

Test Series: February, 2016

MOCK TEST PAPER – 1
INTERMEDIATE (IPC) : GROUP – II
PAPER – 5: ADVANCED ACCOUNTING

Question No. 1 is compulsory.

*Answer any **five** questions from the remaining **six** questions.*

Wherever necessary suitable assumptions may be made and disclosed by way of a note.

Working Notes should form part of the answer.

Time Allowed: 3 Hours

Maximum Marks: 100

1. (a) A major fire has damaged the assets in a factory of a Limited Company on 5th April – five days after the year end and closure of accounts. The loss is estimated at Rs. 10 crores out of which Rs. 7 crores will be recoverable from the insurers. Explain briefly how the loss should be treated in the final accounts for the previous year.
- (b) Sunshine Limited imported raw materials worth US \$9,000 on 25th February, 2015, when the exchange rate was Rs. 44 per US Dollar. The transaction was recorded in the books at the above mentioned rate. The payment for the transaction was made on 10th April, 2015, when the exchange rate was Rs. 48 per US Dollar. At the year end 31st March, 2015, the rate of exchange was Rs. 49 per US Dollar.
The Chief Accountant of the company passed an entry on 31st March, 2015 adjusting the cost of raw material consumed for the difference between Rs. 48 and Rs. 44 per US Dollar. Discuss whether this treatment is justified as per the provisions of AS-11 (Revised).
- (c) Suhana Ltd. issued 12% secured debentures of Rs. 100 Lakhs on 01.05.2013, to be utilized as under:

<i>Particulars</i>	<i>Amount (Rs.in lakhs)</i>
Construction of factory building	40
Purchase of Machinery	35
Working Capital	25

In March 2014, construction of the factory building was completed and machinery was installed and ready for its intended use. Total interest on debentures for the financial year ended 31.03.2014 was Rs. 11,00,000. During the year 2013-14, the company had invested idle fund out of money raised from debentures in banks' fixed deposit and had earned an interest of Rs. 2,00,000.

Show the treatment of interest under Accounting Standard 16 and also explain nature of assets.

(d) An engineering goods company provides after sales warranty for 2 years to its customers. Based on past experience, the company has been following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period:

Less than 1 year : 2% provision

More than 1 year : 3% provision

The company has raised invoices as under:

Invoice Date	Amount (Rs.)
19th January, 2014	40,000
29th January, 2015	25,000
15th October, 2015	90,000

Calculate the provision to be made for warranty under Accounting Standard 29 as at 31st March, 2015 and 31st March, 2016. Also compute amount to be debited to Profit and Loss Account for the year ended 31st March, 2016. (4 x 5 = 20 Marks)

2. Amar, Akbar and Antony are in partnership. The following is their Balance Sheet as at March 31, 2015 on which date they dissolved their partnership. They shared profit in the ratio of 5:3:2.

Liabilities	Rs.	Assets	Rs.
Creditors	80,000	Plant and machinery	60,000
Loan A/c – Amar	20,000	Premises	80,000
Capital A/cs - Amar	1,00,000	Stock	60,000
Akbar	30,000	Debtors	1,20,000
Antony	<u>90,000</u>		
	3,20,000		3,20,000

It was agreed to repay the amounts due to the partners as and when the assets were realised, viz.

April 15, 2015	Rs. 60,000
May 1, 2015	Rs. 1,46,000
May 31, 2015	Rs. 94,000

Prepare a statement showing how the distribution should be made under maximum loss method and write up the cash account and partners' capital accounts. (16 Marks)

3. The following is the summarized Balance Sheet of Krishna Ltd. as at March 31, 2016 :

	Rs. in lacs
Liabilities	
Fully paid equity shares of Rs. 10 each	500
Capital Reserve	6
12% Debentures	400
Debenture Interest Outstanding	48
Trade payables	165
Directors' Remuneration Outstanding	10
Other Outstanding Expenses	11
Provisions	<u>33</u>
	<u>1,173</u>
Assets	
Goodwill	15
Land and Building	184
Plant and Machinery	286
Furniture and Fixtures	41
Inventory	142
Trade receivables	80
Cash at Bank	27
Discount on Issue of Debentures	8
Profits and Loss Account	<u>390</u>
	<u>1,173</u>

The following scheme of internal reconstruction was framed, approved by the Tribunal, all the concerned parties and implemented:

- (i) All the equity shares be converted into the same number of fully-paid equity shares of Rs. 2.50 each.
- (ii) Directors agree to forego their outstanding remuneration.
- (iii) The debentureholders also agree to forego outstanding interest in return of their 12% debentures being converted into 13% debentures.

- (iv) The existing shareholders agree to subscribe for cash, fully paid equity shares of Rs. 2.50 each for Rs. 125 lacs.
- (v) Trade payables are given the option of either to accept fully-paid equity shares of Rs. 2.50 each for the amount due to them or to accept 80% of the amount due in cash. Trade payables for Rs. 65 lacs accept equity shares whereas those for Rs. 100 lacs accept Rs. 80 lacs in cash in full settlement.
- (vi) The Assets are revalued as under:

	Rs. in lacs
Land and building	230
Plant and Machinery	220
Inventory	120
Trade receivables	76

Pass Journal Entries for all the above mentioned transactions and draft the company's Balance Sheet immediately after the reconstruction. (16 Marks)

4. (a) ABC Ltd. came up with public issue of 3,00,000 Equity Shares of Rs.10 each at Rs.15 per share. P, Q and R took underwriting of the issue in ratio of 3 : 2: 1 with the provisions of firm underwriting of 20,000, 14,000 and 10,000 shares respectively.

Applications were received for 2,40,000 shares excluding firm underwriting. The marked applications from public were received as under:

P - 60,000

Q - 50,000

R - 60,000

Compute the liability of each underwriter as regards the number of shares to be taken up assuming that the benefit of firm underwriting is not given to individual underwriters.

(b) On 1st April, 2014, a company offered 100 shares to each of its 500 employees at Rs. 50 per share. The employees are given a year to accept the offer. The shares issued under the plan shall be subject to lock-in on transfer for three years from the grant date. The market price of shares of the company on the grant date is Rs.60 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at Rs.56 per share.

On 31st March, 2015, 400 employees accepted the offer and paid Rs. 50 per share purchased. Nominal value of each share is Rs.10.

Record the issue of share in the books of the company under the aforesaid plan.

(8 + 8 = 16 Marks)

5. (a) From the following information furnished to you by Ayushman Insurance Co. Ltd., you are required to pass Journal entries relating to unexpired risk reserve and show in columnar form "Unexpired Risks Reserve Account" for 2015.

(i) On 31.12.2014, it had reserve for unexpired risks amounting to Rs. 40 crores. It comprised of Rs. 15 crores in respect of marine insurance business, Rs. 20 crores in respect of fire insurance business and Rs. 5 crores in respect of miscellaneous insurance business.

(ii) Ayushman Insurance Co. Ltd. creates reserves at 100% of net premium income in respect of marine insurance policies and at 50% of net premium income in respect of fire and miscellaneous income policies.

(iii) During 2015, the following business was conducted:

	Marine	(Rs. in crores)	
		Fire	Miscellaneous
Premium collected from:			
(a) Insured in respect of policies issued	18.00	43.00	12.00
(b) Other insurance companies in respect of risks undertaken	7.00	5.00	4.00
Premium paid/payable to other insurance companies on business ceded	6.70	4.30	7.00

(b) From the following information of M/s. XY Bank Ltd. for the year ended 31st March, 2014, compute the provisions to be made in the Bank's Books for Doubtful Assets

	Rs. in Lakhs
Doubtful Assets (More than 3 Years)	2,000
DICGS 100% Cover	200
Value of Security including DICGC Cover	1,000

(12 + 4 = 16 marks)

6. (a) M/s. Sandeep having Head Office at Delhi has a Branch at Kolkata. The Head Office does wholesale trade only at cost plus 80%. The Goods are sent to Branch at the wholesale price viz. cost plus 80%. The Branch at Kolkata wholly engaged in retail trade and the goods are sold at cost to Head Office plus 100%.

Following details are furnished for the year ended 31st March, 2014 :

	Head Office (Rs.)	Kolkata Branch (Rs.)
Opening Stock (As on 01.04.2013)	1,25,000	-
Purchases	21,50,000	-
Goods sent to Branch (cost to H.O. plus 80%)	7,38,000	-
Sales	23,79,600	7,30,000
Office Expenses	50,000	4,500
Selling Expenses	32,000	3,300
Staff Salary	45,000	8,000

You are required to prepare Trading and Profit & Loss Account of the Head Office and Branch for the Year ended 31st March, 2014.

(b) Department R sells goods to Department S at a profit of 25% on cost and Department T at 10% profit on cost. Department S sells goods to R and T at a profit of 15% and 20% on sales respectively. Department T charges 20% and 25% profit on cost to Department R and S respectively.

Department managers are entitled to 10% commission on net profit subject to unrealized profit on departmental sales being eliminated. Departmental profits after charging manager's commission, but before adjustment of unrealized profit are as under:

	Rs.
Department R	54,000
Department S	40,500
Department T	27,000

Stock lying at different departments at the end of the year are as under:

	Dept. R Rs.	Dept. S Rs.	Dept. T Rs.
Transfer from Department R	-	22,500	16,500
Transfer from Department S	21,000	-	18,000
Transfer from Department T	9,000	7,500	-

Find out the correct departmental profits after charging manager's commission.

(8 +8 =16 marks)

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

(a) Under what circumstances, an LLP can be wound up by the Tribunal.

(b) A liquidator is entitled to receive remuneration at 2% on the assets realized, 3% on the amount distributed to Preferential Creditors and 3% on the payment made to Unsecured Creditors. The assets were realized for Rs.45,00,000 against which payment was made as follows :

Liquidation expenses	Rs. 50,000
Secured Creditors	Rs. 15,00,000
Preferential Creditors	Rs. 1,25,000

The amount due to Unsecured Creditors was Rs.15,00,000. You are asked to calculate the total remuneration payable to liquidator. Calculation shall be made to the nearest multiple of a rupee.

(c) AB Ltd. launched a project for producing product X in October, 2013. The Company incurred Rs. 20 lakhs towards Research and Development expenses upto 31st March, 2015. Due to prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years.

Advise the Company as per the applicable Accounting Standard.

(d) From the following information relating to Y Ltd. Calculate Earnings Per Share (EPS):

	Rs. in crores
Profit before V.R.S. payments but after depreciation	75.00
Depreciation	10.00
VRS payments	32.10
Provision for taxation	10.00
Fringe benefit tax	5.00
Paid up share capital (shares of Rs. 10 each fully paid)	93.00

(e) "One of the characteristics of financial statements is neutrality"- Do you agree with this statement? $(4 \times 4 = 16 \text{ Marks})$

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SUGGESTED ANSWERS/HINTS

1. (a) The loss due to break out of fire is an example of event occurring after the balance sheet date. The event being in the nature of a fire which is unpredictable does not relate to conditions existing at the balance sheet date. It has not affected the financial position as on the date of balance sheet and therefore requires no specific adjustments in the financial statements. However, AS 4 states that disclosure is generally made of events occurring after balance sheet date i.e. in subsequent periods that represent unusual changes affecting the existence or substratum of the enterprise after the balance sheet date. In the given case, the amount of loss of assets in a factory is material and may be considered as an event affecting the substratum of the enterprise. Hence, as recommended in AS 4, disclosure of the event should be made.
(b) As per AS 11, 'The Effects of Changes in Foreign Exchange Rates', initial recognition of a foreign currency transaction is done in the reporting currency by applying the exchange rate at the date of the transaction. Accordingly, on 25th February 2015, the raw material purchased and its creditors will be recorded at US dollar $9,000 \times \text{Rs. } 44 = \text{Rs. } 3,96,000$.

Also, as per the standard, on balance sheet date such transaction is reported at closing rate of exchange, hence it will be valued at the closing rate i.e. Rs. 49 per US dollar ($\text{USD } 9,000 \times \text{Rs. } 49 = \text{Rs. } 4,41,000$) at 31st March, 2015, irrespective of the payment made for the same subsequently at lower rate in the next financial year.

The difference of Rs. 5 (49 – 44) per US dollar i.e. Rs. 45,000 ($\text{USD } 9,000 \times \text{Rs. } 5$) will be shown as an exchange loss in the profit and loss account for the year ended 31st March, 2015 and will not be adjusted against the cost of raw materials.

In the subsequent year on settlement date, the company would recognize or provide in the Profit and Loss account an exchange gain of Rs. 1 per US dollar, i.e. the difference from balance sheet date to the date of settlement between Rs. 49 and Rs. 48 per US dollar i.e. Rs. 9,000. Hence, the accounting treatment adopted by the Chief Accountant of the company is incorrect i.e. it is not in accordance with the provisions of AS 11.

- (c) According to AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible

for capitalisation should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

Also AS 16 "Borrowing Costs" states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost

$$= \text{Rs. } 11,00,000 - \text{Rs. } 2,00,000 = \text{Rs. } 9,00,000$$

Sr. No.	Particulars	Nature of assets	Interest to be Capitalized (Rs.)	Interest to be charged to Profit & Loss Account (Rs.)
i	Construction of factory building	Qualifying Asset*	$9,00,000 \times 40/100$ = Rs. 3,60,000	NIL
ii	Purchase of Machinery	Not a Qualifying Asset	NIL	$9,00,000 \times 35/100$ = Rs. 3,15,000
iii	Working Capital	Not a Qualifying Asset	NIL	$9,00,000 \times 25/100$ = Rs. 2,25,000
	Total		<u>Rs. 3,60,000</u>	<u>Rs. 5,40,000</u>

* A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

(d) Provision to be made for warranty under AS 29 'Provisions, Contingent Liabilities and Contingent Assets'

$$\begin{aligned} \text{As at 31st March, 2015} &= \text{Rs. } 40,000 \times .02 + \text{Rs. } 25,000 \times .03 \\ &= \text{Rs. } 800 + \text{Rs. } 750 = \text{Rs. } 1,550 \end{aligned}$$

$$\begin{aligned} \text{As at 31st March, 2016} &= \text{Rs. } 25,000 \times .02 + \text{Rs. } 90,000 \times .03 \\ &= \text{Rs. } 500 + \text{Rs. } 2,700 = \text{Rs. } 3,200 \end{aligned}$$

Amount debited to Profit and Loss Account for year ended 31st March, 2016

	Rs.
Balance of provision required as on 31.03.2016	3,200
Less: Opening Balance as on 1.4.2015	(1,550)
Amount debited to profit and loss account	<u>1,650</u>

Note: No provision will be made on 31st March, 2015 in respect of sales amounting Rs. 40,000 made on 19th January, 2014 as the warranty period of 2 years has already expired.

2. (a) Statement of Distribution of Cash by 'Maximum Loss Method'

	Creditors Rs.	Amar's Loan Rs.	Amar Rs.	Akbar Rs.	Antony Rs.
Balance due 15 th April 2015 realised Rs. 60,000	80,000	20,000	1,00,000	30,000	90,000
Paid to creditors	(60,000)	—	—	—	—
Balance due 1 st May, 2015 realised Rs. 1,46,000	20,000	20,000	1,00,000	30,000	90,000
Paid to creditors (Rs. 20,000)	20,000	—	—	—	—
Paid to Amar's loan (Rs. <u>20,000</u>)	—	<u>20,000</u>	—	—	—
Balance due (1)	Nil	Nil	1,00,000	30,000	90,000
Balance Rs. <u>1,06,000</u>					
Maximum Loss (1,00,000+30,000+90,000- 1,06,000) = Rs. 1,14,000 shared in Profit & Loss ratio 5:3:2			(57,000) 43,000	(34,200) (4,200)	(22,800) 67,200
Akbar's deficiency shared by Amar & Antony in capital ratio 100:90			(2,210)	4,200	(1,990)
Cash paid [2]			<u>40,790</u>	—	<u>65,210</u>
Balance due (3) [1-2]			59,210	30,000	24,790
31 st May 2015 realised Rs. 94,000					
Maximum Loss [59,210+30,000+24,790- 94,000]=					
Rs. 20,000 shared in 5:3:2			(10,000)	(6,000)	(4,000)
Cash paid (4)			<u>49,210</u>	<u>24,000</u>	<u>20,790</u>
Balance/Loss* on realisation (3-4)			<u>10,000</u>	<u>6,000</u>	<u>4,000</u>

Cash Account

	Rs.		Rs.
To Realization Account	60,000	By Creditors Account	60,000
To Realization Account	1,46,000	By Creditors Account	20,000
To Realization Account	94,000	By Amar's Loan Account	20,000
	<u> </u>	By Amar's Capital Account	40,790
	<u> </u>	By Antony's Capital Account	65,210
	<u> </u>	By Amar's Capital Account	49,210
	<u> </u>	By Akbar's Capital Account	24,000
	<u> </u>	By Antony's Capital Account	20,790
	<u> </u>		
	<u>3,00,000</u>		3,00,000

Partners' Capital Accounts

	Amar Rs.	Akbar Rs.	Antony Rs.		Amar Rs.	Akbar Rs.	Antony Rs.
To Cash	40,790	-	65,210	By Balance b/d	1,00,000	30,000	90,000
To Cash	49,210	24,000	20,790				
To Balance c/d							
Realization loss*	<u>10,000</u>	<u>6,000</u>	<u>4,000</u>				
	<u>1,00,000</u>	<u>30,000</u>	<u>90,000</u>		<u>1,00,000</u>	<u>30,000</u>	<u>90,000</u>

* If no further realization takes place, then Amar, Akbar and Anthony will bear loss on realization Rs. 10,000, Rs. 6,000 and Rs. 4,000 respectively.

3.

Journal Entries

		Rs. in lacs
	Dr.	Cr.
Equity Share Capital (Rs. 10 each) A/c	Dr.	500
To Equity Share Capital (Rs. 2.50 each) A/c		125
To Reconstruction A/c		375
(Conversion of all the equity shares into the same number of fully paid equity shares of Rs. 2.50 each as per scheme of reconstruction)		
Director's Remuneration Outstanding A/c	Dr.	10
To Reconstruction A/c		10
(Outstanding remuneration foregone by the directors as per scheme of reconstruction)		

12% Debentures A/c	Dr.	400	
Debenture Interest Outstanding A/c	Dr.	48	
To 13% Debentures A/c			400
To Reconstruction A/c			48
(Conversion of 12% debentures into 13% debentures, Debenture holders forgoing outstanding debenture interest)			
Bank A/c	Dr.	125	
To Equity Share Application A/c			125
(Application money received for fully paid equity shares of Rs. 2.5 each from existing shareholders)			
Equity Share Application A/c	Dr.	125	
To Equity Share Capital (Rs. 2.50 each) A/c			125
(Application money transferred to share capital)			
Trade payables A/c	Dr.	165	
To Equity Share Capital (Rs. 2.50 each) A/c			65
To Bank A/c			80
To Reconstruction A/c			20
(Trade payables for Rs. 65 lakhs accepting shares for full amount and those for Rs. 100 lakhs accepting cash equal to 80% of claim in full settlement)			
Capital Reserve A/c	Dr.	6	
To Reconstruction A/c			6
(Being the loss on reconstruction (balance in the Reconstruction A/c) transferred to Capital Reserve)			
Land and Building A/c	Dr.	46	
To Reconstruction A/c			46
(Appreciation made in the value of land and building as per scheme of reconstruction)			
Reconstruction A/c	Dr.	505	
To Goodwill A/c			15
To Plant and Machinery A/c			66
To Inventory A/c			22
To Trade receivables A/c			4
To Discount on issue of Debentures A/c			8
To Profit and Loss A/c			390
(Writing off losses and reduction in the values of assets as per scheme of reconstruction—W.N. 1)			

Note: In a scheme of Reconstruction, Goodwill, Losses etc should be written off against the Reconstruction Account whether or not it is mentioned in the question.

Balance Sheet of Krishna Ltd. (and Reduced) as on 31st March, 2016

Particulars	Note No.	Amount
		Rs.
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	315
(2) Non-Current Liabilities		
(a) Long-term borrowings - 13% Debentures		400
(3) Current Liabilities		
(a) Other current liabilities		11
(b) Short-term provisions		33
	Total	759
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
(i) Tangible assets	2	491
(ii) Intangible assets	3	0
(2) Current assets		
(a) Current investments		
(b) Inventories		120
(c) Trade receivables		76
(d) Cash and cash equivalents(W.N.2)		72
	Total	759

Notes to Accounts

		Rs.
1	Share Capital	
	Equity Share Capital (Rs. 2.50 each)	125
	Add: Fresh issue	125
	Add: Equity shares issued to trade payables	65
	1,26,000 Fully paid equity shares of Rs. 2.50 each	315

	(26,000 shares have been issued for consideration other than cash)		
2	Tangible assets		
a)	Land and Building	184	
	<i>Add: Amount of appreciation under scheme of reconstruction</i>	<u>46</u>	230
b)	Plant and Machinery	286	
	<i>Less: Amount written off under scheme of reconstruction dated.</i>	<u>(66)</u>	220
c)	Furniture and Fixtures		<u>41</u>
			<u>491</u>
3	Intangible assets		
	Goodwill	15	
	<i>Less: Amount written off under scheme of reconstruction</i>	<u>15</u>	-

Working Notes :

1. (Rs. in lacs)

Reconstruction Account

	Rs.		Rs.
To Goodwill	15	By Equity Share Capital A/c	375
To Plant and Machinery	66	By Director's Remuneration Outstanding A/c	10
To Inventory	22	By Debenture Interest Outstanding A/c	48
To Trade receivables	4	By Trade payables	20
To Discount on issue of Debentures		By Capital Reserve (Balancing Figure)	6
	8	By Land and Building	46
To Profit and Loss A/c	<u>390</u>		<u>505</u>
	<u>505</u>		<u>505</u>

2. Cash at bank as on 31st March, 2016 (after reconstruction)

	Rs.
Cash at bank (before reconstruction)	27
<i>Add: Proceeds from issue of equity shares</i>	<u>125</u>
	152
<i>Less: Payment made to trade payables (80% of Rs. 100 Lakhs)</i>	<u>(80)</u>
	72

4. (a) Calculation of liability of each underwriter (in shares) assuming that the benefit of firm underwriting is not given to individual underwriters

(Number of shares)

	P	Q	R	Total
Gross Liability (Total Issue – Issued to Promoters, Directors etc)	1,50,000	1,00,000	50,000	3,00,000
Less: Marked applications (excluding firm underwriting)	(60,000)	(50,000)	(60,000)	(1,70,000)
Balance	90,000	50,000	(10,000)	1,30,000
Less: Surplus of R allocated to P and Q in the ratio of 3:2	(6,000)	(4,000)	10,000	-
Balance	84,000	46,000	-	1,30,000
Less: Unmarked applications including firm underwriting (Refer W.N.)	(57,000)	(38,000)	(19,000)	(1,14,000)
Net Liability	27,000	8,000	(19,000)	16,000
Less: Surplus of R allocated to P and Q in the ratio of 3:2	(11,400)	(7,600)	19,000	-
	15,600	400	-	16,000
Add: Firm underwriting	20,000	14,000	10,000	44,000
Total Liability	35,600	14,400	10,000	60,000

Working Note:

Applications received from public	2,40,000 shares
Add: Shares underwritten firm (20,000 + 14,000 + 10,000)	44,000 shares
Total applications	2,84,000 shares
Less: Marked applications (60,000 + 50,000 + 60,000)	(1,70,000 shares)
Unmarked applications including firm underwriting	1,14,000 shares

(b) Fair value of an option = Rs. 56 – Rs. 50 = Rs. 6

Number of shares issued = 400 employees x 100 shares/employee = 40,000 shares

Fair value of ESPP = 40,000 shares x Rs. 6 = Rs. 2,40,000

Vesting period = 1 month

Expenses recognized in 2014-15 = Rs. 2,40,000

Date	Particulars	Rs.	Rs.
31.03.2015	Bank (40,000 shares x Rs. 50) Dr. Employees compensation expense A/c Dr. To Share Capital (40,000 shares x Rs.10) To Securities Premium (40,000 shares x Rs.46) (Being option accepted by 400 employees & payment made @ Rs.56 share)	20,00,000 2,40,000 4,00,000 18,40,000	
	Profit & Loss A/c Dr. To Employees compensation expense A/c (Being Employees compensation expense transferred to Profit & Loss A/c)	2,40,000	2,40,000

5. (a) **In the books of Ayushman Insurance Co. Ltd.**

Journal Entries

Date	Particulars	(Rs. in crores)	
		Dr.	Cr.
1.1.2015	Unexpired Risk Reserve (Fire) A/c Dr. Unexpired Risk Reserve (Marine) A/c Dr. Unexpired Risk Reserve (Miscellaneous) A/c Dr. To Fire Revenue Account To Marine Revenue Account To Miscellaneous Revenue Account (Being unexpired risk reserve brought forward from last year)	20.00 15.00 5.00 20.00 15.00 5.00	
31.12.2015	Marine Revenue A/c Dr. To Unexpired Risk Reserve A/c (Being closing reserve for unexpired risk created at 100% of net premium income amounting to Rs.18.3 crores i.e.18+7-6.70)	18.30	18.30
	Fire Revenue A/c Dr. To Unexpired Risk Reserve A/c (Being closing reserve for unexpired risk created at 50% of net premium income of Rs. 43.7 crores i.e.43+5-4.30)	21.85	21.85

Miscellaneous Revenue A/c	Dr.	4.50	
To Unexpired Risk Reserve A/c			4.50
(Being closing reserve for unexpired risk created at 50% net premium income of Rs. 9 crores i.e. 12+4-7)			

Unexpired Risk Reserve Account

Date	Particulars	Marine (Rs.)	Fire (Rs.)	Misc. (Rs.)	Date	Particulars	Marine (Rs.)	Fire (Rs.)	Misc. (Rs.)
1.1.2015	To Revenue A/c	15.00	20.00	5.00	1.1.2015	By Balance b/d	15.00	20.00	5.00
31.12.2015	To Balance c/d	18.30	21.85	4.50	31.12.2015	By Revenue A/c	18.30	21.85	4.50
		33.30	41.85	9.50			33.30	41.85	9.50

(b) Computation of provision in the books of XY Bank Ltd.

		(Rs. in lakhs)
Doubtful Assets (more than 3 years)		2,000
Less: Value of security (excluding DICGC cover)		<u>(800)</u>
		1,200
Less: DICGC cover		<u>(200)</u>
Unsecured portion		<u>1,000</u>
Provision:		
for unsecured portion @100%		1,000 lakhs
for secured portion @ 100%		<u>800 lakhs</u>
Total provision to be made in the books of XY Bank		<u>1,800 lakhs</u>

6. (a)

Trading and Profit and Loss A/c

For the year ended 31st March 2014

	Head office Rs.	Branch Rs.		Head office Rs.	Branch Rs.
To Opening stock	1,25,000	-	By Sales	23,79,600	7,30,000
To Purchases	21,50,000	-	By Goods sent to branch	7,38,000	-
To Goods received from head office		- 7,38,000	By Closing stock (W.N.1 & 2)	5,43,000	81,000

To Gross profit c/d	13,85,600	73,000			
	<u>36,60,600</u>	<u>8,11,000</u>		<u>36,60,600</u>	<u>8,11,000</u>
To Office expenses	50,000	4,500	By Gross profit	13,85,600	73,000
To Selling expenses	32,000	3,300	b/d		
To Staff salaries	45,000	8,000			
To Branch Stock Reserve (W.N.3)	36,000	-			
To Net Profit	12,22,600	57,200			
	<u>13,85,600</u>	<u>73,000</u>		<u>13,85,600</u>	<u>73,000</u>

Working Notes:

(1)	Calculation of closing stock of head office:	Rs.
	Opening Stock of head office	1,25,000
	Goods purchased by head office	<u>21,50,000</u>
		22,75,000
	Less: Cost of goods sold [31,17,600 (23,79,600+ 7,38,000) x100/180]	<u>(17,32,000)</u>
		5,43,000
(2)	Calculation of closing stock of branch:	Rs.
	Goods received from head office [At invoice value]	7,38,000
	Less: Invoice value of goods sold [7,30,000 x 180/200]	<u>(6,57,000)</u>
		81,000
(3)	Calculation of unrealized profit in branch stock:	
	Branch stock	Rs. 81,000
	Profit included	80% of cost
	Hence, unrealized profit would be = Rs. 81,000 x 80/180 =	Rs. 36,000

(b)

	Departments		
	R Rs.	S Rs.	T Rs.
Profit before adjustment of unrealized profits	54,000	40,500	27,000
Add: Managerial commission (1/9)	<u>6,000</u>	<u>4,500</u>	<u>3,000</u>
	60,000	45,000	30,000
Less: Unrealised profit on stock (Refer W.N.)	<u>(6,000)</u>	<u>(6,750)</u>	<u>(3,000)</u>
	54,000	38,250	27,000

Less: Managers' commission @ 10%	<u>(5,400)</u>	<u>(3,825)</u>	<u>(2,700)</u>
Profit after adjustment of unrealized profits	<u>48,600</u>	<u>34,425</u>	<u>24,300</u>

Working Notes:

Value of unrealised profit

	Rs.
<u>Transfer by department R to</u> S department $(22,500 \times 25/125) = 4,500$ T department $(16,500 \times 10/110) = 1,500$	6,000
<u>Transfer by department S to</u> R department $(21,000 \times 15/100) = 3,150$ T department $(18,000 \times 20/100) = 3,600$	6,750
<u>Transfer by department T to</u> R department $(9,000 \times 20/120) = 1,500$ S department $(7,500 \times 25/125) = 1,500$	3,000

7. (a) Under following circumstances, an LLP can be wound up by the Tribunal:

- (i) If the LLP decides that it should be wound up by the Tribunal;
- (ii) If for a period of more than six months, the number of partners of the LLP is reduced below two;
- (iii) If the LLP is unable to pay its debts;
- (iv) If the LLP has acted against the interests of the integrity and sovereignty of India, the security of the state or public order;
- (v) If the LLP has defaulted in the filing of the Statement of Account and Solvency with the Registrar for five consecutive financial years;
- (vi) If the Tribunal is of the opinion that it is just and equitable that the LLP be wound up.

(b) Calculation of Total Remuneration payable to Liquidator

	Amount in Rs.
2% on Assets realised	$45,00,000 \times 2\% = 90,000$
3% on payment made to Preferential creditors	$1,25,000 \times 3\% = 3,750$
3% on payment made to Unsecured creditors (Refer W.N)	<u>45,000</u>
Total Remuneration payable to Liquidator	<u>1,38,750</u>

Working Note:

Liquidator's remuneration on payment to unsecured creditors =

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

= Rs. 45,00,000 – Rs. 50,000 – Rs. 15,00,000 – Rs. 1,25,000 – Rs. 90,000 – Rs. 3,750

= Rs. 27,31,250

Sufficient amount is available for unsecured creditors therefore Liquidator's remuneration on payment to unsecured creditors = 3% x Rs. 15,00,000 = Rs. 45,000

(c) As per AS 26 "Intangible Assets", expenditure on research should be recognized as an expense when it is incurred. An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the conditions specified in the standard. An intangible asset (arising from development) should be derecognised when no future economic benefits are expected from its use according to the standard. Therefore, the manager cannot defer the expenditure write off to future years.

Hence, the expenses amounting Rs. 20 lakhs incurred on the research and development project has to be written off in the current year ending 31st March, 2015.

(d)

		Rs. in crores
Profit after depreciation but before VRS Payment		75.00
Less: Depreciation – No. adjustment required	-	
VRS payments	32.10	
Provision for taxation	10.00	
Fringe benefit tax	5.00	(47.10)
Net Profit		27.90
No. of shares		9.30 crores

$$EPS = \frac{\text{Net profit}}{\text{No. of shares}} = \frac{27.90}{9.30} = \text{Rs. 3 per share.}$$

(e) Yes, one of the characteristics of financial statements is neutrality. To be reliable, the information contained in financial statement must be neutral, that is free from bias. Financial Statements are not neutral if by the selection or presentation of information, the focus of analysis could shift from one area of business to another thereby arriving at a totally different conclusion on the business results. For example if the assets of a company primarily consist of debtors and insurance claims and the financial statements do not specify that the insurance claims have been lying unrealized for a number of years or that a few key debtors have not given balance confirmation certificates, an erroneous conclusion may be drawn on the liquidity of the company. Financial statements are said to depict the true and fair view of the business of the organization by virtue of neutrality.

Test Series: February, 2016

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

Question No. 1 is compulsory.

*Attempt any **five** questions from the Rest.*

Time Allowed – 3 Hours

Maximum Marks – 100

1. Discuss the following:

(a) “An element of surprise can significantly improve audit effectiveness.” (5 Marks)

(b) Disclosure requirements of Reserves and Surplus as per the Companies Act, 2013. (5 Marks)

(c) Assertions in the following case:

Particulars	Amount (Rs.)	Amount (Rs.)
Plant and Machinery (at cost)		2,00,000
Less: Depreciation till the end of previous year	70,000	
Depreciation for the year	13,000	83,000
		1,17,000

(5 Marks)

(d) “The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls.”

(5 Marks)

2. State with reason (in short) whether the following statements are correct or incorrect (Answer any **eight**):

(i) Letter of weakness is issued by the Management.

(ii) C&AG of India may order to conduct test audit of the accounts of a Government company.

(iii) Director's relative can act as an auditor of the company.

(iv) Selling and distribution cost is included in the cost of inventories.

(v) The auditor shall not modify the opinion in the auditor's report.

(vi) Internal control is part of internal check system.

- (vii) The auditor, in the interest of the users, while explaining the nature of his reservation, can describe the work of the expert with his name in the audit report without obtaining prior consent of the expert.
- (viii) If a Limited Liability Partnership Firm is appointed as an auditor of a company, every partner of a firm shall be authorized to act as an auditor.
- (ix) Analytical procedures are unable to help the auditor in determining the nature, timing and extent of other audit procedures at the planning stage.
- (x) Scrutiny of Bank Reconciliation Statement is one of the audit techniques.

(2 x 8 = 16 Marks)

3. How will you vouch/verify the following:

- (a) Bad Debts.
- (b) Cash at Bank.
- (c) Leasehold property.

(d) Profit or Loss arising on sale of Plots held by Real Estate Dealer. *(4 x 4 = 16 Marks)*

4. Discuss with reference to SAs:

- (a) "Operating Conditions" that may cast doubt about going concern assumption.

(4 Marks)

- (b) Inquiry from management is helpful for auditor to evaluate subsequent events. Discuss specific enquiries which might have effect on the financial statements.

(6 Marks)

- (c) The auditor is responsible for maintaining an attitude of professional skepticism throughout the audit. Do you agree with the statement? *(6 Marks)*

5. (a) Explain briefly the technique of "Internal Control Questionnaire" to facilitate the accumulation of information necessary for proper evaluation of internal control.

(4 Marks)

- (b) Mr. A, a director of X Pvt. Ltd., is also a director of another company viz., Y Pvt. Ltd., which has not filed the financial statements and annual return for last three years 2012-13 to 2014-15. Mr. A is of the opinion that he is not disqualified under section 164(2) of the Companies Act, 2013 and the auditor, thus, should not mention disqualification remark in his audit report. Comment as an auditor of the company. *(6 Marks)*

- (c) What special steps are involved in an audit of a Cinema Hall? *(6 Marks)*

6. (a) XYZ Ltd., a manufacturing concern, gave a donation of Rs. 60,000 each to a Charitable Society running a school and a trust set up for the service of blind without taking any prior permission during the financial year ending on 31st March, 2016. The average net profits of the company for the last three years were Rs. 20 lakhs. Comment. (4 Marks)

(b) Mention duties of an auditor if a company alter its capital clause. (6 Marks)

(c) State the background of "Local Bodies". Draft an audit programme for conducting audit of accounts of a Local Body. (6 Marks)

7. Write short notes on any **four** of the following:

(a) Importance of Working Papers.

(b) Advantages of Continuous Audit.

(c) Circumstances in which retiring auditor cannot be reappointed.

(d) Verification of receipt of applications for shares along with application money.

(e) Audit techniques commonly adopted by auditors. (4 x 4 = 16 Marks)

Test Series: February, 2016

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

SUGGESTED ANSWERS / HINTS

1. (a) Element of Surprise Checks: Surprise checks are a part of normal audit procedures. Wherever practical, an element of surprise should be incorporated in the audit procedures.

The element of surprise in an audit may be, both in regard to the time of audit, i.e. selection of date, when the auditor will visit the client's office for audit and selection of areas of audit.

Surprise checks are mainly intended to ascertain whether the internal control system is working effectively and whether the accounting and other records are kept up to date as per the statutory regulations. Surprise checks can exercise good moral check on the client's staff. It helps in determining whether errors or frauds exist and if they exist, brings the matter promptly to the management's attention, so that corrective action can be taken at the earliest.

Surprise checks are very effective in verification of cash and investments, test checking of inventory, verification of accounting records, statutory registers and internal control system. The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

(b) Disclosure Requirements of Reserves and Surplus: Schedule III to the Companies Act, 2013 requires that company shall disclose "Reserves and Surplus" in notes to accounts as follows-

Reserves and Surplus shall be classified as:

- (i) Capital Reserves;
- (ii) Capital Redemption Reserve;
- (iii) Securities Premium Reserve;
- (iv) Debenture Redemption Reserve;
- (v) Revaluation Reserve;
- (vi) Share Options Outstanding Account;
- (vii) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);

(viii) Surplus i.e. balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

(c) **Assertions:** The assertions in the given case are as follows-

- (i) the firm owns the plant and machinery;
- (ii) the historical cost of plant and machinery is Rs. 2 lacs;
- (iii) the plant and machinery physically exists;
- (iv) the asset is being utilised in the business of the company productively;
- (v) total charge of depreciation on this asset is Rs. 83,000 to date on which Rs. 13,000 relates to the year in respect of which the accounts are drawn up; and
- (vi) the amount of depreciation has been calculated on recognised basis and the calculation is correct.

(d) **Tests of Controls:** The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when-

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

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

2. (i) **Incorrect:** Letter of weakness is a report issued by auditor stating the weakness in internal control mechanism. It also suggests measures by which the weakness in the system to be corrected and the control system be made better protected.
- (ii) **Correct:** Comptroller and Auditor-General of India may, in case of a government company, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company.

- (iii) **Incorrect:** As per section 141(3) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company whose relative is a Director or is in the employment of the company as a Director or Key Managerial Personnel.
- (iv) **Incorrect:** As per AS-2 on Valuation of Inventories, in determining the cost of inventories, it is appropriate to exclude selling and distribution costs and recognise them as expenses in the period in which they are incurred. Therefore, it is not appropriate to include selling and distribution cost in the cost of inventories.
- (v) **Incorrect:** The auditor shall modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.
- (vi) **Incorrect:** Internal check has been defined as "checks on day-to-day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". Internal check is a part of the overall internal control system and operates as a built-in device as far as the staff organisation and job allocation aspects of the control system are concerned.
- (vii) **Incorrect:** As per SA 620 "Using the Work of an Auditor's Expert", if the auditor, in the interest of the users includes the name of the expert in his audit report, he can do so only after obtaining the prior permission of the auditor's expert.
- (viii) **Incorrect:** As per section 141(2) of the Companies Act, 2013, where a firm including a limited liability partnership (LLP) 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.
- (ix) **Correct:** SA 520 "Analytical Procedures" states that the auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.
- (x) **Correct:** For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. The scrutiny of Bank Reconciliation Statement is one of the Audit techniques commonly adopted by the auditors.

3. (a) **Bad Debts:** The following procedure may be adopted for verifying bad debts-

- (i) The amount of bad debts should be traced to the schedule of bad debts written off during the year.
- (ii) Major amount of bad debts in the schedule be taken for scrutiny.

- (iii) Check that the amount considered in write off had been overdue for long and scrutinize the correspondence files.
- (iv) Check the authority for write off and the level of authority is sufficient higher than the executive involved in collection.
- (v) The bad debts should be properly disclosed in Statement of Profit and Loss according to its materiality.
- (vi) If provision had already been created for bad debts, see that to the extent of actual bad debts written off, the provision is released.

(b) **Cash at Bank:** While testing the authenticity of cash at bank, the following areas may be considered by the auditor-

- (i) Apart from comparing the entries in the cash book with those in the Pass Book the auditor should obtain a certificate from the bank confirming the balance at the close of the year as shown in the Pass Book.
- (ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.
- (iii) Pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment write-off.
- (iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.
- (v) The auditor should examine the possibility, that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.
- (vi) In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.
- (vii) Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.
- (viii) The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.

- (ix) Where material amounts are held in bank accounts which are blocked, e.g. in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.
- (x) Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

(c) Lease Hold Property: Following are the main steps involved in verification/vouching of lease hold property-

- (i) Inspect the lease agreement to ascertain the amount of premium, if any, for securing the lease and terms and conditions. A lease exceeding the period of one year is not valid unless it has been registered by an instrument. Hence this has to be ensured.
- (ii) Ascertain that all the conditions, the failure of which may result in cancellation of the lease have been complied with, e.g. payment of ground rent, insurance premium, maintenance of lease and property in satisfactory state etc.
- (iii) Ensure that due provisions for any claims that might arise under the dilapidation clause on the expiry of the lease have been made. If such provision has not been made, the auditor should draw the client's attention to it.
- (iv) Ensure that the outlay and legal expenses incurred to acquire lease property have been capitalised. The property must be written off in such a way that it completely wipes off the asset at the end of the lease period.
- (v) He should ascertain that the clause entitles the lessee to sub-let any part of the leased property and ensure its proper compliance.

(d) Profit or Loss Arising on Sale of Plots Held by Real Estate Dealer: The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value, whichever is less.

Profit or loss arising on sale of plots of land by Real Estate Dealer should be verified as follows-

- (i) Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realised for it.

- (ii) This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinised.
- (iii) If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.
- (iv) Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.
- (v) The prices obtained for various plots of land sold should be checked with the plan map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be verified on a reference to certified copies of sale deeds executed.
- (vi) Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.

4. (a) Operating Conditions Casting Doubt About Going Concern Assumption: As per SA 570 “Going Concern”, following are the examples of operating events or conditions that, may cast significant doubt about the going concern assumption-

- (i) Management intentions to liquidate the entity or to cease operations.
- (ii) Loss of key management without replacement.
- (iii) Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- (iv) Labour difficulties.
- (v) Shortages of important supplies.
- (vi) Emergence of a highly successful competitor.

(b) Inquiring from Management to Evaluate Subsequent Event: As per SA 560 “Subsequent Events”, in inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters-

- (i) Whether new commitments, borrowings or guarantees have been entered into.
- (ii) Whether sales or acquisitions of assets have occurred or are planned.
- (iii) Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.

- (iv) Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
- (v) Whether there have been any developments regarding contingencies.
- (vi) Whether any unusual accounting adjustments have been made or are contemplated.
- (vii) Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
- (viii) Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- (ix) Whether any events have occurred that are relevant to the recoverability of assets.

(c) **Professional Skepticism:** As per SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Therefore, professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of overlooking unusual circumstances, over generalising when drawing conclusions from audit observations or using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Further, while obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. This requirement is also designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Therefore, we do agree with the statement.

5. (a) **Internal Control Questionnaire:** Internal control questionnaire is a comprehensive series of questions concerning internal control. It is the most widely used form for collecting information about the existence, operation and efficiency of internal control in the organisation.

In the questionnaire, questions are generally so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.

The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail.

(b) **Reporting for Disqualification of a Director:** Section 143(3)(g) of the Companies Act, 2013 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as a director under section 164(2) of the Companies Act, 2013. As per provisions of section 164(2) of the said Act, if a director is already holding a directorship of a company which has not filed the financial statements or annual returns for any continuous period of three financial years shall not be eligible to be reappointed as a director of that company or appointed in other company for a period of five years from the date on which the said company fails to do so.

In this case, Mr. A is a director of X Pvt. Ltd. as well as of Y Pvt. Ltd., and, Y Pvt. Ltd. has not filed the financial statements and annual return for last three years. Hence, the provisions of section 164(2) are applicable to him and as such he is disqualified from directorship of both the companies. Therefore, the auditor shall report about the disqualification under section 143(3)(g) of the Companies Act, 2013.

(c) **Special Steps Involved in Audit of a Cinema Hall:**

(i) Verify-

(a) that entrance to the cinema hall is only through printed tickets;

- (b) tickets are serially numbered and bound into books;
- (c) that the number of tickets issued for each show and class are different;
- (d) that for advance booking a separate series of tickets is issued and
- (e) inventory of tickets is kept in proper custody.
- (ii) If tickets are issued through computer - audit the system to ensure its reliability and authenticity of data generated by it.
- (iii) System should provide that at the end of each show a proper statement should be prepared and cash collected be tallied.
- (iv) Cash collected is deposited in banks partly on the same day and rest on the next day – depending upon the banking facility available.
- (v) Verify that proper record is kept for free passes issued and the same are issued under proper authority.
- (vi) Cross check the entertainment tax deposited.
- (vii) Verify the income from advertisements and slides showed before the show.
- (viii) Vouch the expenditure incurred on publicity of picture, maintenance of hall, electricity expenses etc.
- (ix) Vouch recoveries of advertisement expenses etc from film distributors.
- (x) Vouch payment of film hire with reference to agreement with distributor or producer.
- (xi) Verify the basis of other incomes earned like restaurant, car and scooter parking and display windows etc.
- (xii) Confirm that depreciation on machinery and furniture has been charged at appropriate rates which are higher, as compared to those admissible in the case of other businesses, in respect of similar assets.

6. (a) **Donation to Charitable Institutions:** Section 181 of the Companies Act, 2013 provides that the Board of Directors of a company may contribute to *bonafide* charitable and other funds with prior permission of the company in general meeting for such contribution in case any amount the aggregate of which, in any financial year, exceed 5% of its average net profits for the three immediately preceding financial years.

In the instant case, XYZ Ltd., a manufacturing concern, has given donation of Rs. 60,000 each to two charitable organisations which amounts to Rs. 1,20,000. The average profits of the last 3 years is Rs. 20 lakhs and the 5% of this works out to Rs. 1,00,000. Hence the maximum of donation could be Rs. 1,00,000 only. For excess of Rs. 20,000, the company is required to take prior permission in general meeting which has not been taken.

By paying donations of Rs. 1,20,000 which is more than Rs. 1,00,000, the Board has contravened the provisions of section 181 of the Companies Act, 2013. Hence, the auditor should qualify his audit report accordingly.

(b) Duties of Auditor if Company Alter its Capital Clause: The auditor's duties in the circumstances shall be-

- (i) to verify that the alteration of capital is authorised by the Articles;
- (ii) to inspect the minutes of the shareholders authorising the alteration;
- (iii) to obtain Allotment Lists containing details of the new holdings of share or stock by each member and to verify the same with the entries;
- (iv) to inspect the directors' resolution in regard to allotment, consolidation, conversion or sub-division passed pursuant to the resolution of the members;
- (v) to examine the cancelled share certificates, if any, and agree the same with the counterfoils of new certificates issued;
- (vi) to see that the procedure, prescribed by the Articles in this regard, has been complied with;
- (vii) to verify that the share capital account is correctly shown in the Balance Sheet; and
- (viii) to see that the necessary intimation to the Registrar contemplated by section 64 of the Companies Act, 2013 has been sent.

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

Municipal government in India covers five distinct types of urban local authorities, viz., the municipal corporations, the municipal councils, the notified area committees, the town area committees and the cantonment committees.

Audit Programme for Local Bodies:

- (i) The Local Fund Audit Wing of the State Govt. is generally in charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure authenticity of his appointment.
- (ii) The auditor while auditing the local bodies should report on the fairness of the contents and presentation of financial statements, the strengths and weaknesses of system of financial control, the adherence to legal and/or

administrative requirements; upon whether value is being fully received on money spent. His objective should be to detect errors and fraud and misuse of resources.

- (iii) The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.
- (iv) He should ensure that all types of sanctions, either special or general, accorded by the competent authority.
- (v) He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.
- (vi) The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

7. (a) **Importance of Working Papers:** Working papers are very useful to the auditor as discussed below-

- (i) It provides guidance to the audit staff with regard to manner of checking the schedules.
- (ii) The auditor is able to fix responsibility on the staff members who signs each schedule.
- (iii) It acts as an evidence in the court of law when a charge of negligence is brought against the auditor.
- (iv) It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

(b) **Advantages of Continuous Audit:**

- (i) Errors are discovered earlier with the result that there is adequate time for making the necessary rectification.
- (ii) Because of the frequent attendance of the auditor, the opportunities of committing frauds are reduced.
- (iii) Fraud, if perpetrated, is detected sooner with the result that size of the fraud is limited and also the chances of recovering the amount lost are improved.
- (iv) The attendance of the audit staff acts a moral check on the client's staff.
- (v) The client's accounts are always kept up-to-date.
- (vi) Since audit can be carried on throughout the year, there is more time for detailed checking of the accounts when the audit is taken up at the close of the year.

- (vii) If the audit of routine transactions is completed before the close of the year, the final accounts can be prepared and reported upon much earlier.
- (viii) If the auditor carries on a continuous audit, he remains constantly in touch with the client's affairs thereby able to carry out his duties efficiently.
- (ix) In the case of continuous audit, the work of the auditor is greatly facilitated since he is in a better position to plan out his engagements and take up the job at his convenience, avoiding the pressure at the close of the financial year when most of the business firms usually close their accounts.

(c) Circumstances where Retiring Auditor cannot be Reappointed: In the following circumstances, the retiring auditor cannot be reappointed-

- (i) A specific resolution has not been passed to reappoint the retiring auditor.
- (ii) The auditor proposed to be reappointed does not possess the qualification prescribed under section 141 of the Companies Act, 2013.
- (iii) The proposed auditor suffers from the disqualifications under section 141(3), 141(4) and 144 of the Companies Act, 2013.
- (iv) He has given to the company notice in writing of his unwillingness to be reappointed.
- (v) A resolution has been passed in AGM appointing somebody else or providing expressly that the retiring auditor shall not be reappointed.
- (vi) A written certificate has not been obtained from the proposed auditor to the effect that the appointment or reappointment, if made, will be in accordance within the limits specified under section 141(3)(g) of the Companies Act, 2013.

(d) Verification of Receipt of Applications for Shares along with Application Money: Amount received along with the applications for shares may be verified in the following manner-

- (i) Check entries in the Application and Allotment Book (or Sheets) with the original applications;
- (ii) Check entries in the Application and the Allotment Book as regards deposits of money, received with the applications, with those in the Cash Book;
- (iii) Vouch amounts refunded to the unsuccessful applicants with copies of Letters of Regret;
- (iv) Check the totals columns in the Application and Allotment Book and confirm the journal entry debiting Share Application Account and crediting Share Capital Account.

(e) Audit Techniques: For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. Some of the techniques commonly adopted by the auditors are the following-

- (i) Posting checking
- (ii) Casting checking
- (iii) Physical examination and count
- (iv) Confirmation
- (v) Inquiry
- (vi) Year-end scrutiny
- (vii) Re-computation
- (viii) Tracing in subsequent period
- (ix) Bank Reconciliation.

Test Series: February, 2016

MOCK TEST PAPER – 1

INTERMEDIATE (IPC): GROUP – II

PAPER – 7: INFORMATION TECHNOLOGY AND STRATEGIC MANAGEMENT

SECTION – A: INFORMATION TECHNOLOGY

Question No. 1 is compulsory.

Attempt any **five** questions from the rest.

Time Allowed – 1½ Hours

Maximum Marks – 50

1. Answer all the following questions in brief.
 - (i) Six Sigma
 - (ii) Decision Tree
 - (iii) Micro Architecture
 - (iv) Virtual Memory
 - (v) Modem
 - (vi) HTTPS (Hyper Text Transfer Protocol Secure)
 - (vii) Transaction Processing System
 - (viii) Smart Cards
 - (ix) Cryptographic Controls
 - (x) Customer Relationship Management Software $(1 \times 10 = 10 \text{ Marks})$
2. (a) Differentiate between Unstructured Threats and Structured Threats. (4 Marks)
(b) Discuss the benefits of e-Commerce Application. (4 Marks)
3. (a) What do you understand by the term “Information System”? Discuss its components in brief. (4 Marks)
(b) Discuss Human Resource Management System (HRMS). (4 Marks)
4. (a) Discuss “Communication Controls” under “Application Functions Based Controls”? (4 Marks)
(b) Differentiate between Manual Information Processing Cycle and Computerized Information Processing Cycle. (4 Marks)
5. (a) Discuss Value Chain Automation, in brief. (3 Marks)
(b) Discuss various success factors of Business Process Reengineering (BPR). (5 Marks)

6. (a) Discuss multiple types of cloud in Cloud Computing Environment. (4 Marks)
(b) Discuss Information System Life Cycle in brief. (4 Marks)

7. Write short notes on any **four** of the following.
(a) Process Management
(b) Application Software
(c) Virtual Private Network (VPN)
(d) Business Intelligence
(e) Grid Computing Security (4 × 2 = 8 Marks)

Test Series: February, 2016

MOCK TEST PAPER – 1

INTERMEDIATE (IPC) GROUP – II

PAPER –7: INFORMATION TECHNOLOGY AND STRATEGIC MANAGEMENT

SECTION – B: STRATEGIC MANAGEMENT

Question No.1 is compulsory.

*Attempt any **five** questions from the rest.*

Time Allowed – 1½ Hours	Maximum Marks – 50
1. (a) A strategic group consists of rival firms with similar competitive approaches and positions in the market. Elucidate the statement.	(3 Marks)
(b) A company appointed you as a Strategic Manager. Being a Strategic Manager what should be your tasks to perform?	(3 Marks)
(c) "A strategic professional has to analyze and redesign the work flows in the context of business process reengineering" – Briefly explain.	(3 Marks)
(d) 'A network structure is suited to unstable environment.' Elaborate.	(3 Marks)
(e) "Environment is the sum of several External and Internal forces that affect the functioning of business." Explain.	(3 Marks)
2. (a) State with reasons which of the following statements is correct/incorrect:	
(i) Balance scorecard is a combination of strategic and marketing objectives.	
(ii) Functional level constitutes the lowest hierarchical level of strategic management.	(2 x 2 = 4 Marks)
(b) Explain the meaning of the following concepts:	
(i) Joint venture.	
(ii) Horizontal integrated diversification.	
(iii) Value chain analysis.	(3 x 1 = 3 Marks)
3. Write short notes on the following:	
(a) Strategic vision.	(2 Marks)
(b) Management issues central to strategy implementation.	(2 Marks)
(c) Corporate culture.	(3 Marks)
4. "The state of competition in an industry is a composite of competitive pressures operating in five areas of the overall market." Explain the model which supports the statement.	(7 Marks)

5. Mr. Aryan is a manager in ABC Ltd. Discuss his leadership role played by him in pushing for good strategy execution. (7 Marks)
6. "Evaluating the worth of a business is central to strategy implementation." In the light of this statement, explain the methods that can be used for determining the worth of a business. (7 Marks)
7. (a) In the light of BCG Growth Matrix state the situation under which the following strategic options are suitable:
 - (i) Build
 - (ii) Hold
 - (iii) Harvest
 - (iv) Divest $(4 \times 1 = 4 \text{ Marks})$
- (b) Distinguish between Cost Leadership and Differentiation Strategies. (3 Marks)

Test Series: February, 2016

MOCK TEST PAPER – 1

INTERMEDIATE (IPC): GROUP – II

PAPER – 7: INFORMATION TECHNOLOGY AND STRATEGIC MANAGEMENT

SECTION – A: INFORMATION TECHNOLOGY

SUGGESTED ANSWERS / HINTS

1. (i) **Six Sigma:** Six Sigma is a set of strategies, techniques, and tools for process improvement. It seeks to improve the quality of process outputs by identifying and removing the causes of defects and minimizing variability in manufacturing and business processes.
- (ii) **Decision Tree:** A Decision Tree is a collection of a basis (condition) and a conclusion (action). In its tree-like representation, the premises and conclusions are shown as nodes, and the branches of the tree connect the premises and the conclusions.
- (iii) **Micro Architecture:** It is a lower level detailed description of the system that is sufficient for completely describing the operation of all parts of the computing system, and how they are inter-connected and inter-operate in order to implement the ISA.
- (iv) **Virtual Memory:** Virtual Memory is not a separate device but an imaginary memory area supported by some operating systems (for example, Windows) in conjunction with the hardware. Virtual memory combines computer's RAM with temporary space on the hard disk.
- (v) **Modem:** A MODEM is a device that converts a digital computer signal into an analog telephone signal (i.e. it modulates the signal) and converts an analog telephone signal into a digital computer signal (i.e. it demodulates the signal) in a data communication system. The word "modem" is a contraction of modulate and demodulate. Modems are required to send computer data with ordinary telephone lines because computer data is in digital form but telephone lines are analog.
- (vi) **HTTPS (Hyper Text Transfer Protocol Secure):** Hypertext Transfer Protocol Secure (HTTPS) is a communications protocol for secure communication over a computer network, with especially wide deployment on the Internet. The security of HTTPS uses long term public and secret keys to exchange a short term session key to encrypt the data flow between client and server.
- (vii) **Transaction Processing System:** A **Transaction Processing System (TPS)** may be defined as a type of information system that collects, stores, modifies and retrieves the day-to-day data transactions of an enterprise. Archetypal examples of such systems would be used in an Airline Reservation Systems, Railway reservation

by IRCT, Banking Systems, or the Accounting System of roughly any outsized company.

(viii) **Smart Cards:** Smart cards have an embedded microchip instead of magnetic strip. The chip contains all the information a magnetic strip contains but offers the possibility of manipulating the data and executing applications on the card. Contact Cards, Contactless Cards and Combi/Hybrid Cards are three types of smart cards.

(ix) **Cryptographic Controls:** Cryptographic Controls are designed to protect the privacy of data and to prevent unauthorized modifications of data. Cryptography achieves this goal by scrambling data into codes (cryptograms) so that it is meaningless to anyone who does not possess the authentication to access the respective system resource or file.

(x) **Customer Relationship Management Software:** These are specialized applications catering to the need of organizations largely in FMCG (Fast-Moving Consumer Goods) categories. These entities need to interact with their customers and respond to them. The response may be in the form of service support or may lead to product innovation. These are sought by entities, which deal directly with consumers.

2. (a) **Unstructured Threats** - These originate mostly from inexperienced individuals using easily available hacking tools from the Internet. Many tools available to anyone on the Internet can be used to discover weaknesses in a company's network. These include port-scanning tools, address-sweeping tools, and many others. Most of these kinds of probes are done more out of curiosity than with a malicious intent in mind. For example, if a company's external web site is hacked; the company's integrity is damaged. Even if the external web site is separate from the internal information that sits behind a protective firewall, the public does not know that. All they know is that if the company's web site is hacked, then it is an unsafe place to conduct business.

Structured Threats - These originate from individuals who are highly motivated and technically competent and usually understand network systems design and the vulnerabilities of those systems. They can understand as well as create hacking scripts to penetrate those network systems. An individual who presents a structured threat typically targets a specific destination or group. Usually, these hackers are hired by industry competitors, or state-sponsored intelligence organizations.

(b) e-Commerce presents immense benefits to individual organizations, consumers, and society as a whole. Some of them are as follows:

- ◆ Reduction in costs to buyers from increased competition in procurement as more suppliers are able to compete in an electronically open marketplace.
- ◆ Reduction in errors, time, and overhead costs in information processing by eliminating requirements for re-entering data.

- ◆ Reduction in costs to suppliers by electronically accessing on-line databases of bid opportunities, on-line abilities to submit bids, and on-line review of rewards.
- ◆ Reduction in time to complete business transactions, particularly from delivery to payment.
- ◆ Creation of new markets through the ability to easily and cheaply reach potential customers.
- ◆ Easier entry into new markets, especially geographically remote markets, for enterprises regardless of size and location.
- ◆ Better quality of goods as specifications are standardized and competition is increased and improved variety of goods through expanded markets and the ability to produce customized goods.
- ◆ Faster time to market as business processes are linked, thus enabling seamless processing and eliminating time delays.
- ◆ Optimization of resource selection as businesses form cooperative teams to increase the chances of economic successes, and to provide the customer products and capabilities more exactly meeting the requirements.
- ◆ Reduction in inventories and reduction of risk of obsolete inventories as the demand for goods and services is electronically linked through just-in-time inventory and integrated manufacturing techniques.
- ◆ Reduction in overhead costs through uniformity, automation, and large-scale integration of management processes.
- ◆ Reduction in use of ecologically damaging materials through electronic coordination of activities and the movement of information rather than physical objects).
- ◆ Reduction in advertising costs.

3. (a) **Information System:** Information System (IS) is a combination of people, hardware, software, communication devices, network and data resources that processes (can be storing, retrieving, transforming information) data and information for a specific purpose. The system needs inputs from user (key in instructions and commands, typing, scanning) which will then be processed (calculating, reporting) using technology devices such as computers, and produce output (printing reports, displaying results) that will be sent to another user or other system via a network and a feedback method that controls the operation.

In general, any specific Information System aims to support operations, management and decision-making.

The major Components of Information System are as follows:

(i) **People Resources** consist of end users and IT specialists;

- (ii) **Hardware resources** involve machines and media; **Software resources** include programs and procedures; and
- (iii) **Data resources** include data and knowledge bases. These are transformed by information processing activities into a variety of information products for end users; and
- (iv) **Network resources** include communications media and networks;
- (v) **Information processing** consists of the system activities of input, processing, output, storage, and control.

All components of Information Systems are mutually connected and cannot exist individually. The relationship between separated components is defined for best process efficiency.

- (b) **Human Resource Management System (HRMS):** A Human Resources Management System (HRMS) is a software application that coalesce many human resources functions, together with benefits administration, payroll, recruiting and training, and performance analysis and assessment into one parcel. In other words, HRMS refers to the systems and processes at the intersection between human resource management (HRM) and information technology.

Some of the key modules of HRMS are as below:

- **Workforce Management:** Integrated across the strategic Human Capital Management (HCM) solution, Workforce Management provides powerful tools to effectively manage labor rules, ensure compliance, and control labor costs and expenses.
- **Time and Attendance Management:** The time and attendance module gathers standardized time and work related efforts. The most advanced modules provide broad flexibility in data collection methods, labor distribution capabilities and data analysis features.
- **Payroll Management:** This module of the system is designed to automate manual payroll functions and facilitate salary, deductions etc calculations, eliminates errors and free up HR staff for more productive tasks.
- **Training Management:** The module tracks the trainer or training organization, costs associated with training schedules. The module also tracks training locations, required supplies and equipment and registered attendees.
- **Compensation Management:** Compensation Management allows integrating employee processes, information and programs with organizational processes and strategies to achieve optimal organizational results.
- **Recruitment Management:** This module helps in hiring the right people with the right target skills and includes processes for managing open

positions/requisitions, applicant screening, assessments, selection and hiring, correspondence, reporting and cost analysis.

- **Personnel Management:** The personnel management comprises of HR master-data, personnel administration, recruitment and salary administration.
- **Organizational Management:** Organizational management includes, organizational structure, staffing schedules & job description.
- **Employee Self Service (ESS):** The employee self-service module allows employees to query HR related data and perform some HR transactions over the system. The module also lets supervisors approve Over-Time requests from their subordinates through the system without overloading the task on HR department.
- **Analytics:** The Analytics module enables organizations to extend the value of an HRMS implementation by extracting HR related data for use with other business intelligence platforms.

4. (a) **Communication Controls:** Components in the communication subsystem are responsible for transporting data among all the other subsystems within a system and for transporting data to or receiving data from another system. Three types of exposure arise in the communication subsystem.

- (a) As data is transported across a communication subsystem, it can be impaired through attenuation, delay distortion, and noise.
- (b) The hardware and software components in a communication subsystem can fail.
- (c) The communication subsystem can be subjected to passive or active subversive attacks.
 - **Physical Component Controls:** One way to reduce expected losses in the communication subsystem is to choose physical component that have characteristics that make them reliable and that incorporate features or provide controls that mitigate the possible effects of exposures. These controls involve Transmission Media - Bounded (Guided) Media or Unbounded (Unguided) Media; Communication Lines – Private (Leased) or Public; Modems; Port Protection Devices; Multiplexors and Concentrators.
 - **Line Error Controls:** Whenever data is transmitted over a communication line, it can be received in error because of attenuation, distortion, or noise that occurs on the line. Error Detection and Error Correction are the two major approaches under Line Error Controls.
 - **Flow Controls:** These are needed because two nodes in a network can differ in terms of the rate at which they can send receive and process data. The simplest form of flow control is “Stop-and-Wait Flow Control” in

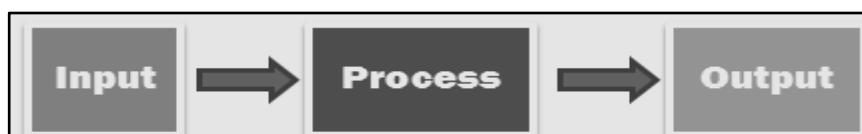
which the sender transmits a frame of data only when the receiver is ready to accept the frame.

- **Link Controls:** This involves two common protocols – HDLC (Higher Level Data Control) and SDLC (Synchronous Data Link Control).
- **Topological Controls:** A communication network topology specifies the location of nodes within a network, the ways in which these nodes will be linked, and the data transmission capabilities of the links between the nodes. Some of the four basic topologies include Bus, Ring, Star and Tree Topology.
- **Channel Access Controls:** Two different nodes in a network can compete to use a communication channel. Whenever the possibility of contention for the channel exists, some type of channel access control technique must be used. These techniques fall into two classes – **Polling methods** and **Contention methods**.
- **Internetworking Controls:** Internetworking is the process of connecting two or more communication networks together to allow the users of one network to communicate with the users of other networks. Three types of devices are used to connect sub-networks in an Internet: Bridge, Router and Gateway.

(b) **Manual Information Processing Cycle:** These are the systems where the level of manual intervention is very high. For example: valuation of exam papers, teaching, operations in operation theatres, ticket checking by railway staff in trains, buying of grocery, billing done by small medical shops, people maintaining books manually, etc. Components of manual information processing cycle include:

- ◆ **Input:** Put details in register.
- ◆ **Process:** Summarize the information.
- ◆ **Output:** Present information to management in the form of reports.

As the level of human intervention is very high the quality of information generated from these systems is prone to flaws such as delayed information, inaccurate information, incomplete information and low levels of detail.

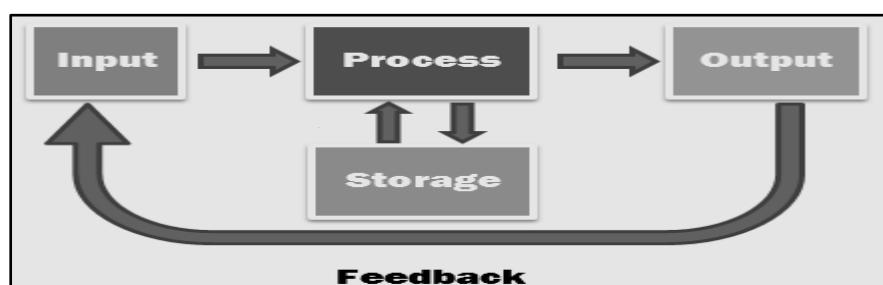


Manual Processing Cycle

Computerized Information Processing Cycle: These are systems where computers are used at every stage of transaction processing. The components of a computerized information processing cycle include:

- ◆ **Input:** Entering data into the computer;
- ◆ **Processing:** Performing operations on the data;
- ◆ **Storage:** Saving data, programs, or output for future use; and
- ◆ **Output:** Presenting the results.

As the processing is computerized the quality of information generated from these systems is timely, accurate, fast and reliable.



Computerized Processing Cycle

5. (a) **Value Chain Automation:** Value Chain refers to separate activities which are necessary to strengthen an organization's strategies and are linked together both inside and outside the organization. It is defined as a chain of activities that a firm operating in a specific industry performs in order to deliver a valuable product or service for the market. The idea of the Value Chain is based on the process view of organizations, the idea of seeing a manufacturing (or service) organization as a system, made up of subsystems each with inputs, transformation processes and outputs. Value chain of a manufacturing organization comprises of Primary and Supportive activities. The primary ones are inclusive of inbound logistics, operations, outbound logistics, marketing and sales, and services. The supportive activities relate to procurement, human resource management, technology development and infrastructure.

Six business functions of the value chain are Research and development; Design of products, services, or processes; Production; Marketing and sales; Distribution and Customer service. Value Chain Analysis is a useful tool for working out how we can create the greatest possible value for our customers. IT helps us identify the ways in which we create value for our customers and then helps us think through how we can maximize this value: whether through superb products, great services, or jobs well done.

(b) Various success factors of Business Process Re-engineering (BPR) are as follows:

- (i) **Organization wide commitment:** Changes to business processes would have a direct impact on processes, organizational structures, work culture, information flows, infrastructure & technologies and job competencies. This requires strong leadership, support and sponsorship from the top management. Top management not only has to recognize the need for change but also has to convince every affected group about the potential benefits of the change to the organization as a whole and secure their commitment.
- (ii) **BPR team composition:** A BPR team is formed which would be responsible to take the BPR project forward and make key decisions and recommendations. The BPR team would include active representatives from top management, business process owners, technical experts and users.
- (iii) **Business needs analysis:** It is important to identify exactly what current processes need reengineering. This would help determine the strategy and goals for BPR. A series of sessions are held with the process owners and stakeholders and all the ideas would be evaluated to outline and conceptualize the desired business process. The outcome of this analysis would be BPR project plan – identifying specific problem areas, setting goals and relating them to key business objectives. This alignment of the BPR strategy with the enterprise strategy is one of the most important aspects.
- (iv) **Adequate IT infrastructure:** Adequate investment in IT infrastructure in line is of vital importance to successful BPR implementation. IT infrastructure is a set of hardware, software, networks, facilities, etc. in order to develop, test, deliver, monitor, control or support IT services. Effective alignment of IT infrastructure to BPR strategy would determine the success of BPR efforts.
- (v) **Effective change management:** BPR involves changes in people behavior and culture, processes and technologies. An effective change management process would consider the current culture to foster a change in the prevailing beliefs, attitudes and behaviors effectively. The success of BPR depends on how effectively management conveys the need for change to the people.
- (vi) **Ongoing continuous improvement:** BPR is an ongoing process; hence innovation and continuous improvement are key to the successful implementation of BPR.

6. (a) The Cloud Computing environment can consist of multiple types of clouds based on their deployment and usage. These are explained as follows:

- **Public Cloud:** The public cloud is made available to the general public or a large industry group and is administrated by third parties or vendors over the Internet, and services are offered on pay-per-use basis. It is widely used in the development, deployment and management of enterprise applications, at

affordable costs; and allows organizations to deliver highly scalable and reliable applications rapidly and at more affordable costs.

- **Private Clouds:** This cloud computing environment resides within the boundaries of an organization and is used exclusively for the organization's benefits. They are built primarily by IT departments within enterprises who seek to optimize utilization of infrastructure resources within the enterprise by provisioning the infrastructure with applications using the concepts of grid and virtualization. The benefit of a Private Cloud is that it enables an enterprise to manage the infrastructure and have more control, but this comes at the cost of IT department creating a secure and scalable cloud.
- **Community Clouds:** This is the sharing of computing infrastructure in between organizations of the same community. For example, all Government organizations within India may share computing infrastructure on the cloud to manage data. The risk is that data may be stored with the data of competitors.
- **Hybrid Clouds:** It is a composition of two or more clouds (Private, Community or Public) and is maintained by both internal and external providers. They have to maintain their unique identity, but are bound together by standardized data and application portability. With a hybrid cloud, organizations might run non-core applications in a public cloud, while maintaining core applications and sensitive data in-house in a private cloud.

(b) **Information system Life Cycle:** This is commonly referred as Software/System Development Life Cycle (SDLC), which is a methodology used to describe the process of building information systems. It is the logical starting point in the entire life cycle of a computerized system. Activities start when any enterprise decides to go for computerization or migrate from existing computerized system to a new one.

Phase 1: System Investigation - This phase examines that 'What is the problem and is it worth solving'? Feasibility study is done under the following dimensions:

- ◆ **Technical feasibility:** Does the technology exist to implement the proposed system or is it a practical proposition?
- ◆ **Economic feasibility:** Is proposed system cost-effective: if benefits do not outweigh costs, it's not worth going ahead?
- ◆ **Legal feasibility:** Is there any conflict between the proposed system and legal requirements?
- ◆ **Operational feasibility:** Are the current work practices and procedures adequate to support the new system?
- ◆ **Schedule feasibility:** How long will the system take to develop, or can it be done in a desired time-frame?

Phase 2: System Analysis - This phase examines that 'What must the Information System do to solve the problem'? The Systems Analyst examines data and information flows in the enterprise using data flow diagrams; establishes what the proposed system will actually do (not how it will do it); analyzes costs and benefits; outlines system implementation options (e.g. in-house or using consultants); considers possible hardware configurations; and makes recommendations.

Phase 3: System Designing - This phase examines that 'How will the Information System do what it must do to obtain the solution to the problem'? This phase specifies the technical aspects of a proposed system in terms of Hardware platform, Software, Outputs, Inputs, User interface, Modular design, Test plan, Conversion plan and Documentation.

Phase 4: System Implementation - This phase examines that 'How will the Solution be put into effect'? This phase involves Coding and testing of the system; Acquisition of hardware and software; and either installation of the new system or conversion of the old system to the new one.

In Installation, new hardware, which may involve extensive re-cabling and changes in office layouts are installed; Training the users on the new system; and Conversion of master files to the new system or creation of new master files.

Phase 5: System Maintenance and Review - This phase evaluates results of solution and modifies the system to meet the changing needs. Post implementation review would be done to address Programming amendments, Adjustment of clerical procedures, Modification of Reports, and Request for new programs.

This is often the longest of the stages since it is an on-going process having some sort of long term continuum.

7. (a) **Process Management:** Process management is based on a view of an organization as a system of interlinked processes which involves concerted efforts to map, improve and adhere to organizational processes. To manage a process,

- ◆ The first task is to define it. This involves defining the steps (tasks) in the process and mapping the tasks to the roles involved in the process.
- ◆ Once the process is mapped and implemented, performance measures can be established. Establishing measurements creates a basis to improve the process.
- ◆ The last piece of the process management definition describes the organizational setup that enables the standardization of and adherence to the process throughout the organization. Assigning enterprise process owners and aligning employees' performance reviews and compensation to the value creation of the processes could accomplish this.

(b) Application Software: Application software includes all those computer software that cause a computer to perform useful tasks beyond the running of the computer itself. It is a collection of programs which address a real life problem of its end users which may be business or scientific or any other problem. The different types of application software are Application Suite, Enterprise Software, Enterprise Infrastructure Software, Information Worker Software, Content Access Software, Educational Software, Media Development Software etc.

Some of the most popular and widely accepted benefits of Application Software are to address user needs, less threat from virus and Regular updates. However, there are certain disadvantages of such software as well. Development is costly and may be Infected from Malware.

(c) Virtual Private Network (VPN): Virtual Private Network (VPN) is a secure network that uses the Internet as its main backbone network, but relies on the firewalls and other security features of the Internet and Intranet connections and those of participating organizations. Many organizations use Virtual Private Networks (VPNs) to establish secure intranets and extranets. A VPN is a private network that uses a public network (usually the Internet) to connect remote sites or users together. The VPN uses "virtual" connections routed through the Internet from the business's private network to the remote site or employee. By using a VPN, businesses ensure security - anyone intercepting the encrypted data can't read it.

(d) Business Intelligence: **Business Intelligence (BI)** is the delivery of accurate, useful information to the appropriate decision makers within the necessary time frame to support effective decision making for business processes. It is comprised of information that contains patterns, relationships, and trends about customers, suppliers, business partners and employees. Business intelligence systems process, store and provide useful information to the user who need it, when they need it. It can handle large amounts of information to help identify and develop new opportunities. BI, in simple words, refers to the process of collecting and refining information from many sources, analyzing and presenting the information in useful ways so that users can make better business decisions. It is essentially timely, accurate, high-value, and actionable business insights, and the work processes and technologies used to obtain them.

(e) Grid Computing Security: Grid systems and applications require standard security functions which are Authentication, Access Control, Integrity, Privacy, and No Repudiation. Authentication and access control issues are:

- To provide authentication to verify the users, process which have user's computation and resources used by the processes to authenticate
- To allow local access control mechanisms to be used without change.

To develop security architecture, following constraints are taken from the characteristics of grid environment and application.

- **Single Sign-on:** A user should authenticate once and they should be able to acquire resources, use them, and release them and to communicate internally without any further authentication.
- **Protection of Credentials:** User passwords, private keys, etc. should be protected.
- **Interoperability with local security solutions:** Access to local resources should have local security policy at a local level. Despite of modifying every local resource there is an inter-domain security server for providing security to local resource.
- **Exportability:** The code should be exportable i.e. they cannot use a large amount of encryption at a time. There should be a minimum communication at a time.
- **Support for secure group communication:** In a communication there are number of processes which coordinate their activities. This coordination must be secure and for this there is no such security policy.
- **Support for multiple implementations:** There should be a security policy which should provide security to multiple sources based on public and private key cryptography.

Test Series: February, 2016

MOCK TEST PAPER – 1

INTERMEDIATE (IPC): GROUP – II

PAPER – 7: INFORMATION TECHNOLOGY AND STRATEGIC MANAGEMENT

SECTION – B: STRATEGIC MANAGEMENT

SUGGESTED ANSWERS/HINTS

1. (a) A strategic group consists of those rival firms that have similar competitive approaches and positions in the market. Organisations in the same strategic group can resemble one another in any of the several ways: they may have comparable product-line breadth, sell in the same price/quality range, emphasize the same distribution channels, use essentially the same product attributes to appeal to similar types of buyers, depend on identical technological approaches, or offer buyers similar services and technical assistance.

Identifying strategic group is required to examine the industry's competitive structure in the process of strategic analysis.

1. (b) Being a strategic manager, my primary task of the will be conceptualizing, designing and executing company strategies.

For this purpose, my tasks will include:

- Defining the mission and goals of the organization.
- Determining what businesses it should be in.
- Allocating resources among the different businesses.
- Formulating and implementing strategies that span individual businesses.
- Providing leadership for the organization.

1. (c) Business Process Reengineering (BPR) refers to the analysis and redesign of workflows and processes both within and between the organizations. The orientation of the redesign effort is radical. It involves total deconstruction and rethinking of a business process in its entirety.

The workflows are studied, appraised and improved in terms of time, cost, output, quality, and responsiveness to customers. The redesign effort aims to simplify and streamline a process by eliminating all extra avoidable steps, activities, and transactions. With the help of redesigning workflows, organizations can drastically reduce the number of stages of work, and improve their performance.

1. (d) The network structure is radical in nature and could be termed a "non-structure" as it virtually eliminates in-house business functions and outsource many of them. An organisation organized in this manner is often called a virtual organization because

it is composed of a series of project groups or collaborations linked by constantly changing non-hierarchical, cobweb-like networks. The network structure becomes most useful when the environment of a firm is unstable and is expected to remain so wherein there is usually a strong need for innovation and quick response. Instead of having salaried employees, it may contract with people for a specific project or length of time with suppliers and distributors.

(e) Business environment in which an organization exists can be broadly divided into two parts: the external and the internal. Since the environment is complex and has multiple elements of it helps to understand it better. External environmental factors are largely beyond the control of individual enterprise and are. These are technological, physical, political and socio-cultural. Internal environment is the environment that has a direct impact on the business and is within the control of the entrepreneurs. These are internal management, machinery, methods of production, suppliers, customers etc.

2. (a) (i) **Incorrect:** Balance scorecard is a combination of strategic and financial objectives. It measures company performance, requires setting both financial and strategic objectives and tracking their achievement. Unless a company is in deep financial difficulty, such that its very survival is threatened, company managers are well advised to put more emphasis on achieving strategic objectives than on achieving financial objectives whenever a trade-off has to be made.

(ii) **Correct:** Functional-level managers and strategies operate at the lowest hierarchical level of strategic management. Functional level is responsible for the specific business functions or operations (human resources, purchasing, product development, customer service, and so on) that constitute a company or one of its divisions. Although they are not responsible for the overall performance of the organisation, functional managers have a major strategic role to develop functional strategies in their area that help to fulfil the strategic objectives set by business and corporate-level managers.

(b) (i) A joint venture is a business agreement in which parties agree to develop, for a finite time, a new entity and new assets by contributing equity. They exercise control over the enterprise and consequently share revenues, expenses and assets.

(ii) Horizontal integrated diversification is an expansion strategy through the acquisition of one or more similar organisation(s) operating at the same stage of the production-marketing chain that is going into complementary products, by-products or taking over competitors' products.

(iii) Value chain analysis refers to separate activities which are necessary to underpin an organization's strategies and are linked together both within and

around the organization. Value chain of a manufacturing organization comprises of primary and supportive activities.

3. (a) A Strategic vision is a road map of a company's future – providing specifics about technology and customer focus, the geographic and product markets to be pursued, the capabilities it plans to develop, and the kind of company that management is trying to create.
- (b) Management issues central to strategy implementation include
 - allocating resources,
 - altering an existing organizational structure,
 - restructuring and reengineering,
 - revising reward and incentive plans,
 - minimizing resistance to change,
 - matching managers with strategy,
 - developing a strategy-supportive culture,
 - adapting production/operations processes,
 - developing an effective human resource function and, if necessary,
 - downsizing.
- (c) Corporate culture refers to values, beliefs, business principles, traditions, ways of operating, and internal work environment. An organization's culture is either an important contributor or an obstacle to successful strategy execution. The beliefs, vision, objectives, business approaches and practices underpinning a company's strategy may be compatible with its culture or not. When they are, the culture becomes a valuable ally in strategy implementation and execution.

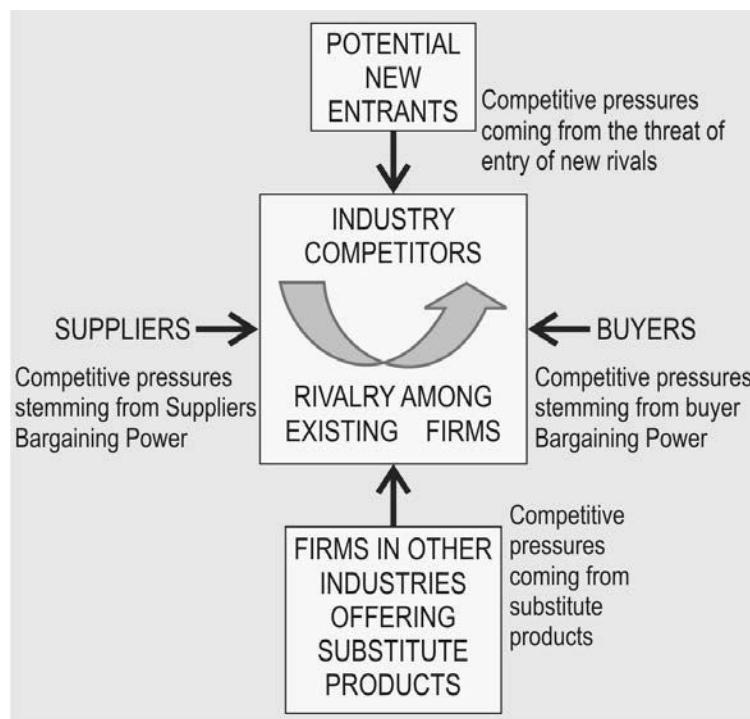
A culture grounded in values, practices, and behavioural norms that match what is needed for good strategy execution helps energize people throughout the company to do their jobs in a strategy-supportive manner, adding significantly to the power and effectiveness of strategy execution. When the culture is in conflict with some aspect of the company's direction, performance targets or strategy, the culture becomes a stumbling block that impedes successful strategy implementation and execution.

4. Five forces model of Michael Porter is a powerful and widely used tool for systematically diagnosing the significant competitive pressures in the market and assessing their strength and importance. The model holds that the state of competition in an industry is a composite of competitive pressures operating in five areas of the overall market. These five forces are:
 - (a) **Threat of new entrants:** New entrants are always a powerful source of competition. The new capacity and product range they bring in throw up new competitive pressure. And the bigger the new entrant, the more severe the competitive effect.

New entrants also place a limit on prices and affect the profitability of existing players.

- (b) **Bargaining power of customers:** This force will become heavier depending on the possibilities of the buyers forming groups or cartels. Mostly, this is a phenomenon seen in industrial products. Quite often, users of industrial products come together formally or informally and exert pressure on the producer. The bargaining power of the buyers influences not only the prices that the producer can charge but also influences in many cases, costs and investments of the producer because powerful buyers usually bargain for better services which involve costs and investment on the part of the producer.
- (c) **Bargaining power of suppliers:** Quite often suppliers, too, exercise considerable bargaining power over companies. The more specialised the offering from the supplier, greater is his clout. And, if the suppliers are also limited in number they stand a still better chance to exhibit their bargaining power. The bargaining power of suppliers determines the cost of raw materials and other inputs of the industry and, therefore, industry attractiveness and profitability.
- (d) **Rivalry among current players:** The rivalry among existing players is quite obvious. This is what is normally understood as competition. For any player, the competitors influence strategic decisions at different strategic levels. The impact is evident more at functional level in the prices being changed, advertising, and pressures on costs, product and so on.
- (e) **Threats from substitutes:** Substitute products are a latent source of competition in an industry. In many cases they become a major constituent of competition. Substitute products offering a price advantage and/or performance improvement to the consumer can drastically alter the competitive character of an industry. And they can bring it about all of a sudden. For example, coir suffered at the hands of synthetic fibre. Wherever substantial investment in R&D is taking place, threats from substitute products can be expected. Substitutes, too, usually limit the prices and profits in an industry.

The five forces together determine industry attractiveness/profitability. This is so because these forces influence the causes that underlie industry attractiveness/profitability. For example, elements such as cost and investment needed for being a player in the industry decide industry profitability, and all such elements are governed by these forces. The collective strength of these five competitive forces determines the scope to earn attractive profits. The strength of the forces may vary from industry to industry.



Five Forces Model of Competition

5. A strategy manager has many different leadership roles to play: visionary, chief entrepreneur and strategist, chief administrator, culture builder, resource acquirer and allocator, capabilities builder, process integrator, crisis solver, spokesperson, negotiator, motivator, arbitrator, policy maker, policy enforcer, and head cheerleader. Managers have five leadership roles to play in pushing for good strategy execution:
 - (a) Staying on top of what is happening, closely monitoring progress, working through issues and obstacles.
 - (b) Promoting a culture that mobilizes and energizes organizational members to execute strategy and perform at a high level.
 - (c) Keeping the organization responsive to changing conditions, alert for new opportunities and remain ahead of rivals in developing competitively valuable competencies and capabilities.
 - (d) Ethical leadership and insisting that the organization conduct its affairs like a model corporate citizen.
 - (e) Pushing corrective actions to improve strategy execution and overall strategic performance.

6. It is true that evaluating the worth of a business is central to strategy implementation. There are circumstances where it is important to evaluate the actual worth of the business. These circumstances can be wide and varied. At a higher level they may include acquisition, merges or diversification. They may also include other situations such as fixing of share price in an issue. Acquisition, merger, retrenchment may require establishing the financial worth or cash value of a business to successfully implement such strategies.

Various methods for determining a business's worth can be grouped into three main approaches.

- (i) Net worth or stockholders' equity: Net worth is the total assets minus total outside liabilities of an organisation.
- (ii) Future benefits to owners through net profits: These benefits are considered to be much greater than the amount of profits. A conservative rule of thumb is to establish a business's worth as five times the firm's current annual profit. A five-year average profit level could also be used.
- (iii) Market-determined business worth: This, in turn, involves three methods.
 - (a) First, the firm's worth may be based on the selling price of a similar company.
 - (b) Price-earnings ratio method whereby the market price of the firm's equity shares is divided by the annual earnings per share and multiplied by the firm's average net income for the preceding years.
 - (c) Outstanding shares method whereby one has to simply multiply the number of shares outstanding by the market price per share and add a premium.

7. (a). In the light of BCG Growth Matrix, once an organisation has classified its products or SBUs, it must determine what role each will play in the future. The four strategies that can be pursued are:

- (i) **Build:** Here the objective is to increase market share, even by forgoing short-term earnings in favour of building a strong future with large market share.
- (ii) **Hold:** Here the objective is to preserve market share.
- (iii) **Harvest:** Here the objective is to increase short-term cash flow regardless of long-term effect.
- (iv) **Divest:** Here the objective is to sell or liquidate the business because resources can be better used elsewhere.

(b) According to Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus.

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

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