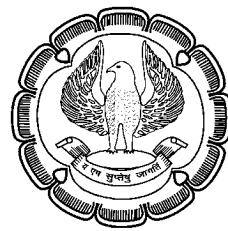


**INTERMEDIATE COURSE
(UNDER REVISED SCHEME OF
EDUCATION AND TRAINING)**

GROUP - II

REVISION TEST PAPERS

MAY, 2019



BOARD OF STUDIES

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

(Set up by an Act of Parliament)

New Delhi

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REVISION TEST PAPER, MAY 2019 – OBJECTIVE & APPROACH

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

I Objective of Revision Test Paper

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

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

The primary objectives of the RTP are:

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

RTPs contain the following:

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

Students must bear in mind that the RTP contains a variety of questions based on different sections of the syllabi and thus a comprehensive study of the entire syllabus is a pre-requisite before answering the questions of the RTP. In other words, in order to

derive maximum benefit out of the RTPs, it is advised that before proceeding to solve the questions given in the RTP, students ought to have thoroughly read the Study Materials.

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

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

II. Planning and preparing for examination

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

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

Examination tips

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

- Reach the examination hall well in time.
- As soon as you get the question paper, read it carefully and thoroughly. You are given separate 15 minutes for reading the question paper.
- Plan your time so that appropriate time is awarded for each question. Keep sometime for checking the answers as well.
- First impression is the last impression. The question which you can answer in the best manner should be attempted first.
- Always attempt to do all questions. Therefore, it is important that you must finish each question within allocated time.

- Read the question carefully more than once before starting the answer to understand very clearly as to what is required.
- Answer all parts of a question one after the other; do not answer different parts of the same question at different places.
- Write in a neat and legible hand-writing.
- Always be concise and write to the point and do not try to fill pages unnecessarily.
- There must be logical expression of the answer.
- In case a question is not clear, you may state your assumptions and then answer the question.
- Check your answers carefully and underline important points before leaving the examination hall.

III. Subject-wise Guidance – An Overview

PAPER 5: ADVANCED ACCOUNTING

The Revisionary Test Paper (RTP) of Advanced Accounting is divided into two parts viz Part I - Relevant Announcements, Amendments and Notifications for May, 2019 examination and Part II – Questions and Answers.

It may be noted that the July, 2017 edition of the Study Material is relevant for May, 2019 Examination.

Part I of the Revisionary Test Paper consists of the 'Relevant Amendments and Notifications - applicable and not applicable' for May, 2019 examination. The purpose of this information in the RTP is to apprise the students with the latest developments applicable for May, 2019 examination. The brief summary of the same has been given as under:

A. Applicable for May, 2019 examination:

- I. Amendments in Schedule III (Division I) to the Companies Act, 2013
- II. Maintenance of Statutory Liquidity Ratio (SLR)
- III. Maintenance of Cash Reserve Ratio (CRR)

B. Not applicable for May, 2019 examination:

- I. Ind ASs issued by the Ministry of Corporate Affairs.
- II. The Guidance Note on 'Accounting for Depreciation in Companies in context of schedule II to the Companies Act, 2013'.

Part II of the Revisionary Test Paper consists of twenty questions together with their answers. First fourteen questions are based on different topics discussed in the study material. Last 6 questions of this RTP are based on Guidance Notes and Accounting Standards. For easy reference, the topic / accounting standard number on which the question is based has been quoted at the top of each question. The details of topics, on which questions in the RTP are based, are as under:

Question No.	Topic
1	Employee Stock Option Plans
2	Buy Back of Securities
3	Equity Shares with Differential Rights
4	Underwriting of Shares
5	Amalgamation of Companies
6	Internal Reconstruction of a Company
7	Liquidation of a Company
8	Financial statements of Insurance Companies
9	Financial statements of Banking Companies
10	NBFCs
11	Mutual Funds
12	Valuation of Goodwill
13	Consolidated Financial Statements
14 to 20	Accounting Standards

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

PAPER – 6: AUDITING AND ASSURANCE

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

The Revisionary Test Paper (RTP) of Auditing and Assurance for May, 2019 carries twenty eight descriptive questions along with 10 MCQs. and their answers. These questions have been taken from the entire syllabus which is divided into thirteen chapters along with engagement and quality control standards etc. discussed in the study material.

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

This RTP of Auditing and Assurance has been divided into two parts *viz* Part I – Legislative Amendments / Notifications / Circulars / Rules / Guidelines issued by Regulating Authority relevant for May, 2019 examination and Part II – Questions and Answers.

The relevant notified sections of the Companies Act, 2013 and other legislative amendments including relevant Notifications / Circulars / Rules / Guidelines issued by Regulating Authorities up to 31st October, 2018 are applicable for May, 2019 Examination. The questions have been answered in this RTP keeping in view latest amendments as per above mentioned date.

PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC MANAGEMENT

Section – A: Enterprise Information Systems

The Revision Test Paper on Enterprise Information Systems is a supplementary tool that provides comprehensive view of the entire syllabus which is divided into five chapters. It is based on the study material that is already provided to the students. The chapter-wise questions and answers are provided so that students could test their preparation level for the examination. Full answer to each question is specified so that students would be benefited without searching the answers from various sources.

The RTP contains total 10 questions out of which first 3 questions numbered 1 to 3 are Multiple Choice Questions (MCQ) based on different chapters. Each MCQ has four options out of which only one option is correct. Remaining 7 questions numbered 4 to 10 are descriptive questions given chapter-wise. The questions have been selected from various chapters/topics uniformly keeping in view the complete coverage of the whole syllabus and check the students' preparedness on answering the questions based on different skill levels "Comprehension & Knowledge" as well as "Analysis & Application". The questions provide an insight to the students on their understanding of the fundamental concepts of Information Systems and Business Process flows, Financial and Accounting systems, Core Banking Systems and e-Commerce and m-Commerce transactions.

Section – B: Strategic Management

The Revision Test Paper in the subject of Strategic Management for the May, 2019 examination contains 18 questions. Broadly, the questions included are of two categories – multiple choice questions and other descriptive questions. Each question is further subdivided into different parts to extensively cover different chapters of the syllabus.

In the first question multiple choice questions with four alternatives are included and the student has to opt the correct option. Subsequently, sixteen descriptive questions have been included that covers all the eight chapters of the syllabus. Chapter names have been mentioned before questions. In the last question, student has to distinguish between two concepts.

The students should take up this Revision Test Paper as a tool to check their preparedness in the subject. To properly self-assess the preparation in the subject, students must attempt the questions on their own. Mere reading will not be helpful. Compare your answers with the suggested answers and hints given to assess the present status of understanding and identify areas for improvement.

Work hard and perform well in the examination.

PAPER – 8: FINANCIAL MANAGEMENT AND ECONOMICS FOR FINANCE

PAPER – 8A: FINANCIAL MANAGEMENT

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

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

Financial Management

Qs. No.	Topic	About the Problem
1.	Ratio Analysis	Comment on Ratios.
2.	Cost of Capital	Determination of the weighted average cost of capital of the company using book value weights and market value weights.
3.	Capital Structure	Ascertainment of the probable price of share

4.	Leverage	Calculation of leverages.
5.	Investment Decisions/ Capital Budgeting	Capital Budgeting decisions.
6.	Financing of Working Capital	Working Capital Investment and its financing.
7.	Financing of Working Capital.	Estimation of Working Capital Requirement.
8.	Risk Analysis in Capital Budgeting	Calculation of NPV based on Risks adjusted discount rate.
9.	Dividend Decision	Calculation of price of each share using Gordon's Model
10 (a)	Scope and Objective of Financial Management	Functions of Finance Manager.
10 (b)	Scope and Objective of Financial Management	Inter relationship between investment, financing and dividend decisions
10 (c)	Types of Financing	Debt securitisation

Section B: Economics for Finance

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

Since this paper is knowledge and applications oriented, the first question related simple calculations like various components of National Income, second question related applications Multiplier concepts, third and fourth question related various situations of market failures of the economy and Fiscal policy. In sixth and seventh questions Money market, concepts of money supply and demand and Monetary policy aspects described. The topics of International trade related questions are described in questions eight, ninth and tenth.

Answers have been given in detail so as to enable you to understand and comprehend the steps involved in answering/solving the problems. This answers have been presented in the manner which is expected from the students in the examination. Students must attempt the questions themselves under examination conditions and then see the answers. This will help you in knowing your level of preparedness and further strategies your final preparation and presentation.

PAPER – 5: ADVANCED ACCOUNTING

PART – I: ANNOUNCEMENTS STATING APPLICABILITY & NON-APPLICABILITY For MAY, 2019 EXAMINATION

A. Applicable for May, 2019 Examination

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

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

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

II. **Maintenance of Statutory Liquidity Ratio (SLR)**

Section 24 and Section 56 of the Banking Regulation Act, 1949 – Maintenance of SLR and holdings of SLR in HTM category

It has been decided to reduce the SLR requirement of banks from 20.0 per cent of their Net Demand and Time Liabilities (NDTL) to 19.5 per cent from the fortnight commencing October 14, 2017 as announced in the Fourth Bi-monthly Monetary Policy Statement, 2017-18 on October 04, 2017. The related notification is DBR.No.Ret.BC.91/12.02.001/2017-18 dated October 4, 2017.

Currently, the banks are permitted to exceed the limit of 25 per cent of the total investments under HTM category, provided the excess comprises of SLR securities and total SLR securities held under HTM category are not more than 20.5 per cent of NDTL. In order to align this ceiling on the SLR holdings under HTM category with the mandatory SLR, it has been decided to reduce the ceiling from 20.5 per cent to 19.5 per cent in a phased manner, i.e. 20 per cent by December 31, 2017 and 19.5 per cent by March 31, 2018.

As per extant instructions, banks may shift investments to/from HTM with the approval of the Board of Directors once a year, and such shifting will normally be allowed at the beginning of the accounting year. In order to enable banks to shift their excess SLR securities from the HTM category to AFS/HFT to comply with instructions as

indicated in paragraph 3 above, it has been decided to allow such shifting of the excess securities and direct sale from HTM category. This would be in addition to the shifting permitted at the beginning of the accounting year, i.e., in the month of April. Such transfer to AFS/HFT category as well as sale of securities from HTM category, to the extent required to reduce the SLR securities in HTM category in accordance with the regulatory instructions, would be excluded from the 5 per cent cap prescribed for value of sales and transfers of securities to/from HTM category under paragraph 2.3 (ii) of the Master Circular on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks.

III. Maintenance of Cash Reserve Ratio (CRR)

Reserve Bank of India has decided to reduce the Cash Reserve Ratio (CRR) of Scheduled Commercial Banks by 25 basis points from 4.25 per cent to **4.00 per cent of their Net Demand and Time Liabilities (NDTL)** with effect from the fortnight beginning February 09, 2013 vide circular DBOD.No.Ret.BC.76/ 12.01.001 /2012-13 dated January 29, 2013. The Local Area Banks shall also maintain CRR at 3.00 per cent of its net demand and time liabilities up to February 08, 2013 and 4.00 per cent of its net demand and time liabilities from the fortnight beginning from February 09, 2013.

Note: Chapters No.2, 12, 13 and 14 have been revised and the revised chapters have been web hosted at the BoS Knowledge Portal.

B. Not applicable for May, 2019 examination

Non-Applicability of Ind AS for May, 2019 Examination

The Ministry of Corporate Affairs has notified Companies (Indian Accounting Standards) Rules, 2015 on 16th February, 2015, for compliance by certain class of companies. These Ind AS are not applicable for May, 2019 Examination.

II- The Guidance Note on 'Accounting for Depreciation in Companies in context of schedule II to the Companies Act, 2013' is not applicable for May 2019 Examination.

PART – II : QUESTIONS AND ANSWERS

QUESTIONS

Employee Stock Option Plans

1. A company has its share capital divided into shares of ₹ 10 each. On 1-1-20X1, it granted 7,500 employees stock options at ₹ 50, when the market price was ₹ 140. The options were to be exercised between 1-3-20X2 to 31-03-20X2. The employees exercised their options for 7,200 shares only; remaining options lapsed. Pass the necessary journal entries for the year ended 31-3-20X2, with regard to employees' stock options.

Buy Back of Securities

2. Alpha Limited furnishes the following summarized Balance Sheet as at 31st March, 2017:

Liabilities	(₹ in lakhs)	Assets	(₹ in lakhs)
Equity share capital (fully paid up shares of ₹ 10 each)	2,400	Machinery	3,600
Securities premium	350	Furniture	450
General reserve	530	Investment	148
Capital redemption reserve	400	Inventory	1,200
Profit & loss A/c	340	Trade receivables	500
12% Debentures	1,500	Cash at bank	1,500
Trade payables	1,400		
Other current liabilities	<u>478</u>		
	<u>7,398</u>		<u>7,398</u>

On 1st April, 2017, the company announced the buy back of 25% of its equity shares @ ₹ 15 per share. For this purpose, it sold all of its investments for ₹ 150 lakhs.

On 5th April, 2017, the company achieved the target of buy back.

You are required to:

- (1) Pass necessary journal entries for the buy-back.
- (2) Prepare Balance Sheet of Alpha Limited after buy-back of the shares.

Equity Shares with Differential rights

3. Explain the conditions under Companies (Share Capital and Debentures) Rules, 2014, to deal with equity shares with differential rights.

Underwriting of Shares

4. A joint stock company resolved to issue 10 lakh equity shares of ₹10 each at a premium of ₹1 per share. One lakh of these shares were taken up by the directors of the company, their relatives, associates and friends, the entire amount being received forthwith. The remaining shares were offered to the public, the entire amount being asked for with applications.

The issue was underwritten by X, Y and Z for a commission @2% of the issue price, 65% of the issue was underwritten by X, while Y's and Z's shares were 25% and 10% respectively. Their firm underwriting was as follows :

X 30,000 shares, Y 20,000 shares and Z 10,000 shares. The underwriters were to submit unmarked applications for shares underwritten firm with full application money along with members of the general public.

Marked applications were as follows:

X 1,19,500 shares, Y 57,500 shares and Z 10,500 shares.

Unmarked applications totaled 7,00,000 shares.

Accounts with the underwriters were promptly settled.

You are required to prepare a statement calculating underwriters' liability for shares other than shares underwritten firm.

Amalgamation of Companies

5. P Ltd. and Q Ltd. decided to amalgamate as on 01.04.2018. Their summarized Balance Sheets as on 31.03.2018 were as follows:

(₹ in '000)

Particulars	P Ltd.	Q Ltd.
Source of Funds:		
Equity share capital (₹10 each)	300	280
9% preference share Capital (₹100 each)	60	40
Investment allowance Reserve	10	4
Profit and Loss Account	68	68
10 % Debentures	100	60
Trade Payables	50	30
Tax provision	14	8
Total	<u>602</u>	<u>490</u>
Application of Funds:		
Building	120	100
Plant and Machinery	160	140
Investments	80	50
Trade receivables	90	70
Inventories	72	80
Cash and Bank	80	50
Total	<u>602</u>	<u>490</u>

From the following information, you are required to prepare the Balance Sheet as on 01.04.2018 of a new company, R Ltd., which was formed to take over the business of both the companies and took over all the assets and liabilities:

(i) 50 % Debenture are to be converted into Equity Shares of the New Company.

- (ii) Investments are non- current in nature.
- (iii) Fixed Assets of P Ltd. were valued at 10% above cost and that of Q Ltd. at 5% above cost.
- (iv) 10 % of trade receivables were doubtful for both the companies. Inventories to be carried at cost.
- (v) Preference shareholders were discharged by issuing equal number of 9% preference shares at par.
- (vi) Equity shareholders of both the transferor companies are to be discharged by issuing Equity shares of ₹10 each of the new company at a premium of ₹ 5 per share.

Give your answer on the basis that amalgamation is in the nature of purchase.

Internal Reconstruction of a Company

6. The Balance Sheet of Lion Limited as on 31-03-2018 is given below:

Particulars	Note No.	Amount (₹ in lakh)
<u>Equity & Liabilities</u>		
<u>Shareholders' Funds</u>		
Shares' Capital	1	1,400
Reserves & Surplus	2	(522)
<u>Non-Current Liabilities</u>		
Long term Borrowings	3	700
<u>Current Liabilities</u>		
Trade Payables	4	102
Other Liabilities	5	24
Total		1704
<u>Assets</u>		
<u>Non-Current Assets</u>		
<u>Property, Plant & Equipment</u>		
Tangible Assets	6	750
<u>Current Assets</u>		
Current Investments	7	200
Inventories	8	300
Trade Receivables	9	450

Cash & Cash Equivalents	10	4
Total		1704

Notes to Accounts:

	₹ in Lakhs
(1) Share Capital	
Authorised :	
200 lakh shares of ₹ 10 each	2,000
8 lakh, 8% Preference Shares of ₹ 100 each	800
	2,800
Issued, Subscribed and paid up:	
100 lakh Equity Shares of ₹ 10 each, full paid up	1,000
4 lakh 8% Preference Shares of ₹ 100 each, fully paid up	400
	1400
(2) Reserves and Surplus	
Debit balance of Profit & Loss A/c	(522)
(3) Long Term Borrowings	
6% Debentures (Secured by Freehold Property)	400
Directors' Loan	300
	700
(4) Trade Payables	
Trade payables for Goods	102
(5) Other Current Liabilities	
Interest Accrued and Due on 6% Debentures	24
(6) Tangible Assets	
Freehold Property	550
Plant & Machinery	200
	750
(7) Current Investment	
Investment in Equity Instruments	200
(8) Inventories	
Finished Goods	300
(9) Trade Receivables	

Trade receivables for Goods	450
(10) Cash and Cash Equivalents	
Balance with Bank	4

The Board of Directors of the company decided upon the following scheme of reconstruction with the consent of respective shareholders:

- (1) Preference Shares are to be written down to ₹ 80 each and Equity Shares to ₹ 2 each.
- (2) Preference Shares Dividend in arrears for 3 years to be waived by 2/3rd and for balance 1/3rd, Equity Shares of ₹ 2 each to be allotted.
- (3) Debenture holders agreed to take one Freehold Property at its book value of ₹300 lakh in part payment of their holding. Balance Debentures to remain as liability of the company.
- (4) Interest accrued and due on Debentures to be paid in cash.
- (5) Remaining Freehold Property to be valued at ₹400 lakh.
- (6) All investments sold out for ₹250 lakh.
- (7) 70% of Directors' loan to be waived and for the balance, Equity Shares of ₹ 2 each to be allowed.
- (8) 40% of Trade receivables and 80% of Inventories to be written off.
- (9) Company's contractual commitments amounting to ₹600 lakh have been settled by paying 5% penalty of contract value.

You are required to:

- (a) Pass Journal Entries for all the transactions related to internal reconstruction;
- (b) Prepare Reconstruction Account; and
- (c) Prepare notes on Share Capital and Tangible Assets to Balance Sheet, immediately after the implementation of scheme of internal reconstruction.

Liquidation of Company

7. The following is the summarized Balance Sheet of Shah Ltd. Co. which is in the hands of the liquidator:

Balance Sheet as at 31.3.2017

Liabilities	₹	Assets	₹
Share Capital:		Fixed assets	2,00,000

1,000, 6% Preference Shares of ₹ 100 each, fully paid	1,00,000	Inventory Book debts	1,20,000 2,40,000
2,000 Equity shares of ₹ 100 each, fully paid	2,00,000	Cash in hand Profit and loss A/c	40,000 3,00,000
2,000 Equity shares of ₹ 100 each ₹ 75 paid up	1,50,000		
Loan from bank (on security of stock)	1,00,000		
Trade Payables	<u>3,50,000</u>		
	<u>9,00,000</u>		<u>9,00,000</u>

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

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

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

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

Financial Statements of Insurance Companies

8. From the following balances extracted from the books of REAL General Insurance Company Ltd. as on 31st March 2017, you are required to prepare Revenue Accounts in respect of Fire and Marine Insurance Business for the year ended 31st March, 2017.

Particulars	Fire ₹	Marine ₹
Outstanding Claim as on 1 st April, 2016	28,000	7,000
Claims Paid	1,00,000	80,000
Reserved for unexpired Risk as on 1 st April 2016	2,00,000	1,40,000
Premium Received	4,50,000	3,30,000
Agent's Commission	40,000	20,000
Expenses of management	60,000	45,000
Re Insurance Premium –Dr.	25,000	15,000

The following additional points are also to be taken into consideration:

(1) Claims outstanding as on 31st March 2017 were as follows:

(a) Fire Insurance - ₹ 10,000
 (b) Marine Insurance - ₹ 15,000

(2) Premium outstanding as on 31st March, 2017 were as follows:
 (a) Fire Insurance - ₹ 30,000
 (b) Marine Insurance - ₹ 20,000

(3) Reserve for unexpired risk to be maintained at 50% and 100% of net premiums in respect of Fire & Marine Insurance respectively.

(4) Expenses of management due on 31st March, 2017 were ₹ 10,000 for Fire Insurance and ₹ 5,000 in respect of Marine Insurance.

Financial Statements of Banking Companies

9. From the following information of Wealth Bank Limited, Prepare Profit and Loss Account for the year ended 31st March, 2018:

Particulars	₹ in lakhs	Particulars	₹ in lakhs
Interest on Cash Credit	364	Interest paid on Recurring Deposits	17
Interest on Overdraft	150	Interest paid on Savings Bank Deposits	12
Interest on Term Loans	308	Auditor's Fees and Allowances	24
Income on Investments	168	Directors' Fees and Allowance	50
Interest on Balance with RBI	30	Advertisement	36
Commission on remittances and transfer	15	Salaries, allowances and bonus to employees	248
Commission on Letters of Credit	24	Payment to Provident Fund	56
Commission on Government Business	16	Printing & Stationery	28
Profit on Sale of Land & Building	5	Repairs & Maintenance	10
Loss on exchange transactions	10	Postage, courier & telephones	16
Interest paid on Fixed Deposits	25		

Other Information:

		₹ in lakhs	
		Earned	Collected
(i)	Interest on NPA is as follows:		
	Cash Credit	164	80
	Term Loans	90	20
(ii)	Overdraft	150	50
	Classification of Non-performing Advances:		
	Standard		60
	Sub-standard-fully secured		22
	Doubtful assets-fully unsecured		40
	Doubtful assets covered fully by security:		
	Less than 1 year		6
	More than 1 year upto 3 years		3
	More than 3 years		2
	Loss Assets		38

(iii) Provide 35% of the profits towards provision for taxation.
 (iv) Transfer 25% of the profit to Statutory Reserves.

NBFC

10. LK Finance Ltd. is a non-banking financial company. It provides you with the following information regarding its outstanding amount, ₹ 400 lakhs of which installments are overdue on 400 accounts for last two months (amount overdue ₹ 80 lakhs), on 24 accounts for three months (amount overdue ₹ 48 lakhs), on 10 accounts for more than 30 months (amount overdue ₹ 40 lakhs) and on 4 accounts for more than three years (amount overdue ₹ 40 lakhs-already identified as sub-standard assets) and one account of ₹ 20 lakhs which has been identified as non-recoverable by the management. Out of 10 accounts overdue for more than 30 months, 6 accounts are already identified as sub-standard (amount ₹ 12 lakhs) for more than fourteen months and other are identified as sub-standard asset for a period of less than fourteen months.

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

Mutual Fund

11. What do you mean by "Net asset value" (NAV) in case of mutual fund units?

Valuation of Goodwill

12. On the basis of the following information, calculate the value of goodwill (on the basis of closing capital employed) of Holy Ltd. at three years' purchase of super profits, if any, earned by the company in the previous four completed accounting years.

Summarised Balance Sheet of Holy Ltd. as at 31st March, 2018

Liabilities	₹ in lakhs	Assets	₹ in lakhs
Share Capital:		Goodwill	620
Authorised	<u>15,000</u>	Land and Buildings	37,00
Issued and Subscribed	-	Machinery	75,20
10 crore equity shares of ₹ 10 each, fully paid up	10,000	Furniture and Fixtures	20,30
Capital Reserve	520	Patents and Trade Marks	64
General Reserve	65,86	9% Non-trading Investments	12,00
Surplus i.e. credit balance of Profit and Loss (appropriation) A/c	914	Inventory	17,46
Trade payables	11,36	Trade receivables	12,28
Provision for Taxation (net)	<u>44</u>	Cash in hand and at Bank	10,92
	<u>19,200</u>		<u>19,200</u>

The profits before tax of the four years have been as follows:

Year ended 31 st March	Profit before tax in lakhs of ₹
2014	6,380
2015	5,000
2016	6,216
2017	5,800

The rate of income tax for the accounting year 2013-2014 was 40%. Thereafter it has been 38% for all the years so far. But for the accounting year 2017-2018 it will be 35%.

In the accounting year 2013-2014, the company earned an extraordinary income of ₹ 2 crore due to a special foreign contract. In August, 2014 there was an earthquake due to which the company lost property worth ₹ 100 lakhs and the insurance policy did not cover the loss due to earthquake or riots.

9% Non-trading investments appearing in the above mentioned Balance Sheet were purchased at par by the company on 1st April, 2015.

The normal rate of return for the industry in which the company is engaged is 20%. Also note that the company's shareholders, in their general meeting have passed a resolution

sanctioning the directors an additional remuneration of ₹ 100 lakhs every year beginning from the accounting year 2017-2018.

Consolidation Financial Statements

13. The following data is provided to you:

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

Determine in each case:

- (1) Minority interest at the date of acquisition and at the date of consolidation.
- (2) Goodwill or Capital Reserve.

Accounting Standards

AS 7 Construction Contracts

14. GTI Ltd. negotiates with Bharat Oil Corporation Ltd. (BOCL), for construction of "Retail Petrol & Diesel Outlet Stations". Based on proposals submitted to different Regional Offices of BOCL, the final approval for one outlet each in Region X, Region Y, Region Z is awarded to GTI Ltd. A single agreement is entered into between two. The agreement lays down values for each of the three outlets i.e. ₹ 102 lacs, ₹ 150 lacs, ₹ 130 lacs for Region X, Region Y, Region Z respectively. Agreement also lays down completion time for each Region.

Comment whether GTI Ltd. will treat it as single contract or three separate contracts with reference to AS-7?

AS 9 Revenue Recognition

15. Raj Ltd. entered into an agreement with Heena Ltd. to dispatch goods valuing ₹ 5,00,000 every month for next 6 months on receipt of entire payment. Heena Ltd. accordingly made the entire payment of ₹ 30,00,000 and Raj Ltd. started dispatching the goods. In fourth month, due to fire in premise of Heena Ltd., Heena Ltd. requested to Raj

Ltd. not to dispatch goods worth ₹ 15,00,000 ready for dispatch. Raj Ltd. accounted ₹ 15,00,000 as sales and transferred the balance to Advance received against Sales account.

Comment upon the above treatment by Raj Ltd. with reference to the provision of AS-9.

AS 18 Related Party Transactions

16. SP hotels Limited enters into an agreement with Mr. A for running its hotel for a fixed return payable to the later every year. The contract involves the day-to-day management of the hotel, while all financial and operating policy decisions are taken by the Board of Directors of the company. Mr. A does not own any voting power in SP Hotels Limited. Would he be considered as a related party of SP Hotels Limited”?

AS 19 Leases

17. Aksat International Limited has given a machinery on lease for 36 months, and its useful life is 60 months. Cost & fair market value of the machinery is ₹ 5,00,000. The amount will be paid in 3 equal annual installments and the lessee will return the machinery to lessor at termination of lease. The unguaranteed residual value at the end of 3 years is ₹ 50,000. IRR of investment is 10% and present value of annuity factor of ₹ 1 due at the end of 3 years at 10% IRR is 2.4868 and present value of ₹ 1 due at the end of 3rd year at 10% IRR is 0.7513.

You are required to comment with reason whether the lease constitute finance lease or operating lease. If it is finance lease, calculate unearned finance income.

AS 20 Earnings Per Share

18 “While calculating diluted EPS, effect is given to all dilutive potential equity shares that were outstanding during the period.” Explain this statement in the light of relevant AS.

Also calculate the diluted EPS from the following information:

Net Profit for the current year (After Tax)	₹ 1,00,00,000
No. of Equity shares outstanding	10,00,000
No. of 10% Fully Convertible Debentures of ₹ 100 each (Each Debenture is compulsorily & fully convertible into 10 equity shares issued at the mid of the year)	1,00,000
Debenture interest expense for the current year	₹ 5,00,000
Assume applicable Income Tax rate @ 30%	

AS 26 Intangible Assets

19 A Company with a turnover of ₹ 375 crores and an annual advertising budget of ₹ 3 crores had taken up the marketing of a new product. It was estimated that the company would have a turnover of ₹ 37.5 crores from the new product. The company had debited to its

Profit and Loss account the total expenditure of ₹ 3 crores incurred on extensive special initial advertisement campaign for the new product.

Is the procedure adopted by the Company correct?

AS 29 Provisions, Contingent Liabilities and Contingent Assets

20 M/s. XYZ Ltd. is in a dispute with a competitor company. The dispute is regarding alleged infringement of Copyrights. The competitor has filed a suit in the court of law seeking damages of ₹ 200 lacs.

The Directors are of the view that the claim can be successfully resisted by the Company.

How would the matter be dealt in the annual accounts of the Company in the light of AS 29? Explain in brief giving reasons for your answer.

SUGGESTED ANSWERS/HINTS

1. In the books of Company

Journal Entries

Date	Particulars	Dr. ₹	Cr. ₹
1-3-X2 to 31-3-X2	Bank A/c (7,200 x 50) Dr. Employees compensation expenses A/c Dr. To Equity Share Capital A/c (7,200 x 10) To Securities Premium A/c (7,200 x ₹ 130) (Being allotment to employees 7,200 shares of ₹ 10 each at a premium of ₹ 130 at an exercise price of ₹ 50 each)	3,60,000 6,48,000 72,000 9,36,000	
31-3-X2	Profit and Loss account Dr. To Employees compensation expenses A/c (Being transfer of employees compensation expenses)	6,48,000	6,48,000

Working Notes:

- Employee Compensation Expenses = Discount between Market Price and option price = ₹ 140 – ₹ 50 = ₹ 90 per share = ₹ 90 x 7,200 = ₹ 6,48,000 in total.
- Securities Premium Account = ₹ 50 – ₹ 10 = ₹ 40 per share + ₹ 90 per share on account of discount of option price over market price = ₹ 130 per share = ₹ 130 x 7,200 = ₹ 9,36,000 in total.

2. **In the books of Alpha Limited**
Journal Entries

Date 2017	Particulars	Dr.	Cr. (₹ in lakhs)
April 1	Bank A/c Dr. To Investment A/c To Profit on sale of investment (Being investment sold on profit)	150	148 2
April 5	Equity share capital A/c Dr. Securities premium A/c Dr. To Equity shares buy back A/c (Being the amount due to equity shareholders on buy back)	600 300	900
	Equity shares buy back A/c Dr. To Bank A/c (Being the payment made on account of buy back of 60 Lakh Equity Shares)	900	900
April 5	General reserve A/c Dr. Profit and Loss A/c Dr. To Capital redemption reserve A/c (Being amount equal to nominal value of bought back shares from free reserves transferred to capital redemption reserve account as per the law)	530 70	600

Balance Sheet (After buy back)

Particulars	Note No	Amount (₹ in Lakhs)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	1,800
(b) Reserves and Surplus	2	1,322
(2) Non-Current Liabilities		
(a) Long-term borrowings - 12% Debentures		1,500

(3) Current Liabilities		
(a) Trade payables		1,400
(b) Other current liabilities		478
	Total	6,500
II. Assets		
(1) Non-current assets		
(a) Property, Plant & Equipment		
(i) Tangible assets	3	4,050
(2) Current assets		
(a) Current investments		
(b) Inventory		1,200
(c) Trade receivables		5,00
(d) Cash and cash equivalents (W.N.)		750
	Total	6,500

Notes to Accounts

			(₹ in Lakhs)
1.	Share Capital		
	Equity share capital (Fully paid up shares of ₹10 each)		1800
2.	Reserves and Surplus		
	General Reserve	530	
	Less: Transfer to CRR	<u>(530)</u>	-
	Capital Redemption Reserve	400	
	Add: Transfer due to buy-back of shares from P/L	70	
	Transfer due to buy-back of shares from Gen. res.	<u>530</u>	1,000
	Securities premium	350	
	Less: Adjustment for premium paid on buy back	<u>(300)</u>	50
	Profit & Loss A/c	340	
	Add: Profit on sale of investment	2	
	Less: Transfer to CRR	<u>(70)</u>	<u>272</u>
3.	Tangible assets		1,322
	Machinery	3,600	
	Furniture	450	4,050

Working Note:**Cash at bank after buy-back**

	₹ in lakhs
Cash balance as on 1 st April, 2017	1,500
<i>Add: Sale of investments</i>	<u>150</u>
	1,650
<i>Less: Payment for buy back of shares</i>	<u>(900)</u>
	750

3. In exercise of the power conferred under Section 43(a)(ii), the central government announced Rule 4 under Companies (Share Capital and Debentures) Rules, 2014, to deal with equity shares with differential rights.

The rules lay down the following conditions to be compulsorily complied with:

- (a) The articles of association of the company authorizes the issue of shares with differential rights;
- (b) The issue of shares is authorized by an ordinary resolution passed at a general meeting of the shareholders: Provided that where the equity shares of a company are listed on a recognized stock exchange, the issue of such shares shall be approved by the shareholders through postal ballot;
- (c) The shares with differential rights shall not exceed twenty-six percent of the total post-issue paid up equity share capital including equity shares with differential rights issued at any point of time;
- (d) The company having consistent track record of distributable profits for the last three years;
- (e) The company has not defaulted in filing financial statements and annual returns for three financial years immediately preceding the financial year in which it is decided to issue such shares;
- (f) The company has no subsisting default in the payment of a declared dividend to its shareholders or repayment of its matured deposits or redemption of its preference shares or debentures that have become due for redemption or payment of interest on such deposits or debentures or payment of dividend;
- (g) The company has not defaulted in payment of the dividend on preference shares or repayment of any term loan from a public financial institution or State level financial institution or scheduled Bank that has become repayable or interest payable thereon or dues with respect to statutory payments relating to its employees to any authority or default in crediting the amount in Investor Education and Protection Fund to the Central Government;

(h) The company has not been penalized by Court or Tribunal during the last three years of any offence under the Reserve Bank of India Act, 1934, the Securities and Exchange Board of India Act, 1992, the Securities Contracts Regulation Act, 1956, the Foreign Exchange Management Act, 1999 or any other special Act, under which such companies being regulated by sectoral regulators.

4. Statement showing underwriters' liability for shares other than shares underwritten firm

	X	Y	Z	Total
Gross liability (Issued shares – purchased by promoters, directors etc.) (9,00,000 shares in the ratio of 65 : 25 : 10)	5,85,000	2,25,000	90,000	9,00,000
Less: Marked applications	(1,19,500)	(57,500)	(10,500)	(1,87,500)
	4,65,500	1,67,500	79,500	7,12,500
Less: Allocation of unmarked applications (including firm underwriting i.e. 7,00,000) in the ratio 65 : 25 : 10	(4,55,000)	(1,75,000)	(70,000)	(7,00,000)
	10,500	(7,500)	9,500	12,500
Surplus of Y allocated to X and Z in the ratio 65 : 10	(6,500)	7,500	(1,000)	—
Additional shares to be purchased by X & Z	4,000	—	8,500	12,500

	₹	₹	₹
Additional Liability for additional shares @ ₹11	44,000	—	93,500
Underwriting commission payable on Gross Liability (Shares underwritten as Gross liability × ₹11 × 2%)	(1,28,700)	(49,500)	(19,800)
Net Amount payable	(84,700)	(49,500)	—
Net Amount receivable	—	—	73,700

**5. M/s R Ltd.
Balance Sheet as at 1.4.2018**

		Particulars	Notes	₹ in'000
1	a	Equity and Liabilities Shareholders' funds		
	b	Share capital	1	6,55,980
		Reserves and Surplus	2	2,77,990

2	Non-current liabilities			
3	a Long-term borrowings	3	80,000	
3	Current liabilities			
3	a Trade Payables	4	80,000	
	b Short term provision	5	<u>22,000</u>	
		Total		<u>11,15,970</u>
	Assets			
1	Non-current assets			
1	a Property, Plant & Equipment			
	Tangible assets	6	5,60,000	
1	b Non-current investments	7	1,30,000	
2	Current assets			
2	a Inventory	8	1,52,000	
2	b Trade receivables	9	1,44,000	
2	c Cash and cash equivalents	10	1,29,970	
		Total		<u>11,15,970</u>

Notes to accounts

		₹ in '000
1.	Share Capital	
	Equity share capital	
	55,598 Equity shares of ₹10 each, fully paid up (W.N.2)	5,55,980
	Preference share capital	
	9% Preference share capital (Share of ₹100 each) (W.N.2)	1,00,000
		<u>6,55,980</u>
2.	Reserves and Surplus	
	Securities premium (W.N.2)	2,77,990
	Investment allowance reserve	
	(₹10,000+ ₹4,000)	14,000
	Amalgamation adjustment reserve	
		(14,000)
		<u>2,77,990</u>

3. Long-term borrowings		
Secured		
10% Debentures (50% of ₹1,60,000)	80,000	
4. Trade Payables (₹50,000+ ₹30,000)	80,000	
5. Short term provisions		
Provision for tax (₹14,000+ ₹8,000)	22,000	
6. Tangible assets		
Building (₹1,32,000+₹1,05,000)	2,37,000	
Plant and machinery (₹1,76,000+₹1,47,000)	<u>3,23,000</u>	
	<u>5,60,000</u>	
7. Non – current Investments (₹80,000+ ₹50,000)	1,30,000	
8. Inventory		
Stock (₹ 72,000+ ₹ 80,000)	1,52,000	
9. Trade receivables		
Trade receivables (90% of (₹90,000+ ₹70,000))	1,44,000	
10. Cash and cash equivalents		
Cash and Bank (₹ 80,000+ ₹ 50,000 – ₹ 30)	1,29,970	

Working Notes:

1. Calculation of value of equity shares issued to transferor companies

		P Ltd.		Q Ltd.
		(₹)		(₹)
Assets taken over:				
Building		1,32,000		1,05,000
Plant and machinery		1,76,000		1,47,000
Investments		80,000		50,000
Inventories		72,000		80,000
Trade receivables		81,000		63,000
Cash & Bank		<u>80,000</u>		<u>50,000</u>
		6,21,000		4,95,000

<i>Less: Liabilities:</i>				
10% Debentures	1,00,000		60,000	
Trade payables	50,000		30,000	
Tax Provision	<u>14,000</u>	<u>1,64,000</u>	<u>8,000</u>	<u>98,000</u>
		4,57,000		3,97,000
<i>Less: Preference Share Capital</i>		<u>60,000</u>		<u>40,000</u>
		<u>3,97,000</u>		<u>3,57,000</u>

2. **Number of shares issued to equity shareholders, debenture holders and preference shareholders**

	<i>P Ltd.</i>	<i>Q Ltd.</i>	<i>Total</i>
Equity shares issued @ ₹ 15 per share (including ₹ 5 premium) ₹3,97,000/15	26,466 shares ¹		
₹3,57,000/15		23,800 shares	50,266 shares
Equity share capital @ ₹10 Securities premium @ ₹5	₹2,64,660 ₹1,32,330 ₹3,96,990	₹2,38,000 ₹1,19,000 ₹3,57,000	₹5,02,660 ₹2,51,330 ₹7,53,990
<i>50% of Debentures are converted into equity shares @ ₹15 per share</i>			
1,00,000/2 = 50,000/15 60,000/2 = 30,000/15	3,332 shares ²	2,000 shares	5,332 shares
Equity share capital @ ₹10 Security premium @ ₹5	₹33,320 ₹16,660 ₹49,980	₹20,000 ₹10,000 ₹30,000	₹53,320 ₹26,660 ₹79,980
9% Preference share capital issued	₹60,000	₹40,000	₹1,00,000

¹ Cash paid for fraction of shares = ₹ 3,97,000 less ₹ 3,96,990 = ₹10

² Cash paid for fraction of shares = ₹ 50,000 less ₹ 49,980 = ₹20

6. (a)

Journal Entries in the books of Lion Ltd.

	Particulars		Debit (₹ in lakhs)	Credit (₹ in lakhs)
(i)	8% Preference share capital A/c (₹100 each) To 8% Preference share capital A/c (₹ 80 each) To Capital Reduction A/c (Being the preference shares of ₹100 each reduced to ₹80 each as per the approved scheme)	Dr.	400	320 80
(ii)	Equity share capital A/c (₹10 each) To Equity share capital A/c (₹ 2 each) To Capital Reduction A/c (Being the equity shares of ₹10 each reduced to ₹2 each)	Dr.	1,000	200 800
(iii)	Capital Reduction A/c To Equity share capital A/c (₹ 2 each) (Being 1/3 rd arrears of preference share dividend of 3 years to be satisfied by issue of 16 lakhs equity shares of ₹2 each)	Dr.	32	32
(iv)	6% Debentures A/c To Freehold property A/c (Being claim of Debenture holders settled in part by transfer of freehold property)	Dr.	300	300
(v)	Accrued debenture interest A/c To Bank A/c (Being accrued debenture interest paid)	Dr.	24	24
(vi)	Freehold property A/c To Capital Reduction A/c (Being appreciation in the value of freehold property)	Dr.	150	150

(vii)	Bank A/c To Investments A/c To Capital Reduction A/c (Being investment sold at profit)	Dr.	250	200 50
(viii)	Director's loan A/c To Equity share capital A/c (₹ 2 each) To Capital Reduction A/c (Being director's loan waived by 70% and balance being discharged by issue of 45 lakhs equity shares of ₹2 each)	Dr.	300	90 210
(ix)	Capital Reduction A/c To Profit and loss A/c To Trade receivables A/c (450 x 40%) To Inventories-in-trade A/c (300x 80%) To Bank A/c (600 x 5%) (Being certain value of various assets, penalty on cancellation of contract, profit and loss account debit balance written off through Capital Reduction Account)	Dr.	972	522 180 240 30
(x)	Capital Reduction A/c To Capital reserve A/c (Being balance transferred to capital reserve account as per the scheme)		286	286

(b) Capital Reduction Account

Dr.			
	(₹ in lakhs)		(₹ in lakhs)
To Equity Share Capital	32	By Preference Share Capital	80
To Trade receivables	180	By Equity Share Capital	800
To Finished Goods	240	By Freehold Property	150
To Profit & Loss A/c	522	By Bank	50

To Bank A/c	30	By Director's Loan	210
To Capital Reserve	<u>286</u>		<u>1,290</u>
	<u>1,290</u>		<u>1,290</u>

(c) Notes to Balance Sheet

	(₹ in lakhs)	(₹ in lakhs)
1. <u>Share Capital</u>		
<u>Authorised:</u>		
200 lakhs Equity shares of ₹ 2 each	400	
8 lakhs 8% Preference shares of ₹ 80 each	<u>640</u>	
		<u>1,040</u>
<u>Issued:</u>		
161 lakhs equity shares of ₹2 each	322	
4 lakhs Preference Shares of ₹80 each	<u>320</u>	
		<u>642</u>
2. <u>Tangible Assets</u>		
Freehold Property	550	
Less: Utilized to pay Debenture holders	<u>(300)</u>	
	250	
<u>Add: Appreciation</u>	<u>150</u>	400
Plant and Machinery		<u>200</u>
		<u>600</u>

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

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

Working Note:**Return per equity share**

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

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

8. Form B – RA (Prescribed by IRDA)

Real General Insurance Co. Ltd

Revenue Account for the year ended 31st March, 2017

Fire and Marine Insurance Business

	Schedule	Fire Current Year	Marine Current Year
		₹	₹
Premiums earned (net)	1	4,27,500	1,40,000
Profit / (Loss) on sale / redemption of investments		—	—
Others (to be specified)		—	—
Interest, Dividends and Rent – Gross		—	—
Total (A)		<u>4,27,500</u>	<u>1,40,000</u>
Claims incurred (net)	2	82,000	88,000
Commission	3	40,000	20,000
Operating expenses related to Insurance business	4	<u>70,000</u>	<u>50,000</u>
Total (B)		<u>1,92,000</u>	<u>1,58,000</u>
Profit from Fire / Marine Insurance business (A-B)		2,35,500	(18,000)

Schedules forming part of Revenue Account

	<i>Fire</i>	<i>Marine</i>
	₹	₹
Schedule -1		
Premium earned (net)		
Premium received during the year	4,50,000	3,30,000
<i>Add: Outstanding on 31st March 2017</i>	<u>30,000</u>	<u>20,000</u>
	4,80,000	3,50,000
<i>Less: Reinsurance premiums</i>	<u>(25,000)</u>	<u>(15,000)</u>
	4,55,000	3,35,000
<i>Less: Adjustment for change in provision for unexpired risk</i>	<u>(27,500)</u>	<u>(1,95,000)</u>
	<u>4,27,500</u>	<u>1,40,000</u>
Schedule – 2		
Claims incurred (net)		
Claims paid during the year	1,00,000	80,000
<i>Add: Outstanding on 31st March,2017</i>	<u>10,000</u>	<u>15,000</u>
	1,10,000	95,000
<i>Less: Outstanding on 1st April,2016</i>	<u>(28,000)</u>	<u>(7,000)</u>
	<u>82,000</u>	<u>88,000</u>
Schedule – 3		
Commission paid	<u>40,000</u>	<u>20,000</u>
Schedule – 4		
Operating expenses		
Expenses of Management		
Expenses paid during the year	60,000	45,000
<i>Add: Outstanding on 31st March,2017</i>	<u>10,000</u>	<u>5,000</u>
	<u>70,000</u>	<u>50,000</u>

Working note for changes in unexpired Risk Reserve

Reserve for unexpired Risk (Fire Insurance @50%)	
Opening Reserve (1)	₹ 2,00,000
Closing Reserve (₹ 4,55,000 X 50/100) (2)	₹ 2,27,500
Additional Transfer to Reserve (2 – 1)	₹ 27,500

Reserve for unexpired Risk (Marine Insurance @100%)	
Opening Reserve (1)	₹1,40,000
Closing Reserve (₹ 3,35,000 X 100/100) (2)	₹3,35,000
Additional Transfer to Reserve (2 – 1)	₹1,95,000

9.

Wealth Bank Limited
Profit and Loss Account
For the year ended 31st March, 2018

₹ in lakhs

<i>Particulars</i>		<i>Schedule</i>	<i>Year ended 31-3-2018</i>
I	Income		
	Interest earned	13	766
	Other income	14	50
			816
II	Expenditure		
	Interest expended	15	54
	Operating expenses	16	468
	Provisions and Contingencies (Refer W.N.)		158.96
			680.96
III	Profit/Loss		
	Net Profit/(Loss) for the year		135.04
	Net Profit/(Loss) brought forward		Nil
			135.04
IV	Appropriations:		
	Transfer to Statutory reserve (25% of the profits)		33.76
	Balance carried to the balance sheet		101.28
	Total		135.04

Schedule 13 - Interest Earned

		<i>Year ended 31-3-2018 (₹ in lakhs)</i>
I	Interest/discount on advances/bills	
	Interest on cash credit (364-84)	280

	Interest on overdraft (150-100)	50	
	Interest on term loans (308-70)	238	568
II	Income on investments		168
III	Interest on Balance with RBI		30
			766

Interest on NPA is recognized on cash basis, hence difference of accrued interest not received have been reduced from the total accrued interest.

Schedule 14 - Other Income

		Year ended 31-3-2018 (₹ in lakhs)
I	Commission, Exchange and Brokerage:	
	Commission on remittances and transfer	15
	Commission on letter of credit	24
	Commission on Government business	<u>16</u> 55
II	Profit on sale of Land and Building	5
III	Loss on Exchange Transactions	(10) 50

Schedule 15 - Interest Expended

		Year ended 31-3-2018 (₹ in lakhs)
I	Interest on Deposits	
	Fixed deposits	25
	Recurring deposits	17
	Saving bank deposits	<u>12</u> 54

Schedule 16 - Operating Expenses

		Year Ended 31-3-2018 (₹ in lakhs)
I	Payment to and provision for employees	
	Salaries, allowances and bonus	248
	Provident Fund Contribution	<u>56</u> 304
II	Printing and Stationery	28

III	Advertisement and publicity		36
IV	Directors' fees, allowances and expenses		50
V	Auditors' fees and expenses		24
VI	Postage, telegrams, telephones etc.		16
VII	Repairs and maintenance		10
			468

Working Note:

<i>Provisions and contingencies</i>		<i>(₹ in lakhs)</i>
Provision for Advances:		
Standard	$60 \times 0.40\%$	0.24
Sub-standard	$22 \times 15\%$	3.3
Doubtful not covered by security	$40 \times 100\%$	40
Doubtful covered by security:		
Less than 1 year	$6 \times 25\%$	1.5
More than 1 year but less than 3 years	$3 \times 40\%$	1.2
	$2 \times 100\%$	<u>2.0</u>
More than 3 years		
Loss Assets	$(38 \times 100\%)$	38
		86.24
Provision for tax	35% of (Total Income – Total Expenditure)	
	35% of [816-(54 + 468 + 86.24)]	
	35% of 207.76	72.72
		158.96

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

	<i>(₹ in lakhs)</i>
<u>Standard Assets</u>	
Accounts (Balancing figure)	172.00
400 accounts overdue for a period for 2 months	80.00
24 accounts overdue for a period by 3 months	<u>48.00</u>
	300.00

<u>Sub-Standard Assets</u>		
4 accounts identified as sub-standard asset for a period less than 14 months		28.00
<u>Doubtful Debts</u>		
6 accounts identified as sub-standard for a period more than 14 months		12.00
4 accounts identified as sub-standard for a period more than 3 years		40.00
<u>Loss Assets</u>		
1 account identified by management as loss asset		20.00
Total overdue		400.00

11. The net asset value of a mutual fund scheme is basically the per unit market value of all the assets of the scheme. Simply stated, NAV is the value of the assets of each unit of the scheme, or even simpler value of one unit of the scheme. Thus, if the NAV is more than the face value (₹ 10), it means your money has appreciated and vice versa. NAV also includes dividends, interest accruals and reduction of liabilities and expenses besides market value of investments. NAV is the value of net assets under a mutual fund scheme. NAV per unit is NAV of the scheme divided by number of units outstanding. NAV of a scheme keeps on changing with change in market value of portfolio under the scheme.

Net Asset Value (NAV) is calculated as under:

$$\text{Total market value of all Mutual Fund holdings} - \text{All Mutual Fund liabilities} \\ \text{Unit size}$$

12. (1) Capital employed as on 31st March, 2018

(Refer to 'Note')

		₹ in lakhs
Land and Buildings		3,700
Machinery		7,520
Furniture and Fixtures		2,030
Patents and Trade Marks		64
Inventory		1,746
Trade receivables		1,228
Cash in hand and at Bank		1,092
		17,380
Less: Trade payables	1136	
Provision for taxation (net)	44	1,180
		16,200

(2) Future maintainable profit

(Amounts in lakhs of ₹)

	2013-2014 ₹	2014-2015 ₹	2015-2016 ₹	2016-2017 ₹
Profit before tax	6,380	5,000	6,216	5,800
Less: Extraordinary income due to foreign contract	(200)			
Add: Loss due to earthquake		100		
Less: Income from non- trading investments	—	—	(108)	(108)
	6,180	5,100	6,108	5,692

As there is no trend, simple average profits will be considered for calculation of goodwill.

$$\begin{aligned}
 \text{Total adjusted trading profits for the last four years} &= ₹ (6,180 + 5,100 + \\
 &\quad 6,108 + 5,692) \\
 &= ₹ 23,080 \text{ lakhs}
 \end{aligned}$$

$$\begin{aligned}
 \text{Average trading profit before tax} &= 23,080/4 \\
 &= ₹ 5,770 \text{ lakhs} \\
 \text{Less: Additional remuneration to directors} & (100) \text{ Lakh} \\
 & 5670 \text{ Lakh} \\
 \text{Less: Income tax @ 35%} & (1984) \text{ (Approx.)} \\
 & 3686 \text{ Lakh}
 \end{aligned}$$

(3) Valuation of Goodwill on Super Profits Basis

	₹ in lakh
Future maintainable profits	3686
Less: Normal profits (20% of ₹ 16,200 lakhs)	(3240)
Super profits	446

Goodwill at 3 years' purchase of super profits = $3 \times ₹ 446$ lakhs = ₹ 1,338 lakhs

13. (1) Minority Interest = Equity attributable to minorities

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

	Minority% Shares Owned [E]	Minority interest as at the date of acquisition [E] x [A + B] ₹	Minority interest as at the date of consolidation [E] X [C + D] ₹
Case 1 [100-90]	10 %	15,000	17,000
Case 2 [100-85]	15 %	19,500	18,000

Case 3 [100-80]	20 %	14,000	14,000
Case 4 [100-100]	NIL	Nil	Nil

A = Share capital on 1.1.2018

B = Profit & loss account balance on 1.1.2018

C = Share capital on 31.12.2018

D = Profit & loss account balance on 1.1.2018

(2) Calculation of Goodwill or Capital Reserve

	Shareholding % [F]	Cost [G]	Total Equity [A] + [B] = [H]	Parent's Portion of equity [F] x [H]	Goodwill ₹ [G] – [H]	Capital Reserve ₹ [H] – [G]
Case 1	90 %	1,40,000	1,50,000	1,35,000	5,000	—
Case 2	85 %	1,04,000	1,30,000	1,10,500	—	6,500
Case 3	80 %	56,000	70,000	56,000	Nil	Nil
Case 4	100 %	1,00,000	90,000	90,000	10,000	—

14. As per AS 7 'Construction Contracts', when a contract covers number of assets, the construction of each asset should be treated as a separate construction contract when:

- (a) separate proposals have been submitted for each asset;
- (b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
- (c) the costs and revenues of each asset can be identified.

In the given case, each outlet is submitted as a separate proposal to different Zonal Offices, which can be separately negotiated, and costs and revenues thereof can be separately identified. Hence, each asset will be treated as a "single contract" even if there is one single agreement for contracts.

Therefore, three separate contract accounts must be recorded and maintained in the books of GTILtd. For each contract, principles of revenue and cost recognition must be applied separately and net income will be determined for each asset as per AS 7.

15. As per AS 9 "Revenue Recognition", in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are fulfilled:

- (i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

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

In the given case, transfer of property in goods results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. Also, the sale price has been recovered by the seller. Hence, the sale is complete but delivery has been postponed at buyer's request. Raj Ltd. should recognize the entire sale of ₹ 30,00,000 (₹ 5,00,000 x 6) and no part of the same is to be treated as Advance Received against Sales.

16. Mr. A will not be considered as a related party of SP Hotels Limited in view of paragraph 3(c) of AS 18 which states, "individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual". In the above example, in the absence of share ownership, Mr. A would not be considered to exercise significant influence on SP Hotels Limited, even though there is an agreement giving him the power to manage the company. Further, the fact that Mr. A does not have the ability to direct or instruct the board of directors does not qualify him as a key management personnel.

17. Determination of Nature of Lease

Present value of unguaranteed residual value at the end of 3rd year

$$= ₹ 50,000 \times 0.7513$$

$$= ₹ 37,565$$

Present value of lease payments	= ₹ 5,00,000 – ₹ 37,565
	= ₹ 4,62,435

The percentage of present value of lease payments to fair value of the equipment is

$$(₹ 4,62,435 / ₹ 5,00,000) \times 100 = 92.487\%.$$

Since, lease payments substantially covers the major portion of the fair value; the lease constitutes a finance lease.

Calculation of Unearned Finance Income

$$\text{Annual lease payment} = ₹ 4,62,435 / 2.4868 = ₹ 1,85,956 \text{ (approx.)}$$

$$\begin{aligned} \text{Gross investment in the lease} &= \text{Total minimum lease payments} + \text{unguaranteed} \\ &\quad \text{residual value} \\ &= (₹ 1,85,956 \times 3) + ₹ 50,000 \\ &= ₹ 5,57,868 + ₹ 50,000 = ₹ 6,07,868 \end{aligned}$$

$$\begin{aligned} \text{Unearned finance income} &= \text{Gross investment} - \text{Present value of minimum lease} \\ &\quad \text{payments and unguaranteed residual value} \\ &= ₹ 6,07,868 - ₹ 5,00,000 = ₹ 1,07,868 \end{aligned}$$

18. As per AS 20 'Earnings per Share', the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares for calculation of diluted earnings per share. Hence, "in calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period."

Computation of diluted earnings per share =
$$\frac{\text{Adjusted net profit for the current year}}{\text{Weighted average number of equity shares}}$$

Adjusted net profit for the current year

	₹
Net profit for the current year (after tax)	1,00,00,000
Add: Interest expense for the current year	5,00,000
Less: Tax relating to interest expense (30% of ₹5,00,000)	<u>(1,50,000)</u>
Adjusted net profit for the current year	<u>1,03,50,000</u>

Weighted average number of equity shares

Number of equity shares resulting from conversion of debentures

$$= \frac{1,00,000 \times 100}{10} = 10,00,000 \text{ Equity shares}$$

Weighted average number of equity shares used to compute diluted earnings per share

$$= [(10,00,000 \times 12) + (10,00,000 \times 6)]/12 = 15,00,000 \text{ equity shares}$$

$$\text{Diluted earnings per share} = ₹ 1,03,50,000 / 15,00,000 \text{ shares} = ₹ 6.90 \text{ per share}$$

19. According to AS 26 'Intangible Assets', "expenditure on an intangible item should be recognized as an expense when it is incurred unless it forms part of the cost of an intangible asset".

In the given case, advertisement expenditure of ₹ 3 crores had been taken up for the marketing of a new product which may provide future economic benefits to an enterprise by having a turnover of ₹37.5 crores. Here, no intangible asset or another asset is acquired or created that can be recognized.

Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of ₹3 crores to the Profit and Loss account of the year is correct.

20. As per AS 29, 'Provisions, Contingent Liabilities and Contingent Assets', a provision should be recognized when

- (a) an enterprise has a present obligation as a result of a past event;
- (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognized.

In the given situation, since, the directors of the company are of the opinion that the claim can be successfully resisted by the company, therefore there will be no outflow of the resources. Hence, no provision is required. The company will disclose the same as contingent liability by way of the following note:

“Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed copyrights and is seeking damages of ₹ 200 lakhs. However, the directors are of the opinion that the claim can be successfully resisted by the company.”

PAPER – 6: AUDITING AND ASSURANCE

PART – I : ACADEMIC UPDATE

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

Revised Chapter 10-Company Audit is given hereunder:

1. Eligibility, Qualifications and Disqualifications of an Auditor



The provisions relating to eligibility, qualifications and disqualifications of an auditor are governed by **section 141** of the Companies Act, 2013 (hereinafter referred as the Act). The main provisions are stated below:

(1) A person shall be **eligible for appointment** as an auditor of a company **only if he is a chartered accountant**.

It may be noted that a firm whereof majority of partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.

Fig.: Is the person eligible for appointment as auditor?¹

- (2) Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.
- (3) Under **sub-section (3) of section 141** along with **Rule 10** of the Companies (Audit and Auditors) Rules, 2014 (hereinafter referred as CAAR), the following persons shall not be eligible for appointment as an auditor of a company, namely-
 - (a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;
 - (b) an officer or employee of the company;
 - (c) a person who is a partner, or who is in the employment, of an officer or employee of the company;
 - (d) a person who, or his relative or partner -
 - (i) is holding any security or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company;

¹ Source of image: <http://ourfinancebook.com>

It may be noted that the relative may hold security or interest in the company of face value not exceeding ₹ 1,00,000.

It may also be noted that the condition of ₹ 1,00,000 shall, wherever relevant, be also applicable in the case of a company not having share capital or other securities.

Students may also note that in the event of acquiring any security or interest by a relative, above the threshold prescribed, the corrective action to maintain the limits as specified above shall be taken by the auditor **within 60** days of such acquisition or interest.

The following points merit consideration in this regard:

- (i) The value of shares of ₹ 1,00,000 that can be held by relative is the face value not the market value.
- (ii) The limit of ₹ 1,00,000 would be applicable where the securities are held by the relative of an auditor and not where the securities are held by an auditor himself or his partner. In case of an auditor or his partner, securities of even small value shall be a disqualification.
- (iii) Grace period of 60 days for corrective action shall apply only in respect of securities held by relatives. This would not apply to auditor or his partner.

[The term “relative”, as defined under the Companies Act, 2013, means anyone who is related to another as members of a Hindu Undivided Family; husband and wife; Father (including step- father), Mother (including step-mother), Son (including step- son), Son’s wife, Daughter, Daughter’s husband, Brother (including step- brother), Sister (including step- sister).]

EXAMPLES

Ex 1: Mr. A, a practicing Chartered Accountant, is holding securities of XYZ Ltd. having face value of ₹ 900. Whether Mr. A is qualified for appointment as an auditor of XYZ Ltd.?

As per section 141(3)(d)(i), an auditor is disqualified to be appointed as an auditor if he, or his relative or partner holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

In the present case, Mr. A is holding security of ₹ 900 in XYZ Ltd. Therefore, he is not eligible for appointment as an auditor of XYZ Ltd.

Ex 2: Mr. P is a practicing Chartered Accountant and Mr. Q, the relative of Mr. P, is holding securities of ABC Ltd. having face value of ₹ 90,000. Whether Mr. P is qualified from being appointed as an auditor of ABC Ltd.?

As per section 141(3)(d)(i), a person is disqualified to be appointed as an auditor if he, or his relative or partner is holding any security of or interest in

the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Further, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the present case, Mr. Q. (relative of Mr. P), is having securities of ₹ 90,000 face value in ABC Ltd., which is as per requirement of proviso to section 141(3)(d)(i). Therefore, Mr. P will not be disqualified to be appointed as an auditor of ABC Ltd.

Ex 3: M/s BC & Co. is an Audit Firm having partners Mr. B and Mr. C, and Mr. A the relative of Mr. C, is holding securities of MWF Ltd. having face value of ₹ 1,01,000. Whether M/s BC & Co. is qualified from being appointed as an auditor of MWF Ltd.?

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

In the instant case, M/s BC & Co. will be disqualified for appointment as an auditor of MWF Ltd. as the relative of Mr. C (i.e. partner of M/s BC & Co.) is holding the securities in MWF Ltd. which is exceeding the limit mentioned in proviso to section 141(3)(d)(i).

Ex 4: M/s RM & Co. is an audit firm having partners CA. R and CA. M. The firm has been offered the appointment as an auditor of Enn Ltd. for the Financial Year 2016-17. Mr. Bee, the relative of CA. R, is holding 5,000 shares (face value of ₹ 10 each) in Enn Ltd. having market value of ₹ 1,50,000. Whether M/s RM & Co. is disqualified to be appointed as auditors of Enn Ltd.?

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

In the instant case, M/s RM & Co. is an audit firm having partners CA. R and CA. M. Mr. Bee is a relative of CA. R and he is holding shares of Enn Ltd. of face value of ₹ 50,000 only (5,000 shares x ₹ 10 per share).

Therefore, M/s RM & Co. is not disqualified for appointment as an auditors of Enn Ltd. as the relative of CA. R (i.e. partner of M/s RM & Co.) is holding the securities in Enn Ltd. which is within the limit mentioned in proviso to section 141(3)(d)(i) of the Companies Act, 2013.

- (ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of ₹ 5,00,000; or
- (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the Company or its Subsidiary, or its Holding or Associate Company or a Subsidiary of such Holding Company, in excess of ₹ 1,00,000.
- (e) a person or a firm who, whether directly or indirectly has business relationship with the Company, or its Subsidiary, or its Holding or Associate Company or Subsidiary of such holding company or associate company, of such nature as may be prescribed;

Students may note that for the purpose of clause (e) above, the term "business relationship" shall be construed as any transaction entered into for a commercial purpose, except –

- (i) commercial transactions which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts;
- (ii) commercial transactions which are in the ordinary course of business of the company at arm's length price - like sale of products or services to the auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.
- (f) a person whose relative is a Director or is in the employment of the Company as a director or key Managerial Personnel.
- (g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.
- (h) a person who has been convicted by a Court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction.
- (i) **a person who, directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company.**

It may be noted that, for the purposes of this clause, the term "directly or indirectly" shall have the same meaning as assigned to it in the Explanation to section 144, i.e.

In case of auditor being an individual, either himself or through his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant influence or control, or whose name or trade mark or brand is used by such individual, shall be termed as rendering of services directly or indirectly by the auditor; and

In case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever, in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners, shall be termed as rendering of services directly or indirectly by the auditor.

Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:



- (i) accounting and book keeping services;
- (ii) internal audit;
- (iii) design and implementation of any financial information system;
- (iv) actuarial services;
- (v) investment advisory services;
- (vi) investment banking services;

Fig.: Auditor restrained from entering into certain services²

- (vii) rendering of outsourced financial services;
- (viii) management services; and
- (ix) any other kind of services as may be prescribed.

It may be noted that an auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

Example: CA. Poshin is providing the services of investment banking to C Ltd. Later on, he was also offered to be appointed as an auditor of the company for the current financial year. Advise.

Section 141(3)(i) of the Companies Act, 2013 disqualifies a person for appointment as an auditor of a company who, **directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company.** Section 144 of the Companies Act, 2013 prescribes certain

² Source of image: webuildbuzz.com

services not to be rendered by the auditor which includes investment banking services.

Therefore, CA. Poshin is advised not to accept the assignment of auditing as the investment banking service is specifically notified in the list of services not to be rendered by him as per section 141(3)(i) read with section 144 of the Companies Act, 2013.

(4) Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in **sub-section (3)** after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

CASE STUDY

Facts of the Case: Mr. A, a chartered accountant, has been appointed as an auditor of Laxman Ltd. in the Annual General Meeting of the company held in September, 2016, which assignment he accepted. Subsequently in January, 2017 he joined Mr. B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner.

Provisions and Explanation: Section 141(3)(c) of the Companies Act, 2013 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (4) of Section 141 provides that an auditor who becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) of Section 141, he shall be deemed to have vacated his office as an auditor.

Conclusion: In the present case, Mr. A, an auditor of Laxman Ltd., joined as partner with Mr. B, who is Manager Finance of Laxman Limited. The given situation has attracted sub-section (3)(c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of Laxman Limited in accordance with sub-section (4) of section 141.

2. Appointment of Auditor

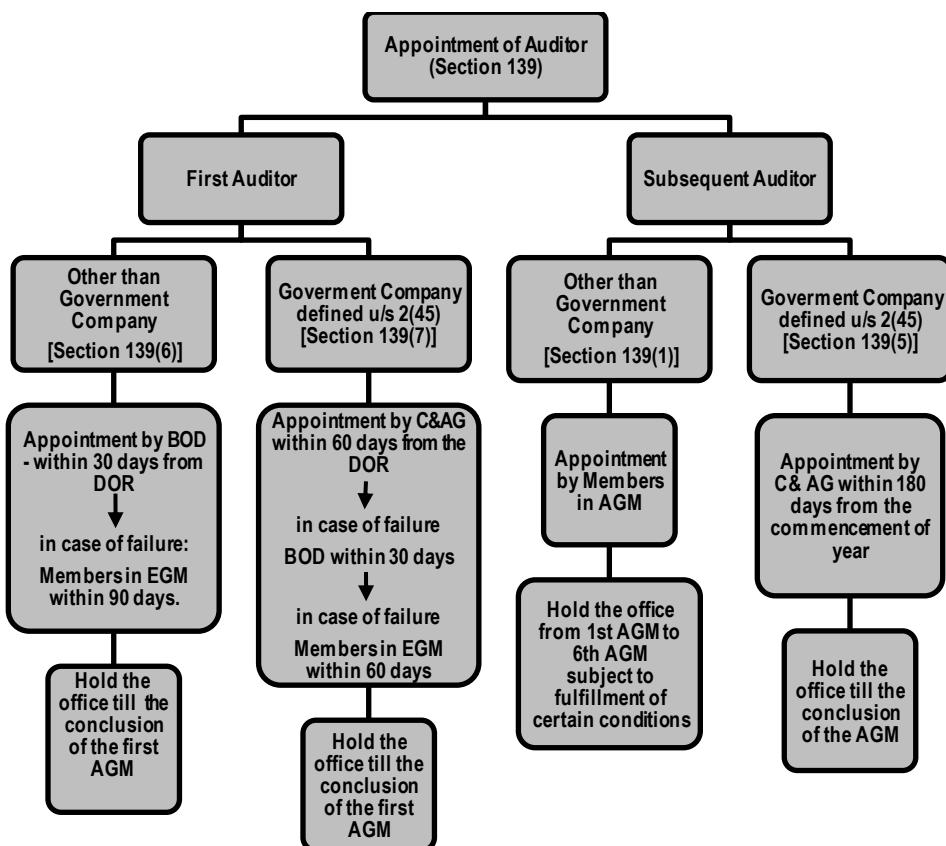


Section 139 of the Companies Act, 2013 contains provisions regarding Appointment of Auditors. Discussion on appointment of auditors may be grouped under two broad headings-

- I Appointment of First Auditors.
- II Appointment of Subsequent Auditors.

Fig: Meeting for appointment of Auditor³

³ Source of image: <http://newhavenscience.org>



2.1 Appointment of First Auditor

2.1.1 Appointment of First Auditors in the case of a company, other than a Government Company: As per **Section 139(6)**, the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

CASE STUDY

Facts of the Case: Managing Director of Pigeon Ltd. himself wants to appoint CA. Champ, a practicing Chartered Accountant, as first auditor of the company.

Provisions and Explanation: Section 139(6) of the Companies Act, 2013 lays down that the first auditor of a company shall be appointed by the Board of Directors within 30 days from the

date of registration of the company. In the instant case, the proposed appointment of CA. Champ, a practicing Chartered Accountant, as first auditor by the Managing Director of Pigeon Ltd. by himself is in violation of Section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company.

Conclusion: *In view of the above, the Managing Director of Pigeon Ltd. should be advised not to appoint the first auditor of the company.*

2.1.2 Appointment of First Auditors in the case of Government Company: A “Government company” is a company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

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

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

CASE STUDY

Facts of the Case: *The first auditor of Bhartiya Petrol Ltd., a Government company, was appointed by the Board of Directors.*

Provisions and Explanation: *In the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013 which states that in the case of a Government company, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company. Hence, in the case of Bhartiya Petrol Ltd., being a government company, the first auditor shall be appointed by the Comptroller and Auditor General of India.*

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

2.2 Appointment of Subsequent Auditor/Reappointment of Auditor

2.2.1 Appointment of Subsequent Auditors in case of Non Government Companies:

Section 139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from

the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

The following points need to be noted in this regard-

- (i) Before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.
- (ii) The certificate shall also indicate whether the auditor satisfies the criteria provided in **section 141**.
- (iii) The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

2.2.2 Appointment of Subsequent Auditors in case of Government Companies: As per **section 139(5)**, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

2.3 Filling of a Casual Vacancy

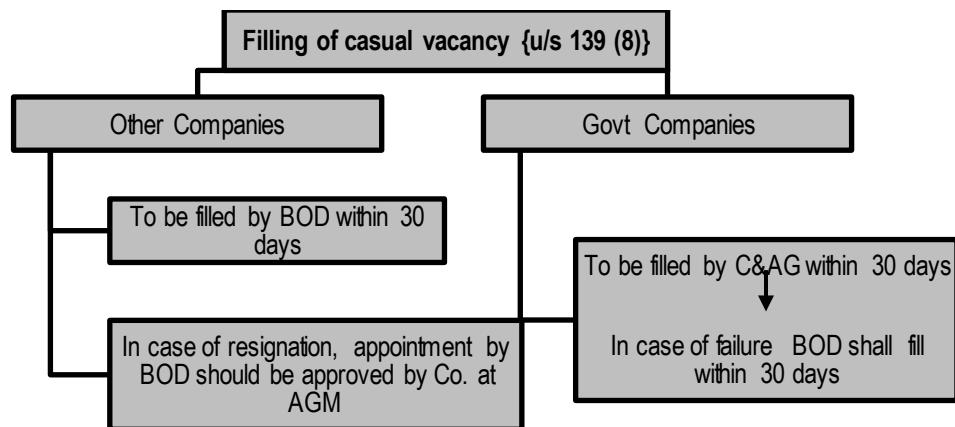
As per **Section 139(8)**, any casual vacancy in the office of an auditor shall-

- (i) **In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Board of Directors within 30 days.

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

- (ii) **In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next 30 days.



2.3.1 Casual Vacancy by Resignation: As per **section 140(2)** the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed **Form ADT-3** (as per Rule 8 of CAAR) with the company and the Registrar, and in case of the companies referred to in **section 139(5)** i.e. Government company, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor shall be punishable with fine which shall not be less than **fifty thousand rupees or the remuneration of the auditor, whichever is less** but which may extend to five lakh rupees as per **section 140(3)**.

CASE STUDY

Facts of the Case: CA. Donald was appointed as the auditor of PS Ltd. at the remuneration of ₹30,000. However, after 4 months of continuing his services, he could not continue to hold his office of the auditor as his wife got a government job at a distant place and he needs to shift along with her to the new place. Thus, he resigned from the company and did not perform his responsibilities relating to filing of statement to the company and the registrar indicating the reasons and other facts as may be relevant with regard to his resignation.

How much fine may he be punishable with under section 140(3) for non-compliance of section 140(2) of the Companies Act, 2013?

Provisions and Explanation: For non-compliance of sub-section (2) of section 140 of the Companies Act, 2013, the auditor shall be punishable with fine, which shall not be less than fifty thousand rupees or the remuneration of the auditor, whichever is less but which may extend to five lakh rupees, under section 140(3) of the said Act.

Conclusion: Thus, the fine under section 140(3) of the Companies Act, 2013 shall not be less than ₹30,000 but which may extend to ₹5,00,000.

Other Important Provisions Regarding Appointment of Auditors

- (1) A retiring auditor may be re-appointed at an annual general meeting, if-
 - (a) he is not disqualified for re-appointment;
 - (b) he has not given the company a notice in writing of his unwillingness to be re-appointed; and
 - (c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.
- (2) Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

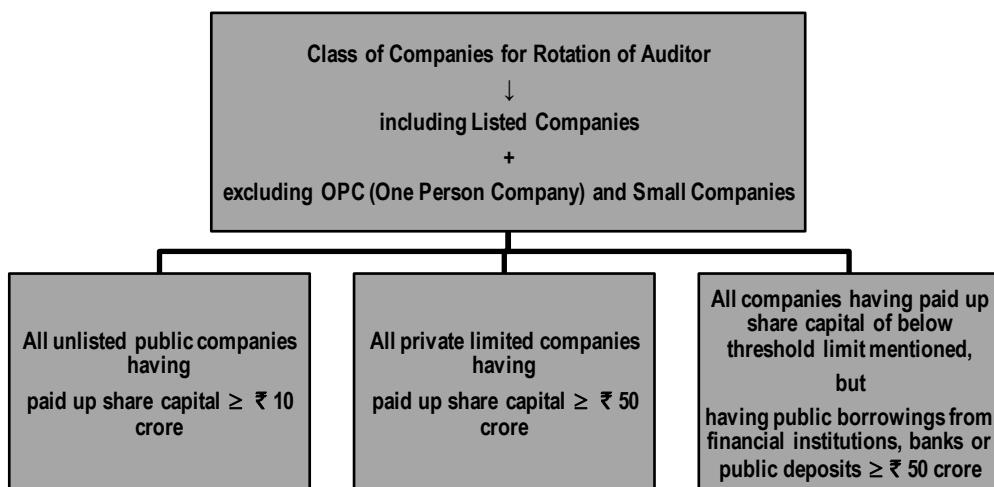
3. Rotation of Auditor

3.1 Applicability of Section 139(2) Rotation of Auditor:

As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the **class of companies** shall mean the following classes of companies excluding one person companies and small companies-



Fig: Rotation of Auditors⁴



- (I) all unlisted public companies having paid up share capital of rupees ten crore or more;
- (II) all private limited companies having paid up share capital of rupees fifty crore or more;
- (III) all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

⁴ Source of image: thehindubusinessline.com

Example: Rano Pvt. Ltd. is a private limited Company, having paid up share capital of ₹ 42 crore but having public borrowing from nationalized banks and financial institutions of ₹ 72 crore, manner of rotation of auditor will be applicable.

As per **section 139(2)**, no listed company or a company belonging to such class or classes of companies as mentioned above, shall appoint or re-appoint-

- (a) an individual as auditor for more than one term of five consecutive years; and
- (b) an audit firm as auditor for more than two terms of five consecutive years. Provided that -
 - (i) an individual auditor who has completed his term under clause (a) shall not be eligible for re-appointment as auditor in the same company for five years from the completion of his term;
 - (ii) an audit firm which has completed its term under clause (b), shall not be eligible for re-appointment as auditor in the same company for five years from the completion of such term.

Example: Jolly Ltd., a listed company, appointed M/s Polly & Co., a Chartered Accountant firm, as the statutory auditor in its AGM held at the end of September, 2016 for 11 years. Here, the appointment of M/s Polly & Co. is not valid as the appointment can be made only for one term of five consecutive years and then another one more term of five consecutive years. It can't be appointed for two terms in one AGM only. Further, a cooling period of five years from the completion of term is required i.e. the firm can't be re-appointed for further 5 years after completion of two terms of five consecutive years.

The following points merit consideration in this regard-

- (1) As on the date of appointment, no audit firm having a common partner or partners to the other audit firm, whose tenure has expired in a company immediately preceding the financial year, shall be appointed as auditor of the same company for a period of five years.

Example: M/s XYZ & Co., is an audit firm having partner Mrs. X, Mr. Y and Mr. Z, whose tenure has expired in the company immediately preceding the financial year. M/s ABZ & Co., another audit firm in which Mr. Z is a common partner, will also be disqualified for the same company along with M/S XYZ & Co. for the period of five years.

- (2) Every company, existing on or before the commencement of this Act which is required to comply with provisions of this sub-section, shall comply with the requirements of this sub-section within a period which shall not be later than the date of the first annual general meeting of the company held, within the period specified under sub-section (1) of section 96, after three years from the date of commencement of this Act.

EXAMPLES

Ex 1: Mr. Raj, a Chartered Accountant, is an individual auditor of Binaca Limited for last 5 years as on March, 2013 (i.e. existing on or before the date of Commencement of

Companies Act, 2013). Keeping in view the transition period as stated in the Companies Act, 2013, Mr. Raj can continue the audit of Binaca Ltd. upto the first annual general meeting to be held after three years from the date of commencement of the Act.

Ex 2: *M/s Raj & Associates, a Chartered Accountants Audit Firm, is doing audit of Binaca Limited for last 11 years as on March, 2013 (i.e. existing on or before the date of Commencement of Companies Act, 2013). Keeping in view the transition period as stated in the Companies Act, 2013, M/s Raj Associates can continue the audit of Binaca Ltd. upto the first annual general meeting to be held after three years from the date of commencement of the Act.*

Students may interlink the above example with Illustrative table explaining rotation in case of individual auditor as well as audit firm which has been given after the 3.2 i.e. Manner of rotation of Auditors by the Companies on Expiry of their Term.*

- (3) It has also been provided that right of the company to remove an auditor or the right of the auditor to resign from such office of the company shall not be prejudiced.
- (4) Subject to the provisions of this Act, members of a company may resolve to provide that-
 - (a) in the audit firm appointed by it, the auditing partner and his team shall be rotated at such intervals as may be resolved by members; or
 - (b) the audit shall be conducted by more than one auditor.
- (5) The Central Government may, by rules, prescribe the manner in which the companies shall rotate their auditors.

3.2 Manner of Rotation of Auditors by the Companies on Expiry of their Term: Rule 6 of the Companies (Audit and Auditors) Rules, 2014 prescribes the manner of rotation of auditors on expiry of their term which is given below-

- (1) The Audit Committee shall recommend to the Board, the name of an individual auditor or of an audit firm who may replace the incumbent auditor on expiry of the term of such incumbent.
- (2) Where a company is required to constitute an Audit Committee, the Board shall consider the recommendation of such committee, and in other cases, the Board shall itself consider the matter of rotation of auditors and make its recommendation for appointment of the next auditor by the members in annual general meeting.
- (3) For the purpose of the rotation of auditors-
 - (i) in case of an auditor (whether an individual or audit firm), the period for which the individual or the firm has held office as auditor prior to the commencement of the Act shall be taken into account for calculating the period of five consecutive years or ten consecutive years, as the case may be;

(ii) the incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms.

Explanation I - For the purposes of these rules the term "same network" includes the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.

Explanation II - For the purpose of rotation of auditors,

(a) a break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation;

(b) if a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years.

***Illustration explaining rotation in case of individual auditor**

Number of consecutive years for which an individual auditor has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which he may be appointed in the same company (including transitional period)	Aggregate period which the auditor would complete in the same company in view of column I and II
I	II	III
5 Years (or more than 5 years)	3 years	8 years or more
4 years	3 years	7 years
3 years	3 years	6 years
2 years	3 years	5 years
1 year	4 years	5 years

Note:

- (1) Individual auditor shall include other individuals or firms whose name or trade mark or brand is used by such individual, if any.
- (2) Consecutive years shall mean all the preceding financial years for which the individual auditor has been the auditor until there has been a break by five years or more.

***Illustration explaining rotation in case of audit firm**

Number of consecutive years for which an audit firm has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which the firm may be appointed in the same company (including transitional period)	Aggregate period which the firm would complete in the same company in view of column I and II
I	II	III
10 Years (or more than 10 years)	3 years	13 years or more
9 years	3 years	12 years
8 years	3 years	11 years
7 years	3 years	10 years
6 years	4 years	10 years
5 years	5 years	10 years
4 years	6 years	10 years
3 years	7 years	10 years
2 years	8 years	10 years
1 years	9 years	10 years

Note:

1. Audit Firm shall include other firms whose name or trade mark or brand is used by the firm or any of its partners.
2. Consecutive years shall mean all the preceding financial years for which the firm has been the auditor until there has been a break by five years or more.

(4) Where a company has appointed two or more individuals or firms or a combination thereof as joint auditors, the company may follow the rotation of auditors in such a manner that both or all of the joint auditors, as the case may be, do not complete their term in the same year.

4 Provisions relating to Audit Committee

4.1 Applicability of section 177 i.e. Constitution of Audit Committee: Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

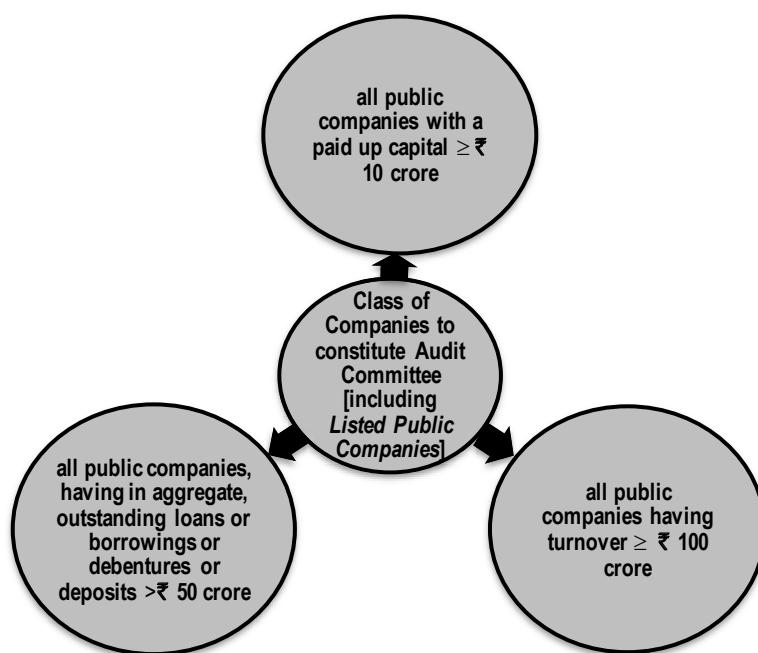


Diagram showing class of companies to constitute Audit Committee

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

- (i) all public companies with a paid up capital of ten crore rupees or more;
- (ii) all public companies having turnover of one hundred crore rupees or more;
- (iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

Explanation- The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

Example: XYZ Ltd., a public company having paid up capital of ₹ 9 crore but having turnover of ₹ 150 crore, will be required to constitute an Audit Committee under section 177 because the requirement for constitution of Audit Committee arises if the company falls into any of the prescribed category.

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

- (1) In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or

the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

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

- (2) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.
- (3) Subject to the provisions of sub-rule (1), where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.
- (4) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.
- (5) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.
- (6) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.
- (7) The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.

5. Auditor's Remuneration

As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein. However, board may fix remuneration of the first auditor appointed by it.

Further, the remuneration, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company. Therefore, it has been clarified that the remuneration to Auditor shall also include any facility provided to him.

6. Removal of Auditors



6.1 Removal of Auditor Before Expiry of Term: According to **Section 140(1)**, the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per **Rule 7 of CAAR, 2014**.

Fig: Auditor leaving office of the auditor⁵

- (1) The application to the Central Government for removal of auditor shall be made in **Form ADT-2** and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.
- (2) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.
- (3) The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.

It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

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.

It is hereby clarified that in the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.

⁵ Source of image: www.123rf.com

6.2 Appointment of Auditor Other Than Retiring Auditor: Section 140(4) lays down procedure to appoint an auditor other than retiring auditor who was removed-

- (1) Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or as the case may be, ten years, as provided under **sub-section (2) of section 139**.
- (2) On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.
- (3) Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,-
 - (a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and
 - (b) send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company. and if a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting.

Students may note that if a copy of representation is not sent as aforesaid, a copy thereof shall be filed with the Registrar.

Curtailing right of the auditor regarding circulation of copy of representation in the case of appointment of auditor other than retiring auditor under section 140(4) of the companies act, 2013:

If the Tribunal is satisfied on an application either of the company or of any other aggrieved person that the rights conferred by **section 140(4)** of the Companies Act, 2013 are being abused by the auditor, then, the copy of the representation may not be sent and the representation need not be read out at the meeting.

7. Ceiling on Number of Audits

It has been mentioned earlier that before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in **section 141(3)(g)** of the Companies Act, 2013 which prescribes that a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than **twenty companies** other than one person companies, dormant

companies, small companies and private companies having paid-up share capital less than ₹ 100 crore, shall not be eligible for appointment as an Auditor of a Company.

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

This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be $3 \times 20 = 60$ company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.

CASE STUDY

"ABC & Co." is an Audit Firm having partners "Mr. A", "Mr. B" and "Mr. C", Chartered Accountants. "Mr. A", "Mr. B" and "Mr. C" are holding appointment as an Auditor in 4, 6 and 10 Companies respectively.

- (i) Provide the maximum number of Audits remaining in the name of "ABC & Co."
- (ii) Provide the maximum number of Audits remaining in the name of individual partner i.e. Mr. A, Mr. B and Mr. C.
- (iii) Can ABC & Co. accept the appointment as an auditor in 60 private companies having paid-up share capital less than ₹ 100 crore, 2 small companies and 1 dormant company?
- (iv) Would your answer be different, if out of those 60 private companies, 45 companies are having paid-up share capital of ₹ 110 crore each?

Fact of the Case: In the instant case, Mr. A is holding appointment in 4 companies, whereas Mr. B is having appointment in 6 Companies and Mr. C is having appointment in 10 Companies. In aggregate all three partners are having 20 audits.

Provisions and Explanations: Section 141(3)(g) of the Companies Act, 2013 states that the following persons shall not be eligible for appointment as an auditor of a company i.e. a person who is in full time employment elsewhere; or a person, or a partner of a firm holding appointment as its auditor, if such person, or partner is at the date of such appointment, or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.

As per section 141(3)(g), this limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be $3 \times 20 = 60$ company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

Conclusion:

- (i) Therefore, ABC & Co. can hold appointment as an auditor of 40 more companies:

<i>Total Number of Audits available to the Firm</i>	= 20*3	= 60
<i>Number of Audits already taken by all the partners</i>		
<i>In their individual capacity</i>	= 4+6+10	= 20
<i>Remaining number of Audits available to the Firm</i>		=40
(ii) <i>With reference to above provisions an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g)- already holding appointments as an auditor. Hence (1) Mr. A can hold: 20 - 4 = 16 more audits. (2) Mr. B can hold 20-6 = 14 more audits and (3) Mr. C can hold 20-10 = 10 more audits.</i>		
(iii) <i>In view of above discussed provisions, ABC & Co. can hold appointment as an auditor in all the 60 private companies having paid-up share capital less than ₹ 100 crore, 2 small companies and 1 dormant company as these are excluded from the ceiling limit of company audits given under section 141(3)(g) of the Companies Act, 2013.</i>		
(iv) <i>As per fact of the case, ABC & Co. is already having 20 company audits and they can also accept 40 more company audits. In addition they can also conduct the audit of one person companies, small companies, dormant companies and private companies having paid up share capital less than ₹ 100 crores. In the given case, out of the 60 private companies, ABC & Co. is offered 45 companies having paid-up share capital of ₹ 110 crore each.</i>		
<i>Therefore, ABC & Co. can also accept the appointment as an auditor for 2 small companies, 1 dormant company, 15 private companies having paid-up share capital less than ₹ 100 crore and 40 private companies having paid-up share capital of ₹ 110 crore each in addition to above 20 company audits already holding.</i>		

Council General Guidelines, 2008 (Chapter VII): In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India hereby specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under Section 224 and /or Section 226 of the Companies Act, 1956 (now section 141(3)(g) of the Companies Act, 2013).

It may be noted that in the case of a firm of chartered accountants in practice, the specified number of audit assignments shall be construed as the specified number of audit assignments for every partner of the firm.

It may also be noted that where any partner of the firm of chartered accountants in practice is also a partner of any other firm or firms of chartered accountants in practice, the number of audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the specified number of audit assignments in the aggregate.

It is further provided that where any partner of a firm or firms of chartered accountants in practice accepts one or more audit assignments in his individual capacity, or in the name of his proprietary firm, the total number of such assignment which may be accepted by all firms in

relation to such chartered accountant and by him shall not exceed the specified number of audit assignments in the aggregate.

- (1) In computing the specified number of audit assignments-
 - (a) the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other chartered accountant in practice or firm of such chartered accountants, shall be taken into account.
 - (b) the number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.
 - (c) a chartered accountant in full time employment elsewhere shall not be taken into account.
- (2) A chartered accountant in practice as well as firm of chartered accountants in practice shall maintain a record of the audit assignments accepted by him or by the firm of chartered accountants, or by any of the partner of the firm in his individual name or as a partner of any other firm as far as possible, in the prescribed manner.

Ceiling on Tax Audit Assignments: The specified number of tax audit assignments that an auditor, as an individual or as a partner of a firm, can accept is **60 numbers**. ICAI has notified that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he accepts in a financial year, more than the specified number of tax audit assignments u/s 44AB.

8. Powers/Rights of Auditors

The auditor has the following powers/rights while conducting an audit:

- (a) **Right of access to books, etc.** – Section 143(1) of the Act provides that the auditor of a company, at all times, shall have a right of access to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and he is entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor.

It may be noted that according to **section 2(59)** of the Act, the term 'officer' includes any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the Board of Directors or any one or more of the directors is or are accustomed to act;

The phrase 'books, accounts and vouchers' includes all books which have any bearing, or are likely to have any bearing on the accounts, whether these be the usual financial books or the statutory or statistical books; memoranda books, e.g., inventory books, costing records and the like may also be inspected by the auditor. Similarly the term 'voucher' includes all or any of the correspondence which may in any way serve to vouch for the accuracy of the accounts. Thus, the right of access is not restricted to books of account alone and it is for the auditor to determine what record or document is necessary for the purpose of the audit.

The right of access is not limited to those books and records maintained at the registered or head office so that in the case of a company with branches, the right also extends to the branch records, if the auditor considers it necessary to have access thereto as per **Section 143(8)**.

Example: X Ltd. restrains its company auditor from visiting another branch at different location and having access to the inventory records maintained at that branch because the branch is already audited by another auditor and the report has been received. Here, it may be noted that the company auditor has right to visit the branch, even if the branch accounts are audited by another auditor, if he considers it necessary to do so for the performance of his duties as auditor.

(b) Right to obtain information and explanation from officers - This right of the auditor to obtain from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor is a wide and important power. In the absence of such power, the auditor would not be able to obtain details of amount collected by the directors, etc. from any other company, firm or person as well as of any benefits in kind derived by the directors from the company, which may not be known from an examination of the books. It is for the auditor to decide the matters in respect of which information and explanations are required by him. When the auditor is not provided the information required by him or is denied access to books, etc., his only remedy would be to report to the members that he could not obtain all the information and explanations he had required or considered necessary for the performance of his duties as auditors.

(c) Right to receive notices and to attend general meeting – The auditors of a company are entitled to attend any general meeting of the company (the right is not restricted to those at which the accounts audited by them are to be discussed); also to receive all the notices and other communications relating to the general meetings, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors.

Section 146 of the Companies Act, 2013 discusses right as well as duty of the auditor. According to the section 146:

“all notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorised representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.”

Thus, it is right of the auditor to receive notices and other communications relating to any general meeting and to be heard at such meeting, relating to the matter of his concern, however, it is duty of the auditor to attend the same or through his authorised representative unless otherwise exempted.

(d) Right to report to the members of the company on the accounts examined by him – The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before

the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under this section and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

(e) Right to Lien – In terms of the general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property. 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.

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.

SA 230 issued by ICAI on Audit Documentation (explanatory text, A- 25), "Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel."

9. Duties of Auditors

Sections 143 of the Companies Act, 2013 specifies the duties of an auditor of a company in a quite comprehensive manner. It is noteworthy that scope of duties of an auditor has generally been extending over all these years.

(1) Duty of Auditor to Inquire on certain matters: It is the duty of auditor to inquire into the following matters-

- (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;
- (b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;
- (c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
- (d) whether loans and advances made by the company have been shown as deposits;
- (e) whether personal expenses have been charged to revenue account;
- (f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 143(1) is reproduced below:

"The auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor's Report will remain exactly the same as the auditor has to inquire and apply his mind to the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our opinion, it is in this light that the auditor has to consider his duties under section 143(1)."

Therefore, it could be said that the auditor should make a report to the members in case he finds answer to any of these matters in adverse.

(2) Duty to Sign the Audit Report: As per section 145 of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company, in accordance with the provisions of section 141(2).

Section 141(2) of the Companies Act, 2013 states that where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

The qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting.

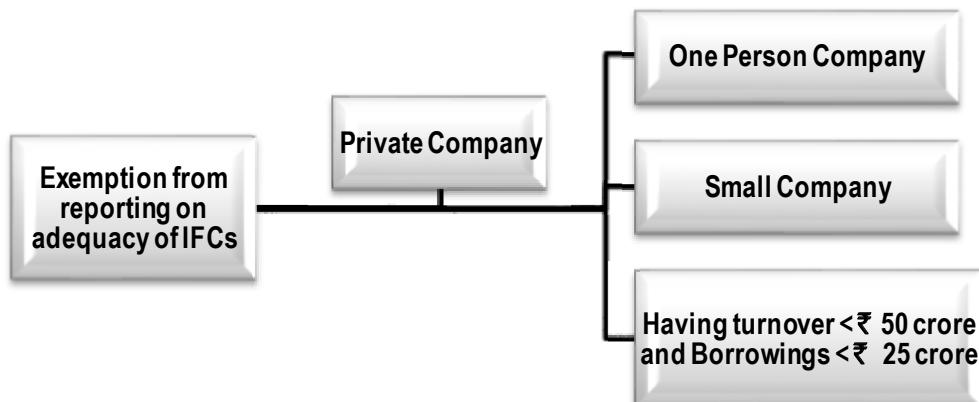
(3) **Duty to comply with Auditing Standards:** As per **section 143(9)** of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further, as per **section 143(10)** of the Act, the Central Government may prescribe the standards of auditing as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

(4) **Duty to report:** As per **section 143(3)**, the auditor's report shall also state –

- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;
- (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
- (e) whether, in his opinion, the financial statements comply with the accounting standards;
- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- (g) whether any director is disqualified from being appointed as a director under sub-section (2) of the section 164;
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
- (i) whether the company has adequate internal financial controls **with reference to financial statements** in place and the operating effectiveness of such controls;

However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall not be applicable to a private company which is a-

- (I) *One person company; or*
- (II) *Small company; or*
- (III) *Company having turnover less than ₹ 50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less than ₹ 25 crore.*



(j) such other matters as may be prescribed. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:-

- (i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
- (ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;
- (iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

[Notes: (1) Students may note that the auditor is also required to report on certain additional matters specified under CARO, 2016 which is discussed later under Para 10 Reporting under Companies (Auditor's Report) Order, 2016.

(2) Students are also required to refer Guidance note on Reporting under section 143(3)(f) and (h) of the Companies Act, 2013.]

(5) Duty to report on frauds:

A. Reporting to the Central Government- As per **section 143(12)** of the Companies Act, 2013 read with **Rule 13** of the Companies (Audit and Auditors) Rules, 2014, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as prescribed.

B. Reporting to the Audit Committee or Board- In case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed.

C. Disclosure in the Board's Report: The companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as prescribed.

Sub-section (13) of section 143 of the Companies Act, 2013 safeguards the act of fraud reporting by the auditor if it is done in good faith. It states that no duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter above if it is done in good faith.

It is very important to note that the provisions regarding fraud reporting shall also apply, *mutatis mutandis*, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12) of section 143, he shall be punishable with fine which shall not be less than ₹ 1 lakh but which may extend to ₹ 25 lakh.

The auditor is also required to report under **clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016 [CARO, 2016]**, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

[Notes: For detailed provisions of CARO, 2016, students may refer Para 10 Reporting under Companies (Auditor's Report) Order, 2016]

Example: The head accountant of a company entered fake invoices of credit purchases in the books of account aggregate of ₹ 50 lakh and cleared all the payments to such bogus creditor. Here, the auditor of the company is required to report the fraudulent activity to the Board or Audit Committee (as the case may be) within 2 days of his knowledge of fraud. Further, the company is also required to disclose the same in Board's Report.

It may be noted that the auditor need not to report the central government as the amount of fraud involved is less than ₹ 1 crore, however, reporting under CARO, 2016 is required.

(6) **Duty to report on any other matter specified by Central Government:** The Central Government may, in consultation with the National Financial Reporting Authority (NFRA), by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.

However, as per the notification dated 29.03.2016, till the time NFRA is constituted, the Central Government may hold consultation required under this sub-section with the Committee chaired by an officer of the rank of Joint Secretary or equivalent in the MCA and the Committee shall have the representatives from the ICAI and Industry Chambers and also special invitees from the National Advisory Committee on Accounting Standards (NACAS) and the office of the C&AG.

[Note: Students may note that Companies (Auditor's Report) Order, 2016 has been notified in this perspective which is discussed later under Para 10 Reporting under Companies (Auditor's Report) Order, 2016]

(7) **Duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor are discussed separately in the chapter under heading 13 branch audit.**

(8) **Duty to state the reason for qualification or negative report:** As per **section 143(4)**, where any of the matters required to be included in the audit report is answered in the negative or with a qualification, the report shall state the reasons there for.

10. Reporting under Companies (Auditor's Report) Order, 2016 [CARO, 2016]

The Central Government, after consultation with the committee constituted under proviso to **section 143(11)** of the Companies Act, 2013, and in supersession of the Companies (Auditor's Report) Order, 2015 dated the 10th April, 2015, has issued the Companies (Auditor's Report) Order, 2016, (CARO, 2016) under section 143(11) of the Companies Act, 2013, dated 29th March, 2016. The requirements of the Order are supplemental to the existing provisions of section 143 of the Act regarding the auditor's report.

The Order is not intended to limit the duties and responsibilities of auditors but only requires a statement to be included in the audit report in respect of the matters specified therein.

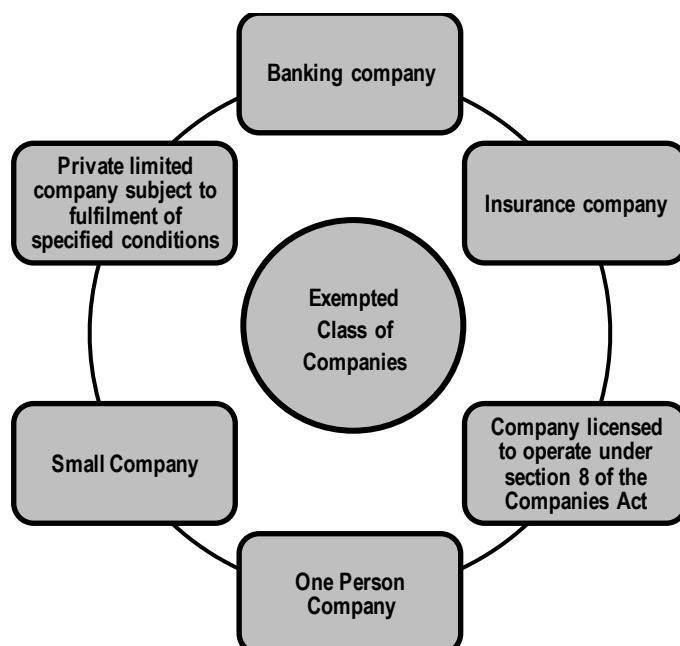
Applicability of the Order: The CARO, 2016 is an additional reporting requirement Order. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013.

However, the Order specifically **exempts** the following class of companies-

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;
- (ii) an insurance company as defined under the Insurance Act, 1938;
- (iii) a company licensed to operate under section 8 of the Companies Act;

- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act;
- (v) a small company as defined under clause (85) of section 2 of the Companies Act; and
- (vi) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than ₹ 1 crore as on the balance sheet date and which does not have total borrowings exceeding ₹ 1 crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Schedule III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding ₹ 10 crore during the financial year as per the financial statements.

It may be noted that the Order shall not be applicable to the auditor's report on consolidated financial statements.



EXAMPLES

Ex. 1: 'Educating Child' is a limited company registered under section 8 of the Companies Act, 2013.

In the given case, 'Educating Child' is licensed to operate under section 8 of the Companies Act, 2013. Therefore, CARO, 2016 shall not be applicable to 'Educating Child' accordingly.

Ex. 2: Ashu Pvt. Ltd. has fully paid capital and reserves of ₹ 50 lakh. During the year, the company had borrowed ₹ 70 lakh each from a bank and a financial institution independently. It has the turnover of ₹ 900 lakh.

In the given case of Ashu Pvt. Ltd., it has paid capital and reserves of ₹ 50 lakh i.e. less than ₹ 1 crore, turnover of ₹ 9 crore i.e. less than ₹ 10 crore. However, it has maximum outstanding borrowings of ₹ 1.40 crore (₹ 70 lakh + ₹ 70 lakh) collectively from bank and financial institution.

Therefore, it fails to fulfill the condition relating to borrowings. Thus, CARO, 2016 shall be applicable to Ashu Pvt. Ltd. accordingly.

Matters to be included in the Auditor's Report: Paragraph 3 of the Order requires the auditor to include a statement in the auditor's report on the following matters, namely-

- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
- (b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- (c) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof;
- (ii) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account;
- (iii) whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,
 - (a) whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;
 - (b) whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
 - (c) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;
- (iv) in respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.
- (v) in case the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been

passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?

(vi) where maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.

(vii) (a) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

(b) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not constitute a dispute).

(viii) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).

(ix) whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;

(x) whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;

(xi) whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act, 2013? If not, state the amount involved and steps taken by the company for securing refund of the same;

(xii) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;

(xiii) whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;

- (xiv) whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;
- (xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with;
- (xvi) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

Reasons to be Stated for Unfavourable or Qualified Answers: Where the answer to any of the questions referred to in **paragraph 3 of the Order** is unfavourable or qualified, in the auditor's report, the auditor shall also state the basis for such unfavourable or qualified answer, as the case may be.

Further, where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons why it is not possible for him to give his opinion on the same.

Example: The company has dispensed with the practice of taking inventory of their inventories at the year-end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations. Explain reporting requirement under CARO, 2016.

Reporting for Physical Verification of Inventory: Clause (ii) of Para 3 of CARO, 2016, requires the auditor to report whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.

The physical verification of inventory is the responsibility of the management of the company which should verify all material items at least once in a year and more often in appropriate cases.

In the given case, the above requirement of physical verification of inventory by the management has not been taken place and therefore the auditor should point out the same under CARO, 2016. He may consider the impact on financial statement and report accordingly.

11. Disclosure in the Auditor's Report

The following paragraphs deal with the manner of qualification and the manner of disclosure, if any, to be made in the auditor's report.

AS-1 – Disclosure of Accounting Policies

In the case of a company, members should qualify their audit reports in case –

- (a) accounting policies required to be disclosed under Schedule III or any other provisions of

the Companies Act, 2013 have not been disclosed, or

- (b) accounts have not been prepared on accrual basis, or
- (c) the fundamental accounting assumption of going concern has not been followed and this fact has not been disclosed in the financial statements, or
- (d) proper disclosures regarding changes in the accounting policies have not been made.

Where a company has been given a specific exemption regarding any of the matters stated above but the fact of such exemption has not been adequately disclosed in the accounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.

In view of the above, the auditor will have to consider different circumstances whether the audit report has to be qualified or only disclosures have to be given.

In the case of enterprises not governed by the Companies Act, the member should examine the relevant statute and make suitable qualification in his audit report in case adequate disclosures regarding accounting policies have not been made as per the statutory requirements. Similarly, the member should examine if the fundamental accounting assumptions have been followed in preparing the financial statements or not. In appropriate cases, he should consider whether, keeping in view the requirements of the applicable laws, a qualification in his report is necessary.

In the event of non-compliance by enterprises not governed by the Companies Act, in situations where the relevant statute does not require such disclosures to be made, the member should make adequate disclosure in his audit report without necessarily making it a subject matter of audit qualification.

In making a qualification / disclosure in the audit report, the auditor should consider the materiality of the relevant item. Thus, the auditor need not make qualification / disclosure in respect of items which, in his judgement, are not material.

A disclosure, which is not a subject matter of audit qualification, should be made in the auditor's report in a manner that it is clear to the reader that the disclosure does not constitute an audit qualification. The paragraph containing the auditor's opinion on true and fair view should not include a reference to the paragraph containing the aforesaid disclosure.

12. Joint Audit

The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the **advantages** that flow may be the following:

- (i) Sharing of expertise.
- (ii) Advantage of mutual consultation.

- (iii) Lower workload.
- (iv) Better quality of performance.
- (v) Improved service to the client.
- (vi) Displacement of the auditor of the company taken over in a take - over often obviated.
- (vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- (viii) Lower staff development costs.
- (ix) Lower costs to carry out the work.
- (x) A sense of healthy competition towards a better performance.

The general **disadvantages** may be the following:

- (i) The fees being shared.
- (ii) Psychological problem where firms of different standing are associated in the joint audit.
- (iii) General superiority complexes of some auditors.
- (iv) Problems of co-ordination of the work.
- (v) Areas of work of common concern being neglected.
- (vi) Uncertainty about the liability for the work done.

The Institute of Chartered Accountants of India has issued Standard on Auditing (SA) 299 (Revised), "Joint Audit of Financial Statements" which lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with Standards on Auditing". This Standard deals with the special considerations in carrying out audit by joint auditors. It requires that-

- (i) *the engagement partner and other key members of the engagement team from each of the joint auditors should be involved in planning the audit.*
- (ii) *the joint auditors should jointly establish an overall audit strategy which sets the scope, timing and direction of the audit, and also guides the development of the audit plan.*
- (iii) *before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:*
 - (1) *identify division of audit areas and common audit areas;*
 - (2) *ascertain the reporting objectives of the engagement;*
 - (3) *consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;*

- (4) consider the results of preliminary engagement activities, or similar engagements performed earlier.
- (5) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.
- (iv) each of the joint auditors should consider and assess the risks of material misstatement and communicate to other joint auditors.
- (v) the joint auditors should discuss and document the nature, timing, and the extent of the audit procedures for (I) common and (II) specific allotted areas of audit to be performed.
- (vi) the joint auditors should obtain common engagement letter and common management representation letter.
- (vii) the work allocation document should be signed by all the joint auditors and communicated to those charged with governance.

It further states that, in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. On the other hand, all the joint auditors shall be jointly and severally responsible for:

- (i) the audit work which is not divided among the joint auditors and is carried out by all joint auditors;
- (ii) decisions taken by all the joint auditors under audit planning in respect of common audit areas;
- (iii) matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;
- (iv) examining that the financial statements of the entity comply with the requirements of the relevant statutes;
- (v) presentation and disclosure of the financial statements as required by the applicable financial reporting framework;
- (vi) ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

In case a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.

It may be noted that the joint auditors are required to issue common audit report. However, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. In such

circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s).

[Note: Student may refer SA 299 (revised) "Joint Audit of Financial Statements" at the link given hereafter <https://resource.cdn.icai.org/49657aasb39352.pdf>]

13. Audit of Branch Office Accounts

As per **section 128(1)** of the Companies Act, 2013, every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

It may be noted that all or any of the books of account aforesaid and other relevant papers may be kept at such other place in India as the Board of Directors may decide and where such a decision is taken, the company shall, within 7 days thereof, file with the Registrar a notice in writing giving the full address of that other place.

Students may also note that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

Sub-section (2) provides that where a company has a branch office in India or outside India, it shall be deemed to have complied with the provisions of sub-section (1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns periodically are sent by the branch office to the company at its registered office or the other place referred in (1).

Further, **sub-section (8) of section 143 of the Companies Act, 2013**, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per **rule 12 of the Companies (Audit and Auditors) Rules, 2014**, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

Using the Work of another Auditor: When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India has dealt with these issues in **SA 600, "Using the Work of another Auditor"**. It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

- (a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit; and
- (b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

14. Cost Audit

Cost Audit is an audit process for verifying the cost of manufacture or production of any article, on the basis of accounts as regards utilisation of material or labour or other items of costs, maintained by the company.

It is covered by **Section 148** of the Companies Act, 2013. The audit conducted under this section shall be in addition to the audit conducted under section 143.

As per section 148 the Central Government may by order specify audit of items of cost in respect of certain companies.

Further, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies.

In this regard, the Central Government has notified the Companies (Cost Records and Audit) Rules, 2014 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

Applicability for Maintenance of Cost Records: Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ₹ 35 crore or more during the immediately preceding financial year, required to include cost records in their books of account. These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006. The said rule has divided the list of companies into (A) Regulated sectors and (B) Non-regulated sectors.

Maintenance of Cost Records: As per Rule 5 of the Companies (Cost Records and Audit) Rules, 2014, every company under these rules including all units and branches thereof, shall, in respect of each of its financial year, is required to maintain cost records in Form CRA-1. The cost records shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.

Additionally, as per **clause (vi) to Paragraph 3 of the CARO, 2016**, the auditor has to report whether maintenance of cost records has been specified by the Central Government under section 148(1) of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.

Applicability of Cost Audit: Rule 4 of the Companies (Cost Records and Audit) Rules, 2014 states the provisions related to the applicability of cost audit depending on the turnover of the company as follows-

- (i) Classes of companies specified under item (A) "Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 50 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 25 crore or more.
- (ii) Classes of companies specified under item (B) "Non-Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 100 crore or

more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 35 crore or more.

Who can be Cost Auditor: The audit shall be conducted by a Cost Accountant who shall be appointed by the Board of such remuneration as may be determined by the members in such manner as may be prescribed.

It may be noted that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records.

It may also be noted that the auditor conducting the cost audit shall comply with the cost auditing standards ("cost auditing standards" mean such standards as are issued by the Institute of Cost Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government).

Appointment of Cost Auditor: Rule 6 of the Companies (Cost Records and Audit) Rules, 2014 requires the companies prescribed under the said Rules to appoint an Auditor within 180 days of the commencement of every financial year. However, before such appointment is made, the written consent of the cost auditor to such appointment and a certificate from him or it shall be obtained.

The certificate to be obtained from the cost auditor shall certify that the-

- (a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Companies Act, 2013, the Cost and Works Accountants Act, 1959 and the rules or regulations made thereunder;
- (b) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Companies Act, 2013 so far as may be applicable;
- (c) the proposed appointment is within the limits laid down by or under the authority of the Companies Act, 2013; and
- (d) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

Every referred company shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of 30 days of the Board meeting in which such appointment is made or within a period of 180 days of the commencement of the financial year, whichever is earlier, through electronic mode, in Form CRA-2, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014.

The cost auditor appointed as such shall continue in such capacity till the expiry of 180 days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed.

Removal of Cost Auditor: The cost auditor may be removed from his office before the expiry of his term, through a board resolution after giving a reasonable opportunity of being heard to the cost auditor and recording the reasons for such removal in writing.

It may be noted that the Form CRA-2 to be filed with the Central Government for intimating appointment of another cost auditor shall enclose the relevant Board Resolution to the effect.

It may further be noted that the above provisions shall not prejudice the right of the cost auditor to resign from such office of the company.

Casual Vacancy in the Office of a Cost Auditor: Any casual vacancy in the office of a Cost Auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors within 30 days of occurrence of such vacancy and the company shall inform the central government in Form CRA-2 within 30 days of such appointment of cost auditor.

Remuneration of Cost Auditor: As per rule 14 of the Companies (Audit and Auditors) Rules, 2014-

- (a) in the case of companies which are required to constitute an audit committee-
 - (i) the Board shall appoint an individual, who is a cost accountant, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor;
 - (ii) the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;
- (b) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

Qualification, Disqualification, Rights, Duties and Obligations of Cost Auditor: The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

Submission of Cost Audit Report:

- (i) **To the Board of Directors of the Company-** The cost auditor shall submit the cost audit report along with his reservations or qualifications or observations or suggestions, if any, in Form CRA-3. He shall forward his report to the Board of Directors of the company within a period of 180 days from the closure of the financial year to which the report relates and the Board of Directors shall consider and examine such report particularly any reservation or qualification contained therein.
- (ii) **To the Central Government-** The company shall within 30 days from the date of receipt

of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein in Form CRA-4 in Extensible Business Reporting Language (XBRL) format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014. If, after considering the cost audit report and the, information and explanation furnished by the company as above, the Central Government is of the opinion, that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

Duty to Report on Fraud: The provisions of **section 143(12)** of the Companies Act, 2013 and the relevant rules on duty to report on fraud shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Act and these rules.

Cost Audit Rules Not to Apply in Certain Cases: The requirement for cost audit under these rules shall not be applicable to a company which is covered under Rule 3, and,

- (i) whose revenue from exports, in foreign exchange, exceeds 75% of its total revenue; or
- (ii) which is operating from a special economic zone.
- (iii) which is engaged in generation of electricity for captive consumption through Captive Generating Plant.

Penal Provisions in Case of Default: If any default is made in complying with the provisions of this section,

- (a) the company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147;
- (b) the cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147.

15. Punishment for non-compliance

Section 147 of the Companies Act, 2013 prescribes following punishments for contravention:

- (1) If any of the provisions of sections 139 to 146 (both inclusive) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.

(2) If an auditor of a company contravenes any of the provisions of section 139 section 143, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees **or four times the remuneration of the auditor, whichever is less.**

It may be noted that if an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than **fifty thousand** rupees but which may extend to twenty-five lakh rupees **or eight times the remuneration of the auditor, whichever is less.**

- (3) Where an auditor has been convicted under sub-section (2), he shall be liable to-
 - (i) refund the remuneration received by him to the company;
 - (ii) and pay for damages to the company statutory bodies or authorities or to **members or creditors of the company** for loss arising out of incorrect or misleading statements of particulars made in his audit report.
- (4) The Central Government shall, by notification, specify any statutory body or authority of an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages the such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.
- (5) 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.

It may be noted that in case of criminal liability of an audit firm, in respect of liability other than fine, the concerned partner(s), who acted in a fraudulent manner or abetted or, as the case may be, colluded in any fraud shall only be liable.

PART – II A: Multiple Choice Questions

1. Marvin Ltd. is a renowned food chain supplier in a posh area providing restaurant facility along with food delivering. CA. Felix was appointed as an auditor of the company for the Financial Year 2017-18. While examining the books of account of the company, CA. Felix came to know about one of the major expenses of the company i.e. rent expense of ₹ 1,20,000 per month, for which he applied substantive analytical procedure for verification purpose. Explain, how would CA. Felix perform substantive analytical procedure in the given scenario?
 - (a) CA. Felix would inspect every single rent invoice per month of ₹ 1,20,000 and verify other elements appropriately.
 - (b) CA. Felix would compare the rental expense of the company with that of another nearby company having corresponding dimensions, for high degree of accuracy.
 - (c) CA. Felix would select the first month rent invoice of ₹ 1,20,000 and appropriately verifying other elements would predict that the rent for the whole year would be ₹ 14,40,000 (i.e. ₹ 1,20,000 * 12). Thereafter, he would compare the actuals with his prediction and follow-up for any fluctuation.
 - (d) (a) and (b), both.
2. Coyote Ltd. is dealing in trading of electronic goods. Huge inventory (60% approximately) of the company is lying on consignment (i.e. under the custody of third party). CA. Star, the auditor of the company, wants to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory lying on consignment. Thus, he requested & obtained confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity, however, it raised doubts about the integrity and objectivity of the third party. Which of the following other audit procedures may be performed by CA. Star to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory under the custody of third party?
 - (a) Attend third party's physical counting of inventory.
 - (b) Arrange for another auditor to attend third party's physical counting of inventory.
 - (c) Inspect warehouse receipts regarding inventory held by third parties.
 - (d) All of the above.
3. In July, 2018, M/s Tom & Co. entered into an agreement with M/s Jerry & Co. under which a machinery would be let on hire and M/s Jerry & Co. would have the option to purchase the machinery in accordance with the terms of the agreement. Thus, M/s Jerry & Co. agreed to pay M/s Tom & Co. a settled amount in periodical instalments. The property in the goods shall be passed to M/s Jerry & Co. on the payment of last of such instalments. While checking such hire-purchase transaction, what would the auditor examine?

(a) That the periodical instalments paid are charged as an expenditure by M/s Jerry & Co.

(b) That the hire purchase agreement specifies clearly the hire-purchase price of the machinery to which the agreement relates.

(c) That M/s Tom & Co. charges depreciation throughout the life of the machinery.

(d) All of the above.

4. The management of Magoo Ltd. has developed a strong internal control in its accounting system in such a way that the work of one person is reviewed by another. Since no individual employee is allowed to handle a task alone from the beginning to the end, the chances of early detection of frauds and errors are high. CA. Olive has been appointed as an auditor of the company for current Financial Year 2017-18. Before starting the audit, she wants to evaluate the internal control system of Magoo Ltd. To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, CA. Olive decided to use internal control questionnaire to know and assimilate the system and evaluate the same. Which of the following questions need not be framed under internal control questionnaire relating to purchases?

(a) Are authorized signatories for purchases limited to elected officials?

(b) Are payments approved only on original invoices?

(c) Does authorized officials thoroughly review the documents before signing cheques?

(d) Are monthly bank reconciliations implemented for each and every bank accounts of the company?

5. CA. Bobby is a recently qualified Chartered Accountant. He is appointed as an auditor of Droopy Ltd. for the current Financial Year 2017-18. He is quite conservative in nature which is also replicated in his professional work. CA. Bobby is of the view that he shall record all the matters related to audit, audit procedures to be performed, audit evidence obtained and conclusions reached. Thus, he maintained a file and recorded each and every of his findings during the audit. His audit file, besides other thing, includes audit programmes, notes reflecting preliminary thinking, letters of confirmation, e-mails concerning significant matters, etc. State which of the following need not be included in the audit documentation?

(a) Audit programmes.

(b) Notes reflecting preliminary thinking.

(c) Letters of confirmation.

(d) E-mails concerning significant matters.

6. While auditing the books of accounts of QHMP Ltd., CA. Ranker, the statutory auditor of the company, came to know that the management of the company has recognized internally generated goodwill as a fixed asset. CA. Ranker discussed with the management that according to accounting standards, internally generated goodwill is not recognized as

an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost. However, the management is quite rigid to the accounting treatment followed for internally generated goodwill and not paying attention to the auditor. Thus, through an example, CA. Ranker explained which type of goodwill may be recognized as a fixed asset for which the management got justified. State which of the following examples the auditor must have given to the management?

- (a) If an item meeting the definition of an intangible asset is acquired in a business combination, it forms part of the goodwill to be recognized at the date of the amalgamation.
- (b) Only those goodwill needs to be recognized as a fixed asset which can be touched like physical assets, for example, land and buildings.
- (c) Goodwill is recognised only when there is a contractual or other legal rights for a physical asset which shall not be amortized over the period.
- (d) All of the above.

7. Eeyore Pvt. Ltd. is incorporated on 1st July, 2017. During the Financial Year ending on 31st March, 2018, the company did not opt for any borrowing at any point of time and have a total revenue of ₹ 60 Lakh. At the year end, it provides the following information regarding its paid-up capital and reserve & surplus-

Particulars	Amount (in ₹)
Paid-up Capital	
- Consideration received in cash for equity shares (including unpaid calls of ₹ 5,00,000)	40,00,000
- Consideration received in cash for preference shares	25,00,000
- Bonus shares allotted	7,00,000
- Share application money received pending allotment	<u>10,00,000</u>
Sub-Total	82,00,000
Reserve & Surplus	
- Balance in Statement of Profit and Loss	15,00,000
- Capital Reserves	10,00,000
Sub-Total	25,00,000
GRAND TOTAL	1,07,00,000

You are provided with the provisions regarding applicability of Companies (Auditor's Report) Order, 2016, (CARO, 2016) issued under section 143(11) of the Companies Act, 2013 to a private limited company that it specifically exempts a private limited company having a paid up capital and reserves and surplus not more than ₹ 1 crore as on the Balance Sheet date and which does not have total borrowings exceeding

₹ 1 crore from any bank at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 exceeding ₹ 10 crore during the financial year.

Considering the information given above, which of the following shall be considered as a reason regarding applicability or non-applicability of CARO, 2016?

- (a) Reporting under CARO, 2016 shall be applicable as the company is having a paid up capital and reserves and surplus of ₹ 1.07 crore i.e. more than ₹ 1 crore as on the Balance Sheet date.
- (b) Reporting under CARO, 2016 shall be applicable as the company is having a paid up capital and reserves and surplus of ₹ 1.02 crore i.e. more than ₹ 1 crore as on the Balance Sheet date.
- (c) Reporting under CARO, 2016 shall not be applicable as the company is having a paid up capital and reserves and surplus of ₹ 0.92 crore i.e. not more than ₹ 1 crore as on the Balance Sheet date.
- (d) Reporting under CARO, 2016 shall not be applicable as the company is having a paid up capital and reserves and surplus of ₹ 0.82 crore i.e. not more than ₹ 1 crore as on the Balance Sheet date.

8. CA. Goofy has been appointed as an auditor for audit of a complete set of financial statements of Dippy Ltd., a listed company. The financial statements of the company are prepared by the management in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013. However, the inventories are misstated which is deemed to be material but not pervasive to the financial statements. Based on the audit evidences obtained, CA. Goofy has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570. Further, CA. Goofy is also aware of the fact that a qualified opinion would be appropriate due to a material misstatement of the Financial Statements. State what phrases should the auditor use while drafting such opinion paragraph?

- (a) In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.
- (b) In our opinion and to the best of our information and according to the explanations given to us, with the foregoing explanation, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.
- (c) In our opinion and to the best of our information and according to the explanations given to us, subject to the misstatement regarding inventories, the aforesaid financial

statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.

(d) In our opinion and to the best of our information and according to the explanations given to us, with the explanation described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.

9. While auditing the accounts of ThoughtCo Ltd., CA. Bliss, the auditor of the company came across certain accounts payable balances for which direct confirmation procedure needs to be applied. Thus, for the year ending 31st March, 2018, he sent positive confirmation requests wherein the trade payables are requested to respond whether or not they are in agreement with the balance shown. The auditor received all the confirmation replies from the trade payables on time as correct except from five of them. What other option the auditor is left with regard to trade payables from which no reply for confirmation requests received?

(a) Perform additional testing which may include agreeing the balance to subsequent cash paid.

(b) Accept the balances as it is assuming other replies against received confirmation requests being correct.

(c) Accept the balances as it is assuming that the trade payables must have replied in case of any discrepancies.

(d) None of the above.

10. CA. Daffy is the auditor of xBose Ltd. for the previous 2 years. However, due to certain unavoidable circumstances, no Annual General Meeting (AGM) was held for the current Financial Year ending on 31st March, 2018 within every possible time limit and thus, the ratification procedure for her appointment in the AGM could not be performed. Whether she may continue to hold the office of the auditor?

(a) CA. Daffy may continue to hold the office of the auditor for the current Financial Year only and thereafter shall resign herself as the ratification procedure could not be completed.

(b) CA. Daffy shall continue to hold the office of the auditor and ask the Board to re-appoint her in a private meeting.

(c) CA. Daffy shall continue to hold the office of the auditor as no such ratification provisions for appointment by members at every AGM exist.

(d) CA. Daffy shall not continue to hold office of the auditor as the ratification procedure could not be completed as per proviso to section 139(1) of the Companies Act, 2013.

PART II B – DESCRIPTIVE QUESTIONS

1. State with reason (in short) whether the following statements are true or false:

- (i) The preparation of financial statements does not involve judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity.
- (ii) Audit procedures used to gather audit evidence may be effective for detecting an intentional misstatement.
- (iii) An audit is an official investigation into alleged wrongdoing.
- (iv) The matter of difficulty, time, or cost involved is in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.
- (v) There is no relation between Audit Plans and knowledge of the client's business
- (vi) Planning is not a discrete phase of an audit, but rather a continual and iterative process.
- (vii) Audit documentation is a substitute for the entity's accounting records.
- (viii) An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 30 days after the date of the auditor's report.
- (ix) When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall not perform substantive procedures that are specifically responsive to that risk.
- (x) The SAs ordinarily refer to inherent risk and control risk separately.

Chapter 1- Nature, Objective and Scope of Audit

2. (a) Explain the overall objective of the auditor as contained in SA 200.

(b) The IAASB functions as an independent standard-setting body under the auspices of IFAC. Explain stating the objective of IAASB and also how it achieves those objectives.

3. (a) Lord Justice Lindley in the course of the judgment in the famous *London & General Bank* case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. Explain stating also the qualities of Auditor.

(b) Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements. Discuss with reference to those fundamental principles of professional ethics.

Chapter 2- Audit Strategy, Audit Planning and Audit Programme

4. (a) Explain the benefits of planning in the audit of financial statements.

(b) Evolving one audit programme applicable to all business under all circumstances is not practicable. Explain

5. (a) The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. Explain

(b) Explain the significant points auditor would consider while developing an audit programme.

Chapter 3- Audit Documentation and Audit Evidence

6. (a) What do you mean by Audit Documentation? Also explain the nature and purpose of audit documentation.

(b) Judging the significance of a matter requires an objective analysis of the facts and circumstances. Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Explain with the help of examples.

7. (a) On the basis of which assumption the financial statements of a company are prepared. Explain. Also describe the objectives of the auditor regarding going concern.

(b) The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. Explain.

8. (a) There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements. Analyse and explain stating the responsibility of auditor in this regard.

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

Chapter 4- Risk Assessment and Internal Control

9. (a) Explain the meaning, objectives and scope of internal audit functions as per SA 610. Also discuss who can be appointed as Internal Auditor?

(b) IT poses specific risks to an entity's internal control. Explain

10. (a) The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. Analyse and explain.

(b) So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. Explain stating clearly the benefits of evaluation of internal control to the auditor.

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

11. Explain how would you deal as an auditor if, as a result of a misstatement resulting from fraud or suspected fraud, you encounter exceptional circumstances that bring into question your ability to continue performing the audit.
12. Discuss the different ways in which defalcation of cash may take place.

Chapter 6- Audit in an Automated Environment

13. Explain the meaning of automated environment. Also discuss the key features of an automated environment.
14. Discuss the situations in which IT will be relevant to an audit.

Chapter 7- Audit Sampling

15. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement. Explain
16. Discuss the factors that should be considered for deciding upon the extent of checking on a sampling plan.

Chapter 8 - Analytical Procedures

17. If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, explain how would the auditor investigate such differences.
18. Explain techniques available as substantive analytical procedures.

Chapter 9 - Audit of Items of Financial Statements

19. Explain the audit procedure to vouch/verify :
 - (i) Rent expenses
 - (ii) Power and Fuel expenses
20. Reserves are amounts appropriated out of profits whereas on the contrary, provisions are amounts charged against revenue. Discuss explaining the difference between the two and also explain clearly revenue reserve and capital reserve.

Chapter 10 - The Company Audit

21. (a) Under **sub-section (3) of section 141 of the Companies Act, 2013** along with **Rule 10** of the Companies (Audit and Auditors) Rules, 2014, state the persons who shall not be eligible for appointment as an auditor of a company
(b) Mr. A, a chartered accountant, has been appointed as an auditor of Laxman Ltd. in the Annual General Meeting of the company held in September, 2016, which assignment he accepted. Subsequently in January, 2017 he joined Mr. B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner. Analyse and explain.
22. The first auditor of Bhartiya Petrol Ltd., a Government company, was appointed by the Board of Directors. Analyse and Explain
23. (a) CA. Donald was appointed as the auditor of PS Ltd. at the remuneration of ₹ 30,000. However, after 4 months of continuing his services, he could not continue to hold his office of the auditor as his wife got a government job at a distant place and he needs to shift along with her to the new place. Thus, he resigned from the company and did not perform his responsibilities relating to filing of statement to the company and the registrar indicating the reasons and other facts as may be relevant with regard to his resignation.
How much fine may he be punishable with under section 140(3) for non-compliance of section 140(2) of the Companies Act, 2013?
(b) Explain the manner and procedure of selection and appointment of auditors as per Rule 3 of Companies (Audit and Auditors) Rules, 2014

Chapter 11 - Audit Report

24. The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. Explain clearly stating the essential audit reporting differences between the approaches. Also define comparative information and audit procedures regarding comparative information.
25. Define Emphasis of Matter paragraph. When the auditor shall include an Emphasis of Matter paragraph in the auditor's report? Also explain how the auditor would include an Emphasis of Matter in the auditor's report?

Chapter 12- Bank Audit

26. The auditor should examine the efficacy of various internal controls over advances in case of Banks to determine the nature, timing and extent of his substantive procedures. Explain what is included in the internal controls over advances.

Chapter 13- Audit of Different Types of Entities

27. Explain the duties of the Comptroller and Auditor General of India.
28. Discuss the matters which should be specially considered in the audit of accounts of a partnership.

SUGGESTED ANSWERS / HINTS**ANSWERS - MULTIPLE CHOICE QUESTIONS**

1. (c)
2. (d)
3. (b)
4. (d)
5. (b)
6. (a)
7. (c)
8. (a)
9. (a)
10. (c)

DESCRIPTIVE ANSWERS

1. (i) **Incorrect:** The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.
- (ii) **Incorrect:** Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- (iii) **Incorrect:** An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

- (iv) **Incorrect:** The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.
- (v) **Incorrect:** The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business
- (vi) **Correct:** According to SA-300, "Planning an Audit of Financial Statements", planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.
- (vii) **Incorrect:** The auditor may include copies of the entity's records (**for example**, significant and specific contracts and agreements) as part of audit documentation. Audit documentation is not a substitute for the entity's accounting records.
- (viii) **Incorrect:** SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.
- (ix) **Incorrect:** When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.
- (x) **Incorrect:** The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

Chapter 1- Nature, Objective and Scope of Audit

2. (a) 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; and

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

(b) **Objectives of International Auditing and Assurance Standards Board:** In 1977, the International Federation of Accountants (IFAC) was set up with a view to bringing harmony in the profession of accountancy on an international scale. In pursuing this mission, the IFAC Board has established the International Auditing and Assurance Standards Board (IAASB) to develop and issue, in the public interest and under its own authority, high quality auditing standards for use around the world. The IFAC Board has determined that designation of the IAASB as the responsible body, under its own authority and within its stated terms of reference, best serves the public interest in achieving this aspect of its mission.

The IAASB functions as an independent standard-setting body under the auspices of IFAC. The objective of the IAASB is to serve the public interest by setting high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The IAASB achieves this objective by:

- Establishing high quality auditing standards and guidance for financial statement audits that are generally accepted and recognized by investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world;
- Establishing high quality standards and guidance for other types of assurance services on both financial and non-financial matters;
- Establishing high quality standards and guidance for other related services;
- Establishing high quality standards for quality control covering the scope of services addressed by the IAASB; and

Publishing other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers.

3. (a) **It is not enough to realise what an auditor should be.** He is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility, errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, Code of ethics mentions integrity,

objectivity and independence as one of the fundamental principles of professional ethics.

He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. ***The Companies Act*** need special mention but mercantile law, specially the law relating to contracts, is no less important. Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.

He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the *sine qua non* of the practice of auditing. He must know thoroughly all accounting principles and techniques.

Lord Justice Lindley in the course of the judgment in the famous *London & General Bank* case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, “an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true”.

(b) **Ethical Requirements Relating to an Audit of Financial Statements:** The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;

- (d) Confidentiality; and
- (e) Professional behavior.

Chapter 2- Audit Strategy, Audit Planning and Audit Programme

4. (a) **Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan.** Adequate planning benefits the audit of financial statements in several ways, including the following:

1. Helping the auditor to devote appropriate attention to important areas of the audit.
2. Helping the auditor identify and resolve potential problems on a timely basis.
3. Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
4. Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
5. Facilitating the direction and supervision of engagement team members and the review of their work.
6. Assisting, where applicable, in coordination of work done by auditors of components and experts.

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

5. (a) **Periodic Review of The Audit Programme**

There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

Example- if the audit programme for the audit of a branch of a financing house, drawn up a number of years ago, fails to take into consideration that the previous policy of

financing of a vehicle has been changed to financing of real estate acquisition, the whole audit conducted thereunder would be entirely misdirected and may even result into nothing more than a farce. [*Pacific Acceptance Corporation Ltd. v. Forsyth and Others.*]

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

(b) Developing the Audit Programme :

1. **Written Audit Programme:** The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.
2. **Audit objective and instruction to assistants:** The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.
3. **Reliance on Internal Controls:** In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.
4. **Timings of performance of audit procedures:** The auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.

5. **Audit planning:** The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

Chapter 3- Audit Documentation and Audit Evidence

6. (a) **Audit documentation:** SA 230 on "Audit Documentation", audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as "working papers" or "work papers" are also sometimes used.)

Nature of Audit Documentation

Audit documentation provides:

- (a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and
- (b) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Purpose of Audit Documentation

The following are the purpose of Audit documentation:

- 1. Assisting the engagement team to plan and perform the audit.
- 2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
- 3. Enabling the engagement team to be accountable for its work.
- 4. Retaining a record of matters of continuing significance to future audits.
- 5. Enabling the conduct of quality control reviews and inspections.
- 6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

(b) **Documentation of Significant Matters and Related Significant Professional Judgments**

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

Examples of significant matters include:

- ◆ Matters that give rise to significant risks.
- ◆ Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.

- ◆ Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- ◆ Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report.

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results.

Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- ◆ The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- ◆ The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- ◆ The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

7. (a) **Going Concern Basis of Accounting**

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Objectives of the auditor regarding going concern are :

- (i) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
- (ii) To support other audit evidence relevant to the financial statements or specific

assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and

- (iii) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor

(b) Audit Procedure Regarding Events Occurring Between The Date Of The Financial Statements And The Date Of The Auditor's Report

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements **have been identified**.

The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment which shall include the following:

- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- (c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- (d) Reading the entity's latest subsequent interim financial statements, if any.

8. (a) Responsibilities of the Auditor

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

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

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

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

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

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

- Management may be unaware of the existence of all related party relationships.
- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.
- Planning and performing the audit with professional skepticism as required by SA 200 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

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

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

(i) **Materiality** may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less

material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.

- (ii) **Risk of material misstatement** may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level (a) Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls. (b) Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control. Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand if assertions have a higher risk of material misstatement, more evidence would be required.
- (iii) **Size of population** refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

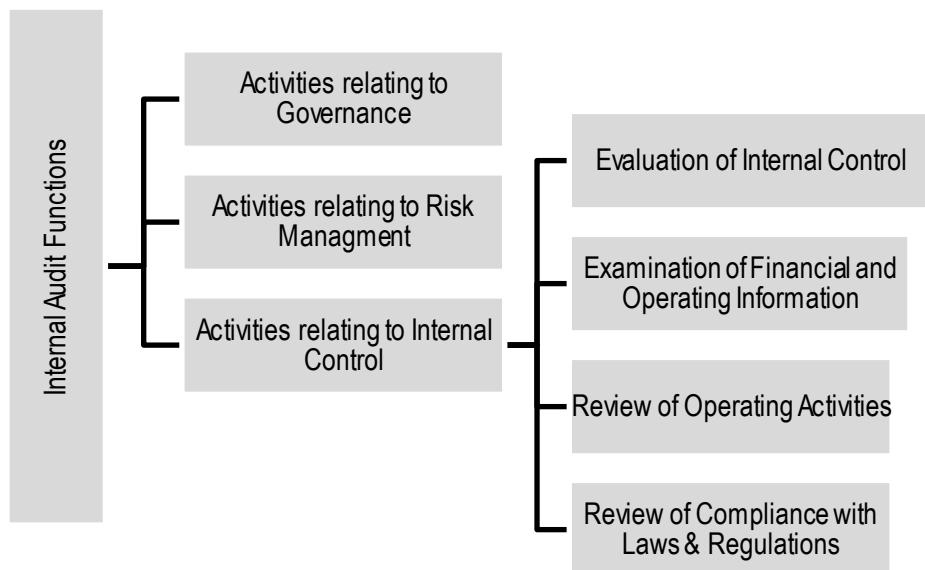
Chapter 4- Risk Assessment and Internal Control

9. (a) **Who can be appointed as Internal Auditor?** As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.

Internal audit function: A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

The objectives and scope of internal audit functions: As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:



1. **Activities Relating to Governance:** The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.
2. **Activities Relating to Risk Management:** The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process). The internal audit function may perform procedures to assist the entity in the detection of fraud.
3. **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 nonfinancial activities of an entity.

(vi) **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.

(b) **IT also poses specific risks to an entity's internal control, including, for example:**

- ◆ Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- ◆ Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- ◆ The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- ◆ Unauthorised changes to data in master files.
- ◆ Unauthorised changes to systems or programs.
- ◆ Failure to make necessary changes to systems or programs.
- ◆ Inappropriate manual intervention.
- ◆ Potential loss of data or inability to access data as required.

10. (a) **Satisfactory Control Environment - not an absolute deterrent to fraud:**

The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures.

The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

(b) **So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme.** The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operations of these internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

Benefits of Evaluation of Internal Control to the Auditor

The review of internal controls will enable the auditor to know:

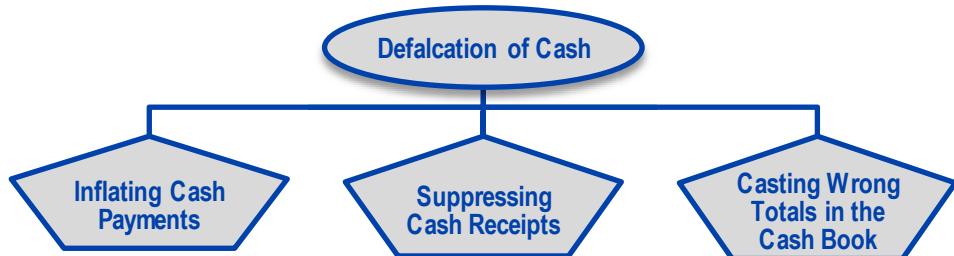
- (i) whether errors and frauds are likely to be located in the ordinary course of operations of the business;
- (ii) whether an adequate internal control system is in use and operating as planned by the management;
- (iii) whether an effective internal auditing department is operating;
- (iv) whether any administrative control has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);
- (v) whether the controls adequately safeguard the assets;
- (vi) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned;
- (vii) how reliable the reports, records and the certificates to the management can be;
- (viii) the extent and the depth of the examination that he needs to carry out in the different areas of accounting;
- (ix) what would be appropriate audit technique and the audit procedure in the given circumstances;
- (x) what are the areas where control is weak and where it is excessive; and
- (xi) whether some worthwhile suggestions can be given to improve the control system.

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

11. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

- (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and
- (c) If the auditor withdraws:
 - (i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
 - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.
- (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and
- (c) If the auditor withdraws:
 - (i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
 - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

12. **Defalcation of Cash:** Defalcation of cash has been found to perpetrate generally in the following ways:



(a) **By inflating cash payments.**

Examples of inflation of payments:

- (1) Making payments against fictitious vouchers.
- (2) Making payments against vouchers, the amounts whereof have been inflated.
- (3) Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.
- (4) Casting a larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals show agreement.

(b) **By suppressing cash receipts.**

Few techniques of how receipts are suppressed are:

- (1) *Teeming and Lading:* Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.
- (2) Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.
- (3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.
- (4) Not accounting for cash sales fully.
- (5) Not accounting for miscellaneous receipts, e.g., sale of scrap, quarters allotted to the employees, etc.
- (6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

- (c) By casting wrong totals in the cash book.

Chapter 6- Audit in an Automated Environment

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

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

Some of the key features of an automated environment are as follows:

Key features of an Automated Environment



The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.

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

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

14. Given below are some situations in which IT will be relevant to an audit,

- Increased use of Systems and Application software in Business (for example, use of ERPs)
- Complexity of transactions has increased (multiple systems, network of systems)
- Hi-tech nature of business (Telecom, e-Commerce)
- Volume of transactions are high (Insurance, Banking, Railways ticketing)
- Company Policy (Compliance)
- Regulatory requirements - Companies Act 2013 IFC, IT Act 2008
- Required by Indian and International Standards - ISO, PCI-DSS, SA 315, SOC, ISAE
- Increases efficiency and effectiveness of audit

Chapter 7 Audit Sampling

15. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

16. The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

- (i) Size of the organisation under audit.
- (ii) State of the internal control.
- (iii) Adequacy and reliability of books and records.
- (iv) Tolerable error range.
- (v) Degree of the desired confidence.

Chapter 8- Analytical Procedures

17. If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (i) **Inquiring of management and obtaining appropriate audit evidence relevant to management's responses:** Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.
- (ii) **Performing other audit procedures as necessary in the circumstances:** The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

18. Techniques available as substantive analytical procedures : The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Substantive analytical procedures generally take one of the following forms:

- **Trend analysis** — A commonly used technique is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.
- **Ratio analysis** — Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.
 - **For example**, Financial ratios may include:
 - Trade receivables or inventory turnover
 - Freight expense as a percentage of sales revenue
- **Reasonableness tests** — Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts.
- **Structural modelling** — A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

Chapter 9 - Audit of Items of Financial Statements

19. (i) Rent expense- Obtain a month wise expense schedule along with the rent agreements. Verify if expense has been recorded for all 12 months and whether the

rent amount is as per the underlying agreement. Specific consideration should be given to escalation clause in the agreement to verify if the rent was to be increased/adjusted during the period under audit. Also, verify if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity

- (ii) **Power and fuel expense**- Obtain a month wise expense schedule along with the power bills. Verify if expense has been recorded for all 12 months. Also, compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis. In relation to the units consumed, analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends

20. **Reserves** are amounts appropriated out of profits that are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist as at the date of the Balance Sheet.

On the contrary, provisions are amounts charged against revenue to provide for:

- (i) Renewal or diminution in the value of assets; or
- (ii) a known liability, the amount whereof could only be estimated and cannot be determined with accuracy; or
- (iii) a claim which is disputed.

Amounts contributed or transferred from profits to make good the diminution in value of assets due to the fact that some of them have been lost or destroyed as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions. Provisions are normally charged to the Statement of Profit and Loss before arriving at the amount of profit. Reserves are appropriations out of profits.

Difference between Reserves and Provisions

The difference between the two is that provisions are amounts set aside to meet specific/identified liabilities or diminution in recoverable value of assets. These must be provided for regardless of the fact whether the Company has earned profit or not.

Reserves on the other hand, represent amounts appropriated out of profits, held for equalising the dividends of the company from one period to another or for financing the expansion of the company or for generally strengthening the company financially.

If we examine the Balance Sheet of a company, at a given time, and deduct the total liabilities to outside trade payables from the value of assets shown therein, the difference between the two figures will represent the net worth of the company based on the book values of assets as on that date. The same shall include the capital contributed by the shareholders as well as total undistributed profit held either to the credit of the Statement of Profit and Loss or to reserves; the reserves again will be segregated as revenue or capital reserves.

Revenue reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose

Examples- to supplement divisible profits in lean years, to finance an extension of business, to augment the working capital of the business or to generally strengthen the company's financial position.

Capital Reserve, on the other hand represents a reserve which does not include any amount regarded as free for distribution through the Statement of Profit and Loss

Examples- share premium, capital redemption reserve.

It may be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve shall also be in the nature of a capital reserve.

A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But the amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.

Chapter 10 - The Company Audit

21. (a) Under **sub-section (3) of section 141** along with **Rule 10** of the Companies (Audit and Auditors) Rules, 2014 (hereinafter referred as CAAR), the following persons shall not be eligible for appointment as an auditor of a company, namely-

- (a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;
- (b) an officer or employee of the company;
- (c) a person who is a partner, or who is in the employment, of an officer or employee of the company;
- (d) a person who, or his relative or partner -

(i) is holding any security or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company;

It may be noted that the relative may hold security or interest in the company of face value not exceeding ₹ 1,00,000.

It may also be noted that the condition of ₹ 1,00,000 shall, wherever relevant, be also applicable in the case of a company not having share capital or other securities.

It may also be noted that in the event of acquiring any security or interest by a relative, above the threshold prescribed, the corrective action to maintain the limits as specified above shall be taken by the auditor **within 60 days** of such acquisition or interest.

- (ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of ₹ 5,00,000; or
- (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the Company or its Subsidiary, or its Holding or Associate Company or a Subsidiary of such Holding Company, in excess of ₹ 1,00,000.
- (e) a person or a firm who, whether directly or indirectly has business relationship with the Company, or its Subsidiary, or its Holding or Associate Company or Subsidiary of such holding company or associate company, of such nature as may be prescribed;
- (f) a person whose relative is a Director or is in the employment of the Company as a director or key Managerial Personnel.
- (g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.
- (h) a person who has been convicted by a Court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction.
- (i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialized services as provided in **section 144**.

(b) **Provisions and Explanation:** Section 141(3)(c) of the Companies Act, 2013 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (4) of Section 141 provides that an auditor who becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) of Section 141, he shall be deemed to have vacated his office as an auditor.

Conclusion: In the present case, Mr. A, an auditor of Laxman Ltd., joined as partner with Mr. B, who is Manager Finance of Laxman Limited. The given situation has attracted sub-section (3)(c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of Laxman Limited in accordance with sub-section (4) of section 141.

22. Provisions and Explanation: In the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013 which states that in the case of a Government company, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration

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

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

23. (a) **Provisions and Explanation:** For non-compliance of sub-section (2) of section 140 of the Companies Act, 2013, the auditor shall be punishable with fine, which shall not be less than fifty thousand rupees or the remuneration of the auditor, whichever is less but which may extend to five lakh rupees, under section 140(3) of the said Act.

Conclusion: Thus, the fine under section 140(3) of the Companies Act, 2013 shall not be less than ₹ 30,000 but which may extend to ₹ 5,00,000.

(b) **Manner and procedure of selection and appointment of auditors-** Rule 3 of CAAR, 2014 prescribes the following manner and procedure of selection and appointment of auditors-

- (1) In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company. It may be noted that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.
- (2) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.
- (3) Subject to the provisions of sub-rule (1), where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.
- (4) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.
- (5) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.

- (6) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.
- (7) The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.

Chapter 11 - Audit Report

24. **The nature of the comparative information** that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

The essential audit reporting differences between the approaches are:

- (a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
- (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

Definition of Comparative information – The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

Audit Procedures regarding comparative information

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

- (a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
- (b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

25. Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

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 judgment, 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:

- (a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter; and
- (b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

Separate section for Emphasis of Matter paragraph

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

- (a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
- (b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
- (c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Chapter 12- Bank Audit

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

- ◆ The bank should make an advance only after satisfying itself as to the creditworthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
- ◆ All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- ◆ The compliance with the terms of sanction and end use of funds should be ensured.
- ◆ Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient

margin needs to be ensured at regular intervals.

- ◆ If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- ◆ All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- ◆ In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- ◆ Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- ◆ The accounts should be kept within both the drawing power and the sanctioned limit.
- ◆ All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- ◆ The operation of each advance account should be reviewed at least once a year, and at more frequent intervals in the case of large advances.

Chapter 13- Audit of Different Types of Entities

27. Duties of the C&AG:

(i) **Compile and submit Accounts of Union and States** - The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. The Comptroller and Auditor General shall, from the accounts compiled by him or [by the Government or any other person responsible in that behalf] prepare in each accounts (including, in the case of accounts compiled by him, appropriation accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union Territory having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

The C&AG Act of 1971 has provisions for relieving him of this responsibility to give information and render assistance to the Union and States: The Comptroller and Auditor General shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time,

require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

- (ii) **General Provisions Relating to Audit** - It shall be the duty of the Comptroller and Auditor General—
 - (a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;
 - (b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;
 - (c) to audit and report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.
- (iii) **Audit of Receipts and Expenditure** - Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.
- (iv) **Audit of Grants or Loans** - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.
- (v) **Audit of Receipts of Union or States** - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly

and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit and report thereon.

- (vi) **Audit of Accounts of Stores and Inventory** - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.
- (vii) **Audit of Government Companies and Corporations** - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The Comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

28. Matters which should be specially considered in the audit of accounts of a partnership:

- (i) Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.
- (ii) Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans; purchase of assets, extraordinary contracts entered into and other such matters as are not of a routine nature.
- (iii) Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.
- (iv) Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.
- (v) Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.
- (vi) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.
- (vii) Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC MANAGEMENT

**SECTION – A: ENTERPRISE INFORMATION SYSTEMS
QUESTIONS**

Multiple Choice Questions

1. Under Asynchronous attacks in a telecommunication network system, _____ involves spying on information being transmitted over communication network.
 - (a) Wire-tapping
 - (b) Data Leakage
 - (c) Subversive Attacks
 - (d) Piggybacking
2. A Bank ABC gave an undertaking to the third party, supplier of goods/ services to pay amount of ₹ 2 crore to him on behalf of a businessman Mr. X; provided the terms and conditions of the undertaking are complied with. This service of banks is known as –
 - (a) Issuing letter of Guarantee
 - (b) Issuing letter of Comfort
 - (c) Issuing letter of Credit
 - (d) Issuing letter of Understanding
3. An aspiring CA in his interview was asked to provide correct sequence of the following sub-processes that represent Accounting Process Flow. The sub processes are - (1) Source Document, (2) Financial Statement, (3) Adjustments (4) Ledger, (5) Adjusted Trial Balance, (6) Closing Entries, (7) Journal and (8) Trial Balance. What should be the answer?
 - (a) (1)-(2)-(3)-(4)-(5)-(6)-(7)-(8)
 - (b) (4)-(3)-(7)-(6)-(1)-(2)-(8)-(5)
 - (c) (1)-(7)-(4)-(8)-(3)-(5)-(6)-(2)
 - (d) (8)-(5)-(3)-(1)-(2)-(4)-(6)-(7)

Chapter 1: Automated Business Processes

4. The GST of 50 items is to be calculated as per the following details. With Code No. and Value of Supply as input, draw a flowchart to calculate the Tax and print the Tax, Code No. of the Item and the Type of Item. (*Note: The rates have been taken hypothetically*)

Code No.(C_No)	Types of Items	Tax Rate
001	Perishable	15%
002	Textiles	10%
003	Luxury Items	20%
004	Machinery	12%

Chapter 2: Financial and Accounting Systems

5. You have been appointed as an Information Systems (IS) Auditor in a company JKL Ltd. and asked to perform an ERP audit. Prepare a checklist of the common concerns that should be asked during development and implementation of the system as well as ERP Audit.
6. Define Business Reporting. Determine the factors that makes Business Reporting significant.

Chapter 3: Information Systems and Its Components

7. In Information Systems, identify the type of Managerial controls that are responsible for the daily running of software and hardware facilities. Prepare a detailed note on these controls.

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

8. Discuss the concept of “Virtualization” and its application areas.
9. Though Mobile computing is a versatile and strategic technology that increases information quality and accessibility, however, it has its own limitations. Analyse them.

Chapter – 5: Core Banking Systems

10. Discuss the risks and their corresponding controls associated with the Treasury Process in Core Banking Systems (CBS).

SUGGESTED ANSWERS/HINTS

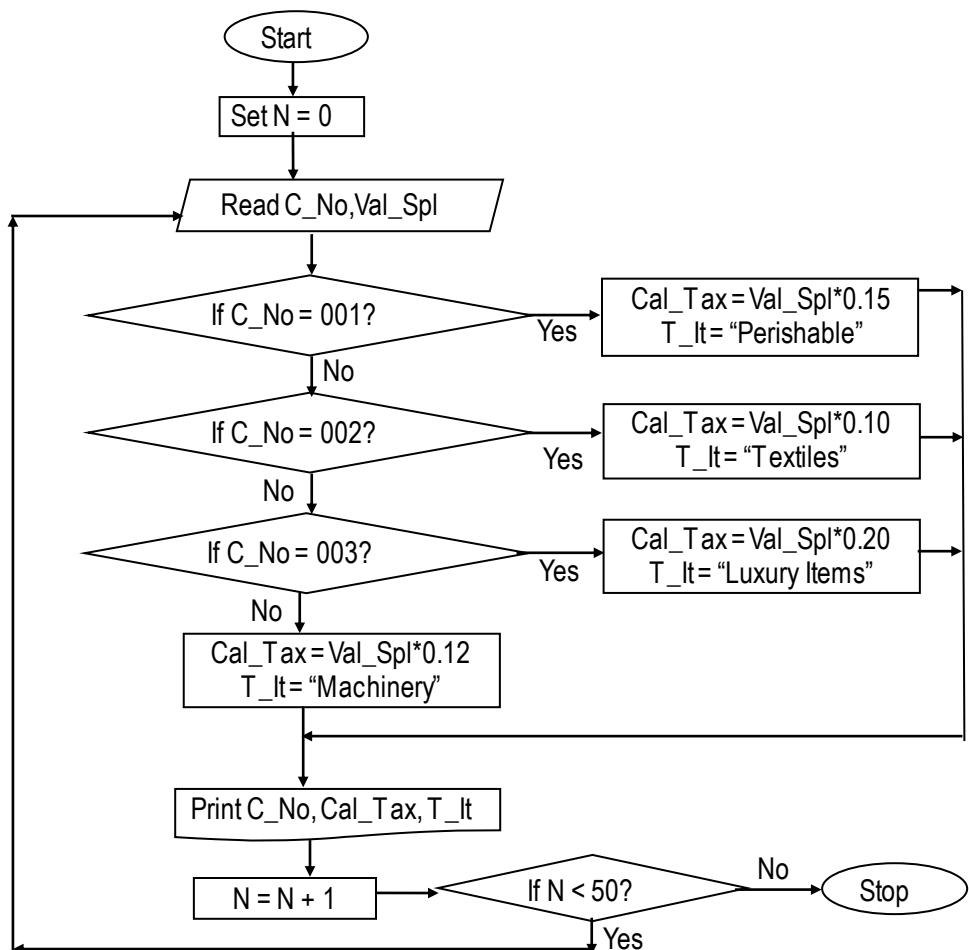
1. (a) Wire-tapping
2. (c) Issuing letter of Credit
3. (c) (1)-(7)-(4)-(8)-(3)-(5)-(6)-(2)
4. The variables are defined as follows:

C = Code No; Val_Spl = Value of Supply;

T_It = Types of Item N = Counter;

Cal_Tax = Calculated Tax after GST

The required flowchart is as below:



5. Some of the questions auditors should ask during an ERP audit are pretty much the same as those that should be asked during development and implementation of the system:

- Does the system process according to GAAP (Generally Accepted Accounting Principles) and GAAS (Generally Accepted Auditing Standards)?
- Does it meet the needs for reporting, whether regulatory or organizational?
- Were adequate user requirements developed through meaningful interaction?
- Does the system protect confidentiality and integrity of information assets?
- Does it have controls to process only authentic, valid, accurate transactions?
- Are effective system operations and support functions provided?

- Are all system resources protected from unauthorized access and use?
- Are user privileges based on what is called “role-based access?”
- Is there an ERP system administrator with clearly defined responsibilities?
- Is the functionality acceptable? Are user requirements met? Are users happy?
- Have workarounds or manual steps been required to meet business needs?
- Are there adequate audit trails and monitoring of user activities?
- Can the system provide management with suitable performance data?
- Are users trained? Do they have complete and current documentation?
- Is there a problem-escalation process?

6. Business Reporting is the public reporting of operating and financial data by a business enterprise, or the regular provision of information to decision-makers within an organization to support them in their work.

Reporting is a fundamental part of the larger movement towards improved business intelligence and knowledge management. Often implementation involves Extract, Transform, and Load (ETL) procedures in coordination with a data warehouse and then using one or more reporting tools. While reports can be distributed in print form or via email, they are typically accessed via a corporate intranet.

Significance of Business Reporting is as follows:

- Effective and transparent business reporting allows organizations to present a cohesive explanation of their business and helps them engage with internal and external stakeholders, including customers, employees, shareholders, creditors, and regulators.
- High-quality business reporting is at the heart of strong and sustainable organizations, financial markets, and economies, as this information is crucial for stakeholders to assess organizational performance and make informed decisions with respect to an organization's capacity to create and preserve value.
- As organizations fully depend on their stakeholders for sustainable success, it is in their interest to provide them with high-quality reports. For example, effective high-quality reporting reduces the risk for lenders and may lower the cost of capital.
- Many organizations are increasingly complex, and have larger economic, environmental, and social footprints. As a result, various stakeholder groups are demanding increased Environmental, Social and Governance (ESG) information, as well as greater insight into how these factors affect financial performance and valuations.
- High-quality reports also promote better internal decision-making. High-quality information is integral to the successful management of the business, and is one of the major drivers of sustainable organizational success.

7. Under the Managerial Controls, **Operations Management Controls** are responsible for the daily running of hardware and software facilities. Operations management typically performs controls over the functions as below:

- (a) **Computer Operations:** The controls over computer operations govern the activities that directly support the day-to-day execution of either test or production systems on the hardware/software platform available. Three types of controls fall under this category.
 - **Operation Controls:** These controls prescribe the functions that either human operators or automated operations facilities must perform.
 - **Scheduling Controls:** These controls prescribe how jobs are to be scheduled on a hardware/software platform.
 - **Maintenance Controls:** These controls prescribe how hardware is to be maintained in good operating order.
- (b) **Network Operations:** This includes the proper functioning of network operations and monitoring the performance of network communication channels, network devices, and network programs and files. Data may be lost or corrupted through component failure. The primary components in the communication sub-systems are given as follows:
 - Communication lines viz. twisted pair, coaxial cables, fibre optics, microwave and satellite etc.
 - **Hardware** – ports, modems, multiplexers, switches and concentrators etc.
 - **Software** – Packet switching software, polling software, data compression software etc.
 - Due to component failure, transmission between sender and receiver may be disrupted, destroyed or corrupted in the communication system.
- (c) **Data Preparation and Entry:** Irrespective of whether the data is obtained indirectly from source documents or directly, keyboard environments and facilities should be designed to promote speed and accuracy and to maintain the wellbeing of keyboard operators.
- (d) **Production Control:** This includes the major functions like - receipt and dispatch of input and output; job scheduling; management of service-level agreements with users; transfer pricing/charge-out control; and acquisition of computer consumables.
- (e) **File Library:** This includes the management of an organization's machine-readable storage media like magnetic tapes, cartridges, and optical disks.
- (f) **Documentation and Program Library:** This involves that documentation librarians ensure that documentation is stored securely; that only authorized personnel gain access to documentation; that documentation is kept up-to-date and that adequate

backup exists for documentation. The documentation may include reporting of responsibility and authority of each function; Definition of responsibilities and objectives of each functions; Reporting responsibility and authority of each function; Policies and procedures; Job descriptions and Segregation of Duties.

- (g) **Help Desk/Technical support:** This assists end-users to employ end-user hardware and software such as micro-computers, spreadsheet packages, database management packages etc. and provided the technical support for production systems by assisting with problem resolution.
- (h) **Capacity Planning and Performance Monitoring:** Regular performance monitoring facilitates the capacity planning wherein the resource deficiencies must be identified well in time so that they can be made available when they are needed.
- (i) **Management of Outsourced Operations:** This has the responsibility for carrying out day-to-day monitoring of the outsourcing contract.

8. In computing, **Virtualization** means to create a virtual version of a device or resource, such as a server, storage device, network or even an operating system where the framework divides the resource into one or more execution environments. Virtualization refers to technologies designed to provide a layer of abstraction between computer hardware systems and the software running on them. By providing a logical view of computing resources, rather than a physical view; virtualization allows its' users to manipulate their systems' operating systems into thinking that a group of servers is a single pool of computing resources and conversely, allows its users to run multiple operating systems simultaneously on a single machine. Thus, the core concept of Virtualization lies in Partitioning, which divides a single physical server into multiple logical servers. For example - Partitioning of a hard drive is considered virtualization because one drive is partitioned in a way to create two separate hard drives. Devices, applications and human users can interact with the virtual resource as if it were a real single logical resource.

Application Areas of Virtualization are as follows:

- ◆ **Server Consolidation:** Virtual machines are used to consolidate many physical servers into fewer servers, which in turn host virtual machines. Each physical server is reflected as a virtual machine "guest" residing on a virtual machine host system. This is also known as "Physical-to-Virtual" or 'P2V' transformation.
- ◆ **Disaster Recovery:** Virtual machines can be used as "hot standby" environments for physical production servers. This changes the classical "backup-and-restore" philosophy, by providing backup images that can "boot" into live virtual machines, capable of taking over workload for a production server experiencing an outage.
- ◆ **Testing and Training:** Virtualization can give root access to a virtual machine. This can be very useful such as in kernel development and operating system courses.

- ◆ **Portable Applications:** Portable applications are needed when running an application from a removable drive, without installing it on the system's main disk drive. Virtualization can be used to encapsulate the application with a redirection layer that stores temporary files, windows registry entries and other state information in the application's installation directory and not within the system's permanent file system.
- ◆ **Portable Workspaces:** Recent technologies have used virtualization to create portable workspaces on devices like iPods and USB memory sticks.

9. Limitations of Mobile Computing are as follows:

- ◆ **Insufficient Bandwidth:** Mobile Internet access is generally slower than direct cable connections using technologies such as General Packet Radio Service (GPRS) and Enhanced Data for GSM (Global System for Mobile Communication), 3G and more recently 4G networks. These networks are usually available within range of commercial cell phone towers. Higher speed wireless LANs are inexpensive but have very limited range.
- ◆ **Security Standards:** When working mobile, one is dependent on public networks, requiring careful use of Virtual Private Network (VPN). Security is a major concern while concerning the mobile computing standards on the fleet. One can easily attack the VPN through a huge number of networks interconnected through the line.
- ◆ **Power consumption:** When a power outlet or portable generator is not available, mobile computers must rely entirely on battery power. Combined with the compact size of many mobile devices, this often means unusually expensive batteries must be used to obtain the necessary battery life. Mobile computing should also consider Greener IT in such a way that it saves the power or increases the battery life.
- ◆ **Transmission interferences:** Weather, terrain, and the range from the nearest signal point can all interfere with signal reception. Reception in tunnels, some buildings, and rural areas is often poor.
- ◆ **Potential health hazards:** People who use mobile devices while driving are often distracted from driving are thus assumed more likely to be involved in traffic accidents. Cell phones may interfere with sensitive medical devices. There are allegations that cell phone signals may cause health problems.
- ◆ **Human interface with device:** Screens and keyboards tend to be small, which may make them hard to use. Alternate input methods such as speech or handwriting recognition require training.

10. The Risks and their corresponding Controls associated with the Treasury Process in Core Banking Systems are as follows:

S. No.	Risk	Key Controls
1.	Unauthorized securities setup in systems such as Front office/Back office.	Appropriate Segregation of duties and review controls around securities master setup/amendments.
2.	Inaccurate trade is processed.	Appropriate Segregation of duties and review controls to ensure the accuracy and authorization of trades.
3.	Unauthorized confirmations are processed.	Complete and accurate confirmations to be obtained from counter-party.
4.	Insufficient Securities available for Settlement	Effective controls on securities and margins.
5.	Incomplete and inaccurate data flow between systems.	Inter-system reconciliations, Interfaces and batch processing controls.
6.	Insufficient funds are available for settlements.	Controls at Clearing Corporation of India Limited (CCIL)/National Electronic Funds Transfer (NEFT)/ Real Time Gross Settlement (RTGS) to ensure the margin funds availability and the timely funds settlements.
7.	Incorrect Nostro payments processed.	Controls at Nostro reconciliation and payments.

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

1. In the questions given below select the best answer out of options (a), (b), (c), or (d):
 - (i) Which of the following statement is not true with regards to strategy?
 - (a) Strategy reduces uncertainty.
 - (b) Strategy is long range blueprint of desired position.
 - (c) Strategy relates organisations to the external environment.
 - (d) Strategy is perfect and flawless.
 - (ii) The strategic management process is:
 - (a) a solution that guarantees prevention of organizational failure.
 - (b) concerned with a resources, capabilities, and competencies, but not the conditions in its external environment.
 - (c) not to be used in the not-for-profit organisations.
 - (d) full set of commitments, decisions, and actions related to the firm.
 - (iii) Mission:
 - (a) is an internally-focused definition of the organization's societal goals.
 - (b) is a statement of a firms unique purpose and scope of operations.
 - (c) does not relate to the industry in which the firm intends to compete.
 - (d) is developed by a firm before the firm develops its strategic intent.
 - (iv) A _____ consists of those rival firms which have similar competitive approaches and positions in the market.
 - (a) BCG Matrix.
 - (b) Strategic group.
 - (c) Strategy Map.
 - (d) Industry.
 - (v) According to C.K. Prahalad and Gary Hamel, major core competencies are identified in three areas - _____, _____, and application to other markets.
 - (a) Competitor differentiation, customer value.
 - (b) Competitor differentiation, focus.
 - (c) Cost leadership, differentiation.
 - (d) Profits, growth.

- (vi) Which of the following statement is not true about strategic decisions?
 - (a) They need top-management involvement.
 - (b) Involve commitment of organisational resources.
 - (c) They are based on external environment
 - (d) They have insignificant impact on the long-term prosperity
- (vii) Strategic decision making can take place at three common levels of an organisation as follows:
 - (a) Divisional, group and individual.
 - (b) Executive, leader and manager.
 - (c) Corporate, business and functional.
 - (d) Strategic, tactical and operational.
- (viii) Which of the following is not a type of diversification strategy?
 - (a) Vertical diversification.
 - (b) Concentric diversification.
 - (c) Conglomerate diversification.
 - (d) Co-generic diversification.
- (ix) A thing that a firm does especially well in comparison to the rival firms is:
 - (a) Opportunity availed.
 - (b) Successful leadership.
 - (c) Competitive advantage.
 - (d) Comparative advantage.
- (x) Stability strategy is a _____ strategy.
 - (a) Functional level.
 - (b) Business level.
 - (c) Corporate level.
 - (d) implementation.
- (xi) Under BCG an SBU with products having little market share but in an attractive industry is referred to as:
 - (a) Cash cow.
 - (b) Star.
 - (c) Dog.

(d) Question mark.

(xii) Which of the following does not form part of Richard Rumelt's criteria for strategy audit?

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

(xiii) According to Porter, which of the following is important to achieve competitive advantage?

- (a) Differentiation and cost advantage.
- (b) Outsourcing activities.
- (c) Having strong relationship with buyer and sellers.
- (d) Focus on most competitive businesses.

(xiv) What will happen in case many new businesses enter a market?

- (a) Barriers to entry will rise.
- (b) Competitive rivalry will intensify.
- (c) Capacity of industry will fall.
- (d) Industry will become more lucrative.

(xv) Marketing Strategy is the following type of strategy:

- (a) Business Strategy.
- (b) Functional Strategy.
- (c) Growth Strategy.
- (d) Product Strategy.

(xvi) Which of the following situation will most likely suit a transformational leader?

- (a) An organization that is in trouble.
- (b) A growing organization.
- (c) An organization in a stable environment.
- (d) An organization at maturity stage of product life cycle.

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

- (a) Changing.
- (b) Deep freezing.
- (c) Refreezing.

(d) Unfreezing.

(xviii) An organization acquires its supplier is an example of:

- (a) Horizontal integrated diversification.
- (b) Forward integrated diversification.
- (c) Backward integrated diversification.
- (d) Conglomerate diversification.

Descriptive answers

Chapter 1-Introduction to Strategic Management

2. 'Do Good Group' is a not-for-profit organization based in northern India working towards childcare. The group educates people towards immunization, sanitation and works in coordination with local hospitals or medical centers. Recently, a new team has taken over the management of its activities. Explain whether tools of strategic Management are relevant for the group.
3. Are there any limitations attached to strategic management in organizations? Discuss.

Chapter 2-Dynamics of Competitive Strategy

4. Rohit Patel is having a small chemist shop in the central part of Ahmedabad. What kind of competencies Rohit can build to gain competitive advantage over online medicine sellers?
5. What is a Strategic Group? Discuss the procedure for constructing a strategic group map.

Chapter 3-Strategic Management Process

6. Shri Alok Kumar is having his own medium size factory in Aligarh manufacturing hardware consisting handles, hinges, tower bolts and so on. He has a staff of more than 220 in his organisation. One of the leading brand of Hardware seller in India is rebranding and selling the material from his factory. Shri Alok Kumar, believes in close supervision and takes all major and minor decisions in the organisation.

Do you think Shri Alok should take all decisions himself? What should be nature of decisions that should be taken by him.

7. What are the elements in strategic intent of organisation?

Chapter 4-Corporate Level Strategies

8. With the global economic recession Soft Cloth Ltd. incurred significant losses in all its previous five financial years. Currently, they are into manufacturing of cloth made of cotton, silk, polyester, rayon, lycra and blends. Competition is also intense on account of cheap imports. The company is facing cash crunch and has not been able to pay the salaries to its employees in the current month.

Suggest a grand strategy that can be opted by Soft Cloth Ltd.

9. What are the advantages of a strategic alliance?

Chapter 5-Business Level Strategies

10. Rahul Sharma is Managing Director of a company which is manufacturing trucks. He is worried about the entry of new businesses. What kind of barriers will help Rahul against such a threat?

11. What do you understand by cost leadership? How is it achieved?

Chapter 6-Functional Level Strategies

12. ABC Ltd is a company that has grown eleven times its size in last five years. With the increase in size the company is facing difficulty in managing things. Many a times functional level is not in sync with the corporate level. What will you like to advise to the company and why?

13. Explain the prominent areas where human resource manager can play a strategic role.

Chapter 7-Organisation and Strategic Leadership

14. Ramesh, is owner of a popular brand of Breads. Yashpal, his son after completing Chartered Accountancy started assisting his father in running of business. The approaches followed by father and son in management were very different. While Ramesh preferred to use authority and having a formal system of defining goals and motivation with explicit rewards and punishments, Yashpal believed in involving employees and generating enthusiasm to inspire people to deliver in the organization.

Discuss the difference in leadership style of father and son.

15. Discuss the concept of Multi Divisional Structure.

Chapter 8-Strategy Implementation and Control

16. HQ is a service company? Two years back the company hired a reputed management consultant to formulate its strategy. The consultant recommended an aggressive expansion plan. Now in an internal review meeting the company finds that many of the suggestions are not even fully considered.

Which part of strategic management process is missing in HQ?

17. What is Benchmarking? Explain briefly the elements involved in Benchmarking process.

Differences between the two concepts

18. Distinguish between the following:

- (a) Mergers and acquisitions.
- (b) Vision and mission.
- (c) Logistic management and supply chain management.
- (d) Corporate and business level.

SUGGESTED ANSWERS / HINTS

Multiple Choice Questions

Answer 1

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

Descriptive answers

2. The tools of strategic management process are effectively being used by a number of not-for-profit or charitable organizations. While 'Do Good Group' 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 'Do Good Group' 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.
 - ◆ Setting goals in the area of childcare. It can be in terms of geographical coverage and number of children.
 - ◆ Analyzing the desired future position with the past and present situation.
3. The presence of strategic management cannot counter all hindrances and always achieve success. There are limitations attached to strategic management. These can be explained in the following lines:
 - ◆ Environment is highly complex and turbulent. It is difficult to understand the complex environment and exactly pinpoint how it will shape-up in future. The organisational estimate about its future shape may awfully go wrong and jeopardise all strategic plans.
 - ◆ Strategic management is a time-consuming process. Organisations spend a lot of time in preparing, communicating the strategies that may impede daily operations and negatively impact the routine business.
 - ◆ Strategic management is a costly process. Strategic management adds a lot of expenses to an organization. Expert strategic planners need to be engaged, efforts are made for analysis of external and internal environments devise strategies and

properly implement. These can be really costly for organisations with limited resources.

- ◆ In a competitive scenario, where all organisations are trying to move strategically, it is difficult to clearly estimate the competitive responses to a firm's strategies.

4. Capabilities that are valuable, rare, costly to imitate, and non-substitutable are core competencies. A small chemist shop has a local presence and functions within a limited geographical area. Still it can build its own competencies to gain competitive advantage. Rohit Patel can build competencies in the areas of:

- (i) Developing personal and cordial relations with the customers.
- (ii) Providing home delivery with no additional cost.
- (iii) Developing a system of speedy delivery that can be difficult to match by online sellers. Being in central part of city, he can create a network to supply at wider locations in the city.
- (iv) Having extended working hours for convenience of buyers.
- (v) Providing easy credit or a system of monthly payments to the patients consuming regular medicines.

5. A strategic group consists of those rival firms which have similar competitive approaches and positions in the market. Companies in the same strategic group can resemble one another in any of the several ways – have comparable product-line breadth, same price/quality range, same distribution channels, same product attributes, identical technological approaches, offer similar services and technical assistance and so on.

The procedure for constructing a strategic group map and deciding which firms belong in which strategic group is as follows:

- ◆ Identify the competitive characteristics that differentiate firms in the industry typical variables are price/quality range (high, medium, low); geographic coverage (local, regional, national, global); degree of vertical integration (none, partial, full); product-line breadth (wide, narrow); use of distribution channels (one, some, all); and degree of service offered (no-frills, limited, full).
- ◆ Plot the firms on a two-variable map using pairs of these differentiating characteristics.
- ◆ Assign firms that fall in about the same strategy space to the same strategic group.
- ◆ Draw circles around each strategic group making the circles proportional to the size of the group's respective share of total industry sales revenues.

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

As owner manager at the top level in the company, Shri Alok Kumar should concentrate on strategic decisions. These are higher level decisions having organisation wide implications. The major dimensions of strategic decisions are as follows:

- ◆ Strategic decisions require top-management involvement as they involve thinking in totality of the organization.
- ◆ Strategic decisions involve significant commitment of organisational resources.
- ◆ Strategic decisions necessitate consideration of factors in the firm's external environment.
- ◆ Strategic decisions are likely to have a significant impact on the long-term prosperity of the firm.
- ◆ Strategic decisions are future oriented.
- ◆ Strategic decisions usually have major multifunctional or multi-business consequences.

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

- (i) **Vision:** Vision implies the blueprint of the company's future position. It describes where the organisation wants to land. It depicts the organisation's aspirations and provides a glimpse of what the organization would like to become in future. Every sub system of the organization is required to follow its vision.
- (ii) **Mission:** Mission delineates the firm's business, its goals and ways to reach the goals. It explains the reason for the existence of the firm in the society. A mission statement helps to identify, 'what business the company undertakes.' It defines the present capabilities, activities, customer focus and role in society.
- (iii) **Business Definition:** It seeks to explain the business undertaken by the firm, with respect to the customer needs, target markets, and alternative technologies. With the help of business definition, one can ascertain the strategic business choices.
- (iv) **Business Model:** Business model, as the name implies is a strategy for the effective operation of the business, ascertaining sources of income, desired customer base, and financial details. Rival firms, operating in the same industry rely on the different business model due to their strategic choice.
- (v) **Goals and Objectives:** These are the base of measurement. Goals are the end results, that the organization attempts to achieve. On the other hand, objectives are time-based measurable targets, which help in the accomplishment of goals. These

are the end results which are to be attained with the help of an overall plan. However, in practice, no distinction is made between goals and objectives and both the terms are used interchangeably.

8. Soft Cloth Ltd. is facing internal as well as external challenges. The external environment is in economic recession and the organization is facing cash crunch. The company needs to work on retrenchment / turnaround strategy. The strategy is suitable in case of issues such as:

- ◆ Persistent negative cash flow.
- ◆ Uncompetitive products or services
- ◆ Declining market share
- ◆ Deterioration in physical facilities
- ◆ Overstaffing, high turnover of employees, and low morale
- ◆ Mismanagement

The company may consider to substantially reduce the scope of its activity. This is done through an attempt to find out the problem areas and diagnose the causes of the problems. Next, steps are taken to solve the problems.

These steps result in different kinds of retrenchment strategies. If the organization chooses to focus on ways and means to reverse the process of decline, it adopts a turnaround strategy. If it cuts off the loss-making units, divisions, or SBUs, curtails its product line, or reduces the functions performed, it adopts a divestment strategy. If none of these actions work, then it may choose to abandon the activities totally, resulting in a liquidation strategy.

9. A strategic alliance is a relationship between two or more businesses that enables each to achieve certain strategic objectives which neither would be able to achieve on its own. The strategic partners maintain their status as independent and separate entities, share the benefits and control over the partnership, and continue to make contributions to the alliance until it is terminated. The advantages of strategic alliance can be broadly categorised as follows:

- (a) **Organizational:** Strategic alliance helps to learn necessary skills and obtain certain capabilities from strategic partners. Strategic partners may also help to enhance productive capacity, provide a distribution system, or extend supply chain.
- (b) **Economic:** There can be reduction in costs and risks by distributing them across the members of the alliance. Greater economies of scale can be obtained in an alliance, as production volume can increase, causing the cost per unit to decline.
- (c) **Strategic:** Rivals can join together to cooperate instead of compete. Strategic alliances may also be useful to create a competitive advantage by the pooling of resources and skills. This may also help with future business opportunities and the

development of new products and technologies. Strategic alliances may also be used to get access to new technologies or to pursue joint research and development.

(d) **Political:** Sometimes strategic alliances are formed with a local foreign business to gain entry into a foreign market either because of local prejudices or legal barriers to entry.

10. A firm's profitability tends to be higher when other firms are blocked from entering the industry. New entrants can reduce industry profitability because they add new production capacity leading to increase supply of the product even at a lower price and can substantially erode existing firm's market share position. Barriers to entry represent economic forces that slow down or impede entry by other firms. Common barriers to entry include:

- (i) **Capital Requirements:** When a large amount of capital is required to enter an industry, firms lacking funds are effectively barred from the industry, thus enhancing the profitability of existing firms in the industry.
- (ii) **Economies of Scale:** Many industries are characterized by economic activities driven by economies of scale. Economies of scale refer to the decline in the per-unit cost of production (or other activity) as volume grows.
- (iii) **Product Differentiation:** Product differentiation refers to the physical or perceptual differences, or enhancements, that make a product special or unique in the eyes of customers.
- (iv) **Switching Costs:** To succeed in an industry, new entrants must be able to persuade existing customers of other companies to switch to its products. When such switching costs are high, buyers are often reluctant to change.
- (v) **Brand Identity:** The brand identity of products or services offered by existing firms can serve as another entry barrier. Brand identity is particularly important for infrequently purchased products that carry a high unit cost to the buyer.
- (vi) **Access to Distribution Channels:** The unavailability of distribution channels for new entrants poses another significant entry barrier. Despite the growing power of the internet, many firms may continue to rely on their control of physical distribution channels to sustain a barrier to entry to rivals.
- (vii) **Possibility of Aggressive Retaliation:** Sometimes the mere threat of aggressive retaliation by incumbents can deter entry by other firms into an existing industry.

11. Cost leadership is a low cost competitive strategy that aims at broad mass market. It requires vigorous pursuit of cost reduction in the areas of procurement, production, storage and distribution of product or service and also economies in overhead costs. Because of its lower costs, the cost leader is able to charge a lower price for its products than its competitors and still make satisfactory profits. A primary reason for pursuing forward, backward, and horizontal integration strategies is to gain cost leadership benefits.

A successful cost leadership strategy usually permeates the entire firm, as evidenced by high efficiency, low overhead, limited perks, intolerance of waste, intensive screening of budget requests, wide spans of control, rewards linked to cost containment, and broad employee participation in cost control efforts. Some risks of pursuing cost leadership are that competitors may imitate the strategy.

To achieve cost leadership, following are the actions that could be taken:

- (a) Forecast the demand of a product or service promptly.
- (b) Optimum utilization of the resources to get cost advantages.
- (c) Achieving economies of scale leads to lower per unit cost of product/service.
- (d) Standardisation of products for mass production to yield lower cost per unit.
- (e) Invest in cost saving technologies and try using advance technology for smart working.
- (f) Resistance to differentiation till it becomes essential.

12. The higher-level corporate strategies need to be segregated into viable plans and policies that are compatible with each other and communicated down the line. The higher-level strategies need to be broken into functional strategies for implementation. These functional strategies, in form of marketing, finance, human resource, production, research and development help in achieving the organisational objective. The reasons why functional strategies are needed can be enumerated as follows:

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

13. The prominent areas where the human resource manager can play strategic role are as follows:

- (a) **Providing purposeful direction:** The human resource manager must be able to lead people and the organization towards the desired direction involving people right from the beginning. The most important task of a HR manager is to ensure that the objectives of an organization are internalized by everyone.
- (b) **Building core competency:** The human resource manager has a great role to play in developing core competency by the firm. A core competence is a unique strength

of an organization which may not be shared by others. This may be in the form of human resources, marketing capability, or technological capability.

- (c) **Creating competitive advantage:** Creating and maintaining a competitive advantage in the globalized market is the object of any organization. There are two important ways a business can achieve a competitive advantage over the others. The first is cost leadership and second is differentiation.
- (d) **Facilitation of change:** The human resource manager will be more concerned with substance rather than form, accomplishments rather than activities, and practice rather than theory. The HR function will be responsible for furthering the organization and devote more time to promote changes than to maintain the status quo.
- (e) **Managing workforce diversity:** In modern organizations, management of diverse workforce is a great challenge. Workforce diversity can be observed in terms of male and female workers, young and old workers, educated and uneducated workers, unskilled and professional employee, etc.
- (f) **Empowerment of human resources:** Empowerment means authorizing every member of an organization to take up his/her own destiny realizing his/her full potential. It involves giving more power to those who, at present, have little control what they do and little ability to influence the decisions being made around them.
- (g) **Development of works ethic and culture:** Greater efforts will be needed to achieve cohesiveness because employees will have transient commitment to groups. As changing work ethic requires increasing emphasis on individuals, jobs will have to be redesigned to provide challenge. A vibrant work culture will have to be developed in the organizations to create an atmosphere of trust and encourage creative ideas.

14. Ramesh is a follower of transactional leadership style that focuses on designing systems and controlling the organization's activities. Such a leader believes in using authority of its office to exchange rewards, such as pay and status. They prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement or non-achievement. Transactional leaders try to build on the existing culture and enhance current practices. The style is better suited in persuading people to work efficiently and run operations smoothly.

On the other hand, Yashpal is follower of transformational leadership style. The style uses charisma and enthusiasm to inspire people to exert them for the good of the organization. Transformational leaders offer excitement, vision, intellectual stimulation and personal satisfaction. They inspire involvement in a mission, giving followers a 'dream' or 'vision' of a higher calling so as to elicit more dramatic changes in organizational performance. Such a leadership motivates followers to do more than originally affected to do by stretching their abilities and increasing their self-confidence, and also promote innovation throughout the organization.

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

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

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

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

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

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

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

17. 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. It developed out of need to have information against which performance can be measured. Benchmarking helps businesses in improving performance by learning from the best practices and the processes by which they are achieved. 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 managerial functions like product development, customer services, human resources management, etc.

The various steps in Benchmarking Process are as under:

- (i) **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.
- (ii) **Clearly understanding existing decisions processes:** The step will involve compiling information and data on performance.
- (iii) **Identify best processes:** Within the selected framework best processes are identified. These may be within the same organization or external to them.
- (iv) **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.
- (v) **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.
- (vi) **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.

Differences between the two concepts

18. (a) Merger and acquisition in simple words are defined as a process of combining two or more organizations together.

Some organizations prefer to grow through mergers. Merger is considered to be a process when two or more companies come together to expand their business operations. In such a case the deal gets finalized on friendly terms and both the organizations share profits in the newly created entity. In a merger two organizations combine to increase their strength and financial gains along with breaking the trade barriers.

When one organization takes over the other organization and controls all its business operations, it is known as acquisitions. In this process of acquisition, one financially strong organization overpowers the weaker one. Acquisitions often happen during recession in economy or during declining profit margins. In this process, one that is financially stronger and bigger establishes its power. The combined operations then run under the name of the powerful entity. A deal in case of an acquisition is often done in an unfriendly manner, it is more or less a forced association.

(b) The vision describes a future identity while the Mission serves as an on-going and time-independent guide.

The vision statement can galvanize the people to achieve defined objectives, even if they are stretch objectives, provided the vision is specific, measurable, achievable, and relevant and time bound. A mission statement provides a path to realize the vision in line with its values. These statements have a direct bearing on the bottom line and success of the organization.

A mission statement defines the purpose or broader goal for being in existence or in the business and can remain the same for decades if crafted well while a vision statement is more specific in terms of both the future state and the time frame. Vision describes what will be achieved if the organization is successful.

(c) Supply chain management is an extension of logistic management. However, there are differences between the two. Logistical activities typically include management of inbound and outbound goods, transportation, warehousing, handling of material, fulfillment of orders, inventory management and supply/demand planning. Although these activities also form part of supply chain management, the latter is much broader. Logistic management can be termed as one of its part that is related to planning, implementing, and controlling the movement and storage of goods, services and related information between the point of origin and the point of consumption.

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

(d) A typical large organization is a multi-divisional organisation that competes in several different businesses. There are three main levels of management: corporate, business, and functional. Corporate level occupies the highest level of strategic decision making and cover actions dealing with the objective of the firm, acquisition and allocation of resources and coordination of strategies of various businesses for optimal performance. The corporate level of management consists of the Chief Executive Officer (CEO), other senior executives. The role of corporate level managers is to oversee the development of strategies for the whole organization. This role includes defining the mission and goals of the organization, determining what businesses it should be in, allocating resources and so on.

Business level comes below corporate level. Business level strategies are the courses of action adopted by an organisation for each of its businesses separately, to serve identified customer groups and provide value to the customers by satisfaction of their needs.

PAPER – 8: FINANCIAL MANAGEMENT AND ECONOMICS FOR FINANCE**SECTION A: FINANCIAL MANAGEMENT****QUESTIONS****Ratio Analysis**

1. From the following table of financial ratios of R. Textiles Limited, comment on various ratios given at the end:

Ratios	2017	2018	Average of Textile Industry
Liquidity Ratios			
Current ratio	2.2	2.5	2.5
Quick ratio	1.5	2	1.5
Receivable turnover ratio	6	6	6
Inventory turnover	9	10	6
Receivables collection period	87 days	86 days	85 days
Operating profitability			
Operating income – ROI	25%	22%	15%
Operating profit margin	19%	19%	10%
Financing decisions			
Debt ratio	49.00%	48.00%	57%
Return			
Return on equity	24%	25%	15%

COMMENT on the following aspect of R. Textiles Limited

- (i) Liquidity
- (ii) Operating profits
- (iii) Financing
- (iv) Return to the shareholders

Cost of Capital

2. As a financial analyst of a large electronics company, you are required to DETERMINE the weighted average cost of capital of the company using (a) book value weights and (b) market value weights. The following information is available for your perusal.

The Company's present book value capital structure is:

	(₹)
Debentures (₹100 per debenture)	8,00,000
Preference shares (₹100 per share)	2,00,000
Equity shares (₹10 per share)	<u>10,00,000</u>
	<u>20,00,000</u>

All these securities are traded in the capital markets. Recent prices are:

Debentures, ₹110 per debenture, Preference shares, ₹120 per share, and Equity shares, ₹ 22 per share

Anticipated external financing opportunities are:

- (i) ₹ 100 per debenture redeemable at par; 10 year maturity, 11 per cent coupon rate, 4 per cent flotation costs, sale price, ₹ 100
- (ii) ₹ 100 preference share redeemable at par; 10 year maturity, 12 per cent dividend rate, 5 per cent flotation costs, sale price, ₹100.
- (iii) Equity shares: ₹ 2 per share flotation costs, sale price = ₹ 22.

In addition, the dividend expected on the equity share at the end of the year is ₹ 2 per share, the anticipated growth rate in dividends is 7 per cent and the firm has the practice of paying all its earnings in the form of dividends. The corporate tax rate is 35 per cent.

Capital Structure

3. Akash Limited provides you the following information:

	(₹)
Profit (EBIT)	2,80,000
Less: Interest on Debenture @ 10%	(40,000)
EBT	2,40,000
Less Income Tax@ 50%	(1,20,000)
	1,20,000
No. of Equity Shares (₹ 10 each)	30,000
Earnings per share (EPS)	4
Price /EPS (PE) Ratio	10

The company has reserves and surplus of ₹ 7,00,000 and required ₹ 4,00,000 further for modernisation. Return on Capital Employed (ROCE) is constant. Debt (Debt/ Debt + Equity) Ratio higher than 40% will bring the P/E Ratio down to 8 and increase the interest

rate on additional debts to 12%. You are required to ASCERTAIN the probable price of the share.

- (i) If the additional capital are raised as debt; and
- (ii) If the amount is raised by issuing equity shares at ruling market price.

Leverage

4. A Company had the following Balance Sheet as on March 31, 2019:

Equity and Liabilities	(₹ in crore)	Assets	(₹ in crore)
Equity Share Capital (10 crore shares of ₹ 10 each)	100	Fixed Assets (Net)	250
Reserves and Surplus	20	Current Assets	150
15% Debentures	200		
Current Liabilities	80		
	400		400

The additional information given is as under:

Fixed Costs per annum (excluding interest) ₹ 80 crores

Variable operating costs ratio 65%

Total Assets turnover ratio 2.5

Income-tax rate 40%

Required:

CALCULATE the following and comment:

- (i) Earnings per share
- (ii) Operating Leverage
- (iii) Financial Leverage
- (iv) Combined Leverage.

Capital Budgeting

5. BT Pathology Lab Ltd. is using an X-ray machines which reached at the end of their useful lives. Following new X-ray machines are of two different brands with same features are available for the purchase.

Brand	Cost of Machine	Life of Machine	Maintenance Cost			Rate of Depreciation
			Year 1-5	Year 6-10	Year 11-15	
XYZ	₹6,00,000	15 years	₹ 20,000	₹ 28,000	₹ 39,000	4%
ABC	₹4,50,000	10 years	₹ 31,000	₹ 53,000	--	6%

Residual Value of both of above machines shall be dropped by 1/3 of Purchase price in the first year and thereafter shall be depreciated at the rate mentioned above.

Alternatively, the machine of Brand ABC can also be taken on rent to be returned back to the owner after use on the following terms and conditions:

- Annual Rent shall be paid in the beginning of each year and for first year it shall be ₹ 1,02,000.
- Annual Rent for the subsequent 4 years shall be ₹ 1,02,500.
- Annual Rent for the final 5 years shall be ₹ 1,09,950.
- The Rent Agreement can be terminated by BT Labs by making a payment of ₹ 1,00,000 as penalty. This penalty would be reduced by ₹ 10,000 each year of the period of rental agreement.

You are required to:

- (a) ADVISE which brand of X-ray machine should be acquired assuming that the use of machine shall be continued for a period of 20 years.
- (b) STATE which of the option is most economical if machine is likely to be used for a period of 5 years?

The cost of capital of BT Labs is 12%.

Working Capital Management

6. A company is considering its working capital investment and financial policies for the next year. Estimated fixed assets and current liabilities for the next year are ₹ 2.60 crores and ₹ 2.34 crores respectively. Estimated Sales and EBIT depend on current assets investment, particularly inventories and book-debts. The Financial Controller of the company is examining the following alternative Working Capital Policies:

Working Capital Policy	Investment in Current Assets	Estimated Sales	EBIT	(₹ in crore)
Conservative	4.50	12.30	1.23	
Moderate	3.90	11.50	1.15	
Aggressive	2.60	10.00	1.00	

After evaluating the working capital policy, the Financial Controller has advised the adoption of the moderate working capital policy. The company is now examining the use of long-term and short-term borrowings for financing its assets. The company will use ₹ 2.50 crores of the equity funds. The corporate tax rate is 35%. The company is considering the following debt alternatives.

Financing Policy	Short-term Debt	Long-term Debt
Conservative	0.54	1.12
Moderate	1.00	0.66
Aggressive	1.50	0.16
Interest rate-Average	12%	16%

You are required to CALCULATE the following:

- (i) Working Capital Investment for each policy:
 - (a) Net Working Capital position
 - (b) Rate of Return
 - (c) Current ratio
- (ii) Financing for each policy:
 - (a) Net Working Capital position.
 - (b) Rate of Return on Shareholders' equity.
 - (c) Current ratio.

Management of Working Capital

7. A proforma cost sheet of a company provides the following particulars:

	Amount per unit (₹)
Raw materials cost	100.00
Direct labour cost	37.50
Overheads cost	75.00
Total cost	212.50
Profit	37.50
Selling Price	250.00

The Company keeps raw material in stock, on an average for one month; work-in-progress, on an average for one week; and finished goods in stock, on an average for two weeks.

The credit allowed by suppliers is three weeks and company allows four weeks credit to its debtors. The lag in payment of wages is one week and lag in payment of overhead expenses is two weeks.

The Company sells one-fifth of the output against cash and maintains cash-in-hand and at bank put together at ₹37,500.

Required:

PREPARE a statement showing estimate of Working Capital needed to finance an activity level of 1,30,000 units of production. Assume that production is carried on evenly throughout the year, and wages and overheads accrue similarly. Work-in-progress stock is 80% complete in all respects.

Risk Analysis in Capital Budgeting

8. An enterprise is investing ₹ 100 lakhs in a project. The risk-free rate of return is 7%. Risk premium expected by the Management is 7%. The life of the project is 5 years. Following are the cash flows that are estimated over the life of the project.

Year	Cash flows (₹ in lakhs)
1	25
2	60
3	75
4	80
5	65

CALCULATE Net Present Value of the project based on Risk free rate and also on the basis of Risks adjusted discount rate.

Dividend Decision

9. The following figures are collected from the annual report of XYZ Ltd.:

Net Profit	₹30 lakhs
Outstanding 12% preference shares	₹100 lakhs
No. of equity shares	3 lakhs
Return on Investment	20%
Cost of capital i.e. (K _e)	16%

CALCULATE price per share using Gordon's Model when dividend pay-out is (i) 25%; (ii) 50% and (iii) 100%.

Miscellaneous

10. Write short notes on the following:

- Functions of Finance Manager.
- Inter relationship between investment, financing and dividend decisions.
- Debt securitisation

SUGGESTED HINTS/ANSWERS

1.

Ratios	Comment
Liquidity	Current ratio has improved from last year and matching the industry average. Quick ratio also improved than last year and above the industry average. This may happen due to reduction in receivable collection period and quick inventory turnover. However, this also indicates idleness of funds. Overall it is reasonably good. All the liquidity ratios are either better or same in both the year compare to the Industry Average.
Operating Profits	Operating Income-ROI reduced from last year but Operating Profit Margin has been maintained. This may happen due to variability of cost on turnover. However, both the ratio are still higher than the industry average.
Financing	The company has reduced its debt capital by 1% and saved operating profit for equity shareholders. It also signifies that dependency on debt compared to other industry players (57%) is low.
Return to the shareholders	R's ROE is 24 per cent in 2017 and 25 per cent in 2018 compared to an industry average of 15 per cent. The ROE is stable and improved over the last year.

2. Determination of specific costs:

$$\begin{aligned}
 \text{(i) Cost Debt } (K_d) &= \frac{\text{Interest}(1-t) + \frac{(RV - NP)}{N}}{\frac{(RV + NP)}{2}} = \frac{\text{₹}11(1-0.35) + \frac{(\text{₹}100 - \text{₹}96)}{10\text{years}}}{\frac{(\text{₹}100 + \text{₹}96)}{2}} \\
 &= \frac{\text{₹}7.15 + \text{₹}0.4}{\text{₹}98} = 0.077 \text{ or } 7.70\%
 \end{aligned}$$

$$\begin{aligned}
 \text{(ii) Cost of Preference Shares } (K_p) &= \frac{PD + \frac{(RV - NP)}{N}}{\frac{(RV + NP)}{2}} = \frac{\text{₹}12 + \frac{(\text{₹}100 - \text{₹}95)}{10\text{years}}}{\frac{(\text{₹}100 + \text{₹}95)}{2}}
 \end{aligned}$$

$$= \frac{\text{₹}12 + \text{₹}0.5}{\text{₹}97.5} = 0.1282 \text{ or } 12.82\%$$

$$(iii) \text{ Cost of Equity shares (K}_e\text{)} = \frac{D_1}{P_0} + G = \frac{\text{₹}2}{\text{₹}22 - \text{₹}2} + 0.07 = 0.17 \text{ or } 17\%$$

I – Interest, t – Tax, RV- Redeemable value, NP- Net proceeds, N- No. of years, PD- Preference dividend, D₁- Expected Dividend, P₀- Price of share (net)

Using these specific costs we can calculate WACC on the basis of book value and market value weights as follows:

(a) Weighted Average Cost of Capital (K₀) based on Book value weights

Source of capital	Book value (₹)	Weights	Specific cost (%)	WACC (%)
Debentures	8,00,000	0.40	7.70	3.08
Preferences shares	2,00,000	0.10	12.82	1.28
Equity shares	10,00,000	0.50	17.00	8.50
		20,00,000	1.00	12.86

(b) Weighted Average Cost of Capital (K₀) based on market value weights:

Source of capital	Market value (₹)	Weights	Specific cost (%)	WACC (%)
Debentures $\left(\frac{\text{₹}8,00,000}{\text{₹}100} \times \text{₹}110 \right)$	8,80,000	0.265	7.70	2.04
Preferences shares $\left(\frac{\text{₹}2,00,000}{\text{₹}100} \times \text{₹}120 \right)$	2,40,000	0.072	12.82	0.92
Equity shares $\left(\frac{\text{₹}10,00,000}{\text{₹}10} \times \text{₹}22 \right)$	22,00,000	0.663	17.00	11.27
	33,20,000	1.000		14.23

3. Ascertainment of probable price of shares of Akash limited

Particulars	Plan-I	Plan-II
	If ₹ 4,00,000 is raised as debt (₹)	If ₹ 4,00,000 is raised by issuing equity shares (₹)
Earnings Before Interest and Tax (EBIT) {20% of new capital i.e. 20% of (₹14,00,000 + ₹4,00,000)} (Refer working note1)	3,60,000	3,60,000
Less: Interest on old debentures (10% of ₹4,00,000)	(40,000)	(40,000)
Less: Interest on new debt (12% of ₹4,00,000)	(48,000)	--
Earnings Before Tax (EBT)	2,72,000	3,20,000
Less: Tax@ 50%	(1,36,000)	(1,60,000)
Earnings for equity shareholders (EAT)	1,36,000	1,60,000
No. of Equity Shares (refer working note 2)	30,000	40,000
Earnings per Share (EPS)	₹ 4.53	₹ 4.00
Price/ Earnings (P/E) Ratio (refer working note 3)	8	10
Probable Price Per Share (PE Ratio × EPS)	₹ 36.24	₹ 40

Working Notes:

1. Calculation of existing Return of Capital Employed (ROCE):

	(₹)
Equity Share capital (30,000 shares × ₹10)	3,00,000
10% Debentures $(₹40,000 \times \frac{100}{10})$	4,00,000
Reserves and Surplus	7,00,000
Total Capital Employed	14,00,000
Earnings before interest and tax (EBIT) (given)	2,80,000
ROCE = $\frac{₹2,80,000}{₹14,00,000} \times 100$	20%

2. Number of Equity Shares to be issued in Plan-II:

$$= \frac{₹4,00,000}{₹40} = 10,000 \text{ shares}$$

Thus, after the issue total number of shares = 30,000 + 10,000 = 40,000 shares

3. Debt/Equity Ratio if ₹ 4,00,000 is raised as debt:

$$= \frac{₹8,00,000}{₹18,00,000} \times 100 = 44.44\%$$

As the debt equity ratio is more than 40% the P/E ratio will be brought down to 8 in Plan-I

4. Total Assets = ₹ 400 crores

Asset Turnover Ratio = 2.5

Hence, Total Sales = $400 \times 2.5 = ₹ 1,000$ crores

Computation of Profits after Tax (PAT)

	(₹ in crore)
Sales	1,000
Less: Variable operating cost (65% of ₹1,000 crore)	(650)
Contribution	350
Less: Fixed cost (other than Interest)	(80)
EBIT	270
Less: Interest on debentures (15% × ₹200 crore)	(30)
EBT	240
Less: Tax 40%	(96)
EAT (earnings available to equity share holders)	144

(i) Earnings per share (EPS)

$$\therefore \text{EPS} = \frac{₹ 144 \text{ crores}}{10 \text{ crore equity shares}} = ₹ 14.40$$

(ii) Operating Leverage

$$\text{Operating leverage} = \frac{\text{Contribution}}{\text{EBIT}} = \frac{350}{270} = 1.296$$

It indicates sensitivity of earnings before interest and tax (EBIT) to change in sales at a particular level.

(iii) Financial Leverage

$$\text{Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}} = \frac{270}{240} = 1.125$$

The financial leverage is very comfortable since the debt service obligation is small vis-à-vis EBIT.

(iv) Combined Leverage

$$\text{Combined Leverage} = \frac{\text{Contribution}}{\text{EBIT}} \times \frac{\text{EBIT}}{\text{EBT}}$$

$$\text{Or, Operating Leverage} \times \text{Financial Leverage} = 1.296 \times 1.125 = 1.458$$

The combined leverage studies the choice of fixed cost in cost structure and choice of debt in capital structure. It studies how sensitive the change in EPS is vis-à-vis change in sales.

5. Since the life span of each machine is different and time span exceeds the useful lives of each model, we shall use Equivalent Annual Cost method to decide which brand should be chosen.

(i) If machine is used for 20 years**Present Value (PV) of cost if machine of Brand XYZ is purchased**

Period	Cash Outflow (₹)	PVF@12%	Present Value
0	6,00,000	1.000	6,00,000
1-5	20,000	3.605	72,100
6-10	28,000	2.045	57,260
11-15	39,000	1.161	45,279
15	(64,000)	0.183	(11,712)
			7,62,927

PVAF for 1-15 years 6.811

$$\text{Equivalent Annual Cost} = \frac{\text{₹7,62,927}}{6.811} = \text{₹ 1,12,014}$$

Present Value (PV) of cost if machine of Brand ABC is purchased

Period	Cash Outflow (₹)	PVF@12%	Present Value
0	4,50,000	1.000	4,50,000
1 - 5	31,000	3.605	1,11,755
6 - 10	53,000	2.045	1,08,385
10	(57,000)	0.322	(18,354)
			6,51,786

PVAF for 1-10 years 5.65

$$\text{Equivalent Annual Cost} = \frac{\text{₹}6,51,786}{5.65} = \text{₹} 1,15,360$$

Present Value (PV) of cost if machine of Brand ABC is taken on Rent

Period	Cash Outflow (₹)	PVF@12%	Present Value
0	1,02,000	1.000	1,02,000
1 - 4	1,02,500	3.037	3,11,293
5 - 9	1,09,950	2.291	2,51,895
			6,65,188

PVAF for 1-10 years 5.65

$$\text{Equivalent Annual Cost} = \frac{\text{₹}6,65,188}{5.65} = \text{₹} 1,17,732$$

Decision: Since Equivalent Annual Cash Outflow is least in case of purchase of Machine of brand XYZ the same should be purchased.

(ii) If machine is used for 5 years

(a) Scrap Value of Machine of Brand XYZ

$$= \text{₹} 6,00,000 - \text{₹} 2,00,000 - \text{₹} 6,00,000 \times 0.04 \times 4 = \text{₹} 3,04,000$$

(b) Scrap Value of Machine of Brand ABC

$$= \text{₹} 4,50,000 - \text{₹} 1,50,000 - \text{₹} 4,50,000 \times 0.06 \times 4 = \text{₹} 1,92,000$$

Present Value (PV) of cost if machine of Brand XYZ is purchased

Period	Cash Outflow (₹)	PVF@12%	Present Value
0	6,00,000	1.000	6,00,000
1 - 5	20,000	3.605	72,100
5	(3,04,000)	0.567	(1,72,368)
			4,99,732

Present Value (PV) of cost if machine of Brand ABC is purchased

Period	Cash Outflow (₹)	PVF@12%	Present Value
0	4,50,000	1.000	4,50,000
1 - 5	31,000	3.605	1,11,755
5	(1,92,000)	0.567	(1,08,864)
			4,52,891

Present Value (PV) of cost if machine of Brand ABC is taken on Rent

Period	Cash Outflow (₹)	PVF@12%	Present Value
0	1,02,000	1.000	1,02,000
1-4	1,02,500	3.037	3,11,293
5	50,000	0.567	28,350
			4,41,643

Decision: Since Cash Outflow is least in case of lease of Machine of brand ABC the same should be taken on rent.

6. (i) Statement showing Working Capital Investment for each policy

	Working Capital Policy		
	Conservative	Moderate	Aggressive
Current Assets: (i)	4.50	3.90	2.60
Fixed Assets: (ii)	2.60	2.60	2.60
Total Assets: (iii)	7.10	6.50	5.20
Current Liabilities: (iv)	2.34	2.34	2.34
Net Worth: (v) = (iii) - (iv)	4.76	4.16	2.86
Total Liabilities: (iv) + (v)	7.10	6.50	5.20
Estimated Sales: (vi)	12.30	11.50	10.00
EBIT: (vii)	1.23	1.15	1.00
(a) Net working capital position: (i) - (iv)	2.16	1.56	0.26
(b) Rate of return: (vii) / (iii)	17.32%	17.69%	19.23%
(c) Current ratio: (i) / (iv)	1.92	1.67	1.11

6. (ii) Statement Showing Effect of Alternative Financing Policy

Financing Policy	Conservative	Moderate	Aggressive
Current Assets (i)	3.90	3.90	3.90
Fixed Assets (ii)	2.60	2.60	2.60
Total Assets (iii)	6.50	6.50	6.50
Current Liabilities (iv)	2.34	2.34	2.34
Short term Debt (v)	0.54	1.00	1.50
Total current liabilities (vi) = (iv) + (v)	2.88	3.34	3.84

Long term Debt (vii)	1.12	0.66	0.16
Equity Capital (viii)	2.50	2.50	2.50
Total liabilities (ix) = (vi)+(vii)+(viii)	6.50	6.50	6.50
Forecasted Sales	11.50	11.50	11.50
EBIT (x)	1.15	1.15	1.15
Less: Interest on short-term debt	0.06	0.12	0.18
	(12% of ₹ 0.54)	(12% of ₹ 1)	(12% of ₹ 1.5)
Interest on long term debt	0.18	0.11	0.03
	(16% of ₹ 1.12)	(16% of ₹ 0.66)	(16% of ₹ 0.16)
Earnings before tax (EBT) (xi)	0.91	0.92	0.94
Taxes @ 35% (xii)	0.32	0.32	0.33
Earnings after tax: (xiii) = (xi) - (xii)	0.59	0.60	0.61
(a) Net Working Capital Position: (i) - [(iv) + (v)]	1.02	0.56	0.06
(b) Rate of return on shareholders Equity capital : (xiii)/ (viii)	23.6%	24.0%	24.4%
(c) Current Ratio (i) / (vi)	1.35	1.17	1.02

7. Statement showing Estimate of Working Capital Needs

	(Amount in ₹)	(Amount in ₹)
A. Current Assets		
(i) Inventories:		
Raw material (1 month or 4 weeks)		
$\left(\frac{1,30,000 \text{ units} \times ₹100}{52 \text{ weeks}} \times 4 \text{ weeks} \right)$	10,00,000	
WIP Inventory (1 week)		
$\left(\frac{1,30,000 \text{ units} \times ₹212.50}{52 \text{ weeks}} \times 1 \text{ week} \right) \times 0.8$	4,25,000	
Finished goods inventory (2 weeks)		
$\left(\frac{1,30,000 \text{ units} \times ₹212.50}{52 \text{ weeks}} \times 2 \text{ weeks} \right)$	10,62,500	24,87,500
(ii) Receivables (Debtors) (4 weeks)		
$\left(\frac{1,30,000 \text{ units} \times ₹212.50}{52 \text{ weeks}} \times 4 \text{ weeks} \right) \times \frac{4}{5^{\text{th}}}$		17,00,000

(iii) Cash and bank balance		37,500
Total Current Assets		42,25,000
B. Current Liabilities:		
(i) Payables (Creditors) for materials (3 weeks)		
$\left(\frac{1,30,000 \text{ units} \times ₹100}{52 \text{ weeks}} \times 3 \text{ weeks} \right)$		7,50,000
(ii) Outstanding wages (1 week)		
$\left(\frac{1,30,000 \text{ units} \times ₹37.50}{52 \text{ weeks}} \times 1 \text{ week} \right)$		93,750
(iii) Outstanding overheads (2 weeks)		
$\left(\frac{1,30,000 \text{ units} \times ₹75}{52 \text{ weeks}} \times 2 \text{ weeks} \right)$		3,75,000
Total Current Liabilities		12,18,750
Net Working Capital Needs (A – B)		30,06,250

8. The Present Value of the Cash Flows for all the years by discounting the cash flow at 7% is calculated as below:

Year	Cash flows ₹ In lakhs	Discounting Factor @ 7%	Present value of Cash Flows ₹ In Lakhs
1	25	0.935	23.38
2	60	0.873	52.38
3	75	0.816	61.20
4	80	0.763	61.04
5	65	0.713	46.35
Total of present value of Cash flow			244.34
Less: Initial investment			(100.00)
Net Present Value (NPV)			144.34

Now when the risk-free rate is 7 % and the risk premium expected by the Management is 7 %. So the risk adjusted discount rate is 7 % + 7 % =14%.

Discounting the above cash flows using the Risk Adjusted Discount Rate would be as below:

Year	Cash flows ₹ in Lakhs	Discounting Factor @ 14%	Present Value of Cash Flows ₹ in lakhs
1	25	0.877	21.93
2	60	0.769	46.14
3	75	0.675	50.63
4	80	0.592	47.36
5	65	0.519	33.74
Total of present value of Cash flow			199.79
Initial investment			(100.00)
Net present value (NPV)			99.79

9.

	₹ in lakhs
Net Profit	30
Less: Preference dividend	12
Earning for equity shareholders	18
Therefore earning per share	18/3 = ₹ 6.00

Price per share according to Gordon's Model is calculated as follows:

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

Here, $E_1 = 6$, $K_e = 16\%$

(i) When dividend pay-out is 25%

$$P_0 = \frac{6 \times 0.25}{0.16 - (0.75 \times 0.2)} = \frac{1.5}{0.16 - 0.15} = 150$$

(ii) When dividend pay-out is 50%

$$P_0 = \frac{6 \times 0.5}{0.16 - (0.5 \times 0.2)} = \frac{3}{0.16 - 0.10} = 50$$

(iii) When dividend pay-out is 100%

$$P_0 = \frac{6 \times 1}{0.16 - (0 \times 0.2)} = \frac{6}{0.16} = 37.50$$

10. (a) Functions of Finance Manager

The Finance Manager's main objective is to manage funds in such a way so as to ensure their optimum utilisation and their procurement in a manner that the risk, cost and control considerations are properly balanced in a given situation. To achieve these objectives the Finance Manager performs the following functions:

- (i) *Estimating the requirement of Funds:* Both for long-term purposes i.e. investment in fixed assets and for short-term i.e. for working capital. Forecasting the requirements of funds involves the use of techniques of budgetary control and long-range planning.
- (ii) *Decision regarding Capital Structure:* Once the requirement of funds has been estimated, a decision regarding various sources from which these funds would be raised has to be taken. A proper balance has to be made between the loan funds and own funds. He has to ensure that he raises sufficient long term funds to finance fixed assets and other long term investments and to provide for the needs of working capital.
- (iii) *Investment Decision:* The investment of funds, in a project has to be made after careful assessment of various projects through capital budgeting. Assets management policies are to be laid down regarding various items of current assets. For e.g. receivable in coordination with sales manager, inventory in coordination with production manager.
- (iv) *Dividend decision:* The finance manager is concerned with the decision as to how much to retain and what portion to pay as dividend depending on the company's policy. Trend of earnings, trend of share market prices, requirement of funds for future growth, cash flow situation etc., are to be considered.
- (v) *Evaluating financial performance:* A finance manager has to constantly review the financial performance of the various units of organisation generally in terms of ROI. Such a review helps the management in seeing how the funds have been utilised in various divisions and what can be done to improve it.
- (vi) *Financial negotiation:* The finance manager plays a very important role in carrying out negotiations with the financial institutions, banks and public depositors for raising of funds on favourable terms.
- (vii) *Cash management:* The finance manager lays down the cash management and cash disbursement policies with a view to supply adequate funds to all units of organisation and to ensure that there is no excessive cash.
- (viii) *Keeping touch with stock exchange:* Finance manager is required to analyse major trends in stock market and their impact on the price of the company share.

(b) Inter-relationship between Investment, Financing and Dividend Decisions

The finance functions are divided into three major decisions, viz., investment, financing and dividend decisions. It is correct to say that these decisions are inter-related because the underlying objective of these three decisions is the same, i.e. maximisation of shareholders' wealth. Since investment, financing and dividend decisions are all interrelated, one has to consider the joint impact of these decisions on the market price of the company's shares and these decisions should also be solved jointly. The decision to invest in a new project needs the finance for the investment. The financing decision, in turn, is influenced by and influences dividend decision because retained earnings used in internal financing deprive shareholders of their dividends. An efficient financial management can ensure optimal joint decisions. This is possible by evaluating each decision in relation to its effect on the shareholders' wealth.

The above three decisions are briefly examined below in the light of their inter-relationship and to see how they can help in maximising the shareholders' wealth i.e. market price of the company's shares.

Investment decision: The investment of long term funds is made after a careful assessment of the various projects through capital budgeting and uncertainty analysis. However, only that investment proposal is to be accepted which is expected to yield at least so much return as is adequate to meet its cost of financing. This have an influence on the profitability of the company and ultimately on its wealth.

Financing decision: Funds can be raised from various sources. Each source of funds involves different issues. The finance manager has to maintain a proper balance between long-term and short-term funds. With the total volume of long-term funds, he has to ensure a proper mix of loan funds and owner's funds. The optimum financing mix will increase return to equity shareholders and thus maximise their wealth.

Dividend decision: The finance manager is also concerned with the decision to pay or declare dividend. He assists the top management in deciding as to what portion of the profit should be paid to the shareholders by way of dividends and what portion should be retained in the business. An optimal dividend pay-out ratio maximises shareholders' wealth.

The above discussion makes it clear that investment, financing and dividend decisions are interrelated and are to be taken jointly keeping in view their joint effect on the shareholders' wealth.

(c) Debt Securitisation: It is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this asset pool, market securities can be issued, e.g. housing finance, auto loans, and credit card receivables.

Process of Debt Securitisation

- (i) *The origination function* – A borrower seeks a loan from a finance company, bank. The creditworthiness of borrower is evaluated and contract is entered into with repayment schedule structured over the life of the loan.
- (ii) *The pooling function* – Similar loans on receivables are clubbed together to create an underlying pool of assets. The pool is transferred in favour of Special purpose Vehicle (SPV), which acts as a trustee for investors.
- (iii) *The securitisation function* – SPV will structure and issue securities on the basis of asset pool. The securities carry a coupon and expected maturity which can be asset-based/mortgage based. These are generally sold to investors through merchant bankers. Investors are – pension funds, mutual funds, insurance funds.

SECTION : B: ECONOMICS FOR FINANCE

QUESTIONS

1 (a) (i) Differentiate between 'taxes on production' and 'product taxes'
(ii) Distinguish between non-economic activities and economic activities?
(b) Using the information given in the following table calculate,
(i) Value added by firm A and firm B
(ii) Gross Domestic Product at Market Price
(iii) Net Domestic Product at Factor Cost.

	Particulars	₹ crore
(i)	Sales by firm B to general government	300
(ii)	Sales by firm A	1500
(iii)	Sales by firm B to households	1350
(iv)	Change in stock of firm A	200
(v)	Closing stock of firm B	140
(vi)	Opening stock of firm B	130
(vii)	Purchases by firm A	270
(viii)	Indirect taxes paid by both the firms	375
(ix)	Consumption of fixed capital	720
(x)	Sales by firm A to B	300

2. (a) Define multiplier. What is the range of values it can take?
(b) How do imports affects investment multiplier?
(c) An increase of investment by ₹ 600 Crores resulted in an increase in national income by 2400 Crores. Find MPC and MPS.

3. (a) Classify each of the following goods based on their characteristics. Mention the rationale.
(i) Open-access Wi-Fi networks
(ii) Roads with toll booths
(iii) Parks
(b) What is the major determinant of the economic functions of a government?
(c) Distinguish between private cost and social cost
(d) Describe the term 'Tragedy of commons'.

4. Explain the concept of adverse selection. What are the possible consequences of adverse selection?

5. (a) Why do you consider national defence as a public good?
(b) Define information failure
6. (a) Explain the function of money as a unit of account?
(b) Examine the different variables on demand for money according to inventory theoretic approach.
7. (a) Define Reserve Money? Compute the Reserve Money from the following data Published by RBI.

Components	(In billions of ₹) As on 7 th July 2018
Currency in circulation	15428.40
Bankers Deposits with RBI	4596.18
Other Deposits with RBI	183.30

- (b) Which of the functions of money do the following items satisfy?
 - (i) A credit card.
 - (ii) A token of specified amount of money which can be used for shopping
- (c) What role does Market Stabilization Scheme (MSS) play in our economy?
8. (a) Mention the core principle of comparative advantage
(b) Explain the operational procedure of the monetary policy of India?
9. How do foreign direct investments affect human capital in recipient countries?
10. (a) What is local content requirement? How will it affect trade?
(b) How is exchange rate determined under floating exchange rate regime?
(c) What is meant by trade distortion?

SUGGESTED ANSWERS/HINTS

1. (a) (i) **Product taxes** like excise duties, customs, sales tax, service tax etc., are levied by the government on goods and services and are generally related to the quantum of production.
Taxes on production, such as, factory license fee, taxes to be paid to the local authorities, pollution tax etc., on the other hand, are unrelated to the quantum of production.
(ii) **Economic activities** as distinguished from non-economic activities, include all human activities which create goods and services that can be valued at market

price. **Non-economic activities** are those which produce goods and service, but are not exchanged in a market transaction so that do not command any market value.

(b) (i) Value added by Firm A and Firm B

$$\begin{aligned}
 \text{Gross Value Added (GVA}_{MP}\text{)} \text{ of Firm A} &= \text{Gross value of output (GVO}_{MP}\text{)} \text{ of Firm A} \\
 &\quad - \text{Intermediate consumption of firm A} \\
 &= (\text{Sales by firm A} + \text{Change in stock of firm A}) - (\text{Purchases by firm A}) \\
 &= [(ii) + (iv)] - (vii) = (1500 + 200) - 270 \\
 &= \mathbf{1430 \text{ Crores}}
 \end{aligned}$$

$$\begin{aligned}
 \text{Gross Value Added (GVA}_{MP}\text{)} \text{ of Firm B} &= \text{Gross value of output (GVO}_{MP}\text{)} \text{ of firm B} \\
 &\quad - \text{Intermediate consumption of firm B} \\
 &= [\text{Sales by firm B to general government} + \text{Sales by firm B to households} + (\text{Closing stock of firm B} - \text{Opening stock of firm B})] - \\
 &\quad \text{Purchases by firm B} \\
 &= [(300 + 1350) + (140 - 130)] - 300 \\
 &= 1650 + 10 - 300 = \mathbf{\text{₹ 1360 Crores}}
 \end{aligned}$$

(ii) Gross Domestic product at Market Price:

$$= \text{Value added by firm A} + \text{Value added by firm B} = 1430 + 1360 = \mathbf{\text{₹ 2790 Crores}}$$

(iii) Net Domestic Price at Factor Cost:

$$\begin{aligned}
 \text{NDP}_{FC} &= \text{Gross Domestic product at market price} - \text{Consumption of fixed capital} \\
 &\quad - \text{Indirect taxes paid by both the firms} \\
 &= 2790 - (ix) - (viii) = 2790 - 720 - (375 - 0) = \mathbf{\text{₹ 1695 Crores}}
 \end{aligned}$$

2. (a) Multiplier expresses the relationship between an initial increment in investment and the resulting increase in aggregate income i.e. how many times the aggregate income increases as a result of an increase in investment. The ratio of ΔY to ΔI is called the investment multiplier, k . For example, if a change in investment of ₹ 2000 million causes a change in national income of ₹ 6000 million, then the multiplier is $6000/2000 = 3$. Thus multiplier indicates the change in national income for each rupee change in the desired investment. The value 3 in the above example tells us that for every Re. 1 increase in desired investment expenditure, there will be ₹ 3 increase in equilibrium national income. The ratio of ΔY to ΔI is called the investment multiplier, k .

$$k = \frac{\text{Change in Income}}{\text{Change in Investment}} = \frac{\Delta Y}{\Delta I}$$

The size of the multiplier effect is given by $\Delta Y = k \Delta I$.

The increase in income per rupee increase in investment is:

$$\frac{\Delta Y}{\Delta I} = \frac{1}{1 - MPC} = \frac{1}{MPS}$$

From the above, we find that the marginal propensity to consume (MPC) is the determinant of the value of the multiplier and that there exists a direct relationship between MPC and the value of multiplier. Higher the MPC, more will be the value of the multiplier, and vice-versa. On the contrary, higher the MPS, lower will be the value of multiplier and vice-versa.

Since, $0 < MPC < 1$; therefore,

if MPC is zero then $K = 1$ and if MPC = 1, then $K = \infty$

The maximum value of multiplier is infinity when the value of MPC is 1 i.e. the economy decides to consume the whole of its additional income.

- (b) The greater will be propensity to import, the lower will be autonomous expenditure multiplier
- (c) The ratio of ΔY to ΔI is called the investment multiplier, k .

$$k = \frac{\text{Change in Income}}{\text{Change in Investment}} = \frac{\Delta Y}{\Delta I}$$

$$\text{Here } \frac{2400}{600} = 4$$

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

$$4 - 4MPC = 1$$

$$4 MPC = 4 - 1 = 3$$

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

$$MPS = 1 - MPC = 0.25$$

3. (a) All the goods mentioned in the question can be classified as impure public good. There are many hybrid goods that possess some features of both public and private goods. These goods are called impure public goods and are partially rivalrous or congestible. Because of the possibility of congestion, the benefit that an individual gets from an impure public good depends on the number of users. Consumption of these goods by another person reduces, but does not eliminate, the benefits that other people receive from their consumption of the same good. Impure public goods also differ from pure public goods in that they are often excludable.

Since free riding can be eliminated, the impure public good may be provided either by the market or by the government at a price or fee. If the consumption of a good can be excluded, then the market would provide a price mechanism for it. The

provider of an impure public good may be able to control the degree of congestion either by regulating the number of people who may use it, or the frequency with which it may be used or both.

(b) The nature of the economic system determines the size and scope of the economic functions of the government. In a centrally planned socialistic economy, the state owns all productive resources and makes all important economic decisions. On the contrary, in a market economy, all important economic decisions are made by individuals and firms who want to maximise self interest and there is only limited role for the government. In a mixed economic system, both markets and government contribute towards resource allocation decisions.

(c) Private cost is the cost faced by the producer or consumer directly involved in a transaction. If we take the case of a producer, his private cost includes direct cost of labour, materials, energy and other indirect overheads. These are usually added up to determine market price. The actions of consumers or producers result in costs or benefits to others and the relevant costs and benefits are not reflected as part of market prices. In other words, market prices do not incorporate externalities. Social costs refer to the total costs to the society on account of a production or consumption activity. Social costs are private costs borne by individuals directly involved in a transaction together with the external costs borne by third parties not directly involved in the transaction. Social costs represent the true burdens carried by society in monetary and non-monetary terms.

(d) Common access resources such as oceans tend to be over-consumed in an unregulated market because they are rivalrous and non-excludable in consumption. 'Tragedy of the commons' is a term to describe the problem which occurs when rivalrous but non-excludable goods are overused by individual users acting independently and rationally according to their own self-interest. In doing so, they behave contrary to the common good of all users by depleting a shared common resource to the disadvantage of the entire universe.

4. Adverse selection is a situation in which asymmetric information about quality eliminates high-quality goods from a market. It a form of market failure which occurs when buyers have better information than sellers due to hidden information, and this can distort the usual market process. For example, in the insurance market adverse selection is the tendency for people with higher risk to obtain insurance coverage to a greater extent than persons with lesser risk because compared to insurance buyers, insurers know less about the health conditions of buyers and are therefore unable to differentiate between high-risk and low-risk persons. If the insurance company charges an average price, and only high-risk consumers buy insurance it will make losses. It is therefore possible that there will be higher overall premium as firms insure themselves against high-risk customers buying insurance. Then the low-risk customers may not want to buy insurance because it is quite expensive. Economic agents end up either selecting a sub-standard product or leaving the market altogether leading to a condition of 'missing market'. If the sellers wish to do

business profitably, they may have to incur considerable costs in terms of time and money for identifying the extent of risk for different buyers.

5. (a) National defence has all characteristics of a public good. It yields utility to people; its consumption is essentially nonrival, non-excludable and collective in nature and is characterized by indivisibility. National defence is available for all individuals whether they pay taxes or not and it is impossible to exclude anyone within the country from consuming and benefiting from it. No direct payment by the consumer is involved in the case of defence. Once it is provided, the additional resource cost of another person consuming it is zero. Defence also has the unique feature of public good i.e. it does not conform to the settings of market exchange. Though defence is extremely valuable for the wellbeing of the society, left to market, it will not be produced at all or will be under produced.
- (b) Perfect information which implies that both buyers and sellers have complete information about anything that may influence their decision making is an important element of an efficient competitive market. Information failure occurs when lack of information can result in consumers and producers making decisions that do not maximize welfare. Information failure is widespread in numerous market exchanges due to complex nature of goods and services that are transacted, inaccurate and incomplete data, and non-availability of correct information
6. (a) A unit of account is a common unit for measuring how much something is worth. The monetary unit (for e.g. Rupee, Dollar) serves as a numeraire or common measure value in terms of which the value of all goods, services, assets, liabilities, income, expenditure etc are measured and expressed. This helps in measuring and fixing the exchange values in terms of a common unit and avoids the problem of recording and expressing the value of each commodity in terms of quantities of other goods. Use of money as a unit of account thus
 - reduces the number of exchange ratios between goods and services
 - makes it possible to keep business accounts
 - allows meaningful interpretation of prices, costs, and profits, and
 - facilitates a system of trade through orderly pricing, comparison of value and rational economic choices.
- (b) Inventory Theoretic Approach (by Baumol and Tobin), assume that there are two media for storing value: money and an interest-bearing alternative asset. There is a fixed cost of making transfers between money and the alternative assets e.g. broker charges. While relatively liquid financial assets other than money (such as, bank deposits) offer a positive return, the above said transaction costs of going between money and these assets justifies holding money.

Baumol used business inventory approach to analyze the behaviour of individuals. Just as businesses keep money to facilitate their business transactions, people also

hold cash balance which involves an opportunity cost in terms of lost interest. Therefore, they hold an optimum combination of bonds and cash balance, i.e., an amount that minimizes the opportunity cost.

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

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

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

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

7. (a) **Reserve Money** = Currency in circulation + Bankers' deposits with the RBI + Other deposits with the RBI

$$= 15428.40 + 4596.18 + 183.30$$

$$= 20207.88$$

(b) (i) A credit card is a medium of exchange
(ii) A token of specified amount of money which can be used for shopping satisfies all 3 functions of money, which are store of value, unit of account, and medium of exchange.

(c) Market Stabilization Scheme for monetary management was introduced in 2004 following a MoU between the Reserve Bank of India (RBI) and the Government of India (GoI) with the primary aim of aiding the sterilization operations of the RBI. (Sterilization is the process by which the monetary authority sterilizes the effects of significant foreign capital inflows on domestic liquidity by off-loading parts of the stock of government securities held by it). Under this scheme, the Government of India borrows from the RBI (such borrowing being additional to its normal borrowing requirements) and issues treasury-bills/dated securities for absorbing excess liquidity from the market arising from large capital inflows.

8. (a) A nation should specialize in the production and export of the commodity in which its absolute disadvantage is smaller (this is the commodity of its comparative advantage) and import the commodity in which its absolute disadvantage is greater (this is the commodity of its comparative disadvantage).

(b) Operating procedures are the variety of rules, traditions and practices used in the actual implementation of monetary policy. It encompasses, basically, a set of tactics such as choice of the operating target and policy instruments, the nature and frequency of use of policy instruments, market interventions, the width of corridor for market interest rates and the manner of policy signals to effect desired changes in the intermediate target. In other words, the operating procedure in monetary policy refers to its implementation in very short run, including the day-to-day operations.

9. Since FDI involves setting up of production base (in terms of factories, power plants, etc.) it generates direct employment in the recipient country. Subsequent FDI as well as domestic investments propelled in the downstream and upstream projects that come up in multitude of other services generate multiplier effects on employment and income. FDI not only creates direct employment opportunities but also, through backward and forward linkages, it is able to generate indirect employment opportunities as well. It is also argued that more indirect employment will be generated to persons in the lower-end services sector occupations thereby catering to an extent even to the less educated and unskilled engaged in those units. This impact is particularly important if the recipient country is a developing country with an excess supply of labour caused by population pressure.

Foreign direct investments also promote relatively higher wages for skilled jobs. However, jobs that require expertise and entrepreneurial skills for creative decision making may generally be retained in the home country and therefore the host country is left with routine management jobs that demand only lower levels of skills and ability. This may result in 'crowding in' of people in jobs requiring low skills, perpetuation of low labour standards and differential treatment.

FDIs are likely to use labor-saving technology and capital-intensive methods in a labour-abundant country and cause labour displacement. Such technology is inappropriate for a labour-abundant country as it does not support generation of jobs which is a crucial requirement to address poverty and unemployment which are the two fundamental areas

of concern for the less developed countries. Not only that foreign entities fail to support employment generation, but they may also drive out domestic firms from the industry resulting in serious problems of displacement of labour.

10. (a) Local content requirements (LCRs) are conditions imposed by a host country government that require investing firms to purchase and use domestically manufactured goods or domestically supplied services in order to operate in an economy. The fraction of a final good to be procured locally may be specified either in value terms (e.g. 25% of the value of a product must be locally produced), by requiring that some minimum share of the value of a good represent home value added, or in physical units (e.g. 50% of component parts for a product must be locally produced). From the viewpoint of domestic producers of inputs, local content requirement provides greater demand which is not necessarily associated to their competitiveness and for components/ parts manufacturers gives protection in the same way that an import quota would. Local content requirement benefits producers and not consumers because such requirements may raise the prices.

(b) Under floating exchange rate regime the equilibrium value of the exchange rate of a country's currency is market determined i.e. the demand for and supply of currency relative to other currencies determines the exchange rate.

(c) Trade is distorted if quantities of commodities produced, bought, and sold and their prices are higher or lower than levels that would usually exist in a competitive market. For example, barriers to imports such as tariffs, domestic subsidies and quantitative restrictions can make agricultural products more costly in a market of a country. The higher prices will result in higher production of crop. Then export subsidies are needed to sell the surplus output in the world markets, where prices are low. Thus, the subsidising countries can be producing and exporting considerably more than what they normally would.

Applicability of Standards/Guidance Notes/Legislative Amendments etc.

for May, 2019 Examination

Intermediate (New Course)

Paper 5: Advanced Accounting

List of Applicable Accounting Standards

- AS 7 : Construction Contracts
- AS 9 : Revenue Recognition
- AS 14: Accounting for Amalgamations
- AS 18 : Related Party Disclosures
- AS 19: Leases
- AS 20 : Earnings Per Share
- AS 24 : Discontinuing Operations
- AS 26 : Intangible Assets
- AS 29 : Provisions, Contingent Liabilities and Contingent Assets.

List of Applicable Guidance Notes issued by ICAI on specified accounting aspects

The Study Guidelines containing the List of applicable Guidance Notes is given as Annexure.

Applicability of the Companies Act, 2013 and other Legislative Amendments for May, 2019 Examination

The relevant notified Sections of the Companies Act, 2013 and legislative amendments including relevant Notifications / Circulars / Rules / Guidelines issued by Regulating Authorities up to 31st October, 2018 will be applicable for May, 2019 Examination.

Non-Applicability of Ind AS

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

ANNEXURE: STUDY GUIDELINES

List of applicable Guidance Notes issued by ICAI on specified accounting aspects

1. Guidance Note on Terms Used in Financial Statements.
2. Guidance Note on Accrual Basis of Accounting.
3. Guidance Note on Accounting for Corporate Dividend Tax.
4. Guidance Note on Accounting for Employee Share-based Payments.
5. Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax

under the Income-tax Act, 1961.

6. Guidance Note on Accounting for Real Estate Transactions (revised 2012)
7. Guidance Note on Turnover in case of Contractors.
8. Guidance Note on Schedule III to the Companies Act, 2013.

Paper 6: Auditing and Assurance

List of topic-wise inclusion in the syllabus

I. List of applicable Statements and Standards for May, 2019 Examination:

Statement on Reporting under Section 227(1A) of the Companies Act, 1956 (Section 143(1) of the Companies Act, 2013).

II. List of applicable Engagements and Quality Control Standards on Auditing for May, 2019 Examination

S.No	SA	<i>Title of Standard on Auditing</i>
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
3	SA 210	Agreeing the Terms of Audit Engagements
4	SA 220	Quality Control for Audit of Financial Statements
5	SA 230	Audit Documentation
6	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements
7	SA 250	Consideration of Laws and Regulations in An Audit of Financial Statements
8	SA 260	Communication with Those Charged with Governance (Revised)
9	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
10	SA 299	Joint Audit of Financial Statements(Revised)
11	SA 300	Planning an Audit of Financial Statements
12	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
13	SA 320	Materiality in Planning and Performing an Audit
14	SA 330	The Auditor's Responses to Assessed Risks

15	SA 402	Audit Considerations Relating to an Entity Using a Service Organization
16	SA 450	Evaluation of Misstatements Identified during the Audits
17	SA 500	Audit Evidence
18	SA 501	Audit Evidence - Specific Considerations for Selected Items
19	SA 505	External Confirmations
20	SA 510	Initial Audit Engagements-Opening Balances
21	SA 520	Analytical Procedures
22	SA 530	Audit Sampling
23	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
24	SA 550	Related Parties
25	SA 560	Subsequent Events
26	SA 570	Going Concern (Revised)
27	SA 580	Written Representations
28	SA 600	Using the Work of Another Auditor
29	SA 610	Using the Work of Internal Auditors (Revised)
30	SA 620	Using the Work of an Auditor's Expert
31	SA 700	Forming an Opinion and Reporting on Financial Statements(Revised)
32	SA 701	Communicating Key Audit Matters in the Independent Auditor's Report (New)
33	SA 705	Modifications to the Opinion in the Independent Auditor's Report (Revised)
34	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report (Revised)
35	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements
36	SA 720	The Auditor's Responsibilities Relating to Other Information (Revised)

III. List of applicable Guidance Notes and other publications for May, 2019 Examination:

1. Guidance Note on Audit of Inventories.
2. Guidance Note on Audit of Debtors, Loans and Advances.

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

IV Applicability of the Companies Act, 2013 and other Legislative Amendments for May 2019 Examination

(i) The **July 2017 Edition of the Study Material** on Intermediate Paper 6: Auditing and Assurance [comprising of 2 Modules – Modules 1 – 2]. is relevant for May, 2019 Examinations. **This is an integrated Study Material cum Practice Manual.**

Students are expected to be updated with the notifications, circulars and other legislative amendments made upto 6 months prior to the examination. **For instance, for May, 2019 examination, significant notifications and circulars issued upto 31st October, 2018 would be relevant.**

The relevant notified Sections of the Companies Act, 2013 and legislative amendments including relevant Notifications / Circulars / Rules / Guidelines issued by Regulating Authority up to 31st October, 2018 will be applicable for May, 2019 Examination. **It may be noted that the significant notifications and circulars issued between 01.05.2017 and 31.10.2018, which are not covered in the July 2017 Edition of the Study Material, would be given as Statutory Update in the Revision Test Paper for May 2019 Examination.**

(ii) Companies (Auditor's Report) Order, 2016 issued by Ministry of Corporate Affairs on 29th March, 2016 is applicable for May, 2019 Examination.