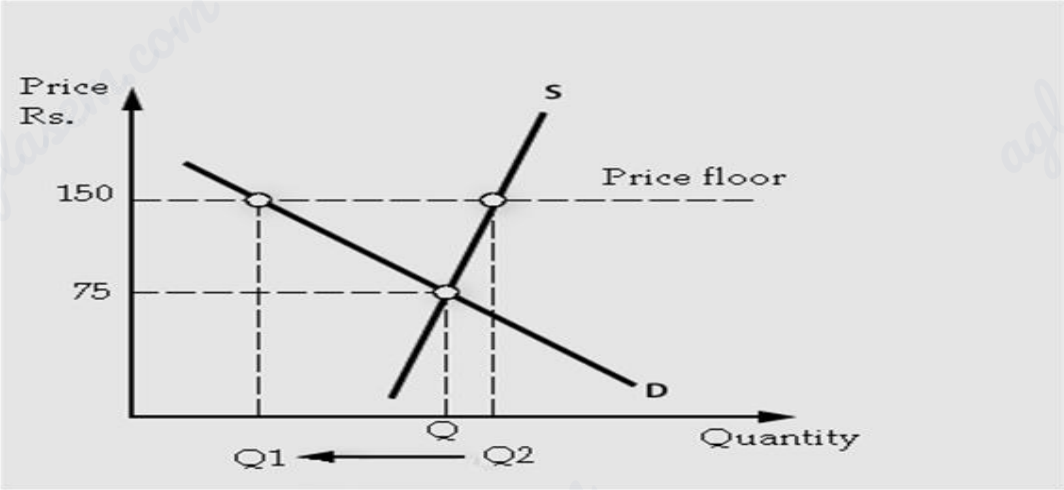
E wallet will affect the money supply in the real world. People hold less cash and more deposits thus reducing the currency-deposit ratio; increasing the money multiplier causing the money supply to increase.

(d) Price Ceiling: When prices of certain essential commodities rise excessively, government may resort to controls in the form of price ceilings for making a resource or commodity available to all at reasonable prices. For example: maximum prices of food grains and essential items are set by government during times of scarcity. A price ceiling which is set below the prevailing market clearing price will generate excess demand over supply.

Price Floor: Government usually intervenes in many primary markets which are subject to extreme as well as unpredictable fluctuations in price. For example, in India, in the case of many crops the government has initiated the Minimum Support Price (MSP) programme as well as procurement by government agencies at the set support prices.

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The objective is to guarantee steady and assured incomes to farmers. In case the market price falls below the MSP, then the guaranteed MSP will prevail. The following diagram will illustrate the effects of a price floor.



Market Outcome of Minimum Support Price

When price floors are set above market clearing price, suppliers are encouraged to over-supply and there would be an excess of supply over demand. At price ₹ 150/ which is much above the market determined equilibrium price of ₹ 75, the market demand is only Q1, but the market supply is Q2.

Question 8

(a) (i) The Rupee dollar exchange rate for two different periods of a particular financial year are as follows:

(1) In the month of January it is $ 1 = ₹ 65; and

(2) In the month of April it is $ 1 = ₹ 70

Answer:

A. What does this indicate?

B. Who will be benefited, either residents of India or foreigners?

C. Explain the impact of exchange fluctuations in terms of appreciation of currency on inflation. ***(3 Marks)***

(ii) One of the biggest problem with using discretionary policy to counteract fluctuations is the different types of lags involved in fiscal policy action. What are these lags?

(2 Marks)

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(b) (i) The following data is available for a company:

Particulars	*Amount (in ₹ Crore)*
Gross Value Added (GVA_{MP})	*2,750*
Sales	*3,450*
Closing Stock	*750*
Interest	*200*
Opening Stock	*900*
Net indirect taxes	*550*
Rent	*310*
Mixed income	*380*
Compensation to employees	*600*
Consumption of fixed capital	*320*

Based on the above information, compute the following:

(i) Amount of Intermediate Consumption.

(ii) Net Domestic Product at Factor Cost (NDP_{FC}),

(iii) Profit of the company. ***(3 Marks)***

(ii) Explain briefly the Deflationary Gap. ***(2 Marks)***

Answer

(a) (i) A. It indicates the **depreciation of Rupee and appreciation of Dollar**

B. Exports become cheaper and more attractive to foreigners; imports will be discouraged as they become costlier to import.

C. **Impact on inflation:**

An appreciation may **cause reduction in the levels of inflation** because imports are cheaper. Lower price of imported capital goods, components and raw materials lead to a **decrease in cost of production** which reflects on decrease in prices. Additionally, decrease in aggregate demand tends to **lower demand pull inflation**. **Living standards of people are likely to improve** due to availability of cheaper consumer goods.

(ii) Lags in fiscal Policy **Lags in fiscal policy:**

One of the biggest problems with using discretionary fiscal policy to counteract fluctuations is the different types of lags involved in fiscal-policy action. There are significant lags are:

Recognition lag: The economy is a complex phenomenon, and the state of the macro-economic variables is usually not easily comprehensible. Just as in the case

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of any other policy, the government must first recognize the need for a policy change.

Decision lag: Once the need for intervention is recognized, the government has to evaluate the possible alternative policies. Delays are likely to occur to decide on the most appropriate policy.

Implementation lag: even when appropriate policy measures are decided on, there are possible delays in bringing in legislation and implementing them.

Impact lag: impact lag occurs when the outcomes of a policy are not visible for some time.

(b) (i) (i) GVA_{MP} = Sales + Change in Stock – Intermediate Consumption

2750 = 3450 + (750-900)- Intermediate Consumption

2750 = 3300-Intermediate Consumption

Intermediate Consumption = 3300-2750

Intermediate Consumption= ₹ 550 Crores

(ii) Net Domestic Product at Factor cost = NDP_{MP} - Net indirect taxes

NDP_{MP} = GVA_{MP} - Consumption of fixed capital

= 2750 – 320 = ₹2430 Crores

NDP_{FC} = 2430 – 550 = ₹1880 crores

(iii) Operating surplus = Rent + Interest + Profit

Profit = Operating surplus – Rent - Interest

NDP_{FC} = Compensation to employees + Operating surplus + Mixed income

1880 = 600 + Operating surplus + 380

Operating surplus = 1880 – 600 – 380 = ₹900 Crores

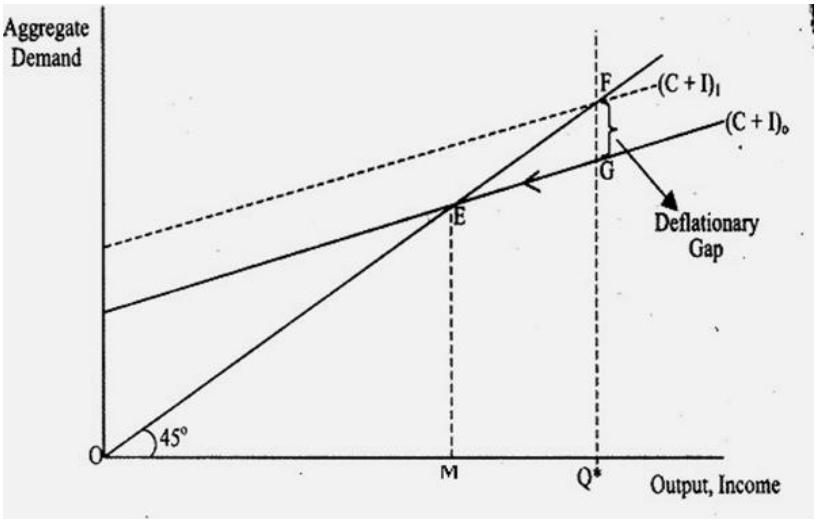
Profit = 900 – 310 - 200 = ₹ 390 crores

(ii) Deflationary **Gap**: If the **aggregate demand is for an amount of output less than the full employment level of output**, then we say there is deficient demand. Deficient demand gives rise to a 'deflationary gap'.

Deflationary gap is thus a measure of the extent of deficiency of aggregate demand, and it causes the economy's income, output, and employment to decline, thus pushing the economy to under- employment equilibrium. The macro- equilibrium

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occurs at a level of GDP less than potential GDP; thus, there is cyclical unemployment i.e. rate of unemployment is higher than the natural rate.



Deficient Demand: Deflationary Gap

Question 9

(a) (i) Explain the operation of Cash Reserve Ratio. ***(3 Marks)***

(ii) "Net Exports" can be negative or positive. How is it significant for the economy of a country? ***(2 Marks)***

(b) (i) Tariffs are basically taxes or duties on goods and services which are imported or exported. Briefly explain Preferential, Applied and Escalated tariff. ***(3 Marks)***

(ii) Write down the name of fiscal function of the Government in Economic System, for the following cases:

(a) Government imposes higher taxes on tobacco products in Union Budget.

(b) Government scheme providing free ration to BPL families.

(c) Government providing subsidy to farmers in purchasing of Urea for agricultural purpose.

(d) Increase in Government expenditure in the time of recession. ***(2 Marks)***

Answer

(a) (i) Operation of Cash Reserve Ratio (CRR):

Cash Reserve Ratio (CRR) refers to the **average daily balance that a bank is required to maintain with the Reserve Bank of India** as a share of its total net demand and time liabilities (NDTL).

Higher the CRR with the RBI, lower will be the liquidity in the system and vice versa. During slowdown in the economy, the RBI reduces the CRR in order to enable the

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banks to expand credit and increases the supply of money available in the economy. In order to contain credit expansion during period's high inflation, the RBI increases the CRR.

(ii) **The Net Exports:** Net exports are the **difference between exports and imports** of a country during the accounting year. It can be positive or negative.

The net export component of GDP is equal to the value of exports (X) minus the value of imports (M). The gap between exports and imports is also called the trade balance. If a country's exports are larger than its imports, then a country is said to have a trade surplus else it will be trade deficit.

Net exports are the difference between exports and imports of a country during the accounting year. It can be positive or negative. Export stimulates economic growth by creating jobs which could potentially reduce poverty and augmenting factor incomes and in so doing raising the standard of livelihood and overall demand for goods and services.

(b) **(i)** Tariffs are basically taxes or duties imposed on goods and services which are imported or exported. It is defined as a financial charge in the form of a tax, imposed at the border on goods going from one customs territory to another. Different tariffs are generally applied to different commodities.

Preferential Tariff: Nearly all countries are part of at least one preferential trade agreement, under which they promise to give another country's products lower tariffs than their MFN rate. These agreements are reciprocal.

Applied Tariff: An 'applied tariff' is the duty that is actually charged on imports on a Most-Favoured Nation (MFN) basis. A WTO member can have an applied tariff for a product that differs from the bound tariff for that product as long as the applied level is not higher than the bound level.

Escalated Tariff: Escalated Tariff structure refers to the system wherein the nominal tariff rates on imports of manufactured goods are higher than the nominal tariff rates on intermediate inputs and raw materials, i.e. the tariff on a product increases as that product moves through the value-added chain.

(ii) **Fiscal Functions of Government**

(i) Allocation function

(ii) Redistribution/distribution function

(iii) Allocation function

(iv) Stabilization function

Question 10

(a) (i) Discuss with example the following types of Foreign Direct Investment.

(A) Horizontal Direct Foreign Investment

(B) Vertical Direct Foreign Investment

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(C) Two-way Direct Foreign Investment ***(3 Marks)***

(ii) Mention the name of the externalities (along with reason in brief) covered in the following acts:

(i) A Road Construction Company provides training to its employees to learn latest technology for durable road construction.

(ii) People taking COVID Booster Dose happily. ***(2 Marks)***

(b) (i) What do you understand by "Liquidity Adjustment Facility (LAF)"? ***(3 Marks)***

(ii) Markets are amazingly competent in organizing the activities of an economy as they are generally efficient and capable of achieving optimal allocation of resources. However, market failure occurs. Discuss briefly any two reasons leading to market failure. ***(2 Marks)***

Answer

(a) (i) (A) Horizontal Direct Foreign Investment: 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.

(B) Vertical Direct Foreign Investment: 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.

(C) Two – way Direct Foreign Investment: Two- Way Direct Foreign Investments' which are reciprocal investments between countries. These investments occur when some industries are more advanced in one nation (for example, the computer industry in the United States), while other industries are more efficient in other nations (such as the automobile industry in Japan).

(ii) (i) As an example of **positive production externality** received in production, we can cite the case of a firm which offers training to its employees for increasing their skills. The firm generates positive benefits on other firms when they hire such workers as they change their jobs.

(ii) A **positive consumption externality** initiated in consumption that confers external benefits on others may be received in consumption or in production. For example, if people taking COVID Booster Dose happily against contagious diseases, they would confer a social benefit to others as well by preventing others from getting infected.

(b) (i) Liquidity Adjustment Facility (LAF): In line with the financial sector reforms, the system of sector-specific refinance schemes (except export credit refinance scheme) was withdrawn. From June 2000, the RBI has introduced Liquidity

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Adjustment Facility (LAF)

The LAF consists of overnight as well as term repo auctions. The aim of term repo is to help develop the inter-bank term money market. This move is expected to set market-based benchmarks for pricing of loans and deposits, and hence improve transmission of monetary policy.

The introduction of LAF is an important landmark since it triggered a rapid transformation in the monetary policy operating environment in India. As a key element in the operating framework of the RBI, its objective is to assist banks to adjust their day-to-day mismatches in liquidity. Currently, the RBI provides financial accommodation to the commercial banks through repos/reverse repos under the Liquidity Adjustment Facility (LAF).

(ii) Reasons leading to market failure:

Market power: Market power or Monopoly power is the **ability of a firm to profitably raise the market price of a good or service over its marginal cost**. The firms that have market power are price makers and therefore can charge a price that gives them positive economic profits.

Externalities: It is something that **one individual does, may have at the margin some effect on others.** It is not the part of the market price mechanism. There is an externality when a consumption or production activity has an indirect effect on other's consumption or production activities and as such effects are not reflected directly in market prices.

Public goods: Public goods have no meaningful demand curve for them. Because of the peculiar characteristics of public goods such as indivisibility, non-excludability and non-rivalry, competitive private markets will fail to generate economically efficient outputs of public goods. If individual's make no offer to pay for public goods, there will be market failure.

Incomplete information: Asymmetric information, adverse selection and moral hazard affect the ability of markets to efficiently allocate resources and therefore, lead to market failure.

Question 11

(a) (i) How are the following transactions treated in National Income Calculation?

(A) B sold a used car to C and receive ₹ 80,000. How much of the sale proceeds will be included in National Income calculation?

(B) Fees paid to real estate agents and lawyers.

(C) Electric power sold to a consumer household.

(ii) What are the guiding principles of World Trade Organization (WTO).

(b) (i) Discuss with examples the major aspects of market failures. ***(3 Marks)***

(ii) Briefly explain the concept of "Liquidity Trap". ***(2 Marks)***

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OR

Why empirical analysis of money supply is important? ***(2 Marks)***

Answer

(a) (i) **(A)** **Sale of used car:** No part of the used car sales proceed of Rs80,000 will be included in national income calculation because sales of used car represents transfer of existing assets which was proceed during some earlier year and was accounted in the national Income calculation of that year

(B) **Fees paid to real estate agents and lawyers:** Fees paid to real estate agents and lawyers represent current production and, therefore, are included in national income.

(C) **Electric power sold to a consumer household:** Electric power sold to a consumer does not require any further processing and does not undergo any further transformation before use. Once a final goods has been sold, it passes out of the active economic flow.

(ii) Right from its inception, the WTO has been driven by a number of fundamental principles which are the foundations of the multilateral trading system. Following are the major **guiding principles**:

- Trade without discrimination
- The National Treatment Principle (NTP)
- Freer trade
- Predictability
- Principle of general prohibition of quantitative restrictions
- Greater competitiveness
- Tariffs as legitimate measures for the protection of domestic industries
- Transparency in Decision Making
- Progressive Liberalization:
- Market Access
- Special privileges to less developed countries
- Protection of Health &Environment
- A transparent, effective, and verifiable dispute settlement mechanism.

(b) (i) **Major aspects of market failures**

There are two aspects of market failures namely, demand-side market failures and supply side market failures.

Demand- side market failures are said to occur **when the demand curves do not take into account the full willingness of consumers to pay for a product**. For

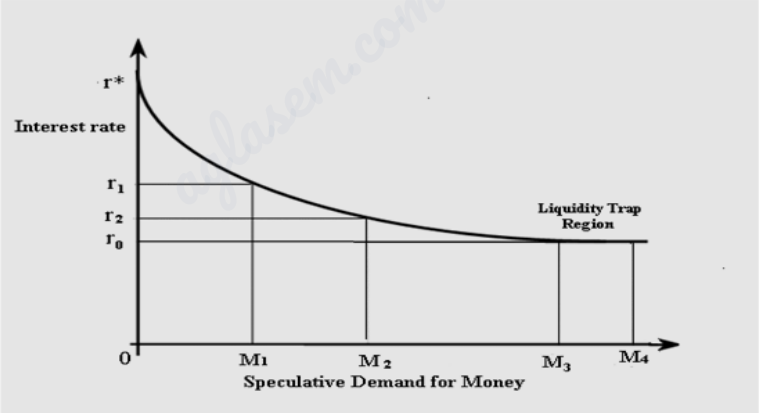
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example, though we experience the benefit, none of us will be willing to pay to view a wayside fountain because we can view it without paying.

Supply-side market failures happen **when supply curves do not incorporate the full cost of producing the product.** For example, a thermal power plant that uses coal may not have to include or pay completely for the costs to the society caused by fumes it discharges into the atmosphere as part of the cost of producing electricity.

(ii) Liquidity trap

At a very high interest rate, say r*, the opportunity cost of holding money (in terms of foregone interest) is high and therefore, people will hold no money in speculative balances. When interest rates fall to very low levels, the expectation is that since the interest rate is very low it cannot go further lower and that in all possibility it will move upwards. In other words, investors would maintain cash savings rather than hold bonds. The speculative demand becomes perfectly elastic with respect to interest rate and the speculative money demand curve becomes parallel to the X axis. This situation is called a 'Liquidity trap'.



Aggregate Speculative Demand for Money

[OR]

The empirical analysis of money supply is important for two reasons:

(1) **It facilitates analysis of monetary developments** in order to provide a deeper understanding of the causes of money growth.

(2) It is essential from a monetary policy perspective as it provides a framework to evaluate whether the stock of money in the economy is consistent with the standards for price stability and to understand the nature of deviations from the standards. The central banks all over the world adopt monetary policy to **stabilize price level** and **GDP growth** by directly controlling the supply of money. This is achieved mainly by managing the quantity of monetary base. **The success of monetary policy depends to a large extent** on the controllability of the monetary base and the money supply.

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