

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

Question No. 1 is compulsory.

*Answer any **four** questions from the remaining **five** 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: Three hours)

(Maximum Marks: 100)

1. (a) X Ltd. negotiates with Bharat Petroleum Corporation Ltd (BPCL), for construction of "Franchise Retail Petrol Outlet Stations". Based on proposals submitted to different "Zonal offices of BPCL", the final approval for one outlet each in Zone A, Zone B, Zone C, Zone D, is awarded to X Ltd. Agreement (in single document) is entered into with BPCL for ₹ 490 lakhs. The agreement lays down values for each of the four outlets (₹ 88 + 132 + 160 + 110 lakhs) in addition to individual completion time. Examine and Decide whether X Ltd., will treat it as a single contract or four separate contracts.
- (b) From the following information, you are required to compute the basic and adjusted Earnings per share:

| | |
|--|----------------------|
| Net profit for 2015-16 | 11 lakh |
| Net profit for 2016-17 | 15 lakh |
| No. of shares issued before rights issue | 5 lakhs |
| Right issue | One for every 5 held |
| Right issue price | 15 per share |
| Last date of exercising right option | 1-06-2016 |
| Fair value of shares before right issue | 21 per share |
- (c) A Ltd. sold machinery having WDV of ₹ 40 lakhs to B Ltd. for ₹ 50 lakhs and the same machinery was leased back by B Ltd. to A Ltd. The lease back is operating lease. Explain the accounting treatment as per AS 19 in the following cases:
 - (i) Sale price of ₹ 50 lakhs is equal to fair value.
 - (ii) Fair value is ₹ 45 lakhs and sale price is ₹ 38 lakhs.
 - (iii) Fair value is ₹ 40 lakhs and sale price is ₹ 50 lakhs.
 - (iv) Fair value is ₹ 46 lakhs and sale price is ₹ 50 lakhs
 - (v) Fair value is ₹ 35 lakhs and sale price is ₹ 39 lakhs.
- (d) Sun Ltd. has entered into a sale contract of ₹ 5 crores with X Ltd. during 2015-2016 financial year. The profit on this transaction is ₹ 1 crore. The delivery of goods to take place during the first month of 2016-2017 financial year. In case of failure of Sun Ltd. to deliver within the schedule, a compensation of ₹ 1.5 crores is to be paid to X Ltd. Sun Ltd. planned to manufacture the goods during the last month of 2015-2016 financial year. As on balance sheet date (31.3.2016), the goods were not manufactured and it was unlikely that Sun Ltd. will be in a position to meet the contractual obligation.
 - (i) Should Sun Ltd. provide for contingency as per AS 29? Explain.
 - (ii) Should provision be measured as the excess of compensation to be paid over the profit?

(4 parts x 5 Marks = 20 Marks)

2. (a) Paper Limited comes out with a public issue of share capital on 01-01-2016 of 30,00,000 equity shares of ₹ 10 each at a premium of 5%. ₹ 2.50 is payable on application (on or before 31-01-2016) and ₹ 3 on allotment (31-3-2016) including premium.

This issue was underwritten by two underwriters namely White and Black, equally, the commission being 4% of the issue price. Each of the underwriters underwrites 60,000 shares firm. Subscriptions including firm underwriting came for 28,80,000 shares, the distribution of forms being White: 15,60,000; Black; 10,80,000 and Unmarked 2,40,000.

One of the allottees (using forms marked with name of White) for 6000 shares fails to pay the amount due to allotment, all the other money due being received in full including any due from the shares devolving upon the underwriters. The commission due was paid separately.

6,000 shares of one allottee who failed to pay the allotment money were finally forfeited by 30-06-2016 and were re-allotted for payment in cash of ₹ 4 per share. You are required to prepare each underwriter's liability (in shares) in statement form and to pass necessary journal entries to record the above events and transactions (including cash).

(b) SMM Ltd. has the following capital structure as on 31st March, 2017: ₹ in crore

| | Particulars | Situation | Situation |
|-------|--|-----------|-----------|
| (i) | Equity share capital (shares of ₹ 10 each) | 1,200 | 1,200 |
| (ii) | Reserves: | | |
| | General Reserves | 1,080 | 1,080 |
| | Securities Premium | 400 | 400 |
| | Profit & Loss | 200 | 200 |
| | Infrastructure Development Reserve (Statutory Reserve) | 320 | 320 |
| (iii) | Loan Funds | 3,200 | 6,000 |

The company has offered buy back price of ₹ 30 per equity share. You are required to calculate maximum permissible number of equity shares that can be bought back in both situations and also required to pass necessary Journal Entries. **(8 + 12 = 20 Marks)**

3. (a) The Balance Sheet of Lion Limited as on 31-03-2016 is given below:

| Particulars | Note No. | Amount (₹ in lakh) |
|---------------------------------|----------|--------------------|
| <u>Equity & Liabilities</u> | | |
| <u>Shareholders' Funds</u> | | |
| Shares' Capital | 1 | 1,400 |
| Reserves & Surplus | 2 | (522) |
| <u>Non-Current Liabilities</u> | | |
| Long term Borrowings | 3 | 700 |
| <u>Current Liabilities</u> | | |
| Trade Payables | 4 | 102 |
| Other Liabilities | 5 | 24 |
| Total | | 1704 |
| Assets | | |
| <u>Non-Current Assets</u> | | |
| <u>Fixed Assets</u> | | |
| Tangible Assets | 6 | 750 |

| <u>Current Assets</u> | | | |
|-------------------------|----|------|--|
| Current Investments | 7 | 200 | |
| Inventories | 8 | 300 | |
| Trade Receivables | 9 | 450 | |
| Cash & Cash Equivalents | 10 | 4 | |
| Total | | 1704 | |

Notes to Accounts:

| | | ₹ in Lakhs |
|------|--|-------------------|
| (1) | Share Capital | |
| | Authorised : | |
| | 200 lakh shares of ₹ 10 each | 2,000 |
| | 8 lakh, 8% Preference Shares of ₹ 100 each | 800 |
| | | <u>2,800</u> |
| | Issued, Subscribed and paid up: | |
| | 100 lakh Equity Shares of ₹ 10 each, full paid up | 1,000 |
| | 4 lakh 8% Preference Shares of ₹ 100 each, fully paid up | 400 |
| | | Total <u>1400</u> |
| (2) | Reserves and Surplus | |
| | Debit balance of Profit & Loss A/c | (522) |
| (3) | Long Term Borrowings | |
| | 6% Debentures (Secured by Freehold Property) | 400 |
| | Directors' Loan | 300 |
| | | <u>700</u> |
| (4) | Trade Payables | |
| | Trade payables for Goods | 102 |
| (5) | Other Current Liabilities | |
| | Interest Accrued and Due on 6% Debentures | 24 |
| (6) | Tangible Assets | |
| | Freehold Property | 550 |
| | Plant & Machinery | 200 |
| | | <u>750</u> |
| (7) | Current Investment | |
| | Investment in Equity Instruments | 200 |
| (8) | Inventories | |
| | Finished Goods | 300 |
| (9) | Trade Receivables | |
| | Trade receivables for Goods | 450 |
| (10) | Cash and Cash Equivalents | |
| | Balance with Bank | 4 |

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

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

You are required to:

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

(b) A Liquidator is entitled to receive remuneration at 2% on the assets realized, 3% on the amount distributed to Preferential Creditors and 5% on the payment made to Unsecured Creditors. The assets were realized for ₹ 25,00,000 against which payment was made as follows:

| | |
|------------------------|-------------|
| Liquidation expenses | ₹ 25,000 |
| Secured Creditors | ₹ 10,00,000 |
| Preferential Creditors | ₹ 75,000 |

The amount due to Unsecured Creditors was ₹ 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. **(15 + 5 = 20 Marks)**

4. (a) From the following information as on 31st March, 2016 of Xeta Insurance Co. Ltd. engaged in fire insurance business, prepare the Revenue Account, reserving 50% of the net premiums for unexpired risks and an additional reserve of ₹ 7,00,000:

| Particulars | Amount (₹) |
|--|------------|
| Reserve for unexpired risk on 31st March, 2015 | 15,00,000 |
| Additional reserve on 31st March, 2015 | 3,00,000 |
| Claims paid | 19,20,000 |
| Estimated liability in respect of outstanding claims on 31st March, 2015 | 1,95,000 |
| Estimated liability in respect of outstanding claims on 31st March, 2016 | 2,70,000 |
| Expenses of management (including ₹ 90,000 incurred in connection with claims) | 8,40,000 |
| Re-insurance premium paid | 2,25,000 |
| Re-insurance recoveries | 60,000 |

| | |
|--|-----------|
| Premiums | 33,60,000 |
| Interest and dividend (gross before TDS) | 1,50,000 |
| Profit on sale of investments | 30,000 |
| Commission | 50,000 |

(b) As on 31st March 2016, Strong Bank Ltd. has a balance of ₹ 27 crores in "rebate on bills discounted" account. The bank provides you the following further information:

- (1) During the financial year ending 31st March 2017, Strong Bank Ltd. discounted bills of exchange of ₹ 4,000 crores charging interest @ 15% p.a. and the average period of discount being 146 days.
- (2) Bills of exchange of ₹ 600 crores were due for realization from the acceptors/customers after 31st March 2017, the average period outstanding after 31st March 2017, being 73 days.

You are required to pass necessary journal entries in the books of Strong Bank Ltd. for the above transactions.

(c) A Mutual Fund raised 100 lakh on April 1, 2017 by issue of 10 lakh units of ₹ 10 per unit. The fund invested in several capital market instruments to build a portfolio of ₹ 90 lakhs. The initial expenses amounted to ₹ 5 lakh. During April, 2017, the fund sold certain securities of cost ₹ 38 lakhs for ₹ 40 lakhs and purchased certain other securities for ₹ 28.20 lakhs. The fund management expenses for the month amounted to ₹ 4.50 lakhs of which ₹ 0.35 lakh was in arrears. The dividend earned was ₹ 1.20 lakhs. 75% of the realized earnings were distributed. The market value of the portfolio on 30.04.2017 was ₹ 112 lakh.

Determine NAV per unit.

(10 Marks +6 Marks +4 Marks = 20 Marks)

5. (a) Given below are the Profit & Loss Accounts of H Ltd. and its subsidiary Ltd. for the year ended 31st March, 2017:

| | H Ltd. (₹ in lacs) | S Ltd. (₹ in lacs) |
|-----------------------------------|-----------------------|-----------------------|
| Incomes: | | |
| Sales and other income | 5,000 | 1,000 |
| Increase in Inventory | 1,000 | 200 |
| | <u>6,000</u> | <u>1,200</u> |
| Expenses: | | |
| Raw material consumed | 800 | 200 |
| Wages and Salaries | 800 | 150 |
| Production expenses | 200 | 100 |
| Administrative Expenses | 200 | 100 |
| Selling and Distribution Expenses | 200 | 50 |
| Interest | 100 | 50 |
| Depreciation | 100 | 50 |
| | <u>2,400</u> | <u>700</u> |
| Profit before tax | 3,600 | 500 |
| Provision for tax | 1,200 | 200 |
| Profit after tax | 2,400 | 300 |
| Dividend paid | 1,200 | 150 |
| Balance of Profit | <u>1,200</u> | <u>150</u> |

Other Information:

H Ltd. sold goods to S Ltd. of ₹ 120 lacs at cost plus 20%. Inventory of S Ltd. includes such goods valuing ₹ 24 lacs. Administrative expenses of S Ltd. include ₹ 5 lacs paid to H Ltd. as consultancy fees. Selling and distribution expenses of H Ltd. include ₹ 10 lacs paid to S Ltd. as commission.

H Ltd. holds 80% of equity share capital of ₹ 1,000 lacs in S Ltd. prior to 2015-2016. H Ltd. took credit to its Profit and Loss Account, the proportionate amount of dividend declared and paid by S Ltd. for the year 2015-2016.

You are required to prepare a consolidated profit and loss account of H Ltd. and its subsidiary S Ltd. for the year ended on 31st March, 2017.

(b) The summarized Balance Sheet of K Ltd. for the year ended on 31st March, 2015, 2016 and 2017 are as follows:

| | (₹ in thousands) | | |
|---|------------------|-----------|-----------|
| | 31.3.2015 | 31.3.2016 | 31.3.2017 |
| Liabilities | | | |
| 1,60,000 equity shares of ₹ 10 each, fully paid | 1,600 | 1,600 | 1,600 |
| General reserve | 1,200 | 1,400 | 1,600 |
| Profit and Loss account | 140 | 160 | 240 |
| Trade Payables | 600 | 800 | 1,000 |
| | 3,540 | 3,960 | 4,440 |
| Assets | | | |
| Goodwill | 1,000 | 800 | 600 |
| Building and Machinery less, depreciation | 1,400 | 1,600 | 1,600 |
| Inventory | 1,000 | 1,200 | 1,400 |
| Trade Receivables | 20 | 160 | 440 |
| Bank balance | 120 | 200 | 400 |
| | 3,540 | 3,960 | 4,440 |

Additional information:

(a) Actual valuations were as under:

| | | | |
|---|-------|-------|-------|
| Building and machinery less, depreciation | 1,800 | 2,000 | 2,200 |
| Inventory | 1,200 | 1,400 | 1,600 |
| Net profit (including opening balance after writing off depreciation, goodwill, tax provision and transferred to general reserve) | 420 | 620 | 820 |

(b) Capital employed in the business at market value at the beginning of 2014-15 was ₹ 36,60,000 which included the cost of goodwill. The normal annual return on average capital employed in the line of business engaged by K Ltd. is 12½%.

(c) The balance in the general reserve on 1st April, 2014 was ₹ 10 lakhs.

(d) The goodwill shown on 31.3.2015 was purchased on 1.4.2014 for ₹ 10 lakhs on which date the balance in the Profit and Loss account was ₹ 1,20,000.

(e) Goodwill is to be valued at 5 year's purchase of Super profit (Simple average method).

You are required to compute the average capital employed in each year and find out the value of goodwill.

(12 Marks + 8 Marks = 20 Marks)

6. (a) A company has its share capital divided into shares of ₹ 10 each. On 1-1-20X1, it granted 5,000 employees stock options at ₹ 50, when the market price was ₹ 140. The options were to be exercised between 1-3-20X2 to 31-03-20X2. The employees exercised their options for 4,800 shares only; remaining options lapsed. Pass the necessary journal entries for the year ended 31-3-20X2, with regard to employees' stock options.

(b) Explain "Non-Performing Assets" as per NBFC Prudential Norms (RBI) directions.

(c) Explain on 'presentation of MAT credit' in the financial statements in brief.

OR

How will a company classify its investment in preference shares, which are convertible into equity shares within one year from the balance sheet date? Will it classify the investment as a current asset or a non-current asset? Explain.

(d) XYZ Ltd. purchased 80% shares of ABC Ltd. on 1st January, 2016 for ₹ 2,80,000. The issued capital of ABC Ltd., on 1st January, 2016 was ₹ 2,00,000 and the balance in the Profit & Loss Account was ₹ 1,20,000.

During the year ended 31st December, 2016, ABC Ltd. earned a profit of ₹ 40,000 and at year end, declared and paid a dividend of ₹ 60,000.

Show by an entry how the dividend should be recorded in the books of XYZ Ltd.

You are required to compute amount of minority interest as on 1st January, 2016 and 31st December, 2016?

(4 Parts x 5 Marks = 20 Marks)

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SUGGESTED ANSWERS/HINTS

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

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

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

Therefore, four separate contract accounts have to be recorded and maintained in the books of X Ltd. For each contract, principles of revenue and cost recognition have to be applied separately and net income will be determined for each asset as per AS - 7.

(b) Computation of theoretical ex-rights fair value per share

Fair value of all outstanding shares immediately prior to exercise of rights + Total amount received from exercise of rights

Number of shares outstanding prior to exercise + number of shares issued in the exercise

$$\frac{(\text{₹ }21.00 \times 5,00,000 \text{ shares}) + (\text{₹ }15.00 \times 1,00,000 \text{ shares})}{5,00,000 \text{ shares} + 1,00,000 \text{ shares}}$$

Theoretical ex-rights fair value per share = ₹ 20.00

(a) **Computation of adjustment factor**

$$(b) \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{\text{₹ }21.00}{\text{₹ }20.00} = 1.05$$

Computation of earnings per share

| | Year 2015-16 | Year 2016-17 |
|---|-----------------|-----------------|
| EPS for the year 2015-16 as originally reported: (₹ 11,00,000/5,00,000 shares) | ₹ 2.20 | |
| EPS for the year 2015-16 restated for rights issue: [₹ 11,00,000/ (5,00,000 shares x 1.05)] | ₹ 2.10 | |
| EPS for the year 2016-17 including effects of rights issue $\frac{\text{₹ }15,00,000}{(5,00,000 \times 1.05 \times 2/12) + (6,00,000 \times 10/12)}$ | | ₹ 2.55 |

(c) Following will be the treatment in the given cases:

- (i) When sales price of ₹ 50 lakhs is equal to fair value, A Ltd. should immediately recognise the profit of ₹ 10 lakhs (i.e. 50 – 40) in its books.
- (ii) When fair value of leased machinery is ₹ 45 lakhs & sales price is ₹ 38 lakhs, then loss of ₹ 2 lakhs (40 – 38) to be immediately recognised by A Ltd. in its books provided loss is not

compensated by future lease payment.

- (iii) When fair value is ₹ 40 lakhs & sales price is ₹ 50 lakhs then, profit of ₹ 10 lakhs is to be deferred and amortised over the lease period.
- (iv) When fair value is ₹ 46 lakhs & sales price is ₹ 50 lakhs, profit of ₹ 6 lakhs (46-40) to be immediately recognised in its books and balance profit of ₹ 4 lakhs (50-46) is to be amortised/deferred over lease period.
- (v) When fair value is ₹ 35 lakhs & sales price is ₹ 39 lakhs, then the loss of ₹ 5 lakhs (40-35) to be immediately recognised by A Ltd. in its books and profit of ₹ 4 lakhs (39-35) should be amortised/deferred over lease period.

(d) (i) AS 29 "Provisions, Contingent Liabilities and Contingent Assets" provides that when an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should be recognised. Sun Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Sun Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Sun Ltd. should provide for the contingency amounting ₹ 1.5 crores as per AS 29.

(ii) Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 2016 and no profit had accrued for the financial year 2015-2016. Therefore, provision should be made for the full amount of compensation amounting ₹ 1.50 crores.

2. (a)

Statement showing liability of underwriters

| a | Particulars | Basis | White | Black |
|----|--|-------|--------------------|--------------------|
| A. | Gross Liability [No. of Shares) | 1:1 | 15,00,000 | 15,00,000 |
| B. | Less: Marked Applications {Net of firm underwriting} | | <u>(15,00,000)</u> | <u>(10,20,000)</u> |
| C. | Balance [A-B] | | - | 4,80,000 |
| D | Less: Unmarked Applications | 1:1 | <u>(1,20,000)</u> | <u>(1,20,000)</u> |
| E | Balance [C-D] | | <u>(1,20,000)</u> | 3,60,000 |
| F | Less: Firm Underwriting | | <u>(60,000)</u> | <u>(60,000)</u> |
| G | Balance | | <u>(1,80,000)</u> | 3,00,000 |
| H | Credit for White 's Oversubscription | | <u>1,80,000</u> | <u>(1,80,000)</u> |
| I | Net Liability | | - | 1,20,000 |
| J | Add: Firm Underwriting | | <u>60,000</u> | <u>60,000</u> |
| K | Total Liability [No. of Shares] | | 60,000 | 1,80,000 |

Note: In the above statement, it has been assumed that the benefit of firm underwriting is given to individual underwriter.

Journal Entries

| | | | | |
|--------|--|--|-----|-----------|
| 2016 | | | | |
| Jan 31 | Bank A/c | | Dr. | 72,00,000 |
| | To Equity Share Application A/c | | | 72,00,000 |
| | (Being application money received @ ₹ 2.50 per share) | | | |
| March | Equity Share Application A/c | | Dr. | 72,00,000 |
| | To Equity Share Capital A/c | | | 72,00,000 |
| | (Being the transfer of application money to share capital on 28,80,000 shares vide Board's Resolution) | | | |

| | | | | |
|---------|---|-----|--------------------------|-----------------------|
| March | Equity Share Allotment A/c (28,80,000 x ₹ 3) | Dr. | 86,40,000 | |
| | To Equity Share Capital A/c (28,80,000 x ₹ 2.5) To Securities Premium A/c (28,80,000 x ₹ 0.5) (Being allotment money due on 28,80,000 shares allotted to public) | | 72,00,000 14,40,000 | |
| March | Black (1,20,000 x ₹ 5.5) To Equity Share Capital A/c (1,20,000 x ₹ 5) To Securities Premium A/c (1,20,000 x ₹ 0.5) (Being the application and allotted money due on net liability of underwriter i.e. 1,20,000 shares) | Dr. | 6,60,000 | 6,00,000 60,000 |
| | Bank A/c To Equity Share Allotment A/c [(28,80,000 – 6,000) x ₹ 3] To Black (1,20,000 x ₹ 5.5) (Being the receipt of money due on allotment except from the allottee for 6,000 shares) | | 92,82,000 | 86,22,000 6,60,000 |
| March | Underwriting Commission A/c To Black A/c To White A/c (Being commission @ 4 % on issue price of ₹ 10.50 for ₹ 30 lakh shares payable to underwriters) | Dr. | 12,60,000 | 6,30,000 6,30,000 |
| | Black A/c White A/c To Bank A/c (Being commission paid to underwriters) | | 6,30,000 6,30,000 | 12,60,000 |
| June 30 | Equity Share Capital A/c (6,000 x 5) Securities Premium A/c (6,000 x 0.5) To Share Allotment A/c (6,000 x 3) To Forfeited Shares A/c (6,000 x 2.5) (Being 6,000 shares forfeited vide Board's Resolution) | Dr. | 30,000 | |
| | Forfeited Shares A/c To Equity Share Capital A/c (6,000 x ₹ 5) (Being the reissue of 6,000 shares @ ₹ 4 as ₹ 5 paid up at par) | | 3,000 | 18,000 15,000 |
| June 30 | Bank A/c (6,000 x ₹ 4) Forfeited Shares A/c To Capital Reserve A/c (Being the transfer of profit on reissue) | Dr. | 24,000 6,000 9,000 | 30,000 9,000 |
| | Forfeited Shares A/c (15,000 – 6,000) | | | |

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

Number of shares (in crores)

| Particulars | When loan fund is | |
|--|-------------------|----------------|
| | ₹ 3,200 crores | ₹ 6,000 crores |
| Shares Outstanding Test (W.N.1) | 30 | 30 |
| Resources Test (W.N.2) | 24 | 24 |
| Debt Equity Ratio Test (W.N.3) | 32 | Nil |
| Maximum number of shares that can be bought back [least of the above] | 24 | Nil |

Journal Entries for the Buy Back

(applicable only when loan fund is ₹ 3,200 crores)

| | | ₹ in crores | Debit | Credit |
|-----|---|--------------------|-------|--------|
| (a) | Equity share buyback account To Bank account (Being payment for buy back of 24 crores equity shares of ₹ 10 each @ ₹ 30 per share) | Dr. 720 | | 720 |
| (b) | Equity share capital account Premium Payable on buyback account To Equity share buyback account (Being cancellation of shares bought back) | Dr. 240 Dr. 480 | | 720 |
| | Securities Premium account General Reserve / Profit & Loss A/c To Premium Payable on buyback account (Being Premium Payable on buyback account charged to securities premium and general reserve/Profit & Loss A/c) | Dr. 400 Dr. 80 | | 480 |
| (c) | General Reserve / Profit & Loss A/c To Capital redemption reserve account (Being transfer of free reserves to capital redemption reserve to the extent of nominal value of share capital bought back out of redeemed through free reserves) | Dr. 240 | | 240 |

Working Notes:

1. **Shares Outstanding Test**

| Particulars | (Shares in crores) |
|-------------------------------|--------------------|
| Number of shares outstanding | 120 |
| 25% of the shares outstanding | 30 |

2. **Resources Test**

| Particulars | |
|---|------------------|
| Paid up capital (₹ in crores) | 1,200 |
| Free reserves (₹ in crores) (1,080 + 400 + 200) | 1,680 |
| Shareholders' funds (₹ in crores) | 2,880 |
| 25% of Shareholders fund (₹ in crores) | ₹ 720 crores |
| Buy back price per share | ₹ 30 |
| Number of shares that can be bought back | 24 crores shares |

3. Debt Equity Ratio Test: Loans cannot be in excess of twice the Equity Funds post Buy Back

| | Particulars | When loan fund is | |
|-----|--|-------------------|------------------|
| (a) | Loan funds (₹) | ₹ 3,200 crores | ₹ 6,000 crores |
| (b) | Minimum equity to be maintained after buy back in the ratio of 2:1 (₹) (a/2) | 3,200 | 6,000 |
| (c) | Present equity shareholders fund (₹) | 1,600 | 3,000 |
| (d) | Future equity shareholders fund (₹) (see W.N.4) | 2,880 | 2,880 |
| (e) | Maximum permitted buy back of Equity (₹) [(d) – (b)] | 2,560 (2,880-320) | N.A. |
| (f) | Maximum number of shares that can be bought back @ ₹ 30 per share | 960 | Nil |
| | As per the provisions of the Companies Act, 2013, company | 32 crore shares | Nil |
| | | Qualifies | Does not Qualify |

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

Suppose amount transferred to CRR account is 'x' and maximum permitted buy-back of equity is 'y' Then

Equation 1 : (Present Equity- Transfer to CRR)- Minimum Equity to be maintained = Maximum Permitted Buy Back

$$\begin{aligned}
 &= (2,880 - x) - 1,600 = y \\
 &= 1280 - x = y
 \end{aligned} \tag{1}$$

Equation 2: Maximum Permitted Buy Back X Nominal Value Per Share/Offer Price Per Share

$$= \left(\frac{y}{30} \times 10 \right) = x \quad \text{Or} \quad 3x = y \tag{2}$$

by solving the above two equations we get

$$x = ₹ 320$$

$$y = ₹ 960$$

3. (a)

Journal Entries in the books of Lion Ltd.

| | Particulars | Debit (₹ in lakhs) | Credit (₹ in lakhs) |
|-----|--|-----------------------|------------------------|
| (i) | 8% Preference share capital A/c (₹100 each) To 8% Preference share capital A/c (₹ 80 each) To Capital Reduction A/c (Being the preference shares of ₹100 each reduced to ₹80 each as per the approved scheme) | Dr. 400 | 320 80 |

| | | | | |
|--------|---|-----|-------|-----|
| (ii) | Equity share capital A/c (₹10 each) | Dr. | 1,000 | |
| | To Equity share capital A/c (₹ 2 each) | | | 200 |
| | To Capital Reduction A/c | | | 800 |
| | (Being the equity shares of ₹10 each reduced to ₹ 2 each) | | | |
| (iii) | Capital Reduction A/c | Dr. | 32 | |
| | To Equity share capital A/c (₹ 2 each) | | | 32 |
| | (Being 1/3 rd arrears of preference share dividend of 3 years to be satisfied by issue of 8 lakhs equity shares of ₹ 2 each) | | | |
| (iv) | 6% Debentures A/c | Dr. | 300 | |
| | To Freehold property A/c | | | 300 |
| | (Being claim of Debenture holders settled in part by transfer of freehold property) | | | |
| (v) | Accrued debenture interest A/c | Dr. | 24 | |
| | To Bank A/c | | | 24 |
| | (Being accrued debenture interest paid) | | | |
| (vi) | Freehold property A/c | Dr. | 150 | |
| | To Capital Reduction A/c | | | 150 |
| | (Being appreciation in the value of freehold property) | | | |
| (vii) | Bank A/c | Dr. | 250 | |
| | To Investments A/c | | | 200 |
| | To Capital Reduction A/c | | | 50 |
| | (Being investment sold at profit) | | | |
| (viii) | Director's loan A/c | Dr. | 300 | |
| | To Equity share capital A/c (₹ 2 each) | | | 90 |
| | To Capital Reduction A/c | | | 210 |
| | (Being director's loan waived by 70% and balance being discharged by issue of 45 lakhs equity shares of ₹2 each) | | | |
| (ix) | Capital Reduction A/c | Dr. | 972 | |
| | To Profit and Loss A/c | | | 522 |
| | To Trade receivables A/c (450x 40%) | | | 180 |
| | To Inventories-in-trade A/c (300x 80%) | | | 240 |
| | To Bank A/c (600 x 5%) | | | 30 |
| | (Being certain value of various assets, penalty on cancellation of contract, profit and loss account debit balance written off through Capital Reduction Account) | | | |
| (x) | Capital Reduction A/c | | 286 | |
| | To Capital reserve A/c | | | 286 |
| | (Being balance transferred to capital reserve account as per the scheme) | | | |

Capital Reduction Account

| Dr. | Cr. |
|-------------------------|--------------|
| | (₹ in lakhs) |
| To Equity Share Capital | 32 |
| To Trade receivables | 180 |
| To Finished Goods | 240 |
| To Profit & Loss A/c | 522 |
| To Bank A/c | 30 |
| To Capital Reserve | <u>286</u> |
| | <u>1,290</u> |
| | <u>1,290</u> |

Notes to Balance Sheet

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

(b) Calculation of Total Remuneration payable to Liquidator

| | Amount in ₹ |
|---|----------------|
| 2% on Assets realised | 25,00,000 x 2% |
| 3% on payment made to Preferential creditors | 75,000 x 3% |
| 3% on payment made to Unsecured creditors (Refer W.N) | <u>39,255</u> |
| Total Remuneration payable to Liquidator | <u>91,505</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

$$= ₹ 25,00,000 - ₹ 25,000 - ₹ 10,00,000 - ₹ 75,000 - ₹ 50,000 - ₹ 2,250 = ₹ 13,47,750.$$

Liquidator's remuneration on payment to unsecured creditors = $3/103 \times ₹ 13,47,750 = ₹ 39,255$

4. (a)

Name of the Insurer: Xeta Insurance Company Limited

Registration No. and Date of registration with IRDA:

Revenue Account for the year ended 31st March, 2016

| Particulars | Schedule | Amount (₹) |
|--|-----------|------------|
| Premium earned (net) | 1 | 26,67,500 |
| Profit on sale of investment | | 30,000 |
| Others | | — |
| Interest and dividend (gross) | | 1,50,000 |
| | Total (A) | 28,47,500 |
| Claims incurred (Net) | 2 | 20,25,000 |
| Commission | 3 | 50,000 |
| Operating expenses related to insurance | 4 | 7,50,000 |
| | Total (B) | 28,25,000 |
| Operating profit from insurance business (A) – (B) | | 22,500 |

Schedule –1 Premium earned (net)

| | ₹ |
|---|------------|
| Premium received | 33,60,000 |
| Less: Premium on reinsurance ceded | (2,25,000) |
| Net Premium | 31,35,000 |
| Less: Adjustment for change in Reserve for Unexpired risk (as per W.N.) | (4,67,500) |
| Total premium earned | 26,67,500 |

Schedule -2 Claims incurred (net)

| | ₹ |
|---|------------|
| Claims paid | 19,20,000 |
| Add: Expenses regarding claims | 90,000 |
| | 20,10,000 |
| Less: Re-insurance recoveries | (60,000) |
| | 19,50,000 |
| Add: Claims outstanding as on 31 st March, 2016 | 2,70,000 |
| | 22,20,000 |
| Less: Claims outstanding as on 31 st March, 2015 | (1,95,000) |
| | 20,25,000 |

Schedule -3 Commission

| | ₹ |
|-----------------|--------|
| Commission paid | 50,000 |

Schedule-4 Operating expenses related to Insurance Business

| | ₹ |
|--|----------|
| Expenses of management (₹ 8,40,000 – ₹ 90,000) | 7,50,000 |

Working Note:

Calculation for change in Reserve for Unexpired risk:

| | ₹ |
|---|-----------------|
| Reserve for Unexpired Risk as on 31 st March, 2016 | 15,67,500 |
| Additional Reserve as on 31 st March, 2016 | <u>7,00,000</u> |
| Less: Reserve for Unexpired Risk as on 31 st March, 2015 | 15,00,000 |
| Additional Reserve as on 31 st March, 2015 | <u>3,00,000</u> |
| | (18,00,000) |
| | 4,67,500 |

(b)

In the books of Strong Bank Ltd.

Journal Entries

| Particulars | Debit (₹) | Credit (₹) |
|--|-----------|--------------|
| Rebate on bills discounted A/c To Discount on bills A/c (Being the transfer of opening balance in 'Rebate on bills discounted A/c' to 'Discount on bills A/c') | Dr. 27 | 27 |
| Bills purchased and discounted A/c To Discount on bills A/c To Clients A/c (Being the discounting of bills of exchange during the year) | Dr. 4,000 | 240 3,760 |
| Discount on bills A/c To Rebate on bills discounted A/c (Being the unexpired portion of discount in respect of the discounted bills of exchange carried forward) | Dr. 18 | 18 |
| Discount on bills A/c To Profit and Loss A/c (Being the amount of income for the year from discounting of bills of exchange transferred to Profit and loss A/c) | Dr. 249 | 249 |

Working Notes:

1. Discount received on the bills discounted during the year

$$₹ 4,000 \text{ crores} \times \frac{15}{100} \times \frac{146}{365} = ₹ 240 \text{ crores}$$

2. Calculation of rebate on bill discounted

$$₹ 600 \text{ crores} \times \frac{15}{100} \times \frac{73}{365} = ₹ 18 \text{ crores}$$

(It is assumed that discounting rate of 15% is used for the bill of ₹ 600 crores also)

3. Income from bills discounted transferred to Profit and Loss A/c would be calculated by preparing Discount on bills A/c

Discount on bills A/c

₹ in crores

| Date | Particulars | Amount | Date | Particulars | Amount |
|---------------|------------------------------------|------------|-----------------------------|-----------------------------------|------------|
| 31 March 2017 | To Rebate on bills discounted | 18 | 1 st April, 2016 | By Rebate on bills discounted b/f | 27 |
| " | To Profit and Loss A/c (Bal. Fig.) | <u>249</u> | 2016-17 | By Bills purchased and discounted | <u>240</u> |
| | | <u>267</u> | | | <u>267</u> |

(c)

| | ₹ in lakhs | ₹ in lakhs | |
|---|---------------|----------------|-----------|
| Opening bank balance [₹ (100 – 90 - 5) lakhs] | 5.00 | | |
| Add: Proceeds from sale of securities | 40.00 | | |
| Dividend received | <u>1.20</u> | 46.20 | |
| Less: Cost of securities | 28.20 | | |
| Fund management expenses [₹ (4.50–0.35) lakhs] | 4.15 | | |
| Capital gains distributed [75% of ₹ (40.00 – 38.00) lakhs] | 1.50 | | |
| Dividends distributed (75% of ₹ 1.20 lakhs) | <u>0.90</u> | <u>(34.75)</u> | |
| Closing bank balance | 11.45 | | |
| Closing market value of portfolio | <u>112</u> | | |
| | 123.45 | | |
| Less: Arrears of expenses | <u>(0.35)</u> | | |
| Closing net assets | <u>123.10</u> | | |
| Number of units | | | 10,00,000 |
| Closing Net Assets Value (NAV) | | | ₹ 12.31 |

5. (a)

Consolidated Profit & Loss Account of H Ltd. and its subsidiary S Ltd.

for the year ended on 31st March, 2017

| Particulars | Note No. | ₹ in Lacs |
|--|----------|--------------|
| I. Revenue from operations | 1 | <u>5,865</u> |
| II. Total revenue | | <u>5,865</u> |
| III. Expenses | | |
| Cost of Material purchased/Consumed | 3 | 1,180 |
| Changes of Inventories of finished goods | 2 | (1,196) |
| Employee benefit expense | 4 | 950 |
| Finance cost | 6 | 150 |
| Depreciation and amortization expense | 7 | 150 |
| Other expenses | 5 | <u>535</u> |
| Total expenses | | <u>1,769</u> |
| IV. Profit before Tax(II-III) | | 4,096 |

| | | |
|--|--------------|----------------|
| V. Tax Expenses | 8 | <u>1,400</u> |
| VI. Profit After Tax | | <u>2,696</u> |
| Profit transferred to Consolidated Balance Sheet | | |
| Profit After Tax | | 2,696 |
| Dividend paid | | |
| H Ltd. | 1,200 | |
| S Ltd. | <u>150</u> | |
| | 1,350 | |
| Less: Share of H Ltd. in dividend of S Ltd. | | |
| 80% of ₹ 150 lacs | <u>(120)</u> | <u>(1,230)</u> |
| Profit to be transferred to consolidated balance sheet | | <u>1,466</u> |

Notes to Accounts

| | | ₹ in Lacs | ₹ in Lacs |
|----|---|--------------|--------------|
| 1. | Revenue from Operations | | |
| | Sales and other income | | |
| | H Ltd. | 5,000 | |
| | S Ltd. | <u>1,000</u> | |
| | | 6,000 | |
| | Less: Inter-company Sales | (120) | |
| | Consultancy fees received by H Ltd. from S Ltd. | (5) | |
| | Commission received by S Ltd. from H Ltd. | <u>(10)</u> | 5,865 |
| 2. | Increase in Inventory | | |
| | H Ltd. | 1,000 | |
| | S Ltd. | <u>200</u> | |
| | | 1,200 | |
| | Less: Unrealized profits ₹ 24 lacs × $\frac{20}{120}$ | <u>(4)</u> | <u>1,196</u> |
| | | | 7,061 |
| 3. | Cost of Material purchased/consumed | | |
| | H Ltd. | 800 | |
| | S Ltd. | <u>200</u> | |
| | | 1,000 | |
| | Less: Purchases by S Ltd. from H Ltd. | <u>(120)</u> | 880 |
| | Direct Expenses | | |
| | H Ltd. | 200 | |
| | S Ltd. | <u>100</u> | |
| | | 300 | |
| | | | 1,180 |
| 4. | Employee benefits and expenses | | |
| | Wages and Salaries: | | |
| | H Ltd. | 800 | |

| | | | | |
|----|---|-------|-----|-------|
| | S Ltd. | | 150 | 950 |
| 5. | Other Expenses | | | |
| | Administrative Expenses | | | |
| | H Ltd. | 200 | | |
| | S Ltd. | 100 | | |
| | | 300 | | |
| | Less: Consultancy fees received by H Ltd. from S Ltd. | (5) | | 295 |
| | Selling and Distribution Expenses: | | | |
| | H Ltd. | 200 | | |
| | S Ltd. | 50 | | |
| | | 250 | | |
| | Less: Commission received from S Ltd. from H Ltd. | (10) | | 240 |
| | | | | 535 |
| 6. | Finance Cost | | | |
| | Interest: | | | |
| | H Ltd. | 100 | | |
| | S Ltd. | 50 | | 150 |
| 7. | Depreciation and Amortisation | | | |
| | Depreciation: | | | |
| | H Ltd. | 100 | | |
| | S Ltd. | 50 | | 150 |
| 8. | Provision for tax | | | |
| | H Ltd. | 1,200 | | |
| | S. Ltd. | 200 | | 1,400 |

(b) 1. Capital Employed at the end of each year

| | 31.3.2015 ₹ | 31.3.2016 ₹ | 31.3.2017 ₹ |
|--------------------------------------|----------------|----------------|----------------|
| Goodwill | 10,00,000 | 8,00,000 | 6,00,000 |
| Building and Machinery (Revaluation) | 18,00,000 | 20,00,000 | 22,00,000 |
| Inventory (Revalued) | 12,00,000 | 14,00,000 | 16,00,000 |
| Trade Receivables | 20,000 | 1,60,000 | 4,40,000 |
| Bank Balance | 1,20,000 | 2,00,000 | 4,00,000 |
| Total Assets | 41,40,000 | 45,60,000 | 52,40,000 |
| Less: Trade Payables | (6,00,000) | (8,00,000) | (10,00,000) |
| Closing Capital | 35,40,000 | 37,60,000 | 42,40,000 |
| Add: Opening Capital | 36,60,000 | 35,40,000 | 37,60,000 |
| Total | 72,00,000 | 73,00,000 | 80,00,000 |
| Average Capital | 36,00,000 | 36,50,000 | 40,00,000 |

Since the goodwill has been purchased, it is taken as a part of Capital employed.

2. Valuation of Goodwill

| | | 31.3.2015 | 31.3.2016 | 31.3.2017 |
|--|--|-------------------|-------------------|-------------------|
| (i) Future Maintainable Profit | | | | |
| Net Profit as given | | 4,20,000 | 6,20,000 | 8,20,000 |
| Less: Opening Balance | | (1,20,000) | (1,40,000) | (1,60,000) |
| Adjustment for Valuation of Opening Inventory | | - | (2,00,000) | (2,00,000) |
| Add: Adjustment for Valuation of closing inventory | | 2,00,000 | 2,00,000 | 2,00,000 |
| Goodwill written off | | - | 2,00,000 | 2,00,000 |
| Transferred to General Reserve | | <u>2,00,000</u> | <u>2,00,000</u> | <u>2,00,000</u> |
| Future Maintainable Profit | | 7,00,000 | 8,80,000 | 10,60,000 |
| Less: 12.50% Normal Return | | <u>(4,50,000)</u> | <u>(4,56,250)</u> | <u>(5,00,000)</u> |
| (ii) Super Profit | | 2,50,000 | 4,23,750 | 5,60,000 |

(iii) Average Super Profit = ₹ (2,50,000+4,23,750+5,60,000) ÷ 3 = ₹ 4,11,250

(iv) Value of Goodwill at five years' purchase = ₹ 4,11,250 × 5 = ₹ 20,56,250.

6. (a) Journal Entries in the books of company

| Date | Particulars | Dr. ₹ | Cr. ₹ |
|-------------------|---|--|----------|
| 1-3-X2 to 31-3-X2 | Bank A/c Employees compensation expenses A/c To Equity Share Capital A/c To Securities Premium A/c (Being allotment to employees 4,800 shares of ₹ 10 each at a premium of ₹ 130 at an exercise price of ₹ 50 each) | Dr. 2,40,000 Dr. 4,32,000 48,000 6,24,000 | |
| 31-3-X2 | Profit and Loss account To Employees compensation expenses A/c (Being transfer of employees compensation expenses) | Dr. 4,32,000 4,32,000 | 4,32,000 |

Working Note:

- Employee Compensation Expenses = Discount between Market Price and option price = ₹ 140 – ₹ 50 = ₹ 90 per share = ₹ 90 x 4,800 = ₹ 4,32,000/- in total.
- The Employees Compensation Expense is transferred to Securities Premium Account.
- Securities Premium Account = ₹ 50 – ₹ 10 = ₹ 40 per share + ₹ 90 per share on account of discount of option price over market price = ₹ 130 per share = ₹ 130 x 4,800 = ₹ 6,24,000/- in total.

(b) 'Non-performing asset' means:

- an asset, in respect of which, interest has remained overdue for a period of six months or more;
- a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;
- a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;
- a bill which remains overdue for a period of six months or more;
- the interest in respect of a debt or the income on receivables under the head 'other current

assets' in the nature of short term loans/advances, which facility remained overdue for a period of six months or more;

(f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;

Note: As per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, the above six months criteria for the assets covered under (a) to (f) is 4 months for the financial year ending March 31, 2017; and from next year ending March 31, 2018 and thereafter it will be 3 months.

(g) the lease rental and hire purchase instalment, which has become overdue for a period of twelve months or more;

Note: The above twelve months criteria for the assets covered under (g) is 6 months for the financial year ending March 31, 2017 and from next year ending March 31, 2018 and thereafter it will be 3 months.

(h) in respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes non-performing asset

(c) Presentation of MAT credit in the financial statements:

Balance Sheet: Where a company recognizes MAT credit as an asset on the basis of the considerations specified in the Guidance Note on Accounting for Credit Available in respect of Minimum Alternate Tax under the Income Tax Act, 1961, the same should be presented under the head 'Loans and Advances'* since, there being a convincing evidence of realization of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'.

In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph 11 of the Guidance Note.

Profit and Loss Account: According to explanation given for paragraph 21 of Accounting Standard 22, "Accounting for Taxes on Income" in the context of Section 115JB of the Income-tax Act, 1961, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the statement of profit and loss in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognized as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the statement of profit and loss and presented as a separate line item therein.

OR

In accordance with the Schedule III, an investment realizable within 12 months from the reporting date is classified as a current asset. Such realisation should be in the form of cash or cash equivalents, rather than through conversion of one asset into another non-current asset. Hence, company must classify such an investment as a non-current asset, unless it expects to sell the preference shares or the equity shares on conversion and realise cash within 12 months.

(d) Total dividend paid = ₹ 60,000
 Out of post-acquisition profit = ₹ 40,000
 Out of pre-acquisition profit = ₹ 20,000

* As per Schedule III to the Companies Act, 2013, it should be presented under the head 'Non-current Assets' sub head 'Long-term Loans and Advances'.

Hence, 2/3rd of dividend received by XYZ will be credited to P & L and 1/3rd will be credited to Investment.

XYZ Ltd.'s share of dividend = ₹ 60,000 X 80% = ₹ 48,000

In the books of XYZ Ltd.

| | ₹ | ₹ |
|--|----------|-----------------|
| Bank A/c | Dr. | 48,000 |
| To Profit & Loss A/c | | 32,000 |
| To Investments in ABC Ltd. | | 16,000 |
| (Dividend received from ABC Ltd. 1/3 credited to investment A/c being out of capital profits – as explained above) | | |
| <i>Goodwill on Consolidation:</i> | | ₹ |
| Cost of shares less dividend out of capital profits | | 2,64,000 |
| Less: Face value of capital i.e. 80% of capital | 1,60,000 | |
| Share of capital profits [1,20,000-20,000 (dividend portion out of pre-acquisition profits)] X 80 % | 80,000 | <u>2,40,000</u> |
| Goodwill | | 24,000 |
| Minority interest on: | | 64,000 |
| 1st January, 2016: 20% of ₹ 3,20,000 [2,00,000 + 1,20,000] | | |
| 31 st December, 2016: 20% of ₹ 3,00,000 [2,00,000 + 1,20,000 + 40,000 – 60,000] | | 60,000 |

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

Question No. 1 is compulsory.

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

Time Allowed – 3 Hours **Maximum Marks – 100**

1. Examine with reasons (in short) whether the following statements are correct or incorrect:
 - (i) A modelling tool constructs a statistical model from financial data only of prior accounting periods to predict current account balances.
 - (ii) When we are designing audit procedures to address an inherent risk or “what can go wrong”, we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence.
 - (iii) According to SA 530 “Audit sampling”, ‘audit sampling’ refers to the application of audit procedures to 100% of items within a population of audit relevance.
 - (iv) The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven.
 - (v) Application controls include manual controls only that operate at a business process level.
 - (vi) Misstatements in the financial statements can arise from fraud only.
 - (vii) The assessment of risks is a matter capable of precise measurement.
 - (viii) The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Central Government.
 - (ix) The auditor shall express an adverse opinion when:
 - (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
 - (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive
 - (x) Other matter paragraph is paragraph included in the auditor’s report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor’s judgment, is of such importance that it is fundamental to users’ understanding of the financial statements.

(2 x 10 = 20 Marks)

2. Discuss the following:
 - (a) The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be. Explain Stating the examples of factors that the auditor may consider when determining the sample size for tests of controls.
 - (b) “The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client’s business” Discuss stating clearly the broad points you would be covering in framing plan to conduct audit in an efficient and effective manner.

(c) The engagement partner of AST AND ASSOCIATES, firm of Chartered Accountants appointed as auditor of Fabric India Ltd is considering as to management of key resources to be employed to conduct audit. Discuss how overall audit strategy would assist the auditor.

(d) Discuss the different ways testing is performed in an automated environment **(5 x 4 = 20 Marks)**

3. (a) RAG is proprietorship firm engaged in the manufacturing of textile and handloom products. It sells its finished products both in the domestic as well as in the international market. The company is making total turnover of Rs. 30 crores. It has also availed cash credit limit of Rs. 5 crores from Canara Bank. In the year 2017-18, proprietor of the firm is worried about the financial position of the company and is under the impression that since he is out of India, therefore firm might run into losses. He approaches a CA about advantages of getting his accounts audited throughout the year so that he may not suffer due to accounting weaknesses. Advise regarding advantages of getting accounts audited. **(5 Marks)**

(b) The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. Discuss. **(5 Marks)**

(c) On going through the financial statements of PQR Ltd, its auditors Kamal Gagan and Associates observed that company has taken Loans from banks and financial institutions. Further, the audit team discusses the following about Liabilities:

“Liabilities are the financial obligations of an enterprise other than owners' funds. Liabilities include loans/ borrowings, trade payables and other current liabilities, deferred payment credits and provisions.

Verification of liabilities is as important as that of assets, for, if any liability is omitted (or understated) or over stated, the Balance Sheet would not show a true and fair view of the state of affairs of the company.”

Advise stating clearly the audit procedures generally required to be undertaken for verification of existence of Borrowings **(5 Marks)**

(d) “Until the invoice is paid, the invoice amount is recorded on the organization's balance sheet as accounts receivable. If balances are not recoverable, then these amounts will need to be written off as an expense in the income statement/ profit and loss account.”

It is important to carry out compliance procedures in the sales audit as part of the debtors' audit procedure.

Verify to ensure that the system for receivables has the necessary features. **(5 Marks)**

4. (a) The objective of the IAASB is to serve the public interest by setting high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. Advise how this objective would be accomplished. **(5 Marks)**

(b) State the matters to be included in the auditor's report as per CARO, 2016 regarding-

(i) Default in repayment of loans or borrowing to a financial institution, bank etc. **(2 Marks)**

(ii) Fraud by the company or on the Company by its officers or employees. **(2 Marks)**

(c) The auditor of XYZ Ltd, engaged in FMCG (Fast Moving Consumable Goods) obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:

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

(ii) The strengths in the control environment elements collectively provide an appropriate

foundation for the other components of internal control.

Advise what is included in control environment. Also explain the elements of control environment. **(6 Marks)**

(d) ABC Ltd is engaged in manufacturing of different type of yarns. On going through its financial statements for the past years, it is observed that inventory is material to the financial statements. You as an auditor of the company wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss, how would you proceed as an auditor. **(5 Marks)**

5. (a) The auditor evaluated, in respect of T Ltd., whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. Auditor's evaluation included consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. Advise the qualitative aspects of the entity's accounting practices. **(5 Marks)**

(b) M/s RM & Co. is an audit firm having partners CA. R and CA. M. The firm has been offered the appointment as an auditor of Enn Ltd. for the Financial Year 2016-17. Mr. Bee, the relative of CA. R, is holding 5,000 shares (face value of Rs. 10 each) in Enn Ltd. having market value of Rs. 1,50,000. One of the shareholders, complains that the appointment of RM & Co. as an auditor is invalid because it incurred disqualification u/s 141 of the Companies Act, 2013. Analyse and advise. **(5 Marks)**

(c) The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, explain the factors that are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures. **(5 Marks)**

(d) Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. Explain with examples. **(5 Marks)**

6. (a) The first auditors of Bhartiya Petrol Ltd., a Government company, were appointed by the Board of Directors. Analyse. **(5 Marks)**

(b) An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations. **(5 Marks)**

(c) The engagement team of FRN & Co.- Auditors of Bank of Baroda held discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. The discussion between the members of the engagement team and the audit engagement partner are being done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit. Analyse and Advise the matters to be discussed in the engagement team discussion. **(5 Marks)**

(d) Advise any five special points in an audit of hospital. **(5 Marks)**

MOCK TEST PAPER
INTERMEDIATE (NEW): GROUP – II
PAPER – 6: AUDITING AND ASSURANCE
SUGGESTED ANSWERS / HINTS

1. (i) **Incorrect:** A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).
- (ii) **Correct.** — When we are designing audit procedures to address an inherent risk or “what can go wrong”, we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.
- (iii) **Incorrect:** According to SA 530 “Audit sampling”, ‘audit sampling’ refers to the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.
- (iv) **Correct:** The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.
- (v) **Incorrect.** Application controls include both automated or manual controls that operate at a business process level. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems.
- (vi) **Incorrect:** Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
- (vii) **Incorrect:** The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.
- (viii) **Incorrect:** The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.
- (ix) **Incorrect:** The auditor shall express a qualified opinion when:
 - (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
 - (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive
- (x) **Incorrect:** Emphasis of Matter paragraph is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

2. (a) The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.

Examples of Factors Influencing Sample Size for Tests of Controls: The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

- ◆ When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased). Thus, sample size will increase.
- ◆ If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be.
- ◆ When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as higher the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
- ◆ An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
- ◆ In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.

(b) "The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business".

Plans should be made to cover, among other things:

- (a) acquiring knowledge of the client's accounting systems, policies and internal control procedures;
- (b) establishing the expected degree of reliance to be placed on internal control;

- (c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and
- (d) coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit.

SA-300, "Planning an Audit of Financial Statements" further expounds this principle. According to it, **planning is not a discrete phase of an audit, but rather a continual and iterative process** that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

- (c) The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

1. The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
2. The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
3. When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
4. How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (**for example, on-site or off-site**), and whether to complete engagement quality control reviews.

- (d) The following are different ways testing is performed in an automated environment :

There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and reperformance. As shown in the illustration below, Inquiry is the most efficient audit test but it is also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.

Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed, etc. The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file as required by SA 230.

When testing in an automated environment, some of the more common methods are as follows:

- Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
- Observe how a user processes transactions under different scenarios.
- Inspect the configuration defined in an application

3. (a) The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory, these advantages are given below:

- (a) **It safeguards the financial interest of persons who are not associated** with the management of the entity, whether they are partners or shareholders, bankers, FI's, public at large etc.
- (b) **It acts as a moral check on the employees** from committing defalcations or embezzlement.
- (c) Audited statements of account are **helpful in settling liability for taxes**, negotiating loans and for determining the purchase consideration for a business.
- (d) These are **also useful for settling trade disputes** for higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.
- (e) An audit can also **help in the detection of wastages and losses** to show the different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures.
- (f) **Audit ascertains whether the necessary books of account and allied records have been properly kept** and helps the client in making good deficiencies or inadequacies in this respect.
- (g) As an appraisal function, **audit reviews the existence and operations of various controls in the organisations** and reports weaknesses, inadequacies, etc., in them.
- (h) Audited accounts are of great help in **the settlement of accounts at the time of admission or death of partner**.
- (i) **Government may require audited and certified statement** before it gives assistance or issues a license for a particular trade.

(b) The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

- ◆ Deleting or discarding superseded documentation.
- ◆ Sorting, collating and cross referencing working papers.
- ◆ Signing off on completion checklists relating to the file assembly process.
- ◆ Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

(c) Review board minutes for approval of new lending agreements. During review, make sure that any new loan agreements or bond issuances are authorized. Ensure that significant debt commitments should be approved by the board of directors

- Agree details of loans recorded (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits imposed by agreements are not exceeded.
- Agree overdrafts and loans recorded to bank confirmation / confirmation to lenders.
- Agree details of leases and hire purchase creditors recorded to underlying agreement.
- Examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- When debt is retired, ensure that a discharge is received on assets securing the debt.
- If we become aware of significant transactions that are outside the normal course of business or that otherwise appear to be unusual given our understanding of the entity and its environment, perform the following procedures:
 - (a) Gain an understanding of the business rationale for such significant unusual transaction.
 - (b) Consider whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity we are auditing.

(d) Trade receivable are an essential part of any organisation's balance sheet. Often referred to as debtors, these are monies which are owed to an organisation by a customer. The most common form of an account receivable is a sale made on credit, via an invoice, to a customer. Typically, an invoice is raised and issued to the customer with the invoice amount being recorded as a debtor balance. Until the invoice is paid, the invoice amount is recorded on the organization's balance sheet as accounts receivable. If balances are not recoverable, then these amounts will need to be written off as an expense in the income statement/ profit and loss account.

It is important to carry out compliance procedures in the sales audit as part of the debtors' audit procedure. In summary, check to ensure that the system for receivables has the following features:

- Only bona fide sales lead to receivables
- All such sales are to approved customers
- All such sales are recorded
- Once recorded, the debts can only be eliminated by receipt of cash or on the authority of a responsible official
- Debts are collected promptly
- Balances are regularly reviewed and aged, a proper system of follow up exists and if necessary adequate provision for bad debt exists
- Clear segregation of duties relating to identification of debt, receipt of income, reconciliations and write off of debts

4. (a) The objective of the IAASB is to serve the public interest by setting high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The IAASB achieves this objective by:

- Establishing high quality auditing standards and guidance for financial statement audits that

are generally accepted and recognized by investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world;

- Establishing high quality standards and guidance for other types of assurance services on both financial and non-financial matters;
- Establishing high quality standards and guidance for other related services;
- Establishing high quality standards for quality control covering the scope of services addressed by the IAASB; and
- Publishing other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers.

(b) **Matters to be included in the Auditor's Report under CARO, 2016:** The auditor's report on the accounts of a company to which CARO applies shall include a statement on the following matters, namely-

- (i) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).
- (ii) whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;

(c) **Control Environment – Component of Internal Control:** The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

- (i) Management has created and maintained a culture of honesty and ethical behavior; and
- (ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

What is included in Control Environment?

The control environment includes:

- (i) the governance and management functions and
- (ii) the attitudes, awareness, and actions of those charged with governance and management.
- (iii) The control environment sets the tone of an organization, influencing the control consciousness of its people.

Elements of the Control Environment: Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- (a) **Communication and enforcement of integrity and ethical values** – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
- (b) **Commitment to competence** – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
- (c) **Participation by those charged with governance** – Attributes of those charged with governance such as:
 - ◆ Their independence from management.

- ◆ Their experience and stature.
- ◆ The extent of their involvement and the information they receive, and the scrutiny of activities.
- ◆ The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(d) **Management's philosophy and operating style** – Characteristics such as management's:

- ◆ Approach to taking and managing business risks.
- ◆ Attitudes and actions toward financial reporting.
- ◆ Attitudes toward information processing and accounting functions and personnel.

(e) **Organisational structure** – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

(f) **Assignment of authority and responsibility** - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

(g) **Human resource policies and practices** – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

(d) When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

- (a) Attendance at physical inventory counting, unless impracticable, to:
 - (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
 - (ii) Observe the performance of management's count procedures;
 - (iii) Inspect the inventory; and
 - (iv) Perform test counts; and
- (b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

5. (a) The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:
 - (i) The selective correction of misstatements brought to management's attention during the audit

Example

- ✍ Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
- ✍ The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives.

(ii) Possible management bias in the making of accounting estimates.

4. SA 540 addresses possible management bias in making accounting estimates.

Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

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

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

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

(c) The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- (i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;
- (ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
- (iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing

of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 (Revised) establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

(d) **Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:**

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome.
- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.

Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

6. (a) A “Government company” is a company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

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

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

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

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

(b) **Receipt of Donations:**

- (i) **Internal Control System:** Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.
- (ii) **Custody of Receipt Books:** Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.
- (iii) **Receipt of Cheques:** Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.

- (iv) **Bank Reconciliation:** Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.
- (v) **Cash Receipts:** Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.
- (vi) **Foreign Contributions,** if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of Donations to Different NGOs:

- (i) **Mode of Sending Remittance:** All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.
- (ii) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.
- (iii) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.
- (iv) **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.
- (v) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.
- (vi) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.
- (c) The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference. The discussion provides:
 - An opportunity for more experienced engagement team members, including the audit engagement partner, to share their insights based on their knowledge of the bank and its environment.
 - An opportunity for engagement team members to exchange information about the bank's business risks.
 - An understanding amongst the engagement team members about effect of the results of the risk assessment procedures on other aspects of the audit, including decisions about the nature, timing, and extent of further audit procedures.

The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit.

The engagement team discussion ordinarily includes a discussion of the following matters:

- Errors that may be more likely to occur;
- Errors which have been identified in prior years;
- Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
- Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;
- Need to maintain professional skepticism throughout the audit engagement;
- Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

(d) **Audit of Hospital:** The special steps involved in such an audit are stated below-

- (1) **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.
- (2) **Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.
- (3) **Income from Investments, Rent etc.:** See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities have been collected.
- (4) **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
- (5) **Reconciliation of Subscriptions:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).
- (6) **Authorisation and Sanctions:** Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.
- (7) **Grants and TDS:** Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.
- (8) **Budgets:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.
- (9) **Internal Check:** Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.
- (10) **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.
- (11) **Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.
- (12) **Inventories:** Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.
- (13) **Management Representation and Certificate:** Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

MOCK TEST PAPER

INTERMEDIATE (NEW): GROUP – II

PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC MANAGEMENT

SECTION – A: ENTERPRISE INFORMATION SYSTEMS

Question No. 1 is compulsory.

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

Time Allowed – 1½ Hours

Maximum Marks – 50

QUESTIONS

1. Answer all the following questions in brief.
 - (i) Discuss “Management Processes” and state their example.
 - (ii) Describe Role Based Access Control (RBAC) in Enterprise Resource Planning (ERP) System.
 - (iii) Discuss briefly the concept of “Virtual Memory”.
 - (iv) Define “Digital Library”.
 - (v) Explain the working of Automated Teller Machines (ATM) Channel Server? **(5 x 2 = 10 Marks)**
2. (a) A company ABC Ltd. is engaged in selling consumer goods to different categories of customers. To increase its sales, different types of discounts are offered to customers. The policy of discount is as given below:
 - i. On cooking range, a discount of 12% is allowed to dealers and 9% to retailers irrespective of the value of the order.
 - ii. A discount of 12% is allowed on washing machine irrespective of the category of customer and the value of the order.
 - iii. On decorative products, dealers are allowed a discount of 20% provided that the value of the order is Rs. 10,000 and above. Retailers are allowed a discount of 10% irrespective of the value of the order.Prepare a flow chart to calculate the discount for the above policy. **(6 Marks)**
- (b) An Internet connection exposes an organization to the harmful elements of the outside world. As an EDP (Electronic Data Processing) operator of an organization ABC, prepare a checklist for Network Access Controls that are required to be implemented in the organization. **(4 Marks)**
3. (a) As an IS Auditor, determine a checklist for the audit of ERP system in an organization. Also, summarize the auditing aspects of ERP systems. **(6 Marks)**
- (b) A bank PQR has many branches all over India. However, the competent authority intends to bring all the branches together under one umbrella and make it centralized. For that, identify most prominently available Core Banking Software in the market. **(4 Marks)**
4. (a) Operating System security involves policy, procedure and controls that determine, ‘who can access the operating system,’ ‘which resources they can access’, and ‘what action they can take’. As an Information Systems auditor, determine the key areas which shall be put in place by any organization. **(6 Marks)**
- (b) Recognize the application areas where the concept of Internet of Things (IoT) has been implemented. **(4 Marks)**

5. (a) "Jan Seva" is a charitable organisation that was established in 2008. It opened its current account with ABC Bank on 1st February, 2008. Following transactions were made by Jan Seva in the month of July 2012:

| Date | Amount of Cash transaction |
|-----------------------------|----------------------------|
| 3 rd July, 2012 | Rs. 5 Lakh |
| 9 th July, 2012 | Rs. 2 Lakh |
| 28 th July, 2012 | Rs. 3 Lakh |

Examining the given situation, determine the liability of the reporting authority with respect to the maintaining of the record of the transaction. **(6 Marks)**

(b) Internal Control Systems can provide an entity with reasonable assurance about achieving the entity's operational, financial reporting and compliance objectives. State the inherent limitations of Internal Control Systems. **(4 Marks)**

6. (a) Ms. Y is using Google Apps through which she can access any application, service and data storage facilities on the Internet and pay as-per-usage. Analyze which computing model is providing her these facilities. Also, determine the model's key characteristics. **(6 Marks)**

(b) Discuss the peculiarities that must be considered while allotting a voucher number to a voucher. **(4 Marks)**

MOCK TEST PAPER

INTERMEDIATE COURSE: GROUP – II

PAPER –7: ENTERPRISE INFORMATION SYSTEMS & STRATEGIC MANAGEMENT

SECTION – B: STRATEGIC MANAGEMENT

Time Allowed – 1½ Hours

Maximum Marks – 50

All questions are compulsory. Choices, if any, are available within question.

Question 1 (Attempt any two parts)

1. (a) Explain competitive advantage.
(b) What is strategic vision?
(c) What do you understand by co-generic merger? **(2 × 2 = 4 Marks)**

Question 2 (Attempt any two parts)

2. Which of the following statements are 'correct' and which are 'incorrect'? Give reasons, in brief, for your answer:
 - (a) Every strategic move is the result of proactive planning.
(b) Economies of scale discourages new entrants.
(c) Human resource management aids in strategic management. **(2 × 2 = 4 Marks)**
3. (a) *Always Fit* is a company that operates in pharmacy store chains. Its stores are specialized in providing prescribed medicines, health and wellness products etc. in the country. The store chain is having surplus space which can be utilized for other purposes. Azad, a senior executive of the research and development wing in the company conceives an idea to manufacture and sell the cosmetic products for utilizing the surplus space available in the pharmacy stores.

Identify and explain the role of Azad in company. **(5 Marks)**

- (b) Arena Ltd. manufactures computers that are of low in production cost, competitive price, and quality to their competitor's product. Profits and market share are declining day by day. Shreekanth, a senior executive realizes that drastic strategies have to be created for the survival of a company. After SWOT analysis by assessing the strengths and weaknesses, they come up with the conclusion that they cannot compete in the computers with the competitors. The management directs Shreekanth to act quick and develop a suitable strategic plan.

Discuss the strategy which can be opted by Shreekanth. **(5 Marks)**

- (c) Mr. Banerjee is head of marketing department of a manufacturing company. His company is in direct competition with thirteen companies at national level. He wishes to study the market positions of rival companies by grouping them into like positions.

Name the tool that may be used by Mr. Banerjee? Explain the procedure that may be used to implement the technique. **(5 Marks)**

4. (a) Briefly explain the importance of strategic management. **(5 Marks)**
- (b) What is strategic decision making? What are its major dimensions? **(5 Marks)**

5. (a) "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. **(5 Marks)**
(b) Distinguish between cost leadership and differentiation strategies. **(5 Marks)**
6. What is strategy audit? Explain the criteria for strategy audit as given by Richard Rumelt.

Or

Define strategic change. Explain the various stages/phases of change process as propounded by Kurt Lewin. **(7 Marks)**

MOCK TEST PAPER

INTERMEDIATE (NEW): GROUP – II

PAPER – 7: ENTERPRISE INFORMATION SYSTEMS AND STRATEGIC MANAGEMENT

SECTION – A: ENTERPRISE INFORMATION SYSTEMS

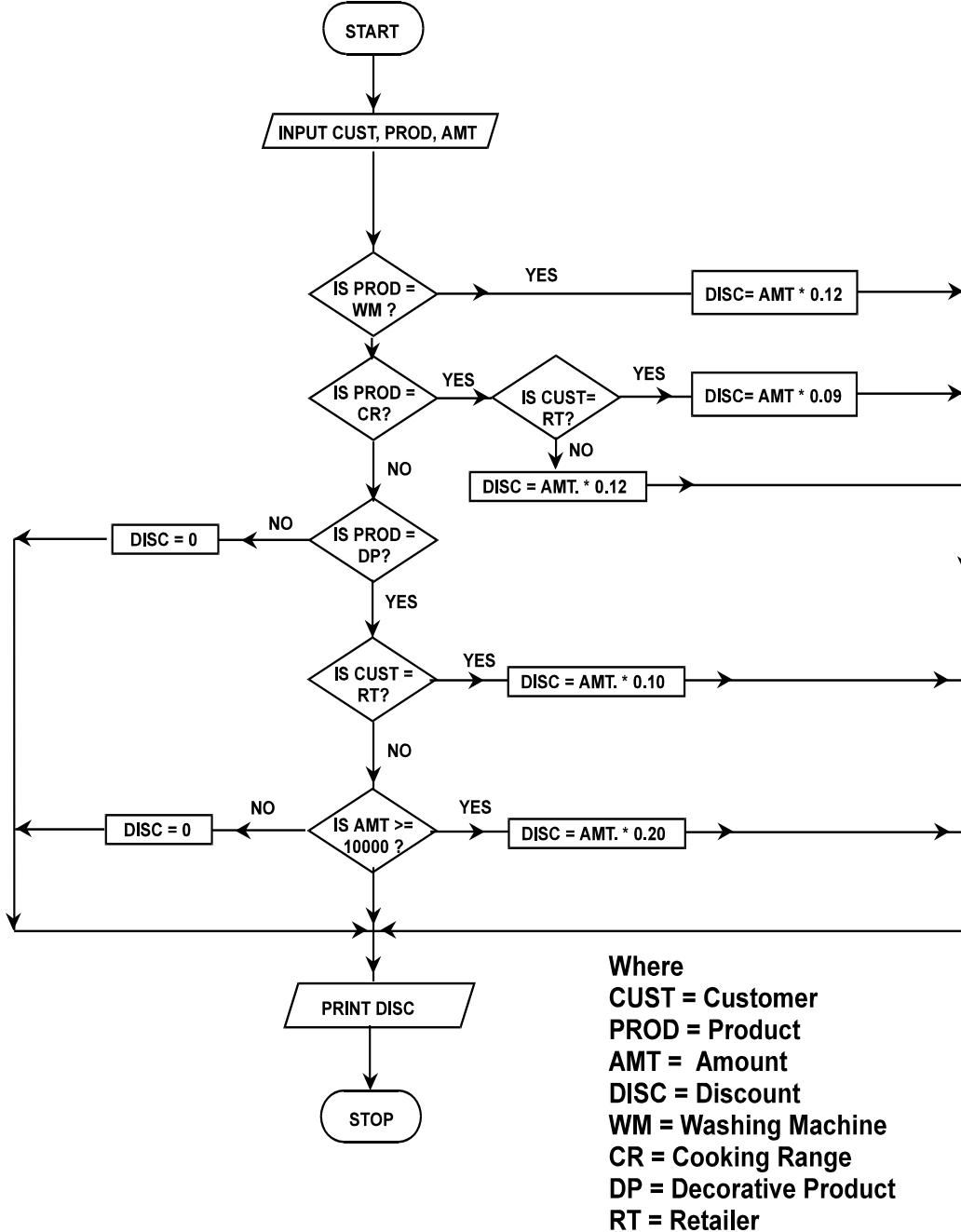
ANSWERS

1. (i) **Management Processes:** Management processes measure, monitor and control activities related to business procedures and systems. Examples of management processes include internal communications, governance, strategic planning, budgeting, and infrastructure or capacity management. Management processes do not provide value directly to the customers, however, have a direct impact on the efficiency of the enterprise.
- (ii) **Role Based Access Control (RBAC) in ERP System:** In computer systems security, role-based access control is an approach to restricting system access to authorized users. It is used by most enterprises and can implement mandatory access control or discretionary access control. RBAC is sometimes referred to as Role-Based Security. Role-Based-Access-Control (RBAC) is a policy neutral access control mechanism defined around roles and privileges. The components of RBAC such as role-permissions, user-role and role-role relationships make it simple to perform user assignments. RBAC can be used to facilitate administration of security in large organizations with hundreds of users and thousands of permissions.

Roles for staff are defined in organization and access to the system can be given according to the role assigned. For example - A junior accountant in accounting department is assigned a role of recording basic accounting transactions, an executive in human resource department is assigned a role of gathering data for salary calculations on monthly basis, etc.
- (iii) **Virtual Memory:** Virtual Memory is an imaginary memory area supported by some operating systems (for example, Windows) in conjunction with the hardware. If a computer lacks the Random-Access Memory (RAM) needed to run a program or operation, Windows uses virtual memory to compensate. Virtual memory combines computer's RAM with temporary space on the hard disk. When RAM runs low, virtual memory moves data from RAM to a space called a paging file. Moving data to and from the paging file frees up RAM to complete its work. Thus, Virtual memory is an allocation of hard disk space to help RAM.
- (iv) **Digital Library:** A Digital Library is a special library with a focused collection of digital objects that can include text, visual material, audio material, video material, stored as electronic media formats, along with means for organizing, storing, and retrieving the files and media contained in the library collection. Digital libraries can vary immensely in size and scope, and can be maintained by individuals, organizations, or affiliated with established physical library buildings or institutions, or with academic institutions. The digital content may be stored locally, or accessed remotely via computer networks. An electronic library is a type of information retrieval system.
- (v) **Automated Teller Machines (ATM) Channel Server:** This server contains the details of ATM account holders. Soon after the facility of using the ATM is created by the Bank, the details of such customers are loaded on to the ATM server. When the Central Database is busy with central end-of-day activities or for any other reason, the file containing the account balance of the customer is sent to the ATM switch. Such a file is called Positive Balance File (PBF). Till the central database becomes accessible, the ATM transactions are passed and the balance available in the ATM server. Once the central database server becomes accessible, all the transactions that took place till such time as the central database became un-accessible would be updated in the central

database. This ensures not only continuity of ATM operations but also ensures that the Central database is always up-to-date. The above process is applicable to stand alone ATMs at the Branch level. As most of the ATMs are attached to the central network, the only control is through ATM Switch.

2. (a) The required flowchart is given in Figure below.



(b) **Network Access Control:** An Internet connection exposes an organization to the harmful elements of the outside world. The checklist for Network Access Controls that are required to be implemented in the organization are as follows:

- **Policy on use of network services:** An enterprise wide policy applicable to internet service requirements aligned with the business need for using the Internet services is the first step. Selection of appropriate services and approval to access them should be part of this policy.

- **Enforced path:** Based on risk assessment, it is necessary to specify the exact path or route connecting the networks; e.g., internet access by employees will be routed through a firewall and proxy.
- **Segregation of networks:** Based on the sensitive information handling function; say a VPN connection between a branch office and the head-office, this network is to be isolated from the internet usage service
- **Network connection and routing control:** The traffic between networks should be restricted, based on identification of source and authentication access policies implemented across the enterprise network facility.
- **Security of network services:** The techniques of authentication and authorization policy should be implemented across the organization's network.
- **Firewall:** A Firewall is a system that enforces access control between two networks. To accomplish this, all traffic between the external network and the organization's Intranet must pass through the firewall that will allow only authorized traffic between the organization and the outside to pass through it. The firewall must be immune to penetrate from both outside and inside the organization. In addition to insulating the organization's network from external networks, firewalls can be used to insulate portions of the organization's Intranet from internal access also.
- **Encryption:** Encryption is the conversion of data into a secret code for storage in databases and transmission over networks. The sender uses an encryption algorithm with a key to convert the original message called the Clear text into Cipher text. This is decrypted at the receiving end. Two general approaches are used for encryption viz. private key and public key encryption.
- **Call Back Devices:** It is based on the principle that the key to network security is to keep the intruder off the Intranet rather than imposing security measure after the criminal has connected to the intranet. The call- back device requires the user to enter a password and then the system breaks the connection. If the caller is authorized, the call back device dials the caller's number to establish a new connection. This limits access only from authorized terminals or telephone numbers and prevents an intruder masquerading as a legitimate user. This also helps to avoid the call forwarding and man-in-the middle attack

3. (a) Checklist to be followed by an IS Auditor for the audit of ERP Systems are as follows:

- Does the system process according to GAAP (Generally Accepted Accounting Principles) and GAAS (Generally Accepted Auditing Standards)?
- Does it meet the needs for reporting, whether regulatory or organizational?
- Were adequate user requirements developed through meaningful interaction?
- Does the system protect confidentiality and integrity of information assets?
- Does it have controls to process only authentic, valid, accurate transactions?
- Are effective system operations and support functions provided?
- Are all system resources protected from unauthorized access and use?
- Are user privileges based on what is called 'role-based access'?
- Is there an ERP system administrator with clearly defined responsibilities?
- Is the functionality acceptable? Are user requirements met? Are users happy?
- Have workarounds or manual steps been required to meet business needs?

- Are there adequate audit trails and monitoring of user activities?
- Can the system provide management with suitable performance data?
- Are users trained? Do they have complete and current documentation?
- Is there a problem-escalation process?

Auditing aspects in case of any ERP system can be summarized as under:

(i) **Auditing of Data**

- **Physical Safety** – Ensuring physical control over data.
- **Access Control** – Ensuring access to the system is given on “need to know” (a junior accountant need not view Profit & Loss Account of the business) and “need to do basis” (HR executive need not record a Purchase Order).

(ii) **Auditing of Processes**

- **Functional Audit** - This includes testing of different functions / features in the system and testing of the overall process or part of process in the system and its comparison with actual process. E.g. Purchase Process, Sales Process, Salary Calculation Process, Recruitment Process, etc. Auditor may check this process in the system and compare it with actual process. It is quite possible that all the aspect present in the actual process may not be integrated in the ERP system. There may be some manual intervention.
- **Input Validations** - This stands for checking of rules for input of data into the system. E.g. a transaction of cash sales on sales counter must not be recorded in a date other than today (not a future date or a back date), amount field must not be zero, stock item field shall not be empty, etc. Input validations shall change according to each data input form.

(b) **Core Banking Solution (CBS)** refers to a common IT solution wherein a central shared database supports the entire banking application. Business processes in all the branches of a bank update a common database in a central server located at a Data Center, which gives a consolidated view of the bank's operations. Branches function as delivery channels providing services to its customers. CBS is centralized Banking Application software that has several components which have been designed to meet the demands of the banking industry. CBS is supported by advanced technology infrastructure and has high standards of business functionality. These factors provide banks with a competitive edge. Core Banking Solution brings significant benefits such as a customer is a customer of the bank and not only of the branch. Further, the CBS is modular in structure and is capable of being implemented in stages as per requirements of the bank. A CBS software also enables integration of all third-party applications, including in-house banking software, to facilitate simple and complex business processes. Some examples of CBS software are given below. These are only illustrative and not exhaustive.

- **Finacle:** Core banking software suite developed by Infosys that provides universal banking functionality covering all modules for banks covering all banking services.
- **FinnOne:** Web-based global banking product designed to support banks and financial solution companies in dealing with assets, liabilities, core financial accounting and customer service.
- **Flexcube:** Comprehensive, integrated, interoperable, and modular solution that enables banks to manage evolving customer expectations.
- **BaNCS:** A customer-centric business model which offers simplified operations comprising loans, deposits, wealth management, digital channels and risk and compliance components.
- **bankMate:** A full-scale Banking solution which is a scalable, integrated e-banking systems that

meets the deployment requirements in traditional and non-traditional banking environments. It enables communication through any touch point to provide full access to provide complete range of banking services with anytime, anywhere paradigm.

Further, there are many CBS software developed by vendors which are used by smaller and co-operative banks. Some of the banks have also developed in-house CBS software. However, the trend is for using high-end CBS developed by vendors depending on cost-benefit analysis and needs.

4. (a) Protecting operating system access is extremely crucial and can be achieved using following steps:

- **Automated terminal identification:** This will help to ensure that a specified session could only be initiated from a certain location or computer terminal.
- **Terminal log-in procedures:** A log-in procedure is the first line of defense against unauthorized access as it does not provide unnecessary help or information, which could be misused by an intruder. When the user initiates the log-on process by entering user-id and password, the system compares the ID and password to a database of valid users and accordingly authorizes the log-in.
- **Access Token:** If the log on attempt is successful, the Operating System creates an access token that contains key information about the user including user-id, password, user group and privileges granted to the user. The information in the access token is used to approve all actions attempted by the user during the session.
- **Access Control List:** This list contains information that defines the access privileges for all valid users of the resource. When a user attempts to access a resource, the system compares his or her user-id and privileges contained in the access token with those contained in the access control list. If there is a match, the user is granted access.
- **Discretionary Access Control:** The system administrator usually determines; who is granted access to specific resources and maintains the access control list. However, in distributed systems, resources may be controlled by the end-user. Resource owners in this setting may be granted discretionary access control, which allows them to grant access privileges to other users. For example, the controller who is owner of the general ledger grants read only privilege to the budgeting department while accounts payable manager is granted both read and write permission to the ledger.
- **User identification and authentication:** The users must be identified and authenticated in a foolproof manner. Depending on risk assessment, more stringent methods like Biometric Authentication or Cryptographic means like Digital Certificates should be employed.
- **Password management system:** An operating system could enforce selection of good passwords. Internal storage of password should use one-way hashing algorithms and the password file should not be accessible to users.
- **Use of system utilities:** System utilities are the programs that help to manage critical functions of the operating system e.g. addition or deletion of users. Obviously, this utility should not be accessible to a general user. Use and access to these utilities should be strictly controlled and logged.
- **Duress alarm to safeguard users:** If users are forced to execute some instruction under threat, the system should provide a means to alert the authorities.
- **Terminal time out:** Log out the user if the terminal is inactive for a defined period. This will prevent misuse in absence of the legitimate user.
- **Limitation of connection time:** Define the available time slot. Do not allow any transaction beyond this time. For example, no computer access after 8.00 p.m. and before 8.00 a.m. - or on a Saturday or Sunday.

(b) Some of the application areas of Internet of Things (IoT) are as follows:

- I. All home appliances to be connected and that shall create a virtual home.
 - Home owners can keep track of all activities in house through their hand-held devices.
 - Home security CCTV is also monitored through hand held devices.
- II. Office machines shall be connected through net.
 - Human resource managers shall be able to see how many people have had a cup of coffee from vending machine and how many are present.
 - How many printouts are being generated through office printer?
- III. Governments can keep track of resource utilizations / extra support needed.
 - Under SWACHH mission government can tag all dustbins with IOT sensors. They (dustbins) generate a message once they are full. Being connected to wi-fi, they can intimate the cleaning supervisor of Municipal Corporation so that BIN can be emptied.

5. (a) The case is based on Sections 12 &13 of the Prevention of Money Laundering Act (PMLA), 2002 read with Rule 3 & Rule 8 of the Prevention of Money Laundering Rule (PMLR), 2002.

- (1) Every reporting entity shall maintain a record of all transactions, including information relating to cash transactions which are integrally connected to each other and which have been individually valued below rupees ten lakh or its equivalent in foreign currency where such series of transactions have taken place within a month and the monthly aggregate exceeds an amount of ten lakh rupees or its equivalent in foreign currency.

The Principal Officer of a reporting entity shall furnish the information in respect of such transactions every month to the Director (Authority appointed by the CG) by the 15th day of the succeeding month.

As per the above stated provision aggregate cash transactions (Rs. 5 lakh + Rs. 2 lakh + Rs. 3 lakh = Rs. 10 lakh) made by the Jan Seva in the month of July 2012 was Rs. 10 Lakh and not in excess to the limit prescribed. So there is no need to inform of the said transactions to the authorised authority.

(b) Internal control, no matter how effective, can provide an entity with only reasonable assurance and not absolute assurance about achieving the entity's operational, financial reporting and compliance objectives. Internal control systems are subject to certain inherent limitations, such as:

- Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.
- The fact that most internal controls do not tend to be directed at transactions of unusual nature. The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and misunderstanding of instructions.
- The possibility of circumvention of internal controls through collusion with employees or with parties outside the entity.
- The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.
- Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

6. (a) Cloud computing model provides the facility to access shared resources and common infrastructure offering services on demand over the network to perform operations that meet changing business needs. Thus, we can say that Ms. Y is using the Cloud Computing model which allows her to use many computing resources as a service through networks, typically the Internet.

Some of the key characteristics of Cloud Computing are as follows:

- **Elasticity and Scalability:** Cloud computing gives us the ability to expand and reduce resources according to the specific service requirement. For example, we may need many server resources for the duration of a specific task. We can then release these server resources after we complete our task.
- **Pay-per-Use:** We pay for cloud services only when we use them, either for the short term (for example, for CPU time) or for a longer duration (for example, for cloud-based storage or vault services).
- **On-demand:** Because we invoke cloud services only when we need them, they are not permanent parts of the IT infrastructure. This is a significant advantage for cloud use as opposed to internal IT services. With cloud services, there is no need to have dedicated resources waiting to be used, as is the case with internal services.
- **Resiliency:** The resiliency of a cloud service offering can completely isolate the failure of server and storage resources from cloud users. Work is migrated to a different physical resource in the cloud with or without user awareness and intervention.
- **Multi Tenancy:** Public cloud service providers often can host the cloud services for multiple users within the same infrastructure. Server and storage isolation may be physical or virtual depending upon the specific user requirements.
- **Workload Movement:** This characteristic is related to resiliency and cost considerations. Here, cloud-computing providers can migrate workloads across servers both inside the data center and across data centers (even in a different geographic area). This migration might be necessitated by cost (less expensive to run a workload in a data centre in another country based on time of day or power requirements) or efficiency considerations (for example, network bandwidth). A third reason could be regulatory considerations for certain types of workloads.

(b) A **Voucher Number** or a **Document Number** is a unique identity of any voucher/ document. A voucher may be identified or searched using its unique voucher number. The peculiarities that must be considered while allotting a voucher number to a voucher are as follows:

- Voucher number must be unique.
- Every voucher type shall have a separate numbering series
- A voucher number may have prefix or suffix or both, e.g. ICPL/2034/17-18. In this case, "ICPL" is the prefix, "17-18" is the suffix and "2034" is the actual number of the voucher.
- All vouchers must be numbered serially, i.e. 1,2,3,4,5,6 and so on.
- All vouchers are recorded in chronological order and hence voucher recorded earlier must have an earlier number, i.e. if voucher number for a payment voucher having date as 15th April 2017 is 112, voucher number for all the vouchers recorded after this date shall be more than 112 only.

MOCK TEST PAPER

INTERMEDIATE COURSE: GROUP – II

PAPER –7: ENTERPRISE INFORMATION SYSTEMS & STRATEGIC MANAGEMENT

SECTION – B: STRATEGIC MANAGEMENT

SUGGESTED ANSWERS/HINTS

1. (a) Competitive advantage is the position of a firm to maintain and sustain a favorable market position when compared to the competitors. Competitive advantage is ability to offer buyers something different and thereby providing more value for the money. It is the result of a successful strategy. This position gets translated into higher market share, higher profits when compared to those that are obtained by competitors operating in the same industry. Competitive advantage may also be in the form of low cost relationship in the industry or being unique in the industry along dimensions that are widely valued by the customers in particular and the society at large.
(b) A strategic vision delineates organisation's aspirations for the business, providing a panoramic view of the position where the organisation is going. A strategic vision points an organization in a particular direction, charts a strategic path for it to follow in preparing for the future, and moulds organizational identity. 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.
(c) In co-generic merger two or more merging organizations are associated in some way or the other related to the production processes, business markets, or basic required technologies. Such merger include the extension of the product line or acquiring components that are required in the daily operations.
2. (a) **Incorrect:** In business, things happen that cannot be fully anticipated or planned for. When market and competitive conditions take an unexpected turn or some aspect of a company's strategy hits a stone wall, some kind of strategic reaction or adjustment is required.
(b) **Correct:** Economies of scale refer to the decline in the per-unit cost of production (or other activity) as volume grows. A large firm that enjoys economies of scale can produce high volumes of goods at successively lower costs. This tends to discourage new entrants.
(c) **Correct:** The human resource management helps the organization to effectively deal with the external environmental challenges. The function has been accepted as a partner in the formulation of organization's strategies and in the implementation of such strategies through human resource planning, employment, training, appraisal and rewarding of personnel.
3. (a) Azad plays role as an intrapreneur who operates within the boundaries of an organisation. He is an employee of *Always Fit*, who is vested with authority of initiating creativity and innovation in the company's products, services and projects, redesigning the processes, workflows and systems.
Azad believes in change and do not fear failure. He discovers a new idea which can benefit the whole organization by utilizing the surplus space in the stores. The job of Azad is extremely challenging. He gets recognition and reward for the success achieved.
(b) Shreekant opt for turnaround strategy which is a highly-targeted effort to return Arena Ltd. to profitability and increase positive cash flows to a sufficient level. Organizations those have faced a significant crisis that has negatively affected operations require turnaround strategy. Once turnaround is successful the organization may turn to focus on growth.

Conditions for turnaround strategies

When firms are losing their grips over market, profits due to several internal and external factors, and if they have to survive under the competitive environment they have to identify danger signals as early as possible and undertake rectification steps immediately. These conditions may be, inter alia cash flow problems, lower profit margins, high employee turnover and decline in market share, capacity underutilization, low morale of employees, recessionary conditions, mismanagement, raw material supply problems and so on.

Action plan for turnaround strategy

- Stage One – Assessment of current problems
- Stage Two – Analyze the situation and develop a strategic plan
- Stage Three – Implementing an emergency action plan
- Stage Four – Restructuring the business
- Stage Five – Returning to normal

(c) A tool to study the market positions of rival companies by grouping them into like positions is strategic group mapping. Grouping competitors is useful when there are many competitors such that it is not practical to examine each one in-depth. In the given scenario there are thirteen competitors. A strategic group consists of those rival firms which have similar competitive approaches and positions in the market.

The procedure for constructing a strategic group map and deciding which firms belong in which strategic group is as follows:

- ◆ Identify the competitive characteristics that differentiate firms in the industry typical variables that are price/quality range (high, medium, low); geographic coverage (local, regional, national, global); degree of vertical integration (none, partial, full); product-line breadth (wide, narrow); use of distribution channels (one, some, all); and degree of service offered (no-frills, limited, full).
- ◆ Plot the firms on a two-variable map using pairs of these differentiating characteristics.
- ◆ Assign firms that fall in about the same strategy space to the same strategic group.
- ◆ Draw circles around each strategic group making the circles proportional to the size of the group's respective share of total industry sales revenues.

4. (a) Importance of Strategic Management: Strategic Management is very important for the survival and growth of business organizations in dynamic business environment. Other major benefits of strategic management are as follows:

- It helps organizations to be more proactive rather than reactive in dealing with its future. It facilitates the organisations to work within vagaries of environment and remains adaptable with the turbulence or uncertain future. Therefore, they are able to control their own destiny in a better way.
- It provides better guidance to entire organization on the crucial point – what it is trying to do. Also provides framework for all major business decisions of an enterprise such a decision on businesses, products, markets, organization structures, etc.
- It facilitates to prepare the organization to face the future and act as pathfinder to various business opportunities. Organizations are able to identify the available opportunities and identify ways and means as how to reach them.
- It serves as a corporate defence mechanism against mistakes and pitfalls. It helps organizations to avoid costly mistakes in product market choices or investments.

- Over a period of time, strategic management helps organizations to evolve certain core competencies and competitive advantages that assist in the fight for survival and growth.

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

The major dimensions of strategic decisions are as follows:

- Strategic decisions require top-management involvement: Strategic decisions involve thinking in totality of the organization. Hence, problems calling for strategic decisions require to be considered by the top management.
- Strategic decisions involve commitment of organisational resources: For example, Strategic decisions to launch a new project by a firm requires allocation of huge funds and assignment of a large number of employees.
- Strategic decisions necessitate consideration of factors in the firm's external environment: Strategic focus in organization involves orienting its internal environment to the changes of external environment.
- Strategic decisions are likely to have a significant impact on the long-term prosperity of the firm: Generally, the results of strategic implementation are seen on a long-term basis and not immediately.
- Strategic decisions are future oriented: Strategic thinking involves predicting the future environmental conditions and how to orient for the changed conditions.
- Strategic decisions usually have major multifunctional or multi-business consequences: As they involve organization in totality they affect different sections of the organization with varying degree.

5. (a) 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. First, the firm's worth may be based on the selling price of a similar company. The second approach is called the 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. The third approach can be called the outstanding shares method whereby one has to simply multiply the number of shares outstanding by the market price per share and add a premium.

(b) 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.

6. A strategy audit is an examination and evaluation of areas affected by the operation of a strategic management process within an organization. The audit of management performance with regard to external strategies helps an organization identify problem areas and correct the strategic approaches that have not been effective so far. It is a process for taking an objective look at the existing strategies of the organization. It involves assessing the direction of a business and comparing that to the course required to succeed in a changing environment."

Companies review their business plans and strategies on regular basis to identify weaknesses and shortcomings to enable a successful development plan. The strategy audit secures that all necessary information for the development of the company are included in the business plan and that the management supports it.

Richard Rumelt's Criteria for Strategy Audit

- a. **Consistency:** A strategy should not present inconsistent goals and policies which can lead to organizational problems and conflicts. Three guidelines to identify are:
 - Strategies may be inconsistent if managerial problems tend to be issue-based rather than people-based.
 - If success for one organizational department means, or is interpreted to mean, failure for another department, then strategies may be inconsistent.
 - If policy problems and issues continue to be brought to the top for resolution, then strategies may be inconsistent.
- b. **Consonance:** Consonance refers to the need for strategists to examine *sets of trends*, as well as individual trends, in auditing strategies. A strategy must represent an adaptive response to the external environment and to the critical changes occurring within it. One difficulty in matching a firm's key internal and external factors in the formulation of strategy is that most trends are the result of interactions among other trends.
- c. **Feasibility:** A strategy must neither overtax available resources nor create unsolvable sub-problems. The final broad test of strategy is its feasibility; that is, can the strategy be attempted within the physical, human, and financial resources of the enterprise? In auditing a strategy, it is important to examine whether an organization has demonstrated in the past that it possesses the abilities, competencies, skills, and talents needed to carry out a given strategy.
- d. **Advantage:** A strategy must provide for the creation and/or maintenance of a competitive advantage in a selected area of activity. Competitive advantages normally are the result of superiority in one of three areas:
 - (1) resources, (2) skills, or (3) position.

or

The changes in the environmental forces often require businesses to make modifications in their existing strategies and bring out new strategies. Strategic change is a complex process and it involves a corporate strategy focused on new markets, products, services and new ways of doing business.

To make the change lasting, Kurt Lewin proposed three phases of the change process for moving the organization from the present to the future. These stages are unfreezing, changing and refreezing.

- (i) **Unfreezing the situation:** The process of unfreezing simply makes the individuals or organizations aware of the necessity for change and prepares them for such a change. Lewin proposes that the changes should not come as a surprise to the members of the organization. Sudden and unannounced change would be socially destructive and morale lowering. The management must pave the way for the change by first “unfreezing the situation”, so that members would be willing and ready to accept the change.
- (ii) **Changing to New situation:** Once the unfreezing process has been completed and the members of the organization recognise the need for change and have been fully prepared to accept such change, their behaviour patterns need to be redefined. H.C. Kellman has proposed three methods for reassigning new patterns of behaviour. These are compliance, identification and internalisation.
- (iii) **Refreezing:** Refreezing occurs when the new behaviour becomes a normal way of life. The new behaviour must replace the former behaviour completely for successful and permanent change to take place. In order for the new behaviour to become permanent, it must be continuously reinforced so that this new acquired behaviour does not diminish or extinguish.