aglasem.com

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)	May 2022

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) *TQ Cycles Ltd. is in the manufacturing of bicycles, a labour intensive manufacturing sector. In April 2022, the Government enhanced the minimum wages payable to workers with retrospective effect from the 1st January,2022. Due to this legislative change, the additional wages for the period from January 2022 to March 2022 amounted to ₹ 30 lakhs. The management asked the Finance manager to charge ₹ 30 lakhs as prior period item while finalizing financial statements for the year 2022-23. Further, the Finance manager is of the view that this amount being abnormal should be disclosed as extra-ordinary item in the Profit and loss account for the financial year 2021-22.*

Discuss with reference to applicable Accounting Standards.

(b) *NAT, a listed entity, as on 1st April,2021 had the following capital structure:*

	₹
10,00,000 Equity Shares having face value of ₹ 1 each	*10,00,000*
10,00,000 8% Preference Shares having face value of ₹ 10 each	*1,00,00,000*

During the year 2021-2022, the company had profit after tax of ₹ 90,00,000

On 1st January,2022, NAT made a bonus issue of one equity share for every 2 equity shares outstanding as at 31st December,2021.

On 1st January,2022, NAT issued 2,00,000 equity shares of ₹ 1 each at their full market price of ₹ 7.60 per share.

NAT's shares were trading at ₹ 8.05 per share on 31st March,2022.

Further it has been provided that the basic earnings per share for the year ended 31st March,2021 was previously reported at ₹ 62.30.

You are required to:

(i) *Calculate the basic earnings per share to be reported in the financial statements of NAT for the year ended 31st March,2022 including the comparative figure, in accordance with AS-20 Earnings Per Share.*

(ii) *Explain why the bonus issue of shares and the shares issue at full market price are treated differently in the calculation of the basic earnings per share?*

© The Institute of Chartered Accountants of India

(c) Alloy Fabrication Limited is engaged in manufacturing of iron and steel rods. The company is in the process of finalisation of the accounts for the year ended 31st March,2022 and needs your advice on the following issues in line with the provisions of AS-29:

(i) On 1stApril,2019, the company installed a huge furnace in their plant. The furnace has a lining that needs to be replaced every five years for technical reasons. At the Balance Sheet date 31st March,2022, the company does not provide any provision for replacement of lining of the furnace.

(ii) A case has been filed against the company in the consumer court and a notice for levy of a penalty of ₹ 50 Lakhs has been received. The company has appointed a lawyer to defend the case for a fee of ₹ 5 Lakhs. 60% of the fees have been paid in advance and rest 40% will be paid after finalization of the case. There are 70% chances that the penalty may not be levied.

(d) Grace Ltd., a firm of contractors provided the following information in respect of a contract for the year ended on 31st March,2022:

Particulars	*(₹ in '000)*
Fixed Price Contract with an escalation clause	*35,000*
Work Certified	*17,500*
Work not Certified (includes ₹ 26,25,000 for materials issued, out of which material lying unused at the end of the period is ₹ 1,40,000)	*3,815*
Estimated further cost to completion	
Progress Payment Received	*17,325*
Payment to be Received	*14,000*
Escalation in cost is by 8% and accordingly the contract price is increased by 8%	*4,900*

From the above information, you are required to:

(i) Compute the contract revenue to be recognized.

(ii) Calculate Profit /Loss for the year ended 31st March,2022 and additional provision for loss to be made, if any, for the year ended 31st March,2022.

(4 Parts X 5 Marks = 20 Marks)

Answer

(a) As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances which though related to prior periods, are determined in the current period.

© The Institute of Chartered Accountants of India

It is given that revision of wages took place in April, 2022 with retrospective effect from 1st January, 2022. Therefore, wages payable for the period from 1.01.2022 to 31.3.2022 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item. The full amount of wages payable to workers will be treated as an expense of current year and it will be charged to profit & loss account for the year 2022-23 as normal expenses.

It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Such an expense does not qualify as an extraordinary item. Therefore, finance manager is incorrect in treating increase as extraordinary item. However, as per AS 5, when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Therefore, additional wages liability of ₹ 30 lakhs should be disclosed separately in the financial statements of TQ Cycles Ltd. for the year ended 31stMarch, 2023.

(b) (i) Calculation of Basic Earnings per share for the year ended 31stMarch, 2022 including the comparative figure:

(a) Earnings for the year ended 31st March, 2021 = EPS x Number of shares outstanding during 2020-2021

= ₹ 62.30 x 10,00,000 equity shares

= ₹ 6,23,00,000

(b) Adjusted Earnings per share after taking into consideration bonus issue

Adjusted Basic EPS = Earnings for the year 2020-2021 / Total outstanding shares +Bonus issue

= ₹ 6,23,00,000 / (10,00,000+ 5,00,000)

= ₹ 6,23,00,000 / 15,00,000

= ₹ 41.53 per share

(c) Basic EPS for the year 2021-2022

Basic EPS = Total Earnings – Preference Shares Dividend) / (Total shares outstanding at the beginning + Bonus issue + weighted average of the shares issued in January, 2022)

= (₹ 90,00,000 – ₹ (1,00,00,000 x 8%) / (10,00,000 + 5,00,000 + (2,00,000 x 3/12))

= ₹ 82,00,000 / 15,50,000 shares

= ₹ 5.29 per share

© The Institute of Chartered Accountants of India

(ii) In case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2021, the earliest period reported.

However, the share issued at full market price does not carry any bonus element and usually results in a proportionate change in the resources available to the enterprise. Therefore, it is taken into consideration from the time it has been issued i.e. the time-weighting factor is considered based on the specific shares outstanding as a proportion of the total number of days in the period.

(c) (i) A provision should be recognized only when an enterprise has a present obligation arising from a past event or obligation. In the given case, there is no present obligation but a future one, therefore no provision is recognized as per AS 29. The cost of replacement of lining of furnace is not recognized as a provision because it is a future obligation. Even a legal requirement does not require the company to make a provision for the cost of replacement because there is no present obligation. Even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

(ii) As per AS 29, an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not. Liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

In the given case, there are 70% chances that the penalty may not be levied. Accordingly, Alloy Fabrication Ltd. should not make the provision for penalty. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

However, a provision should be made for remaining 40% fees of the lawyer amounting ₹ 2,00,000 in the financial statements of financial year 2021-2022.

(d) Calculation of total estimated cost of construction

		₹ in thousand
Cost of Contract incurred till date		
Work certified	17,500	
Work not certified (3,815 thousand – 140 thousand)	3,675	21,175
Add: Estimated future cost		17,325
Total estimated cost of construction		38,500
Contract Price (35,000 thousand x 1.08)		37,800

© The Institute of Chartered Accountants of India

Stage of completion

Percentage of completion till date to total estimated cost of construction = [Cost of work completed till date / total estimated cost of the contract] x 100

= [₹ 21,175 thousand / ₹ 38,500 thousand] x 100= 55%

Revenue to be recognized for the year ended 31st March, 2022

Proportion of total contract value recognized as revenue = Contract price x percentage of completion = ₹ 37,800 thousand x 55% = ₹ 20,790 thousand

Loss to be recognized for the year ended 31st March, 2022

Loss for the year ended 31st March, 2022 = Cost incurred till date – Revenue to be recognized for the year ended 31st March, 2022

= ₹ 21,175 thousand – ₹ 20,790 thousand = ₹ 385 thousand

Provision for loss to be made at the end of 31st March, 2022

		₹ in thousand
Total estimated loss on the contract		
Total estimated cost of the contract	38,500	
Less: Total revised contract price	(37,800)	700
Less: Loss recognized for the year ended 31st March, 2022		(385)
Provision for loss to be made at the end of 31st March, 2022		315

Question 2

The summarized Balance Sheet of A Ltd. and B Ltd. as at 31st March,2022 are as under:

	A Ltd. (in ₹)	*B Ltd. (in ₹)*
Equity shares of ₹10 each, fully paid up	*30,00,000*	*24,00,000*
Securities Premium Account	*4,00,000*	
General Reserve	*6,20,000*	*5,00,000*
Profit and Loss Account	*3,60,000*	*3,20,000*
Retirement Gratuity Fund Account	*1,00,000*	
10% Debentures	*20,00,000*	
Unsecured Loan (including loan from A Ltd.)	*6,00,000*	*8,20,000*
Trade Payables	*1,00,000*	*3,40,000*
	71,80,000	*43,80,000*
Land and Buildings	*28,00,000*	*21,00,000*
Plant and Machinery	*20,00,000*	*7,60,000*

© The Institute of Chartered Accountants of India

Long term advance to B Ltd.	*2,20,000*	
Inventories	*10,40,000*	*7,00,000*
Trade Receivables	*8,20,000*	*5,20,000*
Cash and Bank	*3,00,000*	*3,00,000*
	71,80,000	*43,80,000*

B Ltd. is to declare and pay ₹1 per equity share as dividend, before the following amalgamation takes place with Z Ltd.

Z Ltd. was incorporated to take over the business of both A Ltd. and B Ltd.

(a) *The authorized share capital of Z Ltd. is ₹60 lakhs divided into ₹6 lakhs equity shares of ₹10 each.*

(b) *As per Registered Valuer the value of equity shares of A Ltd. is ₹18 per share and of B Ltd. is ₹ 12 per share respectively and agreed by respective shareholders of the companies.*

(c) *10% Debentures of A Ltd. to be issued 12% Debentures of Z Ltd. at par in consideration of their holdings.*

(d) *A contingent liability of A Ltd. of ₹2,00,000 is to be treated as actual liability.*

(e) *Liquidation expenses including Registered Valuer fees of A Ltd.₹ 50,000 and B Ltd. ₹30,000 respectively to be borne by Z Ltd.*

(f) *The shareholders of A Ltd. and B Ltd. is to be paid by issuing sufficient number of fully paid up equity shares of ₹10 each at a premium of ₹10 per share.*

Assuming amalgamation in the nature of purchase, you are required to pass the necessary journal entries (narrations not required) in the books of Z Ltd. and Prepare Balance Sheet of Z Ltd. immediately after amalgamation of both the companies. ***(20 Marks)***

Answer

Journal Entries in the books of Z Ltd.

		₹	₹
Business Purchase A/c	Dr.	54,00,000	
To Liquidator of A Ltd. A/c			54,00,000
Land & Building A/c	Dr.	28,00,000	
Plant & Machinery A/c	Dr.	20,00,000	
Long term advance to B Ltd. A/c	Dr.	2,20,000	
Inventories A/c	Dr.	10,40,000	
Trade Receivables A/c	Dr.	8,20,000	

© The Institute of Chartered Accountants of India

Cash and Bank A/c	Dr.	3,00,000	
Goodwill A/c	Dr.	12,20,000	
To Retirement Gratuity Fund A/c			1,00,000
To 10% Debentures A/c			20,00,000
To Unsecured Loan A/c			6,00,000
To Trade Payables A/c			1,00,000
To Other liabilities A/c			2,00,000
To Business Purchase A/c			54,00,000
10% Debentures A/c	Dr.	20,00,000	
To 12% Debentures A/c			20,00,000
Liquidator of A Ltd. A/c	Dr.	54,00,000	
To Equity Share Capital A/c			27,00,000
To Securities Premium A/c			27,00,000
Business Purchase A/c	Dr.	28,80,000	
To Liquidator of B Ltd. A/c			28,80,000
Land and Building A/c	Dr.	21,00,000	
Plant & Machinery A/c	Dr.	7,60,000	
Inventories A/c	Dr.	7,00,000	
Trade Receivables A/c	Dr.	5,20,000	
Cash and Bank (less dividend) A/c	Dr.	60,000	
To Unsecured Loan A/c			8,20,000
To Trade Payables A/c			3,40,000
To Business Purchase A/c			28,80,000
To Capital Reserve A/c			1,00,000
Liquidators of B Ltd. A/c	Dr.	28,80,000	
To Equity Share Capital A/c			14,40,000
To Securities Premium A/c			14,40,000
Unsecured Loans A/c	Dr.	2,20,000	
To Long term Advance to B Ltd. A/c			2,20,000
*Capital Reserve A/c	Dr.	1,00,000	
To Cash and Bank A/c (Liquidation expenses)			80,000
To Goodwill A/c			20,000

© The Institute of Chartered Accountants of India

Note:

1. The journal entries for A Ltd. and B Ltd. have been given separately in the above solution. Alternatively, the entries may be given as combined for both companies.

2. *Alternatively, following set of entries may be given in place of the last entry given in the above solution:

Goodwill A/c	Dr.	50,000	
To Cash & Bank A/c (Liquidation expenses of A Ltd.)			50,000
Capital Reserve A/c	Dr.	30,000	
To Cash and Bank A/c (Liquidation expenses of B Ltd.)			30,000
Capital Reserve A/c	Dr.	70,000	
To Goodwill A/c			70,000

Balance Sheet of Z Ltd. as at 31st March, 2022

Particulars	Note No.	(₹)
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	41,40,000
(b) Reserves and Surplus	2	41,40,000
(2) **Non-Current Liabilities**		
(a) Long-term borrowings	3	20,00,000
(b) Long term provisions	4	1,00,000
(3) **Current Liabilities**		
(a) Short-term borrowings[1]	5	12,00,000
(b) Trade payables	6	4,40,000
(a) Other liability		2,00,000
Total		1,22,20,000
II. **Assets**		
(1) **Non-current assets**		
(a) i. Property, plant and equipment	7	76,60,000

[1] *Unsecured loans have been considered as short-term borrowings. Alternatively, it may be considered as long-term borrowings and presented accordingly.*

© The Institute of Chartered Accountants of India

ii. Intangible assets (Goodwill 12,20,000-20,000)		12,00,000
(2) **Current assets**		
(a) Inventories	8	17,40,000
(b) Trade receivables	9	13,40,000
(c) Cash and cash equivalents	10	2,80,000
Total		1,22,20,000

Notes to Accounts

			(₹)	(₹)
1.	Share Capital			
	Authorized Share Capital			
	6,00,000 Equity shares of ₹ 10 each			60,00,000
	Issued: 4,14,000 Equity shares of ₹ 10 each			41,40,000
	(all these shares were Issued for consideration other than cash)			
2.	Reserves and surplus			
	Securities Premium Account			
	(4,14,000 shares × ₹ 10)			41,40,000
3.	Long-term borrowings			
	12% Debentures			20,00,000
4	Long term Provisions			
	Retirement gratuity fund			1,00,000
5.	Short-term borrowings			
	Unsecured loans			
	A Ltd.	6,00,000		
	B Ltd.	8,20,000	14,20,000	
	Less: Mutual		(2,20,000)	12,00,000
6.	Trade payables			
	A Ltd.		1,00,000	
	B Ltd.		3,40,000	4,40,000

© The Institute of Chartered Accountants of India

7.	Property, plant & equipment		
	Land and Building		
	A Ltd.	28,00,000	
	B Ltd.	21,00,000	49,00,000
	Plant and Machinery		
	A Ltd.	20,00,000	
	B Ltd.	7,60,000	27,60,000
			76,60,000
8.	Inventories		
	A Ltd.	10,40,000	
	B Ltd.	7,00,000	17,40,000
9	Trade receivables		
	A Ltd.	8,20,000	
	B Ltd.	5,20,000	13,40,000
10	Cash & cash equivalents		
	A Ltd.	3,00,000	
	B Ltd. [3,00,000-2,40,000(dividend)]	60,000	
		3,60,000	
	Less: Liquidation Expenses	(80,000)	2,80,000

Working Note:

Calculation of amount of Purchase Consideration

	A Ltd.	B Ltd.
Existing shares	3,00,000	2,40,000
Agreed value per share	₹ 18	₹ 12
Purchase consideration	54,00,000	28,80,000
No. of shares to be issued of ₹ 20 each (including ₹ 10 premium)	2,70,000	1,44,000
Face value of shares at ₹ 10	27,00,000	14,40,000
Premium of shares at ₹ 10	27,00,000	14,40,000

© The Institute of Chartered Accountants of India

Question 3

(a) *White Ltd. acquired 2,250 shares of Black Ltd. on 1st October, 2020. The summarized balance sheets of both the companies as on 31st March, 2021 are given below:*

	White Ltd. (₹)	Black Ltd. (₹)
(I) Equity and Liabilities		
(1) Shareholder's fund		
Share capital (Equity shares of ₹ 100 each fully paid up)	6,50,000	3,00,000
Reserves and Surplus		
General Reserve	60,000	30,000
Profit and loss account	1,50,000	90,000
(2) Current Liabilities		
Trade payables	1,15,000	75,000
Due to White Ltd.	-	30,000
Total	9,75,000	5,25,000
(II) Assets:		
Non-current assets		
Property, Plant and Equipment	5,80,000	3,51,000
Investments		
Shares in Black Ltd. (2,250 shares)	2,70,000	
Current assets		
Inventories	50,000	1,20,000
Due from Black Ltd.	36,000	
Cash and Cash equivalents	39,000	54,000
Total	9,75,000	5,25,000

Other information:

(i) During the year, Black Limited fabricated a machine, which is sold to White Ltd. for ₹ 39,000, the transaction being completed on 30th March,2021.

(ii) Cash in transit from Black Ltd. to White Ltd. was ₹ 6,000 on 31st March,2021.

(iii) Profits during the year 2020-2021 were earned evenly.

© The Institute of Chartered Accountants of India

(iv) *The balances of Reserve and Profit and Loss account as on 1st April,2020 were as follows:*

	Reserves	*Profit and Loss A/c*
	₹	*₹*
White Ltd.	*30,000*	*15,000 Profit*
Black Ltd.	*30,000*	*10,000 Loss*

You are required to prepare consolidated Balance Sheet of the group as on 31st March,2021 as per the requirement of Schedule III of the Companies Act, 2013.

(b) (i) *Write a short note on Non-performing assets of a banking company.*

(ii) *Dee Bank provides you the following information relating to their two cash credit accounts:*

	Account A ₹ In Lakhs	*Account B ₹ In Lakhs*
Sanctioned limit	*4,500*	*3,200*
Drawing power	*4,200*	*2,500*
Amount outstanding continuously from 01.01.2021 to 31.03.2021	*3,600*	*2,000*
Total Interest debited for the above period	*288*	*315*
Total credits for the above period	*120*	*380*

State with reason whether the above cash credit accounts are NPA or not?

(15 + 5 = 20 Marks)

Answer

(a) Consolidated Balance Sheet of White Ltd. and its Subsidiary Black Ltd. as at 31st March, 2021

Particulars	**Note No.**	**(₹)**
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	6,50,000
(b) Reserves and Surplus	2	2,55,000
(2) Minority Interest	3	1,05,000
(3) Current Liabilities		
(a) Trade Payables	4	1,90,000
Total		12,00,000

© The Institute of Chartered Accountants of India

II.	**Assets**		
	(1) Non-current assets		
	(a) Property, Plant and Equipment	5	9,31,000
	(2) Current assets		
	(i) Inventory	6	1,70,000
	(ii) Cash & cash equivalent	7	99,000
	Total		12,00,000

Notes to Accounts

			₹
1.	**Share capital**		
	6,500 equity shares of ₹ 100 each, fully paid up		6,50,000
	Total		6,50,000
2.	**Reserves and Surplus**		
	General Reserves		60,000
	Profit and Loss Account	1,50,000	
	Add: 75% share of Black Ltd.'s post-acquisition profits (W.N.1)	37,500	1,87,500
	Capital reserve (W.N. 5)		7,500
	Total		2,55,000
3.	**Minority interest in Black Ltd. (WN 4)**		1,05,000
4.	**Trade payables**		
	White Ltd.	1,15,000	
	Black Ltd.	75,000	1,90,000
5.	**Property, plant and equipment**		
	White Ltd.	5,80,000	
	Black Ltd.	3,51,000	9,31,000
6	**Inventory**		
	White Ltd.	50,000	
	Black Ltd.	1,20,000	1,70,000
7	**Cash & cash equivalent**		
	White Ltd.	39,000	
	Black Ltd.	54,000	
	Cash in transit	6,000	99,000

© The Institute of Chartered Accountants of India

Working Notes:

1.	**Post-acquisition profits of Black Ltd.**		₹
	profits earned during the year = ₹ 90,000 + ₹10,000		1,00,000
	Pre-acquisition profits (1.4.20 to 30.9.20)		50,000
	Post-acquisition profits (1.10.20 to 31.3.21)		50,000
	White Ltd.'s share 75% of 50,000		37,500
	Minority Interest 25% of 50,000		12,500
2.	**Pre-acquisition profits and reserves of Black Ltd.**		
	Reserves as on 1.4.2020		30,000
	Profit and Loss Account		40,000
	[10,000 (loss as on 1.4.20) +50,000 (6 month Adjusted pre-acquisition profits)]		
			70,000
	White Ltd.'s = (75%) × 70,000		52,500
	Minority Interest= (25%) × 70,000		17,500
3.	**Post-acquisition reserves of Black Ltd.**		
	Post-acquisition reserves (Total reserves less pre-acquisition reserves = ₹ 30,000 – 30,000)		nil
4.	**Minority Interest**		
	Paid-up value of (3,000 – 2,250) = 750 shares		
	held by outsiders i.e. 750 × ₹ 100		75,000
	Add: 25% share of pre-acquisition reserves & Profit		17,500
	25% share of post-acquisition profit		12,500
			1,05,000
5.	**Capital Reserve**		
Price paid by White Ltd. for 2,250 shares (A)			2,70,000
Intrinsic value of the shares-			
Paid-up value of 2,250 shares held by White Ltd. i.e. 2,250 × ₹ 100		2,25,000	
Add 75% share of pre-acquisition reserves & profit (70,000 x 75%)		52,500 (B)	2,77,500
Capital reserve (A – B)			7,500

© The Institute of Chartered Accountants of India

(b) (i) Performing assets are also called as Standard Assets. A non-performing asset is a loan or advance for which the principal or interest payment remains overdue for a period of 90 days. The assets other than performing assets are called Non-Performing Assets (NPA). NPAs are classified into three groups: (i) sub-standard Assets (ii) doubtful assets & (iii) Loss Assets.

(i) **Sub-standard Assets** –A Sub-standard asset is one which has been classified as an NPA for a period not exceeding 12 months.

(ii) **Doubtful Assets** - An asset would be classified as doubtful if it has remained in the substandard category for a period of at least12 months.

(iii) **Loss Assets** - A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspectors but the amount has not been written off, wholly or partly. In other words, such an asset is considered uncollectible or if collected of such little value that its continuance as a bank asset is not warranted although there may be some salvage or recovery value.

Income from non-performing assets can only be accounted for as and when it is actually received.

(ii)

	Account A ₹ in lakhs	**Account B ₹ in lakhs**
Sanctioned limit	4,500	3,200
Drawing power	4,200	2,500
Amount outstanding continuously from 1.01.2021 to 31.03.2021	3,600	2,000
Total interest debited	288	315
Total credits	120	380
Is credit in the account is sufficient to cover the interest debited during the period? or	No	Yes
Is amount 'overdue' for a continuous period of 90 days?	Yes	No
	NPA	Not NPA

Question 4

(a) Ajay, Vijay and Sanjay have been in partnership for a number of years, sharing profits and losses in the ratio 7:7: 4 as a wholesale stationers running business under the name "AVS Traders". On 31st March,2021, it was found that some frauds were committed by Sanjay during the year 2020-2021. So, it was decided to dissolve the partnership business on 31st March,2021 when their Balance sheet stood as under:

© The Institute of Chartered Accountants of India

Balance Sheet as at 31st March,2021

Liabilities	*Amount (₹)*	*Assets*	*Amount (₹)*
Capital accounts:		*Building*	*1,90,000*
Ajay 1,80,000		*Inventory*	*1,30,000*
Vijay 1,80,000	*3,60,000*	*Investments*	*50,000*
General Reserve	*36,000*	*Trade Debtors*	*70,000*
Trade Creditors	*80,000*	*Cash & Bank*	*26,000*
Bills payables	*30,000*	*Sanjay's Capital (overdrawn)*	*40,000*
	5,06,000		*5,06,000*

Additional Information:

(i) Following frauds were committed by Sanjay:

(1) Investments costing ₹ 8,000 were sold by Sanjay at ₹ 11,000 and the funds were transferred to his personal account. This sale was omitted from firm's books.

(2) A cheque for ₹ 7,000 received from trade debtors was not recorded in the books and was misappropriated by Sanjay.

(ii) A trade creditor agreed to take over investments of the book value of ₹ 9,000 at ₹ 13,000. The rest of the trade creditors were paid off at a discount of 10%.

(iii) Other assets were realized as follows:

Inventory	*₹ 1,20,000*
Building	*110% of book value*
Investments	*The rest of the investments were sold at a profit of ₹ 7,000*
Trade Debtors	*The rest of the trade debtors were realised at a discount of 10%*

(iv) The Bills payables were settled at a discount of, ₹ 500.

(v) The expenses of dissolution amounted to ₹ 8,060.

(vi) It was found out, that realisation from Sanjay's private assets would be ₹ 7,000.

You are required to prepare

(1) Realisation Account

2) Cash & Bank Account

(3) Partners' Capital Accounts.

(All workings should form part of your answer)

© The Institute of Chartered Accountants of India

(b) Explain the nature of a Limited Liability Partnership. Who can be a designated partner in a Limited Liability Partnership and what are their liabilities? ***(15 + 5 = 20 Marks)***

Answer

(a) **Realization Account**

Particulars	₹	Particulars		₹
To Building	1,90,000	By Trade creditors		80,000
To Inventory	1,30,000	By Bills payable		30,000
To Investment	50,000	By Cash		
To Trade Debtors	70,000	Building	2,09,000	
To Cash - Trade creditors paid (W.N.1)	60,300	Inventory	1,20,000	
To Cash-expenses	8,060	Investments (W.N.2)	40,000	
To Cash-bills payable (30,000-500)	29,500	Trade Debtors (W.N. 3)	56,700	4,25,700
To Partners' Capital A/cs		By Sanjay's Capital A/c (Trade Debtors-unrecorded)		7,000
Ajay 6,160		By Sanjay's Capital A/c (Investments-unrecorded)		11,000
Vijay 6,160				
Sanjay 3,520	15,840			
	5,53,700			5,53,700

Cash and Bank Account

Particulars		Amount ₹	Particulars	Amount ₹
To Balance b/d		26,000	By Realization A/c- Trade creditors paid	60,300
To Realization A/c– (Assets realized)			By Realization A/c-bills payable	29,500
Building	2,09,000		By Realization A/c-expenses	8,060
Inventory	1,20,000		By Capital accounts:	
Investments (W.N.2)	40,000		Ajay	1,80,420

© The Institute of Chartered Accountants of India

Trade Debtors (W.N. 3)	56,700	4,25,700	Vijay	1,80,420
To Sanjay's capital A/c		7,000		
		4,58,700		4,58,700

Partners' Capital Accounts

Particulars	Ajay	Vijay	Sanjay	Particulars	Ajay	Vijay	Sanjay
	₹	₹	₹		₹	₹	₹
To Balance b/d			40,000	By Balance b/d	1,80,000	1,80,000	-
To Trade Debtors-misappropriation			7,000	By General reserve	14,000	14,000	8,000
To Investment-misappropriation			11,000	By Realization profit	6,160	6,160	3,520
To Sanjay's capital A/c (W.N. 4)	19,740	19,740		By Cash A/c			7,000
To Cash A/c	1,80,420	1,80,420		By Ajay's capital A/c			19,740
				By Vijay's capital A/c			19,740
	2,00,160	2,00,160	58,000		2,00,160	2,00,160	58,000

Working Notes:

1. Amount paid to Trade creditors

	₹
Book value	80,000
Less: Creditors taking over investments	(13,000)
	67,000
Less: Discount @ 10%	(6,700)
	60,300

2. Amount received from sale of investments

	₹
Book value	50,000

© The Institute of Chartered Accountants of India

Less: Misappropriated by Sanjay	(8,000)
	42,000
Less: Taken over by a trade creditor	(9,000)
	33,000
Add: Profit on sale of investments	7,000
	40,000

3. Amount received from Trade debtors

	₹
Book value	70,000
Less: Unrecorded receipt	(7,000)
	63,000
Less: Discount @ 10%	(6,300)
	56,700

4. Deficiency of Sanjay

	₹
Balance of capital as on 31st March, 2021	40,000
Debtors-misappropriation	7,000
Investment-misappropriation	11,000
	58,000
Less: Realization Profit	(3,520)
General reserve	(8,000)
Contribution from private assets	(7,000)
Net deficiency of capital	39,480

This deficiency of ₹ 39,480 in Sanjay's capital account will be shared by other partners Ajay and Vijay in their capital ratio of 1:1

Accordingly,

Ajay's share of deficiency = [39,480/2] = ₹ 19,740

Vijay's share of deficiency = [39,480/2] = ₹ 19,740

(b) Nature of Limited Liability Partnership: A limited liability partnership is a body corporate formed and incorporated under the LLP Act, 2008 and is a legal entity separate from that of its partners. A limited liability partnership shall have perpetual succession and any

© The Institute of Chartered Accountants of India

change in the partners of a limited liability partnership shall not affect the existence, rights, or liabilities of the limited liability partnership.

Designated partners: Every limited liability partnership shall have at least two designated partners who are individuals and at least one of them shall be a resident in India. In case of a limited liability partnership in which all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such limited liability partnership or nominees of such bodies corporate shall act as designated partners.

Liabilities of Designated partners: As per the LLP Act, unless expressly provided otherwise in this Act, a designated partner should be-

(a) responsible for the doing of all acts, matters, and things as are required to be done by the limited liability partnership in respect of compliance of the provisions of this Act including filing of any document, return, statement, and the like report pursuant to the provisions of this Act and as may be specified in the limited liability partnership agreement; and.

(b) Liable to all penalties imposed on the limited liability partnership for any contravention of those provisions.

Question 5

(a) Quick Ltd. has the following capital structure as on 31st March,2021:

			₹ in Crores
(1)	***Share Capital:***		*462*
	(Equity Shares of ₹ 10 each, fully paid)		
(2)	***Reserves and Surplus:***		
	General Reserve	*336*	
	Securities Premium Account	*126*	
	Profit and Loss Account	*126*	
	Statutory Reserve	*180*	
	Capital Redemption Reserve	*87*	
	Plant Revaluation Reserve	*33*	*888*
(3)	***Loan Funds:***		
	Secured	*2,200*	
	Unsecured	*320*	*2,520*

On the recommendations of the Board of Directors, on 16th September, 2021, the shareholders of the company have approved a proposal to buy-back of equity shares. The prevailing market value of the company's share is ₹ 20 per share and in order to induce the existing shareholders to offer their shares for buy-back, it was decided to offer a price

© The Institute of Chartered Accountants of India

of 50% over market value. The company had sufficient balance in its bank account for the buy-back of shares.

You are required to compute the maximum number of shares that can be bought back in the light of the above information and also under a situation where the loan funds of the company were either ₹ 1,680 Crores or ₹ 2,100 Crores.

Assuming that the entire buy-back is completed by 31st December,2021, Pass the necessary accounting entries (narrations not required) in the books of the company in each situation.

(b) *Deluxe Commercial Bank has the following capital funds and assets:*

	₹ In Crores
Capital Funds and Assets	
Capital Funds:	
Paid up Equity Share Capital	2,400
Statutory Reserves	480
Securities Premium	480
Capital Reserve (of Which ₹ 128 Crores were due to revaluation of assets and balance due to sale of assets)	288
Profit and Loss Account (Dr. Balance)	48
Assets:	
(i) Cash balance with Reserve Bank of India	192
(ii) Claims on Banks	544
(iii) Other Investments	7,360
Loans and Advances:	
(i) Guaranteed by Government of India and State Governments	1,280
(ii) Bank Staff Advances - fully covered by superannuation benefit	160
Other loans and advances	544
Other Assets:	
(i) Premises, Furniture & Fixtures	12,560
(ii) Intangible Assets	48
Off-Balance Sheet Items:	
Acceptance, Endorsements and Letters of Credit	4,800
Guarantee and other obligations	160

You are required to:

(i) *Segregate the capital funds into Tier I and Tier II capitals, and*

© The Institute of Chartered Accountants of India

(ii) Find out the risk-adjusted asset and risk weighted assets ratio. ***(10 +10 = 20 Marks)***

Answer

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

Number of shares

Particulars	***When loan fund is***		
	₹ 2,520 crores	*₹ 1,680 crores*	*₹ 2,100 crores*
Shares Outstanding Test (W.N.1)	11.55	11.55	11.55
Resources Test (W.N.2)	8.75	8.75	8.75
Debt Equity Ratio Test (W.N.3)	Nil	5.25	Nil
Maximum number of shares that can be bought back [least of the above]	Nil	5.25	Nil

Journal Entries for the Buy-Back
(applicable only when loan fund is ₹ 1,680 crores)

₹ in crores

	Particulars		*Debit*	*Credit*
(a)	Equity share buy-back account	Dr.	157.5	
	To Bank account			157.5
(b)	Equity share capital account (5.25 x ₹ 10)	Dr.	52.5	
	Securities premium account (5.25 x ₹ 20)	Dr.	105	
	To Equity share buy-back account			157.5
(c)	General reserve account	Dr.	52.5	
	To Capital redemption reserve account			52.5

Working Notes:

1. Shares Outstanding Test

Particulars	*(Shares in crores)*
Number of shares outstanding	46.2
25% of the shares outstanding	11.55

2. Resources Test

Particulars	
Paid up capital (₹ in crores)	462

© The Institute of Chartered Accountants of India

Free reserves (₹ in crores) (336+126+126)	588
Shareholders' funds (₹ in crores)	1,050
25% of Shareholders fund (₹ in crores)	₹ 262.5 crores
Buy-back price per share	₹ 30
Number of shares that can be bought back (shares in crores)	8.75 crores shares

3. Debt Equity Ratio Test

	Particulars	*When loan fund is*		
		₹ 2,520 crores	*₹ 1,680 crores*	*₹ 2,100 crores*
(a)	Loan funds (₹ in crores)	2,520	1,680	2,100
(b)	Minimum equity to be maintained after buy-back in the ratio of 2:1 (₹ in crores)	1,260	840	1,050
(c)	Present equity shareholders fund (₹ in crores)	1,050	1,050	1,050
(d)	Future equity shareholder fund (₹ in crores) (See Note 2)	N.A.	997.5 (1,050-52.5)	N.A.
(e)	Maximum permitted buy-back of Equity (₹ in crores) [(d) – (b)] (See Note 2)	Nil	157.5 (by simultaneous equation)	Nil
(f)	Maximum number of shares that can be bought back @ ₹ 30 per share (shares in crores) (See Note 2)	Nil	5.25 (by simultaneous equation)	Nil

Note:

1. Under Situations 1 & 3 the company does not qualify for buy-back of shares as per the provisions of the Companies Act, 2013.
2. As per section 68 of the Companies Act, 2013, the ratio of debt owed by the company should not be more than twice the capital and its free reserve after such buy-back.

© The Institute of Chartered Accountants of India

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

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

Then

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

$(1,050 - x) - 840 = y$

Since $210 - x = y$

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

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

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

Or $3x = y$ (2)

by solving the above two equations we get

$x = ₹ 52.5$ crores

$y = ₹ 157.5$ crores

3. Statutory reserves, capital redemption reserve and plant revaluation reserves are not free reserves.
4. For calculation of debt -equity ratio both secured and unsecured loans have been considered.

(b)

			(₹ in crores)
(i)	**Capital Funds - Tier I:**		
	Paid up Equity Share Capital		2,400.00
	Securities premium		480.00
	Statutory Reserve		480.00
	Capital Reserve (arising out of sale of assets)		160.00
			3,520.00
	Less: Intangible assets	48.00	
	Profit and Loss Account (Dr. balance)	48.00	(96.00)
	Total		3,424.00

© The Institute of Chartered Accountants of India

Capital Funds - Tier II:		
Capital Reserve (arising out of revaluation of assets)	128.00	
Less: Discount to the extent of 55%	(70.40)	57.60
Total Capital Funds		3,481.60

(ii) Calculation of Risk Adjusted Assets

	₹ *in* crore	Weight in %	Amount (₹ in crore)
Funded Risk Assets			
Cash Balance with RBI	192	0	0
Claims on banks	544	20	108.80
Other Investments	7,360	100	7,360
Loans and Advances:			
(i) Guaranteed by government	1,280	0	0
(ii) Staff advances fully covered by superannuation benefits	160	20	32
(iii) Other Loans	544	100	544
Premises, furniture and fixtures	12,560	100	12,560
			20,604.80

Off-Balance Sheet Items	₹ *in crores*	*Credit Conversion Factor*	₹ *in crore*
Acceptances, Endorsements and Letters of credit	4,800	100	4,800
Guarantees and other obligations	160	100	160
			4,960

Risk Weighted Assets Ratio: $\frac{\text{Capital Funds (Tier I \& Tier II)}}{\text{Risk Adjusted Assets+off Balance sheet items}} \times 100$

Capital Adequacy Ratio = 3424 + 57.60/ 20,604.80 + 4,960

= (3481.60/25,564.80) x 100

= 13.62% (rounded off)

© The Institute of Chartered Accountants of India

Question 6

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

(a) *XYZ Ltd. has 5 business segments. Profit / Loss of each of the segments for the year ended 31st March,2022 has been provided below. You are required to identify from the following whether reportable segments or not reportable segments, on the basis of "profitability test" as per AS-17.*

Segment	*Profit (Loss) ₹ in lakhs*
A	*225*
B	*25*
C	*(175)*
D	*(20)*
E	*(105)*

(b) *In a limited company, Equity Share Capital is held by X, Y and Z in the proportion of 30:30:40. Also A, B and C hold preference share capital in the proportion of 50:30:20. The company has not paid the dividend to holders of preference share capital for more than 3 years. Given that the paid-up equity share capital of the company is ₹ 1 Crore and that of preference share capital is ₹ 50 Lakh.*

(i) *Find out the relative weight in the voting right of equity shareholders and preference shareholders.*

(ii) *Also the company proposing to issue equity shares with differential voting rights (DVR) to the extent of ₹ 50 lakhs. Assuming the company fulfils other conditions pertaining to the issue of shares with DVR. Can the company issue the shares with DVR?*

(c) *What are the disclosures requirements for operating leases by the lessee as per AS-19?*

(d) *The position of Bad Luck Limited on its liquidation on 31st March, 2022 is as under:*

Issued and paid up capital:

90,000, 10% Preference Shares of ₹ 100 each, fully paid

90,000 Equity Shares of ₹ 100 each, fully paid up

30,000 Equity Shares of ₹ 50 each, 40 paid up

10,000 Equity Shares of ₹ 10 each, 4 paid up

Calls in arrears are ₹ 3,00,000 and calls received in advance ₹ 2,55,000. Preference dividends are in arrears for two years. Amount left with the liquidator after discharging of all liabilities is ₹ 1,25,15,000. Articles of Association of the company provide for payment of preference dividend arrears in priority to return of equity capital.

© The Institute of Chartered Accountants of India

You are required to prepare the Liquidator's Final Statement of Account.

(e) *On 1st April,2021, a company offered 100 shares to each of its 5,000 employees at ₹ 50 per share. The employees are given a year to accept the offer. The shares issued under the plan shall be subject to lock-in on transfer for three years from the grant date. The market price of shares of the company on the grant date is ₹ 60 per share. Due to post vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at ₹ 56 per share and fair value per option worked out to be ₹ 6.*

On 31st March,2022, 4,000 employees accepted the offer and paid ₹ 50 per share purchased. Nominal value of each share is ₹ 10.

You are required to pass journal entries (with narration) as would appear in the books of the company up to 31st March,2022. ***(4 Parts x 5 Marks = 20 Marks)***

Answer

(a) As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

Its segment results whether profit or loss is 10% or more of:

- The combined result of all segments in profit; i.e. ₹ 250 Lakhs or
- The combined result of all segments in loss; i.e. ₹ 300 Lakhs

Whichever is greater in absolute amount i.e. ₹ 300 Lakhs.

Operating Segment	Absolute amount of Profit or Loss (₹ In lakhs)	Reportable Segment Yes or No
A	225	Yes
B	25	No
C	175	Yes
D	20	No
E	105	Yes

On the basis of the profitability test (result criteria), segments A, C and E are reportable segments (since their results in absolute amount is 10% or more of ₹ 300 lakhs i.e. 30 lakhs).

(b) **(i)** The respective voting right of various shareholders will be

X = 2/3X30/100 = 3/15 OR 20%

Y = 2/3X30/100 = 3/15 OR 20%

Z = 2/3X40/100 = 4/15 OR 26.67%

A = 1/3X50/100 = 1/6 OR 16.67%

© The Institute of Chartered Accountants of India

B = 1/3X30/100 = 1/10 OR 10%

C = 1/3X20/100 = 2/30 OR 6.67%

Hence their relative weights are 3/15: 3/15: 4/15: 1/6: 1/10:2/30 or 6:6:8:5:3:2.

(ii) The voting power in respect of shares with differential rights shall not exceed *seventy four percent* of the total voting power including voting power in respect of equity shares with differential rights (DVR) issued at any point of time as per Companies (Share Capital and Debentures) Rules.

	₹
Existing Equity Share Capital paid up	1,00,00,000.00
Proposed DVR	50,00,000.00
Post DVR Equity Share Capital paid up	1,50,00,000.00
% of shares with DVR to total paid up Equity Share Capital (including Equity Shares with DVR) (₹ 50,00,000 / ₹ 150,00,000 X 100)	33.33%

In the given case 33.33% of shares with DVR to total post issue paid up Equity Capital (including Equity Shares with DVR) is not exceeding 74%. Hence, the company can issue such equity shares.

(c) As per AS 19, lessees are required to make following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancelable operating leases for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years;

(b) the total of future minimum sublease payments expected to be received under non-cancelable subleases at the balance sheet date;

(c) lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

(d) sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;

(e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payments are determined;

(ii) the existence and terms of renewal or purchase options and escalation clauses; and

© The Institute of Chartered Accountants of India

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Note: The Level II and Level III non-corporate entities (and SMCs) need not make disclosures required by (a), (b) and (e) above.

(d) Liquidator's Final Statement of Account

Receipts	₹	Payments	₹
Cash with liquidator	125,15,000	Return to contributors:	
Realization from:		Arrears of Preference dividend	18,00,000
Calls in arrears	3,00,000	Preference shareholders	90,00,000
Final call of ₹ 4 per equity		Calls in advance	2,55,000
share on 10,000 shares		Equity shareholders	
(₹ 4 × 10,000) See WN	40,000	(90,000 × ₹ 20)	18,00,000
	128,55,000		128,55,000

Working Notes:

(i) **Calculation of amount available with liquidator after paying pref. shareholders**

		₹
Cash account balance		125,15,000
Less: Payment for dividend	18,00,000	
Preference shareholders	90,00,000	
Calls in advance	2,55,000	(110,55,000)
		14,60,000
Add: Calls in arrears		3,00,000
		17,60,000

(ii) Paid up Share capital = 90,00,000 + 12,00,000 + 40,000 = ₹ 1,02,40,000

(iii) Deficiency for equity shareholders:

₹ 1,02,40,000 - ₹ 17,60,000 = ₹ 84,80,000

(iv) Nominal Value of Share Capital

= ₹ 90,00,000 + 15,00,000+1,00,000 = 1,06,00,000

(v) % of deficiency to be borne by each equity shareholder:

= (₹ 84,80,000 / ₹ 1,06,00,000) x 100 = 80%

© The Institute of Chartered Accountants of India

(vi) Amount refunded/recovered from equity shareholders:

	90,000 shares of ₹ 100 each	30,000 shares of ₹ 50 each	10,000 shares of ₹ 10 each
Paid up per share	₹ 100	₹ 40	₹ 4
Deficiency to bear per share (80% of nominal value)	₹ 80	₹ 40	₹ 8
	To refund ₹ 20 per share	NIL	To recover ₹ 4 per share

Note: Alternative presentation of the above working notes may be provided in the answer.

(e) Fair value of an option = ₹ 56 – ₹ 50 = ₹ 6

Number of shares issued = 4,000 employees x 100 shares = 4,00,000 shares

Fair value of ESOP = 4,00,000 shares x ₹ 6 = ₹ 24,00,000

Vesting period = 1 year

Expenses recognized in 2021 – 22 = ₹ 24,00,000

Date	Particulars		₹	₹
31.03.2022	Bank (4,00,000 shares x ₹ 50)	Dr.	200,00,000	
	Employees stock compensation expense A/c	Dr.	24,00,000	
	To Share Capital (4,00,000 shares x ₹ 10)			40,00,000
	To Securities Premium (4,00,000 shares x ₹ 46)			184,00,000
	(Being option accepted by 4,000 employees & payment made @ ₹ 56 share)			
	Profit & Loss A/c	Dr.	24,00,000	
	To Employees stock compensation expense A/c			24,00,000
	(Being Employees stock compensation expense transferred to Profit & Loss A/c)			

© The Institute of Chartered Accountants of India

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) Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are detected by obtaining sufficient appropriate audit evidence.

(b) Audit findings and control deficiencies can be evaluated or assessed arbitrarily.

(c) Inappropriate management can override internal controls of any organization.

(d) Once the audit plan has been drafted and communicated, it is obligatory on the auditor to follow the same.

(e) According to CARO 2020, the company auditor is required to state that whether the title deeds of all immovable properties held in the name of the company are disclosed in its financial statements.

(f) SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit, that assist the auditor in preparation of the financial statements.

(g) Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged with proper authorization.

(h) Materiality is not a matter of size. ***(2 x 7 = 14 Marks)***

Answer

(a) Incorrect: Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

(b) Incorrect: Evaluation and assessment of audit findings and control deficiencies involves applying professional judgement that include considerations for quantitative and qualitative measures. Each finding should be looked at individually and in the aggregate by combining with other findings/deficiencies.

(c) Correct: Controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. **For example**, management may

© The Institute of Chartered Accountants of India

enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

(d) **Incorrect:** The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures.

(e) **Incorrect:** According to CARO, 2020, the company auditor is required to state whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company.

(f) **Incorrect:** SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

(g) **Incorrect:** Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

(h) **Incorrect:** Financial statements should disclose all 'material items', i.e., the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. For example -a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future. In certain cases, quantitative limits of materiality are specified.

Question 2

(a) G Pvt. Ltd. had fully paid up Capital and Reserves of ₹ 1.20 crore as at the end of F.Y. 2020-2021. During the F.Y 2021-2022, business was interrupted due to Covid restrictions and therefore the company incurred losses to the tune of ₹ 25 lacs. During the year, the company also borrowed ₹ 55 lakh each from a bank and a financial institution independently. It had a turnover of ₹ 850 lakh (other than revenue of ₹ 250 lakh from discontinuing operations). Ascertain whether CARO, 2020 is applicable to the company.

(4 Marks)

© The Institute of Chartered Accountants of India

(b) *Tree Limited presented its financial statements for the F.Y. 2021-2022 to its auditor for expressing an opinion thereon. The auditor while carrying out the audit started comparing various items of profit and loss account of the year under audit with previous financial years. What is auditor trying to achieve by carrying out those comparisons?* ***(4 Marks)***

(c) *CA N is the auditor of SR Ltd. The auditor expressed his opinion on the financial statements without ascertaining as to whether the financial statements as a whole were free from material misstatements or not. In your opinion, whether CA N has complied with objectives of audit considering the applicability of relevant SA?* ***(3 Marks)***

(d) *Compute the Drawing Power for Cash Credit A/c of S Limited for the month of March 2022 with following information:*

	(Amount in ₹)
Stock	*50,000*
Debtors	*45,000*
(Including Debtor of ₹ 5,000 for an invoice dated 17.11.2021)	
Sundry creditors	*15,000*
Sanctioned Limit	*45,000*

Margin on stock is 20% and on debtors is 50%.

Note: Debtors older than 3 months are ineligible for calculation of DP. ***(3 Marks)***

Answer

(a) Applicability of CARO, 2020 in case of Private Ltd. Company: CARO, 2020 shall apply to every company including a foreign company **except**– a private limited company, not being a subsidiary or holding company of a public company,

(i) having a paid-up capital and reserves and surplus not more than one crore rupees as on the balance sheet date; and

(ii) which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year; and

(iii) which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

Applying the above to the given case, G Pvt. Ltd., its paid-up capital and reserves are ₹ 95 Lakh (₹ 120 Lakh - ₹ 25 Lakh), borrowings from a Bank and financial institution are (₹ 55 Lakh + ₹ 55 Lakh) i.e., ₹ 1.10 Crore, turnover {including discontinuing operations (₹ 850 lakh + ₹ 250 Lakh)} ₹ 1100 Lakh i.e., ₹ 11 Crore.

Since its borrowings and turnover are exceeding the specified limit and therefore it is not exempt from the applicability of CARO, 2020.

© The Institute of Chartered Accountants of India

Solution for HINDI Medium Students

(a) Applicability of CARO, 2020 in case of Private Ltd. Company: CARO, 2020 shall apply to every company including a foreign company **except**– a private limited company, not being a subsidiary or holding company of a public company,

(i) having a paid-up capital and reserves and surplus not more than one crore rupees as on the balance sheet date; and

(ii) which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year; and

(iii) which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

Applying the above to the given case, G Pvt. Ltd., its paid-up capital and reserves are ₹ 95 Lakh (₹ 120 Lakh - ₹ 25 Lakh), Borrowings from a Bank and financial institution are (₹ 55 Lakh + ₹ 55 Lakh) i.e., ₹ 1.10 Crore, turnover {including discontinuing operations (₹ 850 Lakh + ₹ 250) 8,50,00,250} is ₹ 850,00,250 Lakh.

Since its borrowings are exceeding the specified limit and therefore it is not exempt from the applicability of CARO, 2020.

(b) Purpose of Applying Analytical Procedure: Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

The auditor of Tree Ltd. would achieve the following by carrying out the comparison stated in the question:

(i) If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years.

(ii) By setting up certain expenses' ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.

(iii) If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

(iv) It would be possible to identify the existence of unusual transactions, amounts, ratios and trends that might indicate matters that have audit implications.

© The Institute of Chartered Accountants of India

(c) Overall Objectives of the Independent Auditor: As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:

(i) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(ii) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

In the given case of SR Ltd, CA N expressed his opinion on the financial statements of SR Ltd without obtaining reasonable assurance about whether the financial statements as a whole are free from material misstatement or not. Therefore, it can be concluded that CA N did not comply with the objective of audit as stated in SA 200.

(d) Computation of Drawing Power:

Computation of Drawing Power for CC A/c of S Ltd.

Particulars of current assets		**Amount (₹)**	**DP Amt (₹)**
(A) Stocks:			
Stocks at realizable value		50,000	
Less: Unpaid stocks:			
- Sundry creditors	15000	15000	
Paid for stocks		35000	
Margin @ 20%		7000	28000
(B) Debtors:			
Total Debtors		45000	
Less: Ineligible debtors		5000	
Eligible debtors		40000	
Margin @ 50%		20000	20000
Total Drawing Power			**48000**

The sanctioned limit given in the question is ₹ 45000 whereas drawing power as per the above working is ₹ 48000. So, drawing power would be restricted to sanctioned limit i.e., ₹ 45000

© The Institute of Chartered Accountants of India

Question 3

(a) *P Ltd. is a company from a business group "ABCD" and is engaged in trading of garments. The promoters of the company are promoters and directors of some other group companies also. You have been appointed as an auditor of P Ltd. P Ltd has entered into various inter company transactions (within group companies) during the year which are outside its normal course of business. What will be your duties as an auditor in relation to those transactions?* ***(4 Marks)***

(b) *B Ltd. is covered u/s 135 of the Companies Act, 2013 i.e. Corporate Social Responsibility (CSR). What matters (other than the amount spent, amount not spent, amount required to be spent etc.) shall be disclosed by the company with regard to CSR activities done by the company?* ***(4 Marks)***

(c) *The newly appointed auditor of BTN Limited wants to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. What audit procedures should he perform for this purpose?* ***(3 Marks)***

(d) *The Auditor of HK Limited completed the audit of the company in an automated environment. Management of the company requested the auditor to give an idea about any exceptions observed in IT environment that need to be assessed. How the auditor should consider this request and report in light of an audit perspective?* ***(3 Marks)***

Answer

(a) Duties of Auditor in identifying Significant Related Party Transactions: For identified significant related party transactions outside the P Ltd.'s normal course of business, the auditor shall:

1. Inspect the underlying contracts or agreements, if any, and evaluate whether:
   (i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
   (ii) The terms of the transactions are consistent with management's explanations; and
   (iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
2. Obtain audit evidence that the transactions have been appropriately authorised and approved.

(b) Corporate Social Responsibility (CSR): Since B Ltd is covered under section 135 of the Companies Act, the following matters shall be disclosed by the B Ltd with regard to CSR activities:

(a) total of previous years shortfall,

© The Institute of Chartered Accountants of India

(b) reason for shortfall,

(c) nature of CSR activities,

(d) details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard,

(e) where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately.

(c) Audit Procedure Regarding Opening Balances: The newly appointed auditor of BTN Ltd shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor of BTN Ltd shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(1) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss.

(2) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(3) Performing one or more of the following:

(i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements.

(ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

(iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

(d) Assess and report Audit Findings in audit in Automated Environment: At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee. Some points to consider are as follows:

(1) Are there any weaknesses in IT controls?

(2) What is the impact of these weaknesses on overall audit?

(3) Report deficiencies to management – Internal Controls Memo or Management Letter.

(4) Communicate in writing any significant deficiencies to Those Charged with Governance.

© The Institute of Chartered Accountants of India

The auditor of HK Ltd needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control.

Question 4

(a) *CAB, an auditor of DBF Limited engaged in the manufacturing and trading of hardware products, while auditing got aware of some secrets of the company. The auditor acted in an unlawful way in order to deceive or gain an advantage over others and also he encouraged and assisted directors to do something wrong, in particular to commit crime. Now company has requested you to guide it as to how such acts are covered under Companies Act, 2013 and what consequences auditor may face?* ***(4 Marks)***

(b) *The auditor of RMP Limited has identified a fraud that, in his opinion, causes a material misstatement in the financial statements. Management personnel in higher management cadre are associated with manipulation of accounts of the company. But the auditor has not been able to understand as to why this type of fraud is generally committed. Guide him with some reasons.* ***(4 Marks)***

(c) *SPR Ltd has been into the media business since 1990. During the F.Y 2021-2022 many notices were received by the company for hurting public sentiments and financial claims were filed against the company. As an auditor of the company, you requested the management for arranging the meeting with company's external legal counsel. Management is of the view that such meetings are necessary in some certain circumstances only. Can you list down those certain circumstances?* ***(3 Marks)***

(d) *After becoming Chartered Accountant, you have got your first assignment as an auditor of a bank branch dealing in various types of advances. What are the areas which you will be looking for obtaining sufficient appropriate evidence (for advances) besides studying and evaluating internal controls?* ***(3 Marks)***

Answer

(a) Punishment for Non – Compliance/Contravention: Section 147 of the Companies Act, 2013 prescribes punishments:

Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in an fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in this Act or in any other law for the time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally.

However, in case of criminal liability of an audit firm, in respect of liability other than fine, the concerned partner or partners, who acted in a fraudulent manner or abetted or, as the case may be, colluded in any fraud shall only be liable. In view of the above, CA. B would be liable for fine and imprisonment as per Companies Act, 2013.

© The Institute of Chartered Accountants of India

Alternative Solution:

Direction by Tribunal in case Auditor acted in a Fraudulent Manner:

As per sub-section (5) of the section 140, the Tribunal either *suo motu* or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

However, if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

It may be noted that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

(b) Fraudulent Financial reporting – Manipulation of Accounts: In the given case of RMP Ltd, the auditor identified fraud causing material misstatement in the financial statements. Auditor did not understand the reasons of the type of fraud given in the case of RMP Ltd.

Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed:

(1) to avoid incidence of income-tax or other taxes;

(2) for declaring a dividend when there are insufficient profits;

(3) to withhold declaration of dividend even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and

(4) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

(c) Circumstances when becoming necessary to meet with external legal counsel: In the given case of SPR Ltd., Auditor requested the management for meeting with SPR's external legal counsel.

In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims.

© The Institute of Chartered Accountants of India

This may be the case, **for example**, where:

(i) The auditor determines that the matter is a significant risk.

(ii) The matter is complex.

(iii) There is disagreement between management and the entity's external legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

(d) Audit Procedure in Audit of Advances in case of Bank Audit: The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

(i) examining the validity of the recorded amounts;

(ii) examining loan documentation.

(iii) reviewing the operation of the accounts;

(iv) examining the existence, enforceability and valuation of the security;

(v) checking compliance with RBI norms including appropriate classification and provisioning; and

(vi) carrying out appropriate analytical procedures.

Question 5

(a) CA G, auditor of Sports Ltd., while auditing documented all the papers. He retained some of the documents of the company on which he has not worked along with the documents which were his working papers saying that as he was the auditor of the Company, so he has the right to retain all the documents as he may require them for future references. Comment on the action of the auditor. ***(4 Marks)***

(b) Proceedings have been initiated against False Limited for holding benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, but such property is not recorded in books of accounts. As a consultant to the company, what will you advice to the company as far as disclosure requirements are concerned in relation to said proceedings? ***(4 Marks)***

(c) The approach to audit and extent of checking are undergoing a progressive change in favour of more attention towards the questions of principle and controls with a curtailment of non-consequential routine checking. Discuss the given statement. ***(3 Marks)***

(d) M/s T & Co. Chartered Accountants, a partnership firm, is appointed as an auditor of Treatment Hospital run by Smile Foundation, a charitable trust. Over and above the receipts of treatment of patients, during the year trust has received donations from various donors to treat COVID-19 patients and also incurred some capital expenditure for further

© The Institute of Chartered Accountants of India

development of the hospital. On some of the investment income, income tax has been deducted. What are the special points to be considered by M/s T & Co. while auditing such transactions of Treatment Hospital? ***(3 Marks)***

Answer

(a) Right of Lien on the Books and Documents of the Company: Under **section 128** of the Act, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. The company provides reasonable facility to auditor for inspection of the books of account by directors and others authorised to inspect under the Act. Taking an overall view of the matter, it seems that though legally, auditor may exercise right of lien in cases of companies, it is mostly impracticable for legal and practicable constraints. His working papers being his own property, the question of lien, on them does not arise.

In view of above, CA G cannot retain the documents of the company and on which he did not work.

Alternative Solution:

In terms of the general principles of law, any person having the lawful possession of somebody else's property, **on which he worked**, may has retain the property for non-payment of his dues on account of the work done on the property. On this premise, auditor can exercise lien on books and documents placed at his possession by the client for non-payment of fees, for work done on the books and documents. The Institute of Chartered Accountants in England and Wales has expressed a similar view on the following conditions:

(i) Documents retained must belong to the client who owes the money.

(ii) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.

(iii) The auditor can retain the documents only if he has done work on the documents assigned to him.

(iv) Such of the documents can be retained which are connected with the work on which fees have not been paid.

In view of above, CA G cannot retain the documents of the company and on which he did not work.

(b) Disclosure in case of Benami Properties held by the Company: Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, the company shall disclose the following:

© The Institute of Chartered Accountants of India

(a) Details of such property, including year of acquisition,

(b) Amount thereof,

(c) Details of Beneficiaries,

(d) If property is not in the books, then the fact shall be stated with reasons,

(e) Where there are proceedings against the company under this law as an abetter of the transaction or as the transferor, then the details shall be provided,

(f) Nature of proceedings, status of same and company's view on same.

(c) Sampling: An Audit Procedure: No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all the efforts are directed to check all transactions without any exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished i.e., the internal controls as designed by the management are for the very purpose of Prevention, Detection and Correction of Frauds and Errors. Thus, the auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of **principles and controls** with a curtailment of non-consequential routine checking. By routine checking, we traditionally think of extensive checking and vouching of all the entries, disregarding the concept of materiality.

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor. There is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent it has to be done. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do as an auditor is to express his opinion on the financial statements and become bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking (i.e., sampling), he should adopt standards and techniques which are widely followed and which have a recognised basis.

Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability. This enables the auditor to make conclusions and express fair opinion without having to check all of the items within the financial statements.

© The Institute of Chartered Accountants of India

(d) Audit of a Hospital:

(A) Receipts from treatment of patients

1. **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

2. **Collection of Cash from patients**: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patient's bills.

(B) Donations from donors to treat the patients: Ascertain those legacies and donation received for a specific purpose have been applied in the manner agreed upon.

(C) Capital Expenditure Incurred: Verify the Capital Expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee.

(D) Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax. This involves:

(i) vouching the Income-tax refund with the correspondence with the Income-tax Department; and

(ii) checking the calculation of the repayment of claims/refund claim.

Question 6

(a) D Ltd. is a company engaged in publishing business magazines. CA P is the statutory auditor of the company. The company takes property in the barter deal from its real estate customers against publication of their advertisements. The properties obtained during the year through such barter deals have been considered in the books of accounts on the basis of possession letter only and have been included in PPE in the financial statements. Considering this matter of such importance that is fundamental to the users understanding, CA P has decided to communicate the same in his report. CA P seeks your guidance in reporting this matter in his audit report. ***(4 Marks)***

OR

Internal audit not only analyses the effectiveness with which the internal control of a company is operating but also improves the effectiveness of internal control. Elucidate the statement.

(b) The senior member of the firm Kaur & Associates, Chartered Accountants, informed to its auditing staff that at the time of audit reporting regarding corresponding figures, when

© The Institute of Chartered Accountants of India

corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in specified circumstances. What are those exceptional circumstances? ***(4 Marks)***

(c) *When the company is working in an automated environment, it is not necessary for its auditor to understand its automated environment and depends upon the professional judgement of the auditor as to whether gaining knowledge of company's IT systems is required or not. Do you agree with this statement?* ***(3 Marks)***

(d) *The accountant of CHB Limited observed that amount received from Mr. A has been recorded in the account of Mr. B and this mistake was found at the time of tallying account statement provided by Mr. A. What type of error is this? Can you give two more examples of such error and how the same will be detected?* ***(3 Marks)***

Answer

(a) Emphasis of Matter Paragraphs in the Auditor's Report: If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

(i) The auditor would not be required to modify the opinion in accordance with SA 705 as a result of the matter; and

(ii) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

In the given case as the properties obtained during the year through barter deals and included in the PPE in the books of accounts on the basis of possession letter only, hence there is a need to add Emphasis on Matter Paragraph in the Auditor's Report.

The draft of the same is as under:

Emphasis of Matter – Effect of Properties obtained through barter deals by the company

We draw attention to Note (Y) of the financial statements, which describes the effects of the properties obtained through barter by the company. Our opinion is not modified in respect of this matter.

Alternative Solution:

In the given case as the properties obtained during the year through barter deals and included in the PPE in the books of accounts on the basis of possession letter only, hence there is a need to report the same under Clause i(c) of Paragraph 3 Companies (Auditor's Report) Order,2020.

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

© The Institute of Chartered Accountants of India

namely:

(i) (c) whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company,

if not, provide the details thereof in the format below:

Description of property	Gross carrying value	Held in name of	Whether promoter, director or their relative or employee	Period held– indicate range, where appropriate	Reason for not being held in name of company* *also indicate if in dispute
1	2	3	4	5	6

The auditor should state in the Reason (column 6) for not being held in name of company as follows

"Properties obtained during the year through barter deals and included in the PPE in the books of accounts on the basis of possession letter only"

OR

Improvement in Effectiveness of Internal Control: Internal Audit means "An independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system".

Activities Relating to Internal Control:

(i) **Evaluation of internal control:** The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

(ii) **Examination of financial and operating information:** The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

(iii) **Review of operating activities:** The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity.

© The Institute of Chartered Accountants of India

(iv) **Review of compliance with laws and regulations:** The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

Therefore, one of the important aspects of internal audit is not only to evaluate internal control system of an organization but also to suggest improvements for adding value and strengthening it.

(b) Audit reporting Regarding Corresponding Figures:

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:

1. **If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion** and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

   (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

   (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

2. **If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements** on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified.

3. **Prior Period Financial Statements Not Audited-** If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

(c) Understanding and Documenting Automated Environment: When a business operates in a more automated environment it is likely that auditor will see several business functions and activities happening within the systems. Consider the following aspects instead of:

(i) Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).

© The Institute of Chartered Accountants of India

(ii) Accounting entries are posted automatically (for example, sub-ledger to GL postings is automatic).

(iii) Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).

(iv) Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).

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

Companies derive benefit from the use of IT systems as an enabler to support various business operations and activities. Auditors need to understand the relevance of these IT systems to an audit of financial statements.

While it is true that the use of IT systems and automation benefit the business by making operations more accurate, reliable, effective and efficient, such systems also introduce certain new risks, including IT specific risks, which need to be considered, assessed and addressed by management.

To the extent that it is relevant to an audit of financial statements, even auditors are required to understand, assess and respond to such risks that arise from the use of IT systems.

From the above discussion, it is quite apparent that it is necessary for an auditor to understand the automated environment.

Alternative Solution

Understanding and Documenting Automated Environment: In an audit of financial statements, an auditor is required to understand the entity and its business, including IT as per SA 315. Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.

Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment:

(i) Information systems being used (one or more application systems and what they are).

(ii) Their purpose (financial and non-financial).

(iii) Location of IT systems - local vs global.

(iv) Architecture (desktop based, client-server, web application, cloud based).

(v) Version (functions and risks could vary in different versions of same application).

(vi) Interfaces within systems (in case multiple systems exist).

© The Institute of Chartered Accountants of India

(vii) In-house vs Packaged.

(viii) Outsourced activities (IT maintenance and support).

(ix) Key persons (CIO, CISO, Administrators).

The understanding of a company's IT environment that is obtained should be documented.

From the above discussion, it is quite apparent that it is necessary for an auditor to understand the automated environment.

(d) Self-Revealing Error:

Situation mentioned in the case is a Self-Revealing Error. These are such errors the existence of which becomes apparent in the process of compilation of accounts.

Below are two more examples of such errors:

(a) Omission to post a part of a journal entry in to the ledger. (Trial Balance is thrown out of agreement) – Statement of account of parties will reveal the mistake.

(b) Wrong totalling of the Purchase register. Control Account (e.g., the Sundry Trade Payables Account) balances and the aggregate of the balance in the personal ledger will disagree.

Alternative Solution:

Errors of Commission: When a transaction has been mis-recorded either wholly or partially it is called as an error of commission. Error of commission can happen in the following ways-

(i) Errors in posting,

(ii) Errors in Casting,

(iii) Errors in carrying forward,

(iv) Errors occurring during extraction of balances, etc.

The case given in the question is an error of posting.

Posting errors may be of a wrong account, wrong amount or wrong file.

For example,

(i) Omission of posting of any part of the journal entry – Can be detected through trial balance.

(ii) Purchase of ₹ 360 from Mr. A posted in his account at ₹ 630 or sales returns from Mr. X posted as the debit of his account – This error can be detected by verifying entries with underlying vouchers.

Errors of posting in the wrong account may be detected by performing external confirmation as an audit procedure.

© The Institute of Chartered Accountants of India

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) Presently, the flow of information is at an unimaginable high speed for doing any business and need of information is perceived at various levels of hierarchy. With these objectives in focus, define:

(i) Enterprise Information System

(ii) Categories of Business Processes ***(1 + 2 Marks)***

(b) What is an operating system? List any four activities performed by an operating system. ***(1 + 1 Marks)***

Answer

(a) (i) An **Enterprise Information System (EIS)** may be defined as any kind of information system which improves the functions of an enterprise business processes by integration.

Or

An **Enterprise Information System (EIS)** provides a technology platform that enables organizations to integrate and coordinate their business processes on a robust foundation.

Or

An **Enterprise Information System (EIS)** provides a single system that is central to the organization that ensures information can be shared across all functional levels and management hierarchies. It may be used to amalgamate existing applications.

(ii) Depending on the organization, industry, and nature of work; business processes are often broken up into different categories as below:

- **Operational/Primary Processes:** Operational or Primary Processes deal with the core business and value chain. These processes deliver value to the customer by helping to produce a product or service. Operational processes represent essential business activities that accomplish business objectives. For example - Order to Cash (O2C) and Purchase to Pay (P2P) cycles are associated with revenue generation.
- **Supporting/Secondary Processes:** Supporting Processes back core processes and functions within an organization. For example - Accounting,

© The Institute of Chartered Accountants of India

workplace safety and Human Resource (HR) Management that includes activities like recruitment and staffing, training and development, career development etc.

- **Management Processes:** Management Processes measure, monitor and control the activities related to business procedures and systems. Examples of management processes include internal communications, governance, strategic planning, budgeting, and infrastructure or capacity management.

(b) An **Operating System (OS)** is defined as a set of computer programs that manages computer hardware resources and acts as an interface with computer application programs.

Or

An **Operating System (OS)** is a vital component of the system software that makes the hardware usable and manage them by creating an interface between the hardware and the user.

The variety of activities that are executed by an Operating System are as follows:

- Performing hardware functions
- Provide User Interfaces
- Support Hardware Independence
- Memory Management
- Task Management
- Networking Capability
- Logical Access Security
- File management

Question 2

(a) The main business of banks is lending money to the customers. There are certain inherent risks in lending, and they cannot take more than the calculated risks whenever they lend money to their customers. List down the various risks involved and their associated controls in Loans and Advances Process in the banking system. ***(6 Marks)***

(b) The ERP system is like a human body where there are different units and each unit relates to other units. All the units must work in harmony with other units to generate the desired result. What are the important points for integration of modules with Financial and Accounting System? ***(4 Marks)***

© The Institute of Chartered Accountants of India

Answer

(a) Various risks and their associated controls in Loan and Advance process in a Banking system are as follows:

Risks	Key Controls
Credit Line setup is unauthorized and not in line with the bank's policy.	The credit committee checks that the financial ratios, the net-worth, the risk factors and its corresponding mitigating factors, the credit line offered and the credit amount etc. are in line with Credit Risk Policy and that the client can be given the Credit Line.
Credit Line setup is unauthorized and not in line with the bank's policy.	Access rights to authorize the credit limit in Loan Booking system/Core Banking System should be restricted to authorized personnel.
Masters defined for the customer are not in accordance with the re- Disbursement Certificate.	Access rights to authorize the customer master in Loan Booking system/Core Banking System (CBS) should be restricted to authorized personnel. Segregation of Duties (SoD) exists in Loan Disbursement system. The system restricts the maker having checker rights to approve the loan/facilities booked by self in Loan Disbursal System.
Credit Line setup can be breached in Loan disbursement system/CBS.	Loan Disbursement System/CBS restricts booking of loans/ facilities if the limit assigned to the customer is breached in Loan Disbursement System/CBS.
Lower rate of interest/ Commission may be charged to customer.	Loan Disbursement System/CBS restricts booking of loans/ facilities if the rate charged to the customer are not as per defined masters in system.
Facilities/Loan's granted may be unauthorized/in- appropriate.	Segregation of Duties (SoD) exists in Loan Disbursement system. The system restricts the maker having checker rights to approve the loan/facilities booked by self in loan disbursal system.
Inaccurate interest/charge being calculated in the Loan disbursal system.	Interest on fund-based loans and charges for non-fund-based loans are automatically calculated in the Loan disbursal system as per the defined masters.

© The Institute of Chartered Accountants of India

(b) Following points are important for integration of Enterprise Resource Planning (ERP) modules with Financial and Accounting System:

- Master data across all the modules must be same and must be shared with other modules where-ever required.
- Common transaction data must be shared with other modules where-ever required.
- Separate voucher types to be used for each module for easy identification of department recording it.
- Figures and transaction may flow across the department. For example - Closing stock value is taken to Trading Account as well as Balance Sheet and closing stock quantity is required by Purchase Department, Stores Department, Accounts Department, and Production Department, Similarly, salary figures are used by Human Resource Department and Accounts Department simultaneously. Hence, it is necessary to design the system accordingly.

Question 3

(a) For doing business, logical access controls play a critical role ensuring the access to system, data and programs to safeguard against unauthorized access. Towards this, explain 'Logical Access Control' and 'User Access Management Controls' for Technical Exposures'. ***(2 + 4 Marks)***

(b) In Accounting language, voucher is an evidence for a transaction. How do you interpret 'voucher' when referred to a computer? Also explain any three types of vouchers pertaining to accounting. ***(1 + 3 Marks)***

Answer

(a) Logical Access Controls

- These are the controls relating to logical access to information resources such as operating systems controls, application software boundary controls, networking controls, access to database objects, encryption controls etc.
- Logical access controls are the system-based mechanisms used to designate who or what is to have access to a specific system resource and the type of transactions and functions that are permitted.
- These controls are implemented to ensure that access to systems, data and programs is restricted to authorized users to safeguard information against unauthorized use, disclosure or modification, damage, or loss.
- The key factors considered in designing logical access controls include confidentiality and privacy requirements, authorization, authentication, and incident handling, reporting and follow-up, virus prevention and detection, firewalls, centralized security

© The Institute of Chartered Accountants of India

administration, user training and tools for monitoring compliance, intrusion testing and reporting.

Controls for technical exposure related to User Access Management are as follows:

- **User Registration:** Information about every user is documented. Some questions like why and who is the user granted the access; has the data owner approved the access, and has the user accepted the responsibility? etc. are answered. The de-registration process is also equally important.
- **Privilege management:** Access privileges are to be aligned with job requirements and responsibilities are to be minimal w.r.t their job functions. For example, an operator at the order counter shall have direct access to order processing activity of the application system. Similarly, a business analyst could be granted the access to view the report but not modify which would be done by the developer.
- **User password management:** Passwords are usually the default screening point for access to systems. Allocations, storage, revocation, and reissue of password are password management functions. Educating users is a critical component about passwords and making them responsible for their password.
- **Review of user access rights:** A user's need for accessing information changes with time and requires a periodic review of access rights to check anomalies in the user's current job profile, and the privileges granted earlier.

(b) In computer language, the word **Voucher** is a place where transactions are recorded. It is a data input form for inputting transaction data.

The vouchers pertaining to Accounting module are as follows:

Voucher Type	Uses
Contra	For recording of four types of transactions as under. a. Cash deposit in bank. b. Cash withdrawal from bank. c. Cash transfer from one location to another. d. Fund transfers from our one bank account to our own another bank account.
Payment	For recording of all types of payments. Whenever the money is going out of business by any mode (cash/bank). E.g. Payment of salary and rent.
Receipt	For recording of all types of receipts. Whenever the money is being received into business from outside by any mode (cash/bank). For example - Interest received from bank.

© The Institute of Chartered Accountants of India

Journal	For recording of all non-cash/bank transactions. For example - Depreciation, Provision, Write-off, Write-back, Discount given/received, Purchase/Sale of fixed assets on credit, etc.
Sales	For recording all types of trading sales by any mode (cash/bank/credit).
Purchase	For recording all types of trading purchase by any mode (cash/bank/credit).
Credit Note	For making changes/corrections in already recorded sales/purchase transactions.
Debit Note	For making changes/corrections in already recorded sales/purchase transactions.
Memorandum	For recording of transaction which will be in the system but will not affect the trial balance. In other words, memorandum vouchers are used to record suspense payments, receipt, sales, purchase etc. conveyance expenses.

Question 4

(a) Enterprise Risk Management (ERM) framework consists of various interrelated components that are derived from the way the management runs a business and are integrated with the management process. Explain any six components of ERM framework.

(6 Marks)

(b) E-Commerce runs through network-connected systems which can have two types of architecture, namely, two-tier and three-tier architecture. In this context, define three-tier architecture and write its advantages. ***(1 + 3 Marks)***

Answer

(a) Enterprise Risk Management (ERM) framework consists of eight interrelated components that are as follows:

(i) Internal Environment: The internal environment encompasses the tone of an organization and sets the basis for how risk is viewed and addressed by an entity's people, including risk management philosophy and risk appetite, integrity and ethical values, and the environment in which they operate. Management sets a philosophy regarding risk and establishes a risk appetite. The internal environment sets the foundation for how risk and control are viewed and addressed by an entity's people. The core of any business is its people, their individual attributes including integrity, ethical values, and competence and the environment in which they operate. They are the engine that drives the entity and the foundation on which everything rests.

(ii) Objective Setting: Objectives should be set before management can identify events potentially affecting their achievement. ERM ensures that management has a process

© The Institute of Chartered Accountants of India

in place to set objectives and that the chosen objectives support and align with the entity's mission/vision and are consistent with the entity's risk appetite.

(iii) **Event Identification:** Potential events that might have an impact on the entity should be identified. Event identification includes identifying factors – internal and external, that influence how potential events may affect strategy implementation and achievement of objectives. It includes distinguishing between potential events that represent risks, those representing opportunities and those that may be both. Opportunities are channeled back to management's strategy or objective-setting processes. Management identifies inter-relationships between potential events and may categorize events to create and reinforce a common risk language across the entity and form a basis for considering events from a portfolio perspective.

(iv) **Risk Assessment:** Identified risks are analysed to form a basis for determining how they should be managed. Risks are assessed on both an inherent and a residual basis, and the assessment considers both risk likelihood and impact. A range of possible results may be associated with a potential event, and management needs to consider them together.

(v) **Risk Response:** Management selects an approach or set of actions to align assessed risks with the entity's risk tolerance and risk appetite, in the context of the strategy and objectives. Personnel identify and evaluate possible responses to risks, including avoiding, accepting, reducing and sharing risk.

(vi) **Control Activities:** Policies and procedures are established and executed to help ensure that the risk responses that management selected are effectively carried out.

(vii) **Information and Communication:** Relevant information is identified, captured, and communicated in a form and time frame that enables people to carry out their responsibilities. Information is needed at all levels of an entity for identifying, assessing and responding to risk. Effective communication also should occur in a broader sense, flowing down, across and up the entity. Personnel need to receive clear communications regarding their role and responsibilities.

(viii) **Monitoring:** The entire ERM process should be monitored, and modifications made as necessary. In this way, the system can react dynamically, changing as conditions warrant. Monitoring is accomplished through ongoing management activities, separate evaluations of the ERM processes or a combination of both.

(b) **Three - Tier architecture** is a software design pattern and well-established software architecture having three tiers - **Presentation Tier**, **Application Tier,** and **Database Tier**. The Three-tier architecture is a client server architecture in which the functional process logic; data access and computer data storage; and user interface are maintained as independent modules on separate platforms - Application tier; Database tier; and Presentation Tier respectively.

The advantages of Three-Tier Architecture are as follows:

© The Institute of Chartered Accountants of India

- **Clear separation of user-interface-control and data presentation from application-logic:** Through this separation, more clients can have access to a wide variety of server applications. The two main advantages for client-applications are quicker development through the reuse of pre-built business-logic components and a shorter test phase.
- **Dynamic load balancing:** If bottlenecks in terms of performance occur, the server process can be moved to other servers at runtime.
- **Change management:** It is easy and faster to exchange a component on the server than to furnish numerous Personal Computers (PCs) with new program versions.

Question 5

(a) Banking is a backbone of a country's economy which keeps the wheels of economy running. The changes in the banking scenario due to moving over to Core Banking System (CBS) and IT-based operations have enabled banks to reach customers and facilitate seamless transactions with lesser dependence on physical infrastructure. In this context, write down the characteristics of Core Banking System. ***(6 Marks)***

(b) Mobile Apps are commonly used by all for doing electronic transactions. A mobile website works for all mobile devices and usually costs about same as creating a Mobile App. In this context, explain any four modules in mobile websites. ***(4 Marks)***

OR

What are the applications of Internet of Things (IOT) in the area of

(i) Smart City

(ii) Health Care

Answer

(a) The characteristics of Core Banking Systems (CBS) are as follows:

- CBS is a centralized Banking Application software that has several components which have been designed to meet the demands of the banking industry.
- CBS is supported by advanced technology infrastructure and has high standards of business functionality.
- There is a common database in a central server located at a Data Center which gives a consolidated view of the bank's operations.
- Core Banking Solution brings significant benefits such as a customer is a customer of the bank and not only of the branch.
- CBS is modular in structure and is capable of being implemented in stages as per requirements of the bank.
- All branches of bank function as delivery channels providing services to its customers.

© The Institute of Chartered Accountants of India

- A CBS software also enables integration of all third-party applications including in-house banking software to facilitate simple and complex business processes.

(b) The modules that are included in the Mobile App/Mobile websites are as follows:

- **Mobile Store Front Module** is an integral part of m-commerce apps, where all commodities and services are categorized and compiled in catalogues for customers to easily browse through the items on sale and get essential information about the products.
- **Mobile Ticketing Module** is an m-commerce app component that is closely linked to promotional side of commercial business and enables vendors to attract customers by distributing vouchers, coupons, and tickets.
- **Mobile Advertising and Marketing Module** empowers merchants to leverage m-commerce channels to manage its direct marketing campaigns, which are reported to be very effective especially when targeted at younger representatives of digital information consumers.
- **Mobile Customer Support and Information Module** is a point of reference for information about a particular retailer, its offerings, and deals. The news about the company, current discounts, shop locations and other information is either pushed to users' m-commerce apps or can be found in m-commerce app itself.
- **Mobile Banking** is inextricably linked to selling process via m-commerce apps, because no purchase can be finalized without a payment. There are various options for executing mobile payments, among which are direct mobile billing, payments via SMS, credit card payments through a familiar mobile web interface, and payments at physical Point of Sale (POS) terminals with Near Field Communication (NFC) technology.

OR

(i) **Smart City:** Smart city is a big innovation and spans a wide variety of use cases, from water distribution and traffic management to waste management and environmental monitoring. For example, many times we wait for a red traffic light in a totally absurd way, because there is no car or any person around us. With Internet of Things (IoT), these traffic lights can be connected to a circuit of cameras distributed throughout the city that identifies the level of traffic and mass movement, thus avoiding those absurd waits in areas of limited movement.

(ii) **Health Care:** Internet of Things (IoT) has various applications in healthcare which are from remote monitoring equipment to advance and smart sensors to equipment integration. It has the potential to improve how physicians deliver care and keep patients safe and healthy.

© The Institute of Chartered Accountants of India

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

Paramount group of companies is having a strong foot print in the areas of Aviation, Healthcare, Fast moving consumer goods, Home appliances and Electronic goods. Processes, Technology and Marketing capabilities are different for each business. However, each business operates among a group of rivals that produce competing products. In order to get ahead of competition and to contribute for sustained competitive advantages, company intends to improve customer services and in turn increase its market share. To achieve this, company is desirous to analyze its products, processes and service levels for each of its segments.

Company is studying various trade publications, understanding the taste and preferences of customers, meeting with suppliers and also using other relevant information available in public domain for each of its business operations. After studying as above, company wants to compare diverse range of practices and processes being followed by acknowledged leaders in the industry, measures its own productivity and identify the gaps. Instead of following bricks-and-mortar practices, company will be setting goals to be achieved for improvement in its product, processes and services, based on best practices being followed by the companies on a regular basis.

Identify the strategic tool to be used by Paramount group of companies. Also explain in brief the common elements involved in using this tool. ***(1 + 4 = 5 Marks)***

Answer

Paramount group of companies have used ***Benchmarking*** as a strategic tool. Benchmarking is an approach of setting goals and measuring productivity of firms based on best industry practices or against the products, services and practices of its competitors or other acknowledged leaders in the industry. Thus, benchmarking is a process of continuous improvement in search for competitive advantage. Firms can use benchmarking practices to achieve improvements in diverse range of management functions like product development, customer services, human resources management, etc.

Some of the common elements of benchmarking process are as under:

- **Identifying the need for benchmarking**: This step will define the objectives of the benchmarking exercise. It will also involve selecting the type of benchmarking. Organizations identify realistic opportunities for improvements.
- **Clearly understanding existing decisions processes:** The step will involve compiling information and data on performance. This will include mapping processes.
- **Identify best processes:** Within the selected framework best processes are identified. These may be within the same organization or external to it.

© The Institute of Chartered Accountants of India

- **Comparison of own process and performance with that of others:** Benchmarking process also involves comparison of performance of the organization with performance of other organization. Any deviation between the two is analysed to make further improvements.
- **Prepare a report and implement the steps necessary to close the performance gap:** A report on benchmarking initiatives containing recommendations is prepared. Such a report also contains the action plans for implementation.
- **Evaluation:** Business organizations evaluate the results of the benchmarking process in terms of improvements vis-à-vis objectives and other criteria set for the purpose. It also periodically evaluates and reset the benchmarks in the light of changes in the conditions that impact the performance.

Question 7

(a) Good Health is an Association of Persons (AOP), providing awareness to downtrodden on immunization, vaccination, sanitation and other health and hygiene issues. It is a not-for-profit organization, working in coordination with hospitals, medical support centers and local administration.

You are asked to take over the organization and manage it in a better way. Identify whether the concept of strategic management is relevant in this connection? And if so, what basic activities you would perform in order to manage it efficiently?

(1 + 4 = 5 Marks)

(b) "Is it imperative to segregate top level strategies into viable functional plans and policies?" Do you agree with this statement? Support your answer with reason.

(1 + 4 = 5 Marks)

Answer

(a) The concept of strategic management process is effectively being used by a number of not-for-profit or charitable organizations. While 'Good Health' may have social and charitable existence, still it has to generate resources and use them wisely to achieve organisational objectives. Organisation needs to be managed strategically, irrespective whether they have profit motive. The strategic management at 'Good Health' should essentially cover:

- ♦ Analyzing and interpreting the strategic intent in terms of vision, mission and objectives.
- ♦ Generating required resources in terms of finance and manpower (volunteers, paid employees).
- ♦ Undertaking SWOT analysis from time to time.

© The Institute of Chartered Accountants of India

- Setting goals in the area of downtrodden. It can be in terms of geographical coverage and number of downtrodden.
- Analyzing the desired future position with the past and present situation.

(b) Yes, it is imperative to segregate the top-level strategies into viable functional plans and policies that are compatible with each other. Major strategies must be translated to lower levels to give holistic strategic direction to an organisation. Functional strategies provide details to business strategy & govern as to how key activities of the business will be managed. The reasons why functional strategies are needed can be enumerated as follows:

- Functional strategies lay down clearly what is to be done at the functional level. They provide a sense of direction to the functional staff.
- They are aimed at facilitating the implementation of corporate strategies and the business strategies formulation at the business level.
- They act as basis for controlling activities in the different functional areas of business.
- They help in bringing harmony and coordination as they are formulated to achieve major strategies.
- These strategies help the functional managers in handling similar situations occurring in different functional areas in a consistent manner.

Question 8

(a) XYZ Ltd. is an automobile company that offers diversified products for all customer segments. Due to COVID-19, the changes took place in the economy forced the company to change its strategy. Being the CEO of the company, what stages will you follow for developing and executing the new strategy? ***(5 Marks)***

(b) Due to reoccurrence of various variants of Corona virus, LMN Ltd. is facing unstable environment and it has started unbundling and disintegrating its activities. It also started relying on outside vendors for performing these activities. Identify the organisation structure LMN Ltd. is shifting to. Under what circumstances this structure becomes useful? ***(1 + 4 = 5 Marks)***

Answer

(a) Today, India has become the outsourcing hub for many of the global automobile manufacturers. The auto industry comprises of four segments which are passenger vehicles, commercial vehicles, three wheelers and two wheelers. XYZ Ltd. is an automobile company that offers diversified products for all customer segments. The company has already in existence, so it has its own vision, mission and a strategy to execute for achieving its vision. While developing and executing the strategy, XYZ Ltd. might have followed the five-stage managerial process as given below:

© The Institute of Chartered Accountants of India

1. Developing a strategic vision.
2. Environmental and organisational analysis.
3. Formulation of strategy.
4. Implementing and executing the strategy.
5. Strategic evaluation and control.

But due to COVID-19, the automobile industry has faced the lockdown situation. Changes in the economy forced the XYZ Ltd. to change its existing strategy and prepare the new strategy. The changes in the environmental forces due to COVID-19 requires XYZ Ltd. to make modifications in their existing strategies and bring out new strategies. For initiating strategic change, three steps can be followed by the CEO of the company which are as under:

(i) ***Recognize the need for change***: This is the first step to diagnose facets of the corporate culture that are strategy supportive or not. This has already identified by the XYZ Ltd.

(ii) ***Create a shared vision to manage change***: Objectives and vision of both individuals and organization should coincide. The CEO of XYZ Ltd. need to constantly and consistently communicate the vision not only to inform but also to overcome resistance.

(iii) ***Institutionalize the change***: Creating and sustaining a different attitude towards change is essential to ensure that the XYZ Ltd. does not slip back into old ways of thinking or doing things. All these changes should be set up as a practice to be followed by the company and be able to transfer from one level to another as a well settled practice.

(b) LMN Ltd. is shifting into ***network structure.*** It is a newer and somewhat more radical organisational design. The network structure could be termed a "non-structure" as it virtually eliminates in-house business functions and outsource many of them. An organization organized in this manner is often called a virtual organization because it is composed of a series of project groups or collaborations linked by constantly changing non-hierarchical, cobweb-like networks.

The network structure becomes most useful when the environment of a firm is unstable and is expected to remain so. Under such conditions, there is usually a strong need for innovation and quick response. Instead of having salaried employees, it may contract with people for a specific project or length of time. Long-term contracts with suppliers and distributors replace services that the company could provide for itself through vertical integration. The network structure provides organization with increased flexibility and adaptability to cope with rapid technological change and shifting pattern of international trade and competition.

© The Institute of Chartered Accountants of India

Question 9

(a) "Strategy formulation and strategy implementation are intertwined and linked with each other." Elucidate this statement with suitable arguments. ***(5 Marks)***

(b) There are four specific criteria of sustainable competitive advantage that firms can use to determine those capabilities that are known as core competencies. Explain. ***(5 Marks)***

Answer

(a) The strategy formulation and strategy implementation are intertwined and linked with each other. Two types of linkages exist between these two phases of strategic management. The forward linkages deal with the impact of strategy formulation on strategy implementation while the backward linkages are concerned with the impact in the opposite direction.

Forward Linkages: The different elements in strategy formulation starting with objective setting through environmental and organizational appraisal, strategic alternatives and choice to the strategic plan determine the course that an organization adopts for itself. With the formulation of new strategies, or reformulation of existing strategies, many changes have to be affected within the organization. For instance, the organizational structure has to undergo a change in the light of the requirements of the modified or new strategy. The style of leadership has to be adapted to the needs of the modified or new strategies. In this way, the formulation of strategies has forward linkages with their implementation.

Backward Linkages: Just as implementation is determined by the formulation of strategies, the formulation process is also affected by factors related with implementation. While dealing with strategic choice, remember that past strategic actions also determine the choice of strategy. Organizations tend to adopt those strategies which can be implemented with the help of the present structure of resources combined with some additional efforts. Such incremental changes, over a period of time, take the organization from where it is to where it wishes to be.

It is to be noted that while strategy formulation is primarily an entrepreneurial activity, based on strategic decision-making, the implementation of strategy is mainly an administrative task based on strategic as well as operational decision-making.

(b) Four specific criteria of sustainable competitive advantage that firms can use to determine those capabilities that are core competencies. Capabilities that are valuable, rare, costly to imitate, and non-substitutable are core competencies.

i. **Valuable:** Valuable capabilities are the ones that allow the firm to exploit opportunities or avert the threats in its external environment. A firm created value for customers by effectively using capabilities to exploit opportunities. Finance companies build a valuable competence in financial services. In addition, to make

© The Institute of Chartered Accountants of India

such competencies as financial services highly successful require placing the right people in the right jobs. Human capital is important in creating value for customers.

ii. **Rare:** Core competencies are very rare capabilities and very few of the competitors possess this. Capabilities possessed by many rivals are unlikely to be sources of competitive advantage for any one of them. Competitive advantage results only when firms develop and exploit valuable capabilities that differ from those shared with competitors.

iii. **Costly to imitate:** Costly to imitate means such capabilities that competing firms are unable to develop easily.

iv. **Non-substitutable:** Capabilities that do not have strategic equivalents are called non-substitutable capabilities. This final criterion for a capability to be a source of competitive advantage is that there must be no strategically equivalent valuable resources that are themselves either not rare or imitable.

Question 10

(a) ABC Steel Industries finds out that its products have reached at maturity stage and already has overcapacity. Therefore, it concentrates on maintaining operational efficiency of its plants. Identity the strategy implemented by ABC Steel Industries along with reasons. ***(1 + 4 = 5 Marks)***

(b) What do you understand by diversification? Distinguish between concentric and conglomerate diversification. ***(2 + 3 = 5 Marks)***

OR

"The bargaining power of suppliers determines an industry's attractiveness and profitability." Discuss.

Answer

(a) ABC Steel Industries has opted to implement Stability strategy. Stability strategies are intended to safeguard the existing interests and strengths of business. It involves organisations to pursue established and tested objectives, continue on the chosen path, maintain operational efficiency and so on. A stability strategy is pursued when a firm continues to serve in the same or similar markets and deals in same products and services. In stability strategy, few functional changes are made in the products or markets, however, it is not a 'do nothing' strategy. This strategy is typical for mature business organizations. Some small organizations also frequently use stability as a strategic focus to maintain comfortable market or profit position.

Major reasons for Stability strategy are:

- A product has reached the maturity stage of the product life cycle.
- The staff feels comfortable with the status quo as it involves less changes and less risks.

© The Institute of Chartered Accountants of India

- It is opted when the environment in which an organisation is operating is relatively stable.
- Where it is not advisable to expand as it may be perceived as threatening.
- After rapid expansion, a firm might want to stabilize and consolidate itself.

(b) Diversification is defined as entry into new products or product lines, new services or new markets, involving substantially different skills, technology and knowledge. Diversification endeavours can be related or unrelated to existing businesses of the firm.

Following are the differences between the concentric diversification and conglomerate diversifications:

Concentric Diversification	Conglomerate Diversification
Meaning: It occurs when a firm adds related products or markets. **Linkage:** The new business is linked to the existing businesses through process, technology or marketing. **Reasons for pursuing:** The most common reason for pursuing a concentric diversification is that opportunities in a firm's existing line of business are available.	**Meaning:** It occurs when a firm diversifies into areas that are unrelated to its current line of business. **Linkage:** Here no such linkages exist; the new business/product is disjointed from the existing businesses/products. **Reasons for pursuing:** The common reason for pursuing a conglomerate growth strategy is that opportunities in a firm's current line of business are limited or opportunities outside are highly lucrative.

or

Quite often, suppliers too, exercise considerable bargaining power over purchasing companies. The more specialised the offering from the supplier, greater may be its clout. Further, when the suppliers are limited in number, they may openly exhibit their bargaining power. The bargaining power of suppliers determines the cost of raw materials and other inputs of the industry, and therefore, an industry's attractiveness and profitability. Suppliers can influence the profitability of an industry in a number of ways. Suppliers can command bargaining power over a firm when;

(i) Their products are crucial to the buyer and substitutes are not available.

(ii) They can erect/ensure high switching costs.

(iii) They are more concentrated than their buyers. Less suppliers, more buyers.

© The Institute of Chartered Accountants of India

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 answer

Question 1

(a) *Following information and ratios are given for W Limited for the year ended 31st March, 2022:*

Equity Share Capital of ₹ 10 each	*₹ 10 lakhs*
Reserves & Surplus to Shareholders' Fund	*0.50*
Sales / Shareholders' Fund	*1.50*
Current Ratio	*2.50*
Debtors Turnover Ratio	*6.00*
Stock Velocity	*2 Months*
Gross Profit Ratio	*20%*
Net Working Capital Turnover Ratio	*2.50*

You are required to calculate:

(i) Shareholders' Fund

(ii) Stock

(iii) Debtors

(iv) Current liabilities

(v) Cash Balance. ***(5 Marks)***

(b) *Balance sheet of X Ltd for the year ended 31st March,2022 is given below:*

(₹ in lakhs)

Liabilities	***Amount***	***Assets***	***Amount***
Equity Shares ₹ 10 each	*200*	*Fixed Assets*	*500*
Retained earnings	*200*	*Raw materials*	*150*
11% Debentures	*300*	*W.I.P*	*100*
Public deposits (Short-Term)	*100*	*Finished goods*	*50*

© The Institute of Chartered Accountants of India

Trade Creditors	*80*	*Debtors*	*125*
Bills Payable	*100*	*Cash/Bank*	*55*
	980		***980***

Calculate the amount of maximum permissible bank finance under three methods as per Tandon Committee lending norms.

The total core current assets are assumed to be ₹ 30 lakhs. ***(5 Marks)***

(c) *A company requires 36,000 units of a product per year at cost of ₹ 100 per unit. Ordering cost per order is ₹ 250 and the carrying cost is 4.5% per year of the inventory cost. Normal lead time is 25 days and safety stock is NIL.*

Assume 360 working days in a year.

(i) Calculate the Reorder Inventory Level.

(ii) Calculate the Economic Order Quantity (EOQ).

(iii) If the supplier offers 1% quantity discount for purchase in lots of 9,000 units or more, should the company accept the proposal? ***(5 Marks)***

(d) *P Ltd. is considering a project with the following details:*

Initial Project Cost	*₹ 1,00,000*			
Annual Cash Inflow (₹)	*1*	*2*	*3*	*4*
	30,000	*40,000*	*50,000*	*60,000*
Project Life (Years)	*4*			
Cost of Capital	*10%*			

(i) MEASURE the sensitivity of the project to change in initial project cost and Annual cash inflows (considering each factor at a time) such that NPV become zero.

(ii) IDENTIFY which of the two factors; the project is most sensitive to affect the acceptability of the project?

Year	*1*	*2*	*3*	*4*	*5*
$PVIF_{0.10, t}$	*0.909*	*0.826*	*0.751*	*0.683*	*0.621*

(5 Marks)

Answer

(a) (i) Calculation of Shareholders' Fund:

$$\frac{\text{Reserve \& Surplus}}{\text{Shareholders' Funds}} = 0.5$$

© The Institute of Chartered Accountants of India

$$\frac{\text{Reserve \& Surplus}}{\text{Equity Share Capital + Reserve \& Surplus}} = 0.5$$

$$\frac{\text{Reserve \& Surplus}}{10,00,000 + \text{Reserve \& Surplus}} = 0.5$$

Reserve & Surplus = 5,00,000 + 0.5 Reserve & Surplus

0.5 Reserve & Surplus = 5,00,000

Reserve & Surplus = 10,00,000

Shareholders' funds = 10,00,000 +10,00,000

Shareholders' funds = ₹ 20,00,000

(ii) Calculation of Value of Stock:

$$\frac{\text{Sales}}{\text{Shareholders' Funds}} = 1.5$$

Sales = 1.5 × 20,00,000

Sales = 30,00,000

Gross Profit = 30,00,000 × 20% = 6,00,000

Cost of Goods Sold = 30,00,000 – 6,00,000

= ₹ 24,00,000

Stock velocity = 2 months

$$\frac{\text{Average Stock}}{\text{Cost of Goods Sold}} \times 12 = 2$$

$$\frac{\text{Average Stock}}{24,00,000} \times 12 = 2$$

$$\text{Average Stock} = 24,00,000 \times \frac{2}{12}$$

Average stock = ₹ 4,00,000

(iii) Calculation of Debtors:

Debtors Turnover Ratio = 6

$$\therefore \frac{\text{Sales}}{\text{Average Debtor}} = 6$$

© The Institute of Chartered Accountants of India

$$\therefore \frac{30,00,000}{\text{Average Debtor}} = 6$$

Average Debtors = ₹ 5,00,000

(iv) Calculation of Current Liabilities:

Net Working Capital Turnover ratio = 2.5

$$\frac{\text{Sales}}{\text{Current Assets} - \text{Current Liabilites}} = 2.5$$

$$\frac{30,00,000}{\text{Current Assets} - \text{Current Liabilites}} = 2.5$$

Current Assets – Current Liabilities = 12,00,000 ..... (1)

Current Ratio = 2.5

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = 2.5$$

Current Assets = 2.5 Current Liabilities .....(2)

From (1) & (2),

2.5 Current Liabilities – Current Liabilities = 12,00,000

1.5 Current Liabilities = 12,00,000

Current Liabilities = ₹ 8,00,000

(v) Calculation of Cash Balance:

Current Assets = 2.5 Current Liabilities

Current Assets = 2.5 (8,00,000)	= 20,00,000
(-) Debtors	(5,00,000)
(-) Stock	(4,00,000)
Cash Balance	**₹ 11,00,000**

(b) Current Assets = 150 + 100 + 50 + 125 + 55 = ₹ 480 Lakhs

Current Liabilities = 100 + 80 + 100 = ₹ 280 Lakhs

Maximum Permissible Banks Finance under Tandon Committee Norms:

© The Institute of Chartered Accountants of India

Method I

Maximum Permissible Bank Finance = 75% of (Current Assets – Current Liabilities)

= 75% of (480 - 280)

= **₹ 150 Lakhs**

Method II

Maximum Permissible Bank Finance = 75% of Current Assets – Current Liabilities

= 75 % of 480 – 280

= **₹ 80 Lakhs**

Method III

Maximum Permissible Bank Finance = 75% of (Current Assets – Core Current Assets) – Current Liabilities

= 75 % of (480 - 30) – 280

= **₹ 57.5 Lakhs**

(c) Annual Consumption = 36,000 (A)

Ordering Cost = ₹ 250 per order (O)

Carrying Cost = $\frac{4.5}{100} \times 100$

= ₹ 4.5 (C)

Lead Time = 25 days

(i) Reorder Level = Lead Time × Daily Consumption

$= 25 \times \frac{36,000}{360}$

= **2,500 units**

(ii) Economic Order Quantity (EOQ) $= \sqrt{\frac{2AO}{C}}$

$= \sqrt{\frac{2 \times 36,000 \times 250}{4.5}}$

= **2,000 units**

© The Institute of Chartered Accountants of India

(iii) Evaluation of Profitability of Quantity Discount Offer:

(a) When EOQ is ordered

		(₹)
Purchase Cost	(36,000 units × ₹ 100)	36,00,000
Ordering Cost	[(36,000 units/2,000 units) × ₹ 250]	4,500
Carrying Cost	(2,000 units × ½ × ₹ 4.5)	4,500
Total Cost		**36,09,000**

(b) When Quantity Discount is accepted

		(₹)
Purchase Cost	(36,000 units × ₹ 99*)	35,64,000
Ordering Cost	[(36,000 units/9,000 units) × ₹ 250]	1,000
Carrying Cost	(9,000 units × ½ × ₹ 99 x 4.5%)	20,048
Total Cost		**35,85,048**

*Unit Cost = ₹100

Less: Quantity Discount @ 1% = ₹ 1

Purchase Cost = ₹ 99

Advise – The total cost of inventory is lower if Quantity Discount is accepted. Hence, the company is advised to accept the proposal.

(d) Computation of Net Present Value (NPV):

Year	PVF @ 10%	Original Cash Flows (₹)	PV (₹)	PV (₹)
0	1	(1,00,000)		(1,00,000)
1	0.909	30,000	27,270	
2	0.826	40,000	33,040	
3	0.751	50,000	37,550	
4	0.683	60,000	40,980	1,38,840
NPV				**38,840**

Determination of the most Sensitive factor:

(i) Sensitivity Analysis w.r.t. Initial Project cost (such that NPV becomes zero):

NPV of the project would be zero when the initial project cost is increased by ₹ 38,840.

$\therefore$ Percentage change in Initial project cost = $\frac{₹\ 38,840}{₹\ 1,00,000} \times 100$ = **38.84%**

© The Institute of Chartered Accountants of India

(ii) Sensitivity Analysis w.r.t. Annual Cash inflows (such that NPV becomes zero):

NPV of the project would be zero when the Annual cash inflows is decreased by ₹ 38,840.

$\therefore$ Percentage change in the Annual cash inflows = $\frac{₹\ 38,840}{₹\ 1,38,840} \times 100$ = **27.97%**

Conclusion: Annual cash inflows factor is the most sensitive as only a change beyond 27.97% in savings makes the project unacceptable.

Question 2

Details of a company for the year ended 31st March, 2022 are given below:

Sales	*₹ 86 lakhs*
Profit Volume (P/V) Ratio	*35%*
Fixed Cost excluding interest expenses	*₹ 10 lakhs*
10% Debt	*₹ 55 lakhs*
Equity Share Capital of ₹ 10 each	*₹ 75 lakhs*
Income Tax Rate	*40%*

Required:

(i) Determine company's Return on Capital Employed (Pre-tax) and EPS.

(ii) Does the company have a favourable financial leverage?

(iii) Calculate operating and combined leverages of the company.

(iv) Calculate percentage change in EBIT, if sales increases by 10%.

(v) At what level of sales, the Earning before Tax (EBT) of the company will be equal to zero? ***(10 Marks)***

Answer

Income Statement

Particulars	Amount (₹)
Sales	86,00,000
Less: Variable cost (65% of 86,00,000)	55,90,000
Contribution (35% of 86,00,000)	30,10,000
Less: Fixed costs	10,00,000
Earnings before interest and tax (EBIT)	20,10,000
Less: Interest on debt (@ 10% on ₹ 55 lakhs)	5,50,000

© The Institute of Chartered Accountants of India

Earnings before tax (EBT)	14,60,000
Tax (40%)	5,84,000
PAT	8,76,000

(i) ROCE (Pre-tax) = $\frac{\text{EBIT}}{\text{Capital employed}} \times 100 = \frac{\text{EBIT}}{\text{Equity + Debt}} \times 100$

$$\frac{₹\ 20,10,000}{₹\ (75,00,000+55,00,000)} \times 100 = \textbf{15.46\%}$$

EPS (PAT/No. of equity shares) **1.168 or ₹ 1.17**

(ii) ROCE is 15.46% and Interest on debt is 10%. Hence, it has a **favourable financial leverage.**

(iii) Calculation of Operating, Financial and Combined leverages:

Operating Leverage = $\frac{\text{Contribution}}{\text{EBIT}} = \frac{₹\ 30,10,000}{₹\ 20,10,000}$ **=1.497 (approx.)**

Financial Leverage = $\frac{\text{EBIT}}{\text{EBIT}} = \frac{₹\ 20,10,000}{₹\ 14,60,000}$ = 1.377 (approx.)

Combined Leverage = $\frac{\text{Contribution}}{\text{EBT}} = \frac{₹\ 30,10,000}{₹\ 14,60,000}$ = 2.062 (approx.)

Or, = Operating Leverage × Financial Leverage = 1.497 × 1.377 **= 2.06 (approx.)**

(iv) Operating leverage is 1.497. So, if sales are increased by 10%.

EBIT will be increased by 1.497 × 10% i.e. 14.97% (approx.)

(v) Since the combined Leverage is 2.062, sales have to drop by 100/2.062 i.e. 48.50% to bring EBT to Zero.

Accordingly, New Sales = ₹ 86,00,000 × (1 - 0.4850)

= ₹ 86,00,000 × 0.515

= ₹ 44,29,000 (approx.)

Hence, at ₹ 44,29,000 sales level, EBT of the firm will be equal to Zero.

Question 3

Alpha Limited is a manufacturer of computers. It wants to introduce artificial intelligence while making computers. The estimated annual saving from introduction of the artificial intelligence (AI) is as follows:

© The Institute of Chartered Accountants of India

- *reduction of five employees with annual salaries of ₹ 3,00,000 each*
- *reduction of ₹ 3,00,000 in production delays caused by inventory problem*
- *reduction in lost sales ₹ 2,50,000 and*
- *Gain due to timely billing ₹ 2,00,000*

The purchase price of the system for installation of artificial intelligence is ₹ 20,00,000 and installation cost is ₹ 1,00,000. 80% of the purchase price will be paid in the year of purchase and remaining will be paid in next year.

The estimated life of the system is 5 years and it will be depreciated on a straight-line basis.

However, the operation of the new system requires two computer specialists with annual salaries of ₹ 5,00,000 per person.

In addition to above, annual maintenance and operating cost for five years are as below:

(Amount in ₹)

Year	*1*	*2*	*3*	*4*	*5*
Maintenance & Operating Cost	*2,00,000*	*1,80,000*	*1,60,000*	*1,40,000*	*1,20,000*

Maintenance and operating cost are payable in advance.

The company's tax rate is 30% and its required rate of return is 15%.

Year	*1*	*2*	*3*	*4*	*5*
PVIF $_{0.10, t}$	*0.909*	*0.826*	*0.751*	*0.683*	*0.621*
PVIF $_{0.12, t}$	*0.893*	*0.797*	*0.712*	*0.636*	*0.567*
PVIF $_{0.15, t}$	*0.870*	*0.756*	*0.658*	*0.572*	*0.497*

Evaluate the project by using Net Present Value and Profitability Index. ***(10 Marks)***

Answer

Computation of Annual Cash Flow after Tax						
Particulars	**Year 0**	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Savings in Salaries		15,00,000	15,00,000	15,00,000	15,00,000	15,00,000
Reduction in Production Delays		3,00,000	3,00,000	3,00,000	3,00,000	3,00,000
Reduction in Lost Sales		2,50,000	2,50,000	2,50,000	2,50,000	2,50,000
Gain due to Timely Billing		2,00,000	2,00,000	2,00,000	2,00,000	2,00,000
Salary to Computer Specialist		(10,00,000)	(10,00,000)	(10,00,000)	(10,00,000)	(10,00,000)

© The Institute of Chartered Accountants of India

Maintenance and Operating Cost (payable in advance)		(2,00,000)	(1,80,000)	(1,60,000)	(1,40,000)	(1,20,000)
Depreciation (21 lakhs/5)		(4,20,000)	(4,20,000)	(4,20,000)	(4,20,000)	(4,20,000)
Gain Before Tax		6,30,000	6,50,000	6,70,000	6,90,000	7,10,000
Less: Tax (30%)		1,89,000	1,95,000	2,01,000	2,07,000	2,13,000
Gain After Tax		4,41,000	4,55,000	4,69,000	4,83,000	4,97,000
Add: Depreciation		4,20,000	4,20,000	4,20,000	4,20,000	4,20,000
Add: Maintenance and Operating Cost (payable in advance)		2,00,000	1,80,000	1,60,000	1,40,000	1,20,000
Less: Maintenance and Operating Cost (payable in advance)	(2,00,000)	(1,80,000)	(1,60,000)	(1,40,000)	(1,20,000)	-
Net CFAT	(2,00,000)	8,81,000	8,95,000	9,09,000	9,23,000	10,37,000

Note: Annual cash flows can also be calculated Considering tax shield on depreciation & maintenance and operating cost. There will be no change in the final cash flows after tax.

Computation of NPV				
Particulars	**Year**	**Cash Flows (₹)**	**PVF**	**PV (₹)**
Initial Investment (80% of 20 Lacs)	0	16,00,000	1	16,00,000
Installation Expenses	0	1,00,000	1	1,00,000
Instalment of Purchase Price	1	4,00,000	0.870	3,48,000
PV of Outflows (A)				**20,48,000**
CFAT	0	(2,00,000)	1	(2,00,000)
CFAT	1	8,81,000	0.870	7,66,470
CFAT	2	8,95,000	0.756	6,76,620
CFAT	3	9,09,000	0.658	5,98,122
CFAT	4	9,23,000	0.572	5,27,956
CFAT	5	10,37,000	0.497	5,15,389
PV of Inflows (B)				28,84,557
NPV (B-A)				**8,36,557**
Profitability Index (B/A)				**1.408 or 1.41**

© The Institute of Chartered Accountants of India

Evaluation: Since the NPV is positive (i.e. ₹ 8,36,557) and Profitability Index is also greater than 1 (i.e. 1.41), Alpha Ltd. may introduce artificial intelligence (AI) while making computers.

Question 4

The particulars relating to Raj Ltd. for the year ended 31st March, 2022 are given as follows:

Output (units at normal capacity)	*1,00,000*
Selling price per unit	*₹ 40*
Variable cost per unit	*₹ 20*
Fixed cost	*₹ 10,00,000*

The capital structure of the company as on 31st March, 2022 is as follows:

Particulars	***Amount in ₹***
Equity share capital (1,00,000 shares of ₹ 10 each)	*10,00,000*
Reserves and surplus	*5,00,000*
Current liabilities	*5,00,000*
Total	***20,00,000***

Raj Ltd. has decided to undertake an expansion project to use the market potential that will involve ₹ 20 lakhs. The company expects an increase in output by 50%. Fixed cost will be increased by ₹ 5,00,000 and variable cost per unit will be decreased by 15%. The additional output can be sold at the existing selling price without any adverse impact on the market.

The following alternative schemes for financing the proposed expansion program are planned:

		(Amount in ₹)
Alternative	***Debt***	***Equity Shares***
1	*5,00,000*	*Balance*
2	*10,00,000*	*Balance*
3	*14,00,000*	*Balance*

Current market price per share is ₹ 200.

Slab wise interest rate for fund borrowed is as follows:

Fund limit	***Applicable interest rate***
Up-to ₹ 5,00,000	*10%*
Over ₹ 5,00,000 and up-to ₹ 10,00,000	*15%*
Over ₹ 10,00,000	*20%*

© The Institute of Chartered Accountants of India

Find out which of the above-mentioned alternatives would you recommend for Raj Ltd. with reference to the EPS, assuming a corporate tax rate is 40%? ***(10 Marks)***

Answer

Alternative 1 = Raising Debt of ₹ 5 lakh + Equity of ₹ 15 lakh

Alternative 2 = Raising Debt of ₹ 10 lakh + Equity of ₹ 10 lakh

Alternative 3 = Raising Debt of ₹ 14 lakh + Equity of ₹ 6 lakh

Calculation of Earnings per share (EPS)

Particulars	FINANCIAL ALTERNATIVES		
	Alternative 1	Alternative 2	Alternative 3
	(₹)	(₹)	(₹)
Expected EBIT [W. N. (a)]	19,50,000	19,50,000	19,50,000
Less: Interest [W. N. (b)]	(50,000)	(1,25,000)	(2,05,000)
Earnings before taxes (EBT)	**19,00,000**	**18,25,000**	**17,45,000**
Less: Taxes @ 40%	7,60,000	7,30,000	6,98,000
Earnings after taxes (EAT)	**11,40,000**	**10,95,000**	**10,47,000**
Number of shares [W. N. (d)]	1,07,500	1,05,000	1,03,000
Earnings per share (EPS)	**10.60**	**10.43**	**10.17**

Conclusion: Alternative 1 (i.e. Raising Debt of ₹ 5 lakh and Equity of ₹ 15 lakh) is recommended which maximises the earnings per share.

Working Notes (W.N.):

(a) Calculation of Earnings before Interest and Tax (EBIT)

Particulars		
Output (1,00,000 + 50%)	(A)	1,50,000
Selling price per unit		₹ 40
Less: Variable cost per unit (₹ 20 – 15%)		₹ 17
Contribution per unit	(B)	₹ 23
Total contribution	**(A x B)**	**₹ 34,50,000**
Less: Fixed Cost (₹ 10,00,000 + ₹ 5,00,000)		₹ 15,00,000
EBIT		**₹ 19,50,000**

© The Institute of Chartered Accountants of India

(b) Calculation of interest on Debt

Alternative		(₹)	Total (₹)
1	(₹ 5,00,000 x 10%)		50,000
2	(₹ 5,00,000 x 10%)	50,000	
	(₹ 5,00,000 x 15%)	75,000	1,25,000
3	(₹ 5,00,000 x 10%)	50,000	
	(₹ 5,00,000 x 15%)	75,000	
	(₹ 4,00,000 x 20%)	80,000	2,05,000

(c) Number of equity shares to be issued

$$\text{Alternative 1} = \frac{₹\ (20,00,000 - 5,00,000)}{₹\ 200\ \text{(Market price of share)}} = \frac{₹\ 15,00,000}{₹\ 200} = 7,500\ \text{shares}$$

$$\text{Alternative 2} = \frac{₹\ (20,00,000 - 10,00,000)}{₹\ 200\ \text{(Market price of share)}} = \frac{₹\ 10,00,000}{₹\ 200} = 5,000\ \text{shares}$$

$$\text{Alternative 3} = \frac{₹\ (20,00,000 - 14,00,000)}{₹\ 200\ \text{(Market price of share)}} = \frac{₹\ 6,00,000}{₹\ 200} = 3,000\ \text{shares}$$

(d) Calculation of total equity shares after expansion program

	Alternative 1	Alternative 2	Alternative 3
Existing no. of shares	1,00,000	1,00,000	1,00,000
Add: issued under expansion program	7,500	5,000	3,000
Total no. of equity shares	**1,07,500**	**1,05,000**	**1,03,000**

Question 5

A company issues:

- *15% convertible debentures of ₹ 100 each at par with a maturity period of 6 years. On maturity, each debenture will be converted into 2 equity shares of the company. The risk-free rate of return is 10%, market risk premium is 18% and beta of the company is 1.25. The company has paid dividend of ₹ 12.76 per share. Five year ago, it paid dividend of ₹ 10 per share. Flotation cost is 5% of issue amount.*
- *5% preference shares of ₹ 100 each at premium of 10%. These shares are redeemable after 10 years at par. Flotation cost is 6% of issue amount.*

Assuming corporate tax rate is 40%.

© The Institute of Chartered Accountants of India

(i) Calculate the cost of convertible debentures using the approximation method.

(ii) Use YTM method to calculate cost of preference shares.

Year	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
PVIF $_{0.03, t}$	*0.971*	*0.943*	*0.915*	*0.888*	*0.863*	*0.837*	*0.813*	*0.789*	*0.766*	*0.744*
PVIF $_{0.05, t}$	*0.952*	*0.907*	*0.864*	*0.823*	*0.784*	*0.746*	*0.711*	*0.677*	*0.645*	*0.614*
PVIFA $_{0.03, t}$	*0.971*	*1.913*	*2.829*	*3.717*	*4.580*	*5.417*	*6.230*	*7.020*	*7.786*	*8.530*
PVIFA $_{0.05, t}$	*0.952*	*1.859*	*2.723*	*3.546*	*4.329*	*5.076*	*5.786*	*6.463*	*7.108*	*7.722*

Interest rate	*1%*	*2%*	*3%*	*4%*	*5%*	*6%*	*7%*	*8%*	*9%*
FVIF $_{i, 5}$	*1.051*	*1.104*	*1.159*	*1.217*	*1.276*	*1.338*	*1.403*	*1.469*	*1.539*
FVIF $_{i, 6}$	*1.062*	*1.126*	*1.194*	*1.265*	*1.340*	*1.419*	*1.501*	*1.587*	*1.677*
FVIF $_{i, 7}$	*1.072*	*1.149*	*1.230*	*1.316*	*1.407*	*1.504*	*1.606*	*1.714*	*1.828*

(10 Marks)

Answer

(i) Calculation of Cost of Convertible Debentures:

Given that,

R_F = 10%

$R_m - R_f$ = 18%

B = 1.25

D_0 = 12.76

D_{-5} = 10

Flotation Cost = 5%

Using CAPM,

$K_e = R_f + \beta (R_m - R_f)$

= 10%+1.25 (18%)

= **32.50%**

Calculation of growth rate in dividend

$12.76 = 10 (1+g)^5$

$1.276 = (1+g)^5$

$(1+5\%)^5 = 1.276$ ..... from FV Table

g = **5%**

© The Institute of Chartered Accountants of India

Price of share after 6 years $= \frac{D_7}{k_e - g} = \frac{12.76(1.05)^7}{0.325 - 0.05}$

$P_6 = \frac{12.76 \times 1.407}{0.275}$

$P_6 = 65.28$

Redemption Value of Debenture (RV) = 65.28 × 2 = **130.56** (RV)

NP = 95

n = 6

$K_d = \frac{\text{INT (1-t)} + \frac{(RV - NP)}{n}}{\frac{(RV - NP)}{2}} \times 100$

$= \frac{15\ (1-0.4) + \frac{(130.56 - 95)}{6}}{\frac{(130.56 + 95)}{2}} \times 100$

$= \frac{9 + 5.93}{112.78} \times 100$

K_d = 13.24%

(ii) Calculation of Cost of Preference Shares:

Net Proceeds = 100 (1.1) - 6% of 100 (1.1)

= 110 - 6.60

= 103.40

Redemption Value = 100

Year	Cash Flows (₹)	PVF @ 3%	PV (₹)	PVF @ 5%	PV (₹)
0	103.40	1	103.40	1	103.40
1-10	-5	8.530	-42.65	7.722	-38.61
10	-100	0.744	-74.40	0.614	-61.40
			-13.65		**3.39**

$K_p = 3\% + \frac{5\% - 3\%}{[3.39 - (-13.65)]} \times 13.65$

© The Institute of Chartered Accountants of India

$$= 3\% + \frac{2\%}{17.04} \times 13.65$$

K_p = 4.6021%

Question 6

(a) Identify the limitations of Internal Rate of Return. ***(4 Marks)***

(b) Briefly explain the assumptions of Walter's Model. ***(4 Marks)***

(c) State advantages of "Wealth Maximization" goals in Financial Management ***(2 Marks)***

OR

Distinguish between American Depository Receipts and Global Depository Receipts. ***(2 Marks)***

Answer

(a) Limitations of Internal Rate of Return (IRR)

- The calculation **process is tedious** if there is more than one cash outflow interspersed between the cash inflows; there can be multiple IRR, the interpretation of which is difficult.
- The IRR approach **creates a peculiar situation** if we compare two projects with different inflow/outflow patterns.
- It is assumed that under this method all the future cash inflows of a proposal are reinvested at a rate equal to the IRR. **It ignores a firm's ability to re-invest** in portfolio of different rates.
- If mutually exclusive projects are considered as investment options which have considerably different cash outlays. A project with a larger fund commitment but lower IRR contributes more in terms of absolute NPV and increases the shareholders' wealth. In such situation **decisions based only on IRR criterion may not be correct**.

(b) Assumptions of Walter's Model

- All investment proposals of the firm are to be financed **through retained earnings** only.
- **'r'** rate of return & **'K_e'** cost of **capital are constant.**
- **Perfect capital markets**: The firm operates in a market in which all investors are rational and information is freely available to all.
- **No taxes or no tax discrimination** between dividend income and capital appreciation (capital gain). It means there is no difference in taxation of dividend

© The Institute of Chartered Accountants of India

income or capital gain. This assumption is necessary for the universal applicability of the theory, since, the tax rates may be different in different countries.

- **No floatation or transaction cost**: Similarly, these costs may differ country to country or market to market.
- The firm has **perpetual life.**

(c) Advantages of "Wealth Maximization" goals in Financial Management

(i) Emphasizes the long-term gains.

(ii) Recognises risk or uncertainty.

(iii) Recognises the timing of returns.

(iv) Considers shareholders' return.

OR

Distinguish Between American Depository Receipts and Global Depository Receipts:

	American Depository Receipts	Global Depository Receipts
Meaning	It is a negotiable instrument which is issued by US bank, which represent the nazon-US Company stock that is being traded in US stock Exchange	It is a negotiable instrument which is issued by the international depository bank that represent the foreign company's stock trading world-wide.
Issued where	In the US domestic capital market.	European capital market.
Listed in	In the American Stock Exchange	In the Non-US Stock Exchange
Relevance	Foreign companies are able to trade in the US Stock Market.	Foreign companies can trade in any country's stock market other than that of the US.

Alternatively:

American Depository Receipts (ADRs): These are securities offered by **non-US companies who want to list on any of the US exchange**. Each ADR represents a certain number of a company's regular shares. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange.

Global Depository Receipts (GDRs): These are negotiable certificates held in the bank of one country representing a **specific number of shares of a stock traded on the exchange of another country.** These financial instruments are used by companies to raise capital in either dollars or Euros. These are mainly traded in European countries and particularly in London.

© The Institute of Chartered Accountants of India

SECTION – B: ECONOMICS FOR FINANCE

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

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

Question 7

(a) Following information, relating to a particular financial year, are given as under:

	₹ in Crores
Sales	*3,500*
Intermediate consumption	*400*
Closing Stock	*300*
Opening Stock	*200*
Net indirect tax	*600*
Mixed income	*200*
Consumption of fixed capital	*400*
Compensation of employees	*400*

Compute:

(i) GVA_{MP}

(ii) NDP_{MP}

(iii) Operating Surplus ***(3 Marks)***

(b) State the features of Foreign Portfolio Investment. ***(3 Marks)***

(c) Comment on the role of Government intervention for equitable distribution. ***(2 Marks)***

(d) Describe the precautionary motive for money. ***(2 Marks)***

Answer

(a) (i) GVA_{MP} = Sales + Change in stock - Intermediate Consumption

= 3,500 + (300 – 200) – 400

= ₹ 3,200 Crores

(ii) NDP_{MP} = GDP_{MP} – Consumption of Fixed capital

= 3,200 – 400 [here $GDP_{MP} = GVA_{MP}$]

= ₹ 2,800 Crores

© The Institute of Chartered Accountants of India

(iii) $NDP_{FC} = NDP_{MP}$ – Net Indirect Taxes

= 2800 – 600 = ₹ 2,200 Crores

NDP_{FC} = Compensation of employees + Operating surplus + Mixed Income

2,200 = 400 + Operating Surplus + 200

Operating Surplus = 2,200 – 600 **= ₹ 1600 Crores**

(b) Features of Foreign Portfolio Investment:

- Investment is only in financial assets
- Only short-term interest and generally remain invested for short periods
- Relatively easy to withdraw
- Not accompanied by technology transfer
- No direct impact on employment of labour and wages
- No abiding interest in management and control
- Securities are held purely as a financial investment and no significant degree of influence on the management of the enterprise
- Speculative in nature.

(c) Role of Government Intervention for Equitable Distribution: A major function of the present-day governments therefore involves changing the pattern of distribution of income, wealth, and opportunities from what the market would put forward to a more socially optimal and egalitarian one. Governments can redistribute either through the expenditure side or through the revenue side of the budget. On the expenditure side, governments may provide free or subsidized education, healthcare, housing, food, and basic goods etc. to deserving people. On the revenue side, redistribution is done through progressive taxation.

Inequality and the resulting loss of social welfare is sought to be tackled by government through an appropriately framed tax and transfer policy. This involves progressive taxation combined with provision of subsidy to low- income households. Proceeds from progressive taxes may be used to finance public services, especially those such as public housing, which particularly benefit low-income households. Few examples are supply of essential food grains at highly subsidized prices to BPL households, free or subsidised education, healthcare, housing, rations, and basic goods etc. to the deserving people.

(d) Precautionary Motive for Money: Many unforeseen and unpredictable contingencies involving money payments occur in our day-to-day life. Individuals as well as businesses keep a portion of their income to finance such unanticipated expenditures. The amount of money demanded under the precautionary motive depends on the size of income,

© The Institute of Chartered Accountants of India

prevailing economic as well as political conditions and personal characteristics of the individual such as optimism/ pessimism, farsightedness etc. Keynes regarded the precautionary balances just as balances under transactions motive as income elastic and by itself not very sensitive to rate of interest.

The sum of the transaction and precautionary demand, and the speculative demand, is the total demand for money. An increase in income increases the transaction and precautionary demand for money and a rise in the rate of interest decreases the demand for speculative demand money.

Question 8

(a) (i) Differentiate between Non-Discretionary and discretionary Fiscal policy. ***(3 Marks)***

(ii) Write a brief note on Countervailing Duties. ***(2 Marks)***

(b) (i) Explain the 'Circular Flow of Income'. ***(3 Marks)***

(ii) What will be the total money credit created by the commercial banking system for an initial deposit of ₹ 500 if the required reserve ratio is 0.04, 0.06 and 0.10 percent respectively. Compute credit multiplier. ***(2 Marks)***

Answer

(a) (i) Distinction between Non-Discretionary and Discretionary Fiscal Policy

S. No.	Non-Discretionary Fiscal Policy	Discretionary Fiscal Policy
1	These are called automatic Stabilizers. Changes tend to occur automatically without any explicit action by the Government.	These are deliberate policy action by the Government to change the level of expenditure and taxes in order to influence the level of National output employment and prices.
2	Personal income tax, corporate income taxes and transfer payments by Government constitute the major examples.	Specific export subsidies and concessions are examples.
3	Nondiscretionary fiscal policy is that set of policies that are built into the system to stabilize the economy when growth is either too fast or too slow.	Discretionary fiscal policy consists of actions taken at the time of a problem to alter the economy of the moment. Thus, the aim can be anti-cyclical (decrease) or pro cyclical (increase).
4	Non-Discretionary Fiscal Policy ensures self-correcting fiscal response.	Discretionary policy usually implies implementation lags and is not automatically reversed when economic conditions change.

© The Institute of Chartered Accountants of India

Alternatively:

Discretionary fiscal policy refers to deliberate policy actions on the part of the government to change the levels of expenditure and taxes to influence the level of national output, employment, and prices. Non-discretionary fiscal policy or automatic stabilizers are part of the structure of the economy and are 'built-in' fiscal mechanisms that operate automatically to reduce the expansions and contractions of the business cycle. Changes in fiscal policy do not always require explicit action by government. In most economies, changes in the level of taxation and level of government spending tend to occur automatically. These are dependent on and are determined by the level of aggregate production and income, such that the instability caused by business cycle is automatically dampened without any need for discretionary policy action.

However, automatic stabilizers that depend on the level of economic activity alone would not be sufficient to correct instabilities. The government needs to resort to discretionary fiscal policies. Discretionary fiscal policy for stabilization refers to deliberate policy actions on the part of government to change the levels of expenditure, taxes to influence the level of national output, employment, and prices. Governments influence the economy by changing the level and types of taxes, the extent and composition of spending, and the quantity and form of borrowing.

(ii) Countervailing Duties

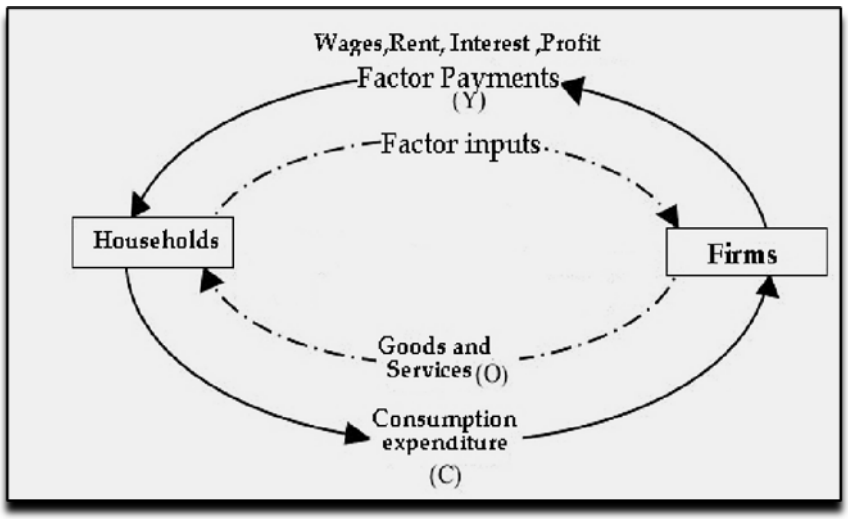
Countervailing duties are tariffs that aim to offset the artificially low prices charged by exporters who enjoy export subsidies and tax concessions offered by the governments in their home country. If a foreign country does not have a comparative advantage in a particular good and a government subsidy allows the foreign firm to be an exporter of the product, then the subsidy generates a distortion from the free-trade allocation of resources. In such cases, CVD is charged in an importing country to negate the advantage that exporters get from subsidies to ensure fair and market-oriented pricing of imported products and thereby protecting domestic industries and firms.

(b) (i) Circular Flow of Income

Circular flow of income is a process where the national income and expenditure of an economy flow in a circular manner continuously through time. Savings, expenditures, exports, and imports are various components of circular flow of income which are (shown in the figure) in the form of currents and cross currents in such a manner that national income equals national expenditure.

© The Institute of Chartered Accountants of India

Circular Flow in Two Sector Economy



The circular broken lines with arrows show factor and product flows and present 'real flows' and the continuous line with arrows show 'money flows' which are generated by real flows. These two circular flows - real flows and money flows - are in opposite directions and the value of real flows equal the money flows because the factor payments are equal to household incomes. There are no injections into or leakages from the system. Since the whole of household income is spent on goods and services produced by firms, household expenditures equal the total receipts of firms which equal the value of output.

Alternatively:

Circular Flow of Income refers to the continuous circulation of production, income generation and expenditure involving different sectors of the economy. There are three different inter linked phases in a circular flow of income namely, production, distribution and disposition as follows:

(i) In the production phase, firms produce goods and services with the help of factor services.

(ii) In the income or distribution phase, the flow of factor incomes in the form of rent, wages, interest and profits from firms to the household occurs.

(iii) In the expenditure or disposition phase, the income received by different factors of production is spent on consumption of goods and services and investment goods.

© The Institute of Chartered Accountants of India

(ii) Credit multiplier = $\frac{1}{\text{Required Reserve Ratio}}$

Credit multiplier when RRR is 0.04 = **25**

Credit multiplier when RRR is 0.06 = **16.67**

Credit multiplier when RRR is 0.10 = **10**

Credit Creation = Initial Deposit x Credit Multiplier

Credit creation = $500 \times \frac{1}{0.04}$ = **12,500**

Credit creation = $500 \times \frac{1}{0.06}$ = **8,333.33**

Credit Creation = $500 \times \frac{1}{0.10}$ = **5,000**

Question 9

(a) (i) Explain 'Global Public goods' with examples. ***(3 Marks)***

(ii) What is aggregate Demand Function? ***(3 Marks)***

(b) (i) Calculate the volume of Transaction:

Price = 105

Velocity of money = 4.2

Money supply 4500 billion

What will be the outcome if volume of transaction increases to 240? ***(3 Marks)***

(ii) What do you mean by 'Bound Tariff'? Explain. ***(2 Marks)***

Answer

(a) (i) Global Public Goods

Global public goods are those public goods with benefits/costs that potentially extend to everyone in the world. These goods have widespread impact on different countries and regions, population groups and generations throughout the entire globe.

Examples of Global Public Goods may be:

- Final public goods which are 'outcomes' such as ozone layer preservation or prevention of climate change and bio-diversity.

© The Institute of Chartered Accountants of India

- Intermediate public goods, which contribute to the provision of final public goods e.g., international health regulations for communicable diseases including HIV/AIDS, tuberculosis, malaria and avian influenza.
- International trade, international financial architecture and global knowledge for development.

The World Bank identifies five areas of global public goods which it seeks to address: namely, the environmental commons, communicable diseases, international trade, international financial architecture, and global knowledge for development. The distinctive characteristic of global public goods is that there is no mechanism (either market or government) to ensure an efficient outcome.

(ii) Aggregate Demand Function

Aggregate demand (AD) is what economists call total planned expenditure. In a simple two-sector economy, the ex-ante aggregate demand (AD) for final goods or aggregate expenditure consists of only two components:

(i) Ex ante aggregate demand for consumer goods (C), and

(ii) Ex ante aggregate demand for investment goods (I).

Thus, AD = C + I (i)

Of the two components, consumption expenditure accounts for the highest proportion of the GDP. In a simple economy, the variable **I is** assumed to be determined exogenously and constant in the short run. Therefore, the short-run aggregate demand function can be written as:

AD = C + $\bar{I}$ (ii)

Where $\bar{I}$ = constant investment.

From the equation (ii), we can infer that, in the short- run, AD depends largely on the aggregate consumption expenditure.

(b) (i) Calculation of Volume of Transaction

MV = PT

4500 × 4.2 = 105 × T

T = (4500 x 4.2) / 105 = **180**

Now if volume of transaction increase to 240 then-

4500 × v = 105 × 240

V = $\frac{105 \times 240}{4,500}$ = **5.6**

© The Institute of Chartered Accountants of India

(ii) Bound Tariff

The bound tariff rate is specific to individual products and represents the maximum level of import duty that can be levied on a product imported by that member. Under this, a WTO member binds itself with a legal commitment not to raise tariff rate above a certain level. By binding a tariff rate, often during negotiations, the members agree to limit their right to set tariff levels beyond a certain level. A member is always free to impose a tariff that is lower than the bound level. Once bound, a tariff rate becomes permanent, and a member can only increase its level after negotiating with its trading partners and compensating them for possible losses of trade. A bound tariff ensures transparency and predictability.

Question 10

(a) (i) What are the common objectives of fiscal policy? ***(3 Marks)***

(ii) State the nature of the monetary policy for the following actions taken by the RBI of the country:

(A) Reduction in the cash reserve ratio.

(B) Selling of securities in the open market.

(C) Increase of repo rate by 50 base point.

(D) Increase in the supply of currency and coins. ***(2 Marks)***

(b) (i) Calculate Multiplier and Marginal Propensity to Consume (MPC) with the help of following information:

Particulars	***2020-21 (₹ in Crore)***	***2021-22 (₹ in Crore)***
Investment	*1600*	*2000*
National Income	*5000*	*6600*

(2 Marks)

(ii) Explain 'Sanitary and Phytosanitary (SPS) Measures'. ***(2 Marks)***

Answer

(a) (i) Common Objectives of Fiscal Policy

Fiscal policy is in the nature of a demand-side policy. An economy which is producing at full-employment level does not require government action in the form of fiscal policy.

The most common objectives of fiscal policy are:

- achievement and maintenance of full employment,
- maintenance of price stability,

© The Institute of Chartered Accountants of India

- acceleration of the rate of economic growth and development, and
- equitable distribution of income and wealth.

(ii) Nature of Monetary Policy

		Nature of Monetary Policy
A	Reduction in cash reserves ratio.	Expansionary
B	Selling of securities in the open market.	Contractionary
C	Increase of repo rate by 50 base point.	Contractionary
D	Increase in the supply of currency and coins.	Expansionary

(b) (i) Calculation of Marginal Propensity to Consume (MPC)

Increase in investment

$\Delta I = 2,000 - 1,600 = ₹ 400$ Crore

Increase in National Income

$= \Delta Y = 6,600 - 5,000$

$= ₹ 1,600$ Crore

Multiplier $k = \frac{\Delta y}{\Delta I} = \frac{1,600}{400} = \mathbf{4}$

We know that $k = \frac{1}{1-MPC}$

$$4 = \frac{1}{1-MPC}$$

$4(1-MPC) = 1$

$4-4MPC = 1$

$3 = 4MPC$

$MPC = \frac{3}{4} = 0.75$

MPC = 0.75

© The Institute of Chartered Accountants of India

(ii) Sanitary and Phytosanitary (SPS) Measures

SPS measures are applied to protect human, animal or plant life from risks arising from additives, pests, contaminants, toxins or disease-causing organisms and to protect biodiversity.

These include ban or prohibition of import of certain goods, all measures governing quality and hygienic requirements, production processes, and associated compliance assessments. For example, prohibition of import of poultry from countries affected by avian flu, meat and poultry processing standards to reduce pathogens, residue limits for pesticides in foods etc.

Question 11

(a) (i) The monetary authority of an economy has provided the following data:

Particulars	*₹ in Crore*
Notes in Circulation	*2,42,09,645*
Rupee Coin in Circulation	*3,25,572*
Small Coins in Circulation	*7,434*
Post Office Saving Bank Deposits	*14,17,868*
Cash in Hand with banks	*9,75,635*
Deposit Money of the Public	*1,77,61,992*
Demand Deposited with banks	*1,73,76,925*
Other Deposits with Reserve Bank	*3,85,074*
Total Post Office Deposits	*1,48,966*
Time Deposits with Banks	*17,86,969*

You are required to calculate (i) M1; and (ii) M2. ***(3 Marks)***

(ii) Identify the market outcomes for each of the following situations:

(A) Playing of loud music at night resulting in inability to sleep.

(B) Wearing of mask during covid-19 pandemic. ***(2 Marks)***

(b) (i) Following information, relating to an economy of a country, for the current year are as under:

Particulars	***(In Crores ₹)***
GDP MP	*6550*
Gross Investment (Including Business fixed investment, Residential construction investment, Public & Inventory investment)	*1000*

© The Institute of Chartered Accountants of India

Government Purchases of goods and services	*1500*
Exports	*400*
Imports	*350*
GNPMP	*6600*
Indirect Taxes	*200*
Depreciation	*200*

Find out:

(A) Private Final Consumption Expenditure

(B) Net Factor Income from Abroad

(C) NNP_{FC} or National Income ***(3 Marks)***

(ii) Explain briefly two key concepts of 'New Trade Theory' that gives advantages to countries that import goods to compete with the home country. ***(2 Marks)***

OR

Explain 'Embargos'. ***(2 Marks)***

Answer

(a) (i) Calculation of M1 and M2

M1 = (Notes in Circulation + Rupee coin in circulation + small coins in circulation – cash in hands with banks) + demand deposit with bank + other deposit with RBI

= 2,42,09,645 + 3,25,572 +7,434 - 9,75,635 +1,73,76,925+3,85,074

= ₹ 4,13,29,015 Crores

M2 = M1+ Post Office Savings Bank Deposits

= 4,13,29,015 +14,17,868

= ₹ 4,27,46,883 Crores

(ii) Situations and Market outcomes:

(A) Playing of loud music at night resulting in inability to sleep

Market Outcome: Negative Consumption externality, over production.

(B) Wearing of mask during COVID-19 pandemic

Market Outcome: Positive consumption externality as it prevents others from getting infected.

© The Institute of Chartered Accountants of India

(b) (i) (A) Private Final Consumption Expenditure:

GDP_{MP} = Private Final Consumption expenditure + Government final consumption expenditure + Gross domestic Capital formation + Net Export

6,550 = Private Final Consumption expenditure + 1,500+1,000+50

Private Final Consumption expenditure = 6550-2550 = **₹ 4000 crores**

(B) Net Factor Income from Abroad:

= $GNP_{MP} – GDP_{MP}$

= 6,600 – 6,550

= ₹ 50 crores

(C) NNP_{FC} or National Income:

= GDP_{MP} – depreciation + NFIA – NIT

= 6,550 – 200+50-200

= ₹ 6,200 crores

(b) (ii) New Trade Theory (NTT): According to NTT, two key concepts that gives advantages to countries that import goods to compete with products from the home country are:

Economies of Scale: As a firm produces more of a product, its cost per unit keeps going down. So, if the firm serves domestic as well as foreign market instead of just one, then it can reap the benefit of large scale of production consequently the profits are likely to be higher.

Network effects: It refer to the way one person's value for a good or service is affected by the value of that good or service to others. The value of the product or service is enhanced as the number of individuals using it increases. This is also referred to as the 'bandwagon effect'. Consumers like more choices, but they also want products and services with high utility, and the network effect increases utility obtained from these products over others. A good example will be Mobile App such as What's App and software like Microsoft Windows.

OR

Embargos:

An embargo is a total ban imposed by government on import or export of some or all commodities to particular country or regions for a specified or indefinite period. This may be done due to political reasons or for other reasons such as health, religious sentiments. This is the most extreme form of trade barrier.

© The Institute of Chartered Accountants of India