MODEL TEST PAPERS

(RELEVANT FOR MAY, 2025 EXAMINATION AND ONWARDS)

FINAL COURSE

GROUP - I

BOARD OF STUDIES

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

The Model Test Papers prepared by the faculty of the Board of Studies. The objective is to enable the students to practice and enhance their understanding of the subject. In case students need any clarifications or have any suggestion to make for further improvement of the content contained herein, they may write to the Joint Director, Board of Studies. The Council of the Institute is not in anyway responsible for the correctness or otherwise of the content published herein.

Edition	:	February, 2025
Website	:	www.icai.org
Committee/Department	:	Board of Studies
E-mail	:	bosnoida@icai.in
Price	:	
Published by	:	The Publication & CDS Directorate on behalf of The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi- 110 002, India
		Typeset and designed at Board of Studies.
Printed by	:	

MODEL TEST PAPERS

FINAL COURSE GROUP - I

Contents

MODEL TEST PAPER 1

FINAL COURSE GROUP - I

PAPER – 1: FINANCIAL REPORTING

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs). Each MCQ is of 2 Marks.*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

All MCQs are compulsory.

Case Scenario 1

Mr. Deepak Goel, a chartered accountant with 10 years of experience was earlier working with a big Indian practicing firm having clientele of IND AS and auditing assurance. Recently he left his job and started his own consultancy firm. He has received certain Ind AS based projects wherein his opinion and guidance on applicability of Ind AS has been sought for on following issues:

1. Narayan Ltd. requires to calculate the tax expense for each quarter, assuming that there is no difference between the estimated taxable income and the estimated accounting income:

	₹
Estimated Gross Annual Income	33,00,000
(inclusive of Estimated Capital Gains of ₹ 8,00,000)	
Estimated Income of Quarter I	7,00,000
Quarter II	8,00,000
Quarter III	12,00,000
(including estimated Capital Gain of ₹ 8,00,000)	
Quarter IV	6,00,000

Tax Rates:

On Capital Gains		12%
On Other Income:	First ₹ 5,00,000	30%
	Balance Income·	40%

2. C Ltd. is a construction company. It enters into a contract with Customer E to build an asset. Depending on when the asset is completed, C will receive either ₹ 1,10,000 or ₹ 1,30,000.

Outcome	**Consideration (₹)**	**Probability**
Project completes on time	1,30,000	90%
Project is delayed	1,10,000	10%

3. In the financial year 20X1-20X2, X Ltd. incurred the following expenditure in acquiring property consisting of 6 identical houses each with separate legal title including the land on which it is built.

The expenditure incurred on various dates is given below:

On 1st April, 20X1 - Purchase cost of the property ₹ 1,80,00,000.

On 1st April, 20X1 – Non-refundable transfer taxes ₹ 20,00,000 (not included in the purchase cost).

On 2nd April, 20X1- Legal cost related to property acquisition ₹ 5,00,000.

On 6th April, 20X1- Advertisement campaign to attract tenants ₹ 3,00,000.

On 8th April, 20X1 - Opening ceremony function for starting business ₹ 1,50,000.

Throughout 20X1-20X2, incurred ₹ 1,00,000 towards day-to-day repair maintenance and other administrative expenses.

X Limited uses one of the six houses for office and accommodation of its few staffs. The other five houses are rented to various independent third parties.

How will X Limited account for all the above-mentioned expenses in the books of account?

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 1 to 6 in line with relevant Ind AS:

1. What will be the weighted average annual income tax rate for Narayan Ltd.

   (a) 29%

   (b) 38%

   (c) 30%

   (d) 40%

2. What will be the tax expense for quarter III and quarter IV?

   (a) ₹ 2,66,000; ₹ 3,04,000

   (b) ₹ 3,04,000; ₹ 2,48,000

   (c) ₹ 2,48,000; ₹ 2,28,000

   (d) ₹ 2,28,000; ₹ 10,46,000

3. What will be the transaction price for C Ltd.?

   (a) ₹ 1,10,000

   (b) ₹ 1,20,000

   (c) ₹ 1,17,000

   (d) ₹ 1,30,000

4. What will be the total cost of the property to X Ltd.?

   (a) ₹ 2,05,00,000

   (b) ₹ 2,09,50,000

   (c) ₹ 1,85,00,000

   (d) ₹ 1,89,50,000

5. What will be the cost of the investment property to be reflected in the balance sheet of X Ltd.?

   (a) ₹ 2,05,00,000

(b) ₹ 2,09,50,000

(c) ₹ 1,70,83,333

(d) ₹ 34,16,667

6. What will be the cost of the owner-occupied property to be reflected in the balance sheet of X Ltd.?

(a) ₹ 2,05,00,000

(b) ₹ 2,09,50,000

(c) ₹ 1,70,83,333

(d) ₹ 34,16,667

Case Scenario 2

G Ltd. (herein after referred as 'the Company') is currently engaged in different business segments and is also looking to expand its operations overseas. The Company is also exploring investment from an overseas investor to carry out the expansion plan. The functional currency of G Ltd. is Rupees. The Company is required to submit its financial statements for the year ended 31st March, 20X2 as per Ind AS.

On 30th September, 20X1, the Company acquired 70% of the share capital of M Ltd., an entity registered as company in Germany. The fair value of the net assets of M Ltd. was 23 million EURO and the purchase consideration paid was 17.5 million EURO on 30th September, 20X1. The exchange rates as at 30th September, 20X1 was ₹ 82 / EURO and at 31st March, 20X2 was ₹ 84 / EURO. NCI is valued at proportionate share of fair value of net assets of M Limited.

G Ltd has made an interest free security deposit against a lease of 5 years redeemable at the end of the lease term, when market interest rate for a deposit for similar period was 12% per annum. Following are the details of the deposit made by G Ltd.:

Particulars	Details
Date of Security Deposit (Starting Date)	1st April, 20X1

Date of Security Deposit (Finishing Date)	31st March, 20X6
Discount rate	12.00%
Security deposit	10,00,000
Present value factor at the end of 5th year	0.567427

The accountant of the company is facing challenge in the accounting treatment of the above issues.

Therefore, analyse the transactions mentioned above and choose the most appropriate option in the below questions 7 to 10 in line with relevant Ind AS:

7. What will be the value of goodwill on acquisition of M Ltd., in Euro, as on 30th September, 20X1?

   (a) 5.5 million EURO

   (b) 2 million EURO

   (c) 1.4 million EURO

   (d) Nil

8. What will be the value of goodwill to be recognised in the financial statements of G Ltd. as on 31st March, 20X2?

   (a) ₹ 117.6 million

   (b) ₹ 114.8 million

   (c) ₹ 451 million

   (d) ₹ 462 million

9. What will be the initial amount of prepaid lease payment in the lease contract to be recognised by G Ltd.?

   (a) ₹ 5,67,427

   (b) ₹ 4,32,573

   (c) ₹ 10,00,000

   (d) Nil

10. What will be the amount of interest income on security deposit to be recognised in the financial statements of G Ltd. as on 31st March, 20X2?

   (a) ₹ 1,20,000

(b) ₹ 68,091

(c) ₹ 51,909

(d) Nil

Case Scenario 3

X Ltd. is a listed entity in India and prepares consolidated financial statements as per the requirements of Ind AS. X Ltd. has a wholly owned subsidiary A Ltd. which is an unlisted entity with a net worth of ₹ 280 crore. A Ltd. is not in the process of listing any of its instruments in public market. A Ltd. has two wholly owned subsidiaries B Ltd. and C Ltd.

Analyse the transactions mentioned above and choose the most appropriate option in the below questions 11 to 13 in line with relevant Ind AS:

11. State which of the following is true for A Ltd. as per the requirements of Ind AS 110?

    (a) Since A Ltd. is an unlisted entity, it is mandatory for it to prepare Consolidated Financial Statements (CFS)

    (b) Even if X Ltd. does not object to A Ltd. for not preparing CFS, A Ltd. has to mandatory prepare CFS

    (c) Even if A Ltd. is an unlisted entity and X Ltd. objects A Ltd. for not preparing CFS, A Ltd. is not required to prepare CFS

    (d) Since A Ltd. is not a listed entity and if X Ltd. does not object to A Ltd. for not preparing CFS, A Ltd. will not be required to prepare CFS.

12. Assume the same facts as given in the scenario for wholly owned subsidiaries A Ltd., X Ltd. is a foreign entity and is listed in stock exchange of a foreign country and it prepares its financial statements as per the generally accepted accounting principles (GAAP) applicable to that country. Now state which of the following is true for A Ltd. as per the requirements of Ind AS 110?

    (a) Since A Ltd. is an unlisted entity, preparation of CFS is not mandatory to it

    (b) Since X Ltd. is not preparing CFS under Ind AS, A Ltd. is mandatorily required to prepare CFS under Ind AS

(c) Even if X Ltd. does not object to A Ltd. for not preparing CFS, A Ltd. is not required to mandatory prepare CFS

(d) Even if A Ltd. is an unlisted entity and X Ltd. objects A Ltd. for not preparing CFS, A Ltd. is not required to prepare CFS

13. Assume the same facts as given in the scenario except that 100% of the investment in A Ltd. is held by Mr. X (an individual) instead of X Ltd. Now state which of the following is true for A Ltd. as per the requirements of Ind AS 110?

(a) A Ltd. is not required to prepare CFS as it is an unlisted entity

(b) Even if Mr. X is an individual, A Ltd. is not mandatorily required to prepare CFS under Ind AS

(c) A Ltd. will prepare consolidated financial statements under AS and not Ind AS

(d) Even if A Ltd. is an unlisted entity, it is mandatorily required to prepare CFS

Case Scenario 4

Deepak started a new company S Pvt. Ltd. with T Ltd. wherein investment of 55% is done by T Ltd. and rest by Deepak. Voting powers are to be given as per the proportionate share of capital contribution. The new company S Pvt. Ltd. formed was the subsidiary of T Ltd. with two directors, and Deepak eventually becomes one of the directors of company. The company, S Pvt. Ltd. was incorporated on 1st April 20X1. The financials of T Ltd. are prepared as per Ind AS. However, S Pvt. Ltd. is preparing its financial statements as per Accounting Standards.

Further, Deepak has started using accounting software and other tools to automate manual processes in S Pvt. Ltd. He is evidencing major change in accounting due to automation of the accounting process. However, at the same time, he also realised that automation comes with its own set of potential drawbacks and challenges.

Analyse the transactions mentioned above and choose the most appropriate option in the below questions 14 and 15 in line with relevant Ind AS:

14. Which of the following statements is true with respect to preparation of financial statements?

(a) S Pvt. Ltd. has to mandatorily prepare its financial statements as per Ind AS

(b) S Pvt. Ltd. is not at all required to prepare its financial statements as per Ind AS

(c) S Pvt. Ltd. has to prepare its financial statements both as per AS and Ind AS

(d) T Ltd. has to prepare its financial statements as per AS.

15. State which of the following is the challenge of the automation process:

(a) Software can automatically categorize transactions into the appropriate accounts

(b) Optical character recognition (OCR) or barcode recognition technology, is automating the entry of data from source documents such as receipts and invoices.

(c) Automation process enables accountants to focus on higher-level tasks such as analysis and planning instead of routine manual entry

(d) Automation requires ongoing training and education to keep up with the latest technology

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to 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 answers.

Maximum Marks – 70 Marks

1. Flywing Airways Ltd is a company which manufactures aircraft parts and engines and sells them to large multinational companies like Boeing and Airbus Industries.

On 1st April 20X1, the company began the construction of a new production line in its aircraft parts manufacturing shed.

Costs relating to the production line are as follows:

Details	Amount ₹'000
Costs of the basic materials (list price ₹12.5 million less a 20% trade discount)	10,000
Recoverable goods and services taxes incurred not included in the purchase cost	1,000
Employment costs of the construction staff for the three months to 30th June 20X1	1,200
Other overheads directly related to the construction	900
Payments to external advisors relating to the construction	500
Expected dismantling and restoration costs	2,000

Additional Information

The construction staff was engaged in the production line, which took two months to make ready for use and was brought into use on 31st May 20X1.

The other overheads were incurred in the two-months period ended on 31st May 20X1. They included an abnormal cost of ₹3,00,000 caused by a major electrical fault.

The production line is expected to have a useful economic life of eight years. At the end of that time Flywing Airways Ltd is legally required to dismantle the plant in a specified manner and restore its location to an acceptable standard. The amount of ₹ 2 million mentioned above is the amount that is expected to be incurred at the end of the useful life of the production line. The appropriate rate to use in any discounting calculations is 5%. The present value of ₹ 1 payable in eight years at a discount rate of 5% is approximately Re.0·68.

Four years after being brought into use, the production line will require a major overhaul to ensure that it generates economic benefits for the second half of its useful life. The estimated cost of the overhaul, at current prices, is ₹ 3 million.

The Company computes its depreciation charge on a monthly basis.

No impairment of the plant had occurred by 31st March 20X2.

Analyze the accounting implications of costs related to production line to be recognized in the balance sheet and profit and loss for the year ended 31st March, 20X2. **(14 Marks)**

2. Summarized Balance Sheets of PN Ltd. and SR Ltd. as on 31st March 20X2 were given as below: (Amount in ₹)

Particulars	PN Ltd.	SR Ltd.
Assets		
Land & building	4,68,000	5,61,600
Plant & Machinery	7,48,800	4,21,200
Investment in SR Ltd.	12,48,000	-
Inventories	3,74,400	1,13,600
Trade Receivables	1,86,500	1,24,800
Cash & Cash equivalents	45,200	24,900
Total Assets	**30,70,900**	**12,46,100**
Equity & Liabilities		
Equity Share Capital (Shares of ₹ 100 each fully paid)	15,60,000	6,24,000
Other Reserves	9,36,000	3,12,000
Retained Earnings	1,78,400	2,55,800
Trade Payables	1,46,900	34,300
Short-term borrowings	2,49,600	20,000
Total Equity & Liabilities	**30,70,900**	**12,46,100**

(i) PN Ltd. acquired 70% equity shares of ₹ 100 each of SR Ltd. on 1st October 20X1.

(ii) The Retained Earnings of SR Ltd. showed a credit balance of ₹ 93,600 on 1st April 20X1 out of which a dividend of 12% was paid on 15th December 20X1.

(iii) PN Ltd. has credited the dividend received to its Retained Earnings.

(iv) Fair value of Plant & Machinery of SR Ltd. as on 1st October 20X1 was ₹ 6,24,000. The rate of depreciation on Plant & Machinery was 10% p.a.

(v) Following are the increases on comparison of Fair Value as per respective Ind AS with book value as on 1st October 20X1 of SR Ltd. which are to be considered while consolidating the Balance Sheets:

(a)	Land & Buildings	₹ 3,12,000
(b)	Inventories	₹ 46,800
(c)	Trade Payables	₹ 31,200

(vi) The inventory is still unsold on Balance Sheet date and the Trade Payables are not yet settled.

(vii) Other Reserves as on 31st March 20X2 are the same as was on 1st April 20X1.

(viii) The business activities of both the company are not seasonal in nature and therefore, it can be assumed that profits are earned evenly throughout the year.

Prepare the Consolidated Balance Sheet as on 31st March 20X2 of the group of entities PN Ltd. and SR Ltd. **(14 Marks)**

3. (a) Blueberry Ltd entered into the following transactions during the year ended 31st March, 20X2:

(i) Entered into a speculative interest rate option costing ₹ 10,000 on 1stApril, 20X0 to borrow ₹ 6,000,000 from Exon Bank commencing 30th June,20X2 for 6 months at 4%.

The value of the option at 31st March, 20X2 was ₹15,250.

(ii) Purchased 6% debentures in Fox Ltd on 1st April, 20X1 (their issue date) for ₹ 150,000 as an investment. Blueberry Ltd. intends to hold the debentures, until their redemption at a premium, in 5 years' time. The effective rate of interest of the bond is 8%.

(iii) Purchased 50,000 shares in Cox Ltd on 1st October, 20X2 for ₹ 3.50 each as an investment. The share price on 31st March, 20X2 was ₹ 3.75.

Show the accounting treatment and relevant extracts from the financial statements for the year ended 31st March, 20X2 of transactions related to financial instruments. Blueberry Ltd. designates financial assets at fair value through Profit or loss only when this is unavoidable. **(10 Marks)**

(b) The entity has an identifiable asset ASSOTA with a carrying amount of ₹ 10,00,000. Its recoverable amount is ₹ 6,50,000. The tax base of ASSOTA is ₹ 8,00,000 and the tax rate is 30%. Impairment losses are not tax deductible. Entity expects to continue to earn profits in future.

For the identifiable asset ASSOTA, what would be the impact on the deferred tax asset/ liability at the end of the period?

(4 Marks)

4. (a) KK Ltd. runs a departmental store which awards 10 points for every purchase of ₹ 500 which can be discounted by the customers for further shopping with the same merchant. Unutilised points will lapse on expiry of two years from the date of credit. Value of each point is ₹ 0.50. During the accounting period 20X1-20X2, the entity awarded 1,00,00,000 points to various customers of which 18,00,000 points remained undiscounted. The management expects only 80% will be discounted in future of which normally 60-70% are redeemed during the next year.

The Company has approached your firm with the following queries and has asked you to suggest Journal Entries under the applicable Ind AS for these award points:

(a)	How should the recognition be done for the sale of goods worth ₹ 10,00,000 on a particular day?
(b)	How should the redemption transaction be recorded in the year 20X1-20X2? The Company has requested you to

	present the sale of goods and redemption as an independent transaction. Total sales of the entity is ₹ 5,000 lakhs.
(c)	How much of the deferred revenue should be recognized at the year-end (20X1-20X2) because of the estimation that only 80% of the outstanding points will be redeemed?
(d)	In the next year 20X2-20X3, 60% of the outstanding points were discounted. Balance 40% of the outstanding points of 20X1-20X2 still remained outstanding. How much of the deferred revenue should the merchant recognize in the year 20X2-20X3 and what will be the amount of balance deferred revenue?
(e)	How much revenue will the merchant recognized in the year 20X3-20X4, if 3,00,000 points are redeemed in the year 20X3-20X4?

(9 Marks)

(b) **Either**

Mr. Atul is an independent director of a company X Ltd. He plays a vital role in the management of X Ltd. and contributes to major decision making process of the organisation. X Ltd. pays sitting fee of ₹ 2,00,000 to him for every Board of Directors' (BOD) meeting he attends. Throughout the year, X Ltd. had 5 such meetings which was attended by Mr. Atul.

Similarly, a non-executive director, Mr. Naveen also attended 5 BOD meetings and charged ₹ 1,50,000 per meeting. The Accountant of X Ltd. believes that they being not the employees of the organisation, their fee should not be disclosed as per related party transaction.

Examine whether the sitting fee paid to independent director and non-executive director is required to be disclosed in the financial statements prepared as per Ind AS? **(5 Marks)**

Or

How will you recognize and present the grants received from the Government in the following cases as per Ind AS 20?

(i) A Ltd. received one acre of land to setup a plant in backward area (fair value of land ₹ 12 lakh and acquired value by Government is ₹ 8 lakhs).

(ii) B Ltd. received an amount of loan for setting up a plant at concessional rate of interest from the Government.

(iii) D Ltd. received an amount of ₹ 25 lakh for immediate start-up of a business without any condition.

(iv) S Ltd. received ₹ 10 lakh for purchase of machinery costing ₹ 80 lakh. Useful life of machinery is 10 years. Depreciation on this machinery is to be charged on straight line basis.

(v) Government gives a grant of ₹ 25 lakh to U Limited for research and development of medicine for breast cancer, even though similar medicines are available in the market but are expensive. The company is to ensure by developing a manufacturing process over a period of two years so that the cost comes down at least to 50%. **(5 Marks)**

5. (a) An entity issues 2,000 convertible bonds at the beginning of Year 1. The bonds have a three-year term and are issued at par with a face value of ₹ 1,000 per bond, giving total proceeds of ₹ 20,00,000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any time up to maturity into 250 ordinary shares. The entity has given an option to settle the principal amount of the convertible bonds in ordinary shares or in cash.

When the bonds are issued, the prevailing market interest rate for similar debt without a conversion option is 9%. At the issue date, the market price of one ordinary share is ₹ 3. Income tax is ignored.

Calculate basic and diluted EPS when

Profit attributable to ordinary equity holders of the parent entity Year 1	₹ 10,00,000
Ordinary shares outstanding	12,00,000
Convertible bonds outstanding	2,000

(4 Marks)

(b) Entity A acquired a subsidiary, entity B, during the year. Summarised information from the consolidated statement of profit and loss and balance sheet is provided, together with some supplementary information.

Consolidated statement of profit and loss	Amount (₹)
Revenue	3,80,000
Cost of sales	(2,20,000)
Gross profit	1,60,000
Depreciation	(30,000)
Other operating expenses	(56,000)
Interest cost	(4,000)
Profit before taxation	**70,000**
Taxation	(15,000)
Profit after taxation	**55,000**

Consolidated balance sheet	20X2	20X1
	Amount (₹)	**Amount (₹)**
Assets		
Cash and cash equivalents	8,000	5,000
Trade receivables	54,000	50,000
Inventories	30,000	35,000
Property, plant and equipment	1,60,000	80,000
Goodwill	18,000	—
Total assets	**2,70,000**	**1,70,000**
Liabilities		
Trade payables	68,000	60,000
Income tax payable	12,000	11,000

Long term debt	1,00,000	64,000
Total liabilities	**1,80,000**	**1,35,000**
Shareholders' equity	**90,000**	**35,000**
Total liabilities and shareholders'	**2,70,000**	**1,70,000**

Other information

All of the shares of entity B were acquired for ₹ 74,000 in cash. The fair values of assets acquired, and liabilities assumed were:

Particulars	**Amount (₹)**
Inventories	4,000
Trade receivables	8,000
Cash	2,000
Property, plant and equipment	1,10,000
Trade payables	(32,000)
Long term debt	(36,000)
Goodwill	18,000
Cash consideration paid	**74,000**

Prepare statement of cash flows of Entity A. **(10 Marks)**

6. (a) Astra Ltd. is a listed entity which operates in the defence and fibre optics sector. It supplies fibre optic cables and racks in the domestic country. This activity is only a trading activity for Astra Ltd. as it procures goods from pre-approved suppliers, and after inspection, sells the goods to IT companies. The sale contract requires Astra Ltd. to deliver these goods to the IT companies' locations (i.e., delivery on site). Payment terms are 30 days after the invoice date to Astra Ltd.

Ms. Suparna Dasgupta, a chartered accountant, has recently joined Astra Ltd. as the Head of the Finance Department.

The Chief Operating Officer (also the executive director) of Astra Ltd. is Ms. Padmaja Srinivasan, a mechanical engineer with an MBA from Harvard University, who rose through the ranks through her excellent skills in project management, marketing, and customer management. Her remuneration includes a bonus computed as a percentage of turnover achieved during the year, and an additional incentive for achieving an EBITDA in excess of 15% of turnover.

Astra Ltd. has sold fibre optic cables amounting to ₹ 2 crores (invoice dated 31st March 20X2) to Ethernet Bullet Ltd., a company providing high-speed internet connectivity services through fibre optic cables as well as dedicated leased lines. The service unit of Ethernet Bullet Ltd. is located next to the factory of Astra Ltd. Though the goods were not moved to Ethernet Bullet Ltd.'s service unit, Astra Ltd. recognized the sale for the year, based on the contention that the service unit is adjacent, and hence the transfer can happen within a few minutes.

The annual results are due for board approval, for the year ending 31st March, and require the sign-off of Ms. Suparna Dasgupta.

Ms. Suparna Dasgupta has been given a 40% increment on joining Astra Ltd., which enables her to comfortably pay off her housing loan mortgage every month. Additionally, she is also given perquisites in the form of business class travel, an exclusive chauffeur-driven car and stock options of the company. Accordingly, she has stated that she cannot afford to lose this job as the salary and perquisites are among the best in the country.

Ms. Padmaja Srinivasan has communicated to Ms. Suparna Dasgupta that many more benefits will accrue if she agrees to present the numbers without any modifications. She has also said that the company would not hesitate to replace Ms. Suparna Dasgupta should she disagree with the contentions above.

Required:

Discuss the potential conflicts which are arising in the above scenario and the ethical principles that would guide Ms. Suparna Dasgupta in responding to the situation. **(9 Marks)**

(b) On 1st April 20X1, Nuogen Ltd. had granted 1,20,000 share options to its employees with the vesting condition being a service condition as follows:

- Vesting date : 31st March 20X2 - 80,000 share options (1-year vesting period since grant date)
- Vesting date : 31st March 20X5 - 40,000 share options (4-year vesting period since grant date)

Each option can be converted into one equity share of Nuogen Ltd. The fair value of the options on grant date, i.e., on 1st April 20X1 was ₹ 20.

Nuogen Ltd. is required to prepare financial statements in Ind AS for the financial year ending 31st March 20X4. The transition date for Ind AS being 1st April 20X2.

The entity has disclosed publicly the fair value of both these equity instruments as determined at the measurement date, as defined in Ind AS 102.

The previous applicable GAAP for the entity was IGAAP (AS) and therein, the entity had not adopted intrinsic method of valuation.

The share options have not been yet exercised by the employees of Nuogen Ltd.

How the share-based payment should be reflected in, the books of Nuogen Ltd. as on 31st March 20X4, assuming that the entity has erred by not passing any entry for the aforementioned transactions in the books of Nuogen Ltd. on grant date, i.e. 1st April 20X1?

(5 Marks)

MODEL TEST PAPER 2

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

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

1. The question paper comprises two parts, Part I and Part II.

2. Part I comprises Case Scenario based Multiple Choice Questions (MCQs)

3. Part II comprises questions which require descriptive type answers.

PART I – Case Scenario based MCQs (30 Marks)

All MCQs are compulsory.

Case Scenario 1

U Ltd. is engaged in mining and many other industries and prepares its financial statements following Indian Accounting Standards and follows April-March as their financial year. During the year 20X2-20X3, the company has faced some issues and for their solution seeks your professional advice.

(i) U Ltd. and F Ltd. are partners of a joint operation engaged in the business of mining precious metals. The entity uses a jointly owned drilling plant in its operations. During the year ended 31st March 20X3, an inspection was conducted by the government authorities in the mining fields. The inspection authorities concluded that adequate safety measures were not followed by the entity. As a consequence, a case was filed and a penalty of ₹ 50 crores has been demanded from U Ltd.

The legal counsel of the company has assessed the demand and opined that appeals may not be useful, and the appeal orders will be unfavourable to the joint arrangement. Out of ₹ 50 crores (to be paid by U Ltd.), ₹ 30 crore will be reimbursed by F Ltd. later, as per the terms of the Joint Operation Agreement. At the year end, actual reimbursement was not received from F Ltd.

(ii) U Ltd. issued on 1st April 20X2, 10% (interest paid annually and having maturity period of 4 years) bonds with a face value of ₹ 2,00,000 at a discount of 10% to finance a qualifying asset which is ready for intended use at the end of year 2. The company amortizes discount using Effective Interest Rate (EIR) method by applying 13.39% p.a. of EIR.

(iii) U Ltd. has issued 10,00,000, 9% cumulative preference shares. The Company has arrears of ₹ 15 crores of preference dividend as on 31st March 20X3, it includes current year arrears of ₹ 1.75 crores. The Company did not declare any dividend for equity shareholders as well as for preference shareholders.

Further U Ltd. has also issued certain optionally convertible debentures, which are outstanding as at the year end.

(iv) On 1st January 20X3, U Ltd. acquired 30% of the shares of T Ltd. The investment was accounted for as an associate in U Ltd.'s consolidated financial statements. Both U Ltd. and T Ltd. have an accounting year end of 31st March 20X3. U Ltd. has no other investments in associates.

Net profit for the year in T Ltd.'s income statement for the year ended 31st March 20X3 was ₹ 0.23 crores. It declared and paid dividend of ₹ 0.1 crore on 1st March 20X3. No other dividends were paid in the year.

(v) On 1st January, 20X3, U Ltd. also acquired a 60% stake in S Ltd. The cash consideration payable was ₹ 1 crore to be paid immediately, and ₹ 1.21 crores after two years. The fair value of net assets of S Ltd. at acquisition date was ₹ 3 crores. U Ltd. has calculated that its cost of capital is 10%. Non-controlling interest is measured at the proportionate share of identifiable net assets.

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 1 to 5 in line with relevant Ind AS:

1. With respect to a joint operation engaged in the business of mining precious metals, how will the liability be disclosed in the books of U Ltd.?

   (a) Provision for ₹ 20 crores and a contingent liability for ₹ 30 crores

   (b) Contingent liability for ₹ 50 crores

   (c) Provision for ₹ 30 crores and a contingent liability for ₹ 20 crores

   (d) Provision for ₹ 50 crores.

2. Compute the amount of borrowing costs to be capitalized related to qualifying assets.

   (a) ₹ 48,753

   (b) ₹ 24,651

(c) ₹ 24,102

(d) Nil

3. What is the amount of preference dividend to be reduced from profit or loss for the year for calculating Basic Earnings Per Share?

(a) ₹ 15 crores

(b) ₹ 1.75 crores

(c) ₹ 13.25 crores

(d) Nothing, as no dividend has been declared by the entity.

4. What amount will be shown as an inflow in respect of earnings from the associate in the statement of cash flows of U Ltd. for the year ended 31st March 20X3?

(a) ₹ 0.020 crores

(b) ₹ 0.026 crores

(c) ₹ 0.030 crores

(d) ₹ 0.046 crores

5. Calculate the amount of goodwill / gain on bargain purchase arising upon acquisition of S Ltd.

(a) ₹ 1 crore gain on bargain purchase

(b) ₹ 80 lakhs gain on bargain purchase

(c) ₹ 20 lakhs goodwill

(d) ₹ 41 lakhs goodwill **(5 x 2 = 10 Marks)**

Case Scenario II

G Ltd. is a multi-national company and prepares and presents its financial statements following Indian Accounting Standards as its securities are listed on National Stock Exchange. G Ltd. has a number of business segments.

(i) H Ltd. is one of the recently acquired Indian subsidiary of G Ltd. It has to adopt Ind AS for the first time as at 31st March, 20X4, with 1st April, 20X2 as the date of transition. As at 31st March, 20X2, the value of raw material inventories was incorrectly reported due to an error. The amounts are significant.

(ii) G Ltd. is also engaged in software development. It enters into a contract with a customer to transfer a software license, perform an installation service and provide unspecified software updates and technical support (online and telephone) for a two-year period. G Ltd. sells the license, installation service and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

(iii) G Ltd. sells a 20% interest in a wholly owned subsidiary K Ltd. to outside investors for ₹ 100 lakh in cash. The carrying value of K Ltd.'s net assets is ₹ 300 lakh, including goodwill of ₹ 65 lakh from the subsidiary's initial acquisition.

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 6 to 8 in line with relevant Ind AS:

6. With respect to H Ltd. state whether the error should be reported in the Ind AS financial statements and how to rectify it.

   (a) H Ltd. shall report the impact of the error as a correction to Statement of Profit and Loss for the comparative period i.e., the year ended 31st March, 20X3.

   (b) The correction shall be reflected in a reconciliation as at the end of the first Ind AS reporting period i.e., as at 31st March, 20X3.

   (c) The impact of the correction is significant and it shall be amortized on a rational and systematic basis in the first two periods of Ind AS reporting i.e., years ended 31st March, 20X3 and 31st March, 20X4.

   (d) The first Ind AS financial statements shall distinguish the correction of errors from changes in accounting policies and reported as part of the reconciliations as at 1st April, 20X2.

7. How many performance obligations G Ltd. has, with respect to the contract with the customer to transfer software license?

   (a) 4 performance obligations

   (b) 3 performance obligations

(c) 2 performance obligations

(d) 1 performance obligation

8. What is the amount of gain on sale of interest in subsidiary K Ltd.?

(a) ₹ 100 lakhs

(b) ₹ 60 lakhs

(c) ₹ 53 lakhs

(d) ₹ 40 lakhs **(3 x 2 = 6 Marks)**

Case Scenario III

A Ltd. is a diversified business group operating in multiple business segments across different parts of the world. It maintains its books of accounts and publishes its annual consolidated financial statements under Indian Accounting Standards.

The central finance team has been working on closing the books of accounts and generating consolidated financial statements for the year ended 31st March 20X3. You are the Finance Controller and your assistants want your views on following transactions for finalization of financial statements:

(i) B Ltd., one of the subsidiaries of A Ltd., reported net income of ₹ 25 lakhs, which equals the company's comprehensive income. The company has no outstanding debt. Following is the information from the comprehensive balance sheet (₹ in lakhs) related to cash flows:

Extract of Balance Sheet	31.03.20X2	31.03.20X3
Equity share capital	100	100
Further issue of equity shares	100	140
Retained earnings	100	115
Total shareholders' equity	300	357

(ii) A Limited also operates in the travel industry and incurs costs unevenly through the financial year. Advertising costs of ₹ 40 lakhs were incurred on 1st July 20X2, and staff bonuses are paid at year-end based on sales. Staff bonuses are expected to be around ₹ 400 lakhs for the year; of that a sum of ₹ 60 lakhs would relate to the period ending 30th September 20X2.

(iii) An item of equipment X was acquired by A Ltd. on 1st April 20X1 for ₹ 1,00,000 having an estimated useful life of 10 years, with a residual value of zero. The asset is depreciated on a straight-line basis. The asset was revalued to ₹ 1,04,000 on 31st March 20X3.

(iv) A Ltd. has spent ₹ 15,00,000 in developing a new product during the year ended 31st March, 20X3. The development costs incurred were recognised as an intangible asset as per Ind AS 38. For the purposes of computing the taxable income, these expenses are allowable in full in the year of incurring the expenses. At the year end, the Company recognised an impairment loss of ₹ 75,000 against the intangible asset.

(v) The company has issued preference shares that are redeemable at the option of the holder. Three months before the end of the year, it was probable that the holders would require redemption.

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 9 to 13 in line with relevant Ind AS:

9. What cashflow should B Ltd. report, as financing activity in the statement of cash flows?

   (a) Issuance of equity shares ₹ 240 million; dividends paid ₹ 10 million

   (b) Issuance of equity shares ₹ 100 million; dividends paid ₹ 10 million

   (c) Issuance of equity shares ₹ 140 million; dividends paid ₹ 10 million

   (d) Issuance of equity shares ₹ 40 million; dividends paid ₹ 10 million

10. With respect to point (ii), what costs should be included in the entity's financial report for the quarter ended 30th September 20X3?

   (a) Advertising costs ₹ 40 lacs; staff bonuses ₹ 100 lacs

   (b) Advertising costs ₹ 10 lacs; staff bonuses ₹ 100 lacs

   (c) Advertising costs ₹ 10 lacs: staff bonuses ₹ 60 lacs

   (d) Advertising costs ₹ 40 lacs; staff bonuses ₹ 60 lacs

11. What will be the annual depreciation charge on equipment X for years 3 to 10 and the amount of the revaluation surplus that can be transferred to retained earnings annually?

    (a) Annual depreciation charge will be ₹ 10,000 and an annual transfer of ₹ 3,000 can be made from revaluation surplus to retained earnings.

    (b) Annual depreciation charge will be ₹ 10,000, however, annual transfer from revaluation surplus to retained earnings is not permitted.

    (c) Annual depreciation charge will be ₹ 13,000 and an annual transfer of ₹ 3,000 may be made from revaluation surplus to retained earnings.

    (d) Annual depreciation charge will be ₹ 13,000, however, annual transfer from revaluation surplus to retained earnings is not permitted.

12. With respect to point (iii), What is the tax base of the intangible asset?

    (a) ₹ 15,00,000

    (b) ₹ 75,000

    (c) ₹ 14,25,000

    (d) ₹ Nil

13. Which one of the following is the appropriate classification for the annual payment of ₹ 12,000 to preference shareholders at year-end?

    (a) Dividend ₹ 12,000

    (b) Interest expense ₹ 12,000

    (c) Dividend ₹ 3,000, interest expense ₹ 9,000

    (d) Dividend ₹ 9,000, interest expense ₹ 3,000 **(5 x 2 = 10 Marks)**

14. On 1st April 20X1, J Ltd. subscribed for 40 million ₹ 1 loan notes in C Ltd. The loan notes were issued at 90 paise and were redeemable at ₹ 1.20 on 31st March 20X6. Interest is payable on 31st March in arrears at 4% of par value. This represents an effective annual rate of return for J Ltd. of 9.9%.

J Ltd.'s intention is to hold the loan notes until redemption. Until 31st October, 20X2 C Ltd. was a successful company with a good reputation for settling all its liabilities on their due dates. However, due to an event which occurred on 31st October 20X2, three of C Ltd.'s major customers became insolvent and this caused liquidity problems for C Ltd. During November 20X2, C Ltd. entered into negotiations with all its creditors, including J Ltd.

J Ltd. agreed to forego the interest payments due on 31st March 20X2 and 20X3, with the payments from 31st March 20X4 onwards resuming as normal.

What would be the initial measurement of financial instruments as subscription of loan notes in C Ltd.?

(a) ₹ 40 million

(b) ₹ 37.782 million

(c) ₹ 38.4 million

(d) ₹ 36 million **(2 Marks)**

15. ABC Ltd., a manufacturing entity, wants to forecast its financial performance based on various scenarios to comply with Ind AS guidelines. It took aid of Artificial Intelligence (AI), which can assist the company in generating accurate financial forecasts by analysing historical data, market trends, and relevant external factors. By leveraging machine learning algorithms, the company can simulate different scenarios, such as changes in market demand, input costs, or regulatory requirements.

How will AI help the management of the company?

(a) With the help of AI, the company can make informed decisions,

(b) With the help of AI, the company can assess potential risks

(c) With the help of AI, the company can develop robust financial strategies in accordance with Ind AS principles.

(d) All of the above **(2 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to 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 answers.

Maximum Marks – 70 Marks

1. On 1st April 20X1, J Ltd. acquired a new subsidiary, B Ltd., purchasing all 150 million shares of B Ltd. The terms of the sale agreement included the exchange of four shares in J Ltd. for every three shares acquired in B Ltd. On 1st April 20X1, the market value of a share in J Ltd. was ₹ 10 and the market value of a share in B Ltd. ₹ 12.00.

   The terms of the share purchase included the issue of one additional share in J Ltd. for every five acquired in B Ltd. if the profits of B Ltd. for the two years ending 31st March 20X2 exceeded the target figure. Current estimates are that it is 80% probable that the management of B Ltd. will achieve this target.

   Legal and professional fees associated with the acquisition of B Ltd. shares were ₹ 12,00,000, including ₹ 2,00,000 relating to the cost of issuing shares. The senior management of J Ltd. estimate that the cost of their time that can be fairly allocated to the acquisition is ₹ 2,00,000. This figure of ₹ 2,00,000 is not included in the legal and professional fees of ₹ 12,00,000 mentioned above.

   The individual Balance Sheet of B Ltd. at 1st April 20X1 comprised net assets that had a fair value at that date of ₹ 1,200 million. Additionally, J Ltd. considered B Ltd. possessed certain intangible assets that were not recognized in its individual Balance Sheet:

   - Customer relationships – reliable estimate of value ₹ 100 million. This value has been derived from the sale of customer databases in the past.

   - An in process research and development project that had not been recognised by B Ltd. since the necessary conditions laid down in Ind AS for capitalisation were only just satisfied at 31st March 20X2. However, the fair value of the whole project (including the research phase) is estimated at ₹ 50 million.

- Employee expertise – estimated value of Director employees of B Ltd. is ₹ 80 million.
- The market value of a share in J Ltd. on 31st March 20X2 was ₹ 11.

Compute the goodwill on consolidation of B Ltd. that will appear in the consolidated balance sheet of J Ltd. at 31st March 20X2 with necessary explanation of adjustments therein. **(14 Marks)**

2. (a) Company A, an Indian company whose functional currency is ₹, enters into a contract to purchase machinery from an unrelated local supplier, company B. The functional currency of company B is also ₹. However, the contract is denominated in USD, since the machinery is sourced by company B from a US based supplier. Payment is due to company B on delivery of the machinery.

Key terms of the contract:

Contractual features	**Details**
Contract/order date	9th September 20X1
Delivery/payment date	31st December 20X1
Purchase price	USD 1,000,000
USD/₹ Forward rate on 9th September, 20X1 for 31st December, 20X1 maturity	67.8
USD/₹ Spot rate on 9th September, 20X1	66.4
USD/₹ Forward rates for 31st December, on:	
30th September	67.5
31st December (spot rate)	67.0

Company A is required to analyse if the contract for purchase of machinery (a capital asset) from company B contains an embedded derivative and whether this should be separately accounted for on the basis of the guidance in Ind AS 109. Also give necessary journal entries for accounting the same. **(10 Marks)**

(b) In December 20X1 an entity entered into a loan agreement with a bank. The loan is repayable in three equal annual instalments starting from December 20X5. One of the loan covenants is that an amount equivalent to the loan amount should be contributed by promoters by 24th March, 20X2, failing which the loan becomes payable on demand. As on 24th March, 20X2, the entity has not been able to get the promoter's contribution. On 25th March, 20X2, the entity approached the bank and obtained a grace period upto 30th June, 20X2 to get the promoter's contribution.

The bank cannot demand immediate repayment during the grace period. The annual reporting period of the entity ends on 31st March.

(i) As on 31st March, 20X2, how should the entity classify the loan?

(ii) Assume that in anticipation that it may not be able to get the promoter's contribution by due date, in February 20X2, the entity approached the bank and got the compliance date extended upto 30th June, 20X2 for getting promoter's contribution. In this case will the loan classification as on 31st March, 20X2 be different from (a) above? **(4 Marks)**

3. (a) LT Ltd. is in the process of constructing a building. The construction process is expected to take about 18 months from 1st January 20X1 to 30th June 20X2. The building meets the definition of a qualifying asset. LT Ltd. incurs the following expenditure for the construction:

1st January, 20X1	₹ 5 crores
30th June, 20X1	₹ 20 crores
31st March, 20X2	₹ 20 crores
30th June, 20X2	₹ 5 crores

On 1st July 20X1, LT Ltd. issued 10% Redeemable Debentures of ₹ 50 crores. The proceeds from the debentures form part of the company's general borrowings, which it uses to finance the construction of the qualifying asset, ie, the building. LT Ltd. had no borrowings (general or specific) before 1st July 20X1 and did not incur any borrowing costs before that date. LT Ltd. incurred ₹ 25 crores of construction costs before obtaining general borrowings on 1st July 20X1 (pre-borrowing expenditure) and ₹ 25 crores after obtaining the general borrowings (post-borrowing expenditure).

For each of the financial years ended 31st March 20X1, 20X2 and 20X3, calculate the borrowing cost that LT Ltd. is permitted to capitalize as a part of the building cost. **(8 Marks)**

(b) An Indian entity, whose functional currency is rupees, purchases USD dominated bond at its fair value of USD 1,000. The bond carries stated interest @ 4.7% p.a. on its face value. The said interest is received at the year end. The bond has maturity period of 5 years and is redeemable at its face value of USD 1,250. The fair value of the bond at the end of year 1 is USD 1,060. The exchange rate on the date of transaction and at the end of year 1 are USD 1 = ₹ 40 and USD 1 = ₹ 45, respectively. The weighted average exchange rate for the year is 1 USD = ₹ 42.

The entity has determined that it is holding the bond as part of an investment portfolio whose objective is met both by holding the asset to collect contractual cash flows and selling the asset. The purchased USD bond is to be classified under the FVTOCI category.

The bond results in effective interest rate (EIR) of 10% p.a.

Calculate gain or loss to be recognised in Profit & Loss and Other Comprehensive Income for year 1. Also pass journal entry to recognise gain or loss on above. (Round off the figures to nearest rupees) **(6 Marks)**

4. (a) AJ Ltd is engaged in the business of trading of chemicals having a net worth of ₹ 150 crores. The company's profitability is good and hence the company has introduced various benefits for its employees to keep them motivated and to ensure that they stay with the organization. The company is an associate of RJ Ltd which is listed on Bombay Stock Exchange in India.

The company initially did not have any HR function but over the last 2 years, the management set up that function and now HR department takes care of all the benefits related to the employees and how they can be structured in a manner beneficial to both the employees and the objectives of the company.

One of the employee benefits involves a lump sum payment to employee on termination of service and that is equal to 1 per cent of final salary for each year of service. Consider the salary in year 1 is ₹ 10,000 and is assumed to increase at 7 per cent (compound) each year.

Taking a discount rate at 10 per cent per year, you are required to compute

(i) benefits attributed (year on year) and

(ii) the obligation in respect of this benefit (year on year)

For an employee who is expected to leave at the end of year 5

Following assumptions may be taken to solve this:

- There are no changes in actuarial assumptions.
- No additional adjustments are needed to reflect the probability that the employee may leave the entity at an earlier or later date. **(6 Marks)**

(b) P Ltd. granted 400 stock appreciation rights (SAR) each to 75 employees on 1st April 20X1 with a fair value ₹ 200. The terms of the award require the employee to provide service for four years in order to earn the award. The fair value of each SAR at each reporting date is as follows:

31st March 20X2	₹ 210
31st March 20X3	₹ 220
31st March 20X4	₹ 215
31st March 20X5	₹ 218

What would be the difference if at the end of the second year of service (i.e. at 31st March 20X3), P Ltd. modifies the terms of the award to require only three years of service? **(8 Marks)**

5. (a) ABC Limited supplies plastic buckets to wholesaler customers. As per the contract entered into between ABC Limited and a customer for the financial year 20X1-20X2, the price per plastic bucket will decrease retrospectively as sales volume increases within the stipulated time of one year.

The price applicable for the entire sale will be based on sales volume bracket during the year.

Price per unit (INR)	Sales volume
90	0 - 10,000 units
80	10,001 - 35,000 units
70	35,001 units & above

All transactions are made in cash.

(i) Suggest how revenue is to be recognised in the books of accounts of ABC Limited as per expected value method, considering a probability of 15%, 75% and 10% for sales volumes of 9,000 units, 28,000 units and 36,000 units respectively. For workings, assume that ABC Limited achieved the same number of units of sales to the customer during the year as initially estimated under expected value method for the financial year 20X1-20X2.

(ii) You are required to pass Journal entries in the books of ABC Limited if the revenue is accounted for as per expected value method for financial year 20X1-20X2. **(5 Marks)**

(b) Mercury Ltd. has sold goods to Mars Ltd. at a consideration of ₹ 10 lakhs, the receipt of which receivable in three equal installments of ₹ 3,33,333 over a two year period (receipts on 1st April, 20X1, 31st March, 20X2 and 31st March, 20X3).

The company is offering a discount of 5 % (i.e. ₹ 50,000) if payment is made in full at the time of sale. The sale agreement reflects an implicit interest rate of 5.36% p.a.

The total consideration to be received from such sale is at ₹ 10 Lakhs and hence, the management has recognised the revenue from sale of goods for ₹ 10 lakhs.

Analyse whether the above accounting treatment made by the accountant is in compliance of the Ind AS. If not, advise the correct treatment along with working for the same. **(5 Marks)**

(c) **Either**

How can one enhance the usefulness of financial information by applying four enhancing qualitative characteristics? **(4 Marks)**

Or

(c) Which entities are required to prepare their financial statements mandatorily on the basis of Indian Accounting Standards (Ind AS)?

(4 Marks)

6. (a) Sunshine Ltd., a listed company in the cosmetics industry, has debt covenants attached to some of its borrowings which are included in Financial Liabilities in the Balance Sheet. These covenants mandate the company to repay the debt in full if Sunshine Ltd. fails to maintain a liquidity ratio and operating margin above the specified limit.

The directors alongwith the CFO of the Company who is a chartered accountant are considering entering into a fresh five-year leasing arrangement but are concerned about the negative impact any potential lease obligations may have on the above-mentioned covenants. Accordingly, the directors and CFO propose that the lease agreement be drafted in such a way that it is a series of six ten-month leases rather than a single five-year lease in order to utilize the short-term lease exemption available under Ind AS 116, Leases. This would then enable accounting for the leases in their legal form. The directors believe that this treatment will meet the requirements of the debt covenant, though such treatment may be contrary to the accounting standards.

Required:

Discuss the ethical and accounting implications of the above issue from the perspective of CFO. **(5 Marks)**

(b) X Pharmaceutical Ltd. seeks your opinion in respect of following accounting transactions:

1. Acquired a 4 year license to manufacture a specialised drug at a cost of ₹ 1,00,00,000 at the start of the year. Production commenced immediately.
2. Also purchased another company at the start of year. As part of that acquisition, X Pharmacy Ltd. acquired a brand with a fair value of ₹ 3,00,00,000 based on sales revenue. The life of the brand is estimated at 15 years.
3. Spent ₹ 1,00,00,000 on an advertising campaign during the first six months. Subsequent sales have shown a significant improvement and it is expected this will continue for 3 years.

4. It has commenced developing a new drug 'Drug-A'. The project cost would be ₹ 10,00,00,000. Clinical trial proved successful and such drug is expected to generate revenue over the next 5 years.

   Cost incurred (accumulated) till 31st March, 20X1 is ₹ 5,00,00,000.

   Balance cost incurred during the financial year 20X1-20X2 is ₹ 5,00,00,000.

5. It has also commenced developing another drug 'Drug B'. It has incurred ₹ 50,00,000 towards research expenses till 31st March, 20X2. The technological feasibility has not yet been established.

Advise how the above transactions will be accounted for in the books of account of X Pharmaceutical Ltd. **(5 Marks)**

(c) You are a senior consultant of your firm and are in process of determining the valuation of KK Ltd. You have determined the valuation of the company by two approaches i.e. Market Approach and Income approach and selected the highest as the final value. However, based upon the discussion with your partner you have been requested to assign equal weights to both the approaches and determine a fair value of shares of KK Ltd. The details of the KK Ltd. are as follows:

Particulars	**₹ in crore**
Valuation as per Market Approach	5268.2
Valuation as per Income Approach	3235.2
Debt obligation as on Measurement date	1465.9
Surplus cash & cash equivalent	106.14
Fair value of surplus assets and Liabilities	312.4
Number of shares of KK Ltd.	8,52,84,223 shares

Determine the Equity value of KK Ltd. as on the measurement date on the basis of above details. **(4 Marks)**

MODEL TEST PAPER 3

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

All MCQs are compulsory.

Case Scenario 1

ABC Ltd. is a diversified business group operating in multiple business segments across different parts of the world. It maintains its books of accounts and publishes its annual financial statements under Indian Accounting Standards. The finance team has been working on closing the books of accounts and generating financial statements for the year ended 31st March 20X3 and are facing issues in the following transactions while finalization of financial statements:

(i) One of the businesses of ABC Ltd. is of manufacturing sugar and chemicals. The Company has taken a term loan for ₹ 5 crores from State Bank to buy certain plant and machinery during the year ended 31 March 20X2. The loan is repayable over a period of 5 years. The terms and conditions of the loan agreement requires the company to maintain a current ratio of 1.33 : 1 and debt-equity ratio of 1 : 2. If these loan covenants fall below this level, then the bank has a right to recall the entire loan.

The loan outstanding as on 31 March, 20X3 was ₹ 4.25 crores. The current ratio of ABC Ltd. was 1 : 1 and debt equity ratio was 0.5 : 2. State Bank sent a notice on 5 April 20X3 demanding repayment of loan, on account of breach of terms of the loan agreement. The financials were signed on 10 May, 20X3.

On receiving the notice, the CFO of ABC Ltd. negotiated with the bank and ensured to rectify the breach. As a result, on 25 April, 20X3, the

Bank has agreed not to recall the loan and allowed the Company to achieve the contracted current and debt-equity ratio by 20X5.

(ii) ABC Ltd. has inventory of raw material Y of 10,000 units as at 31 March, 20X4 with a carrying amount of ₹ 100 each. The current market value of that raw material is ₹ 95 each. ABC Ltd. will use the raw material to manufacture a component for a customer. The conversion cost for making the finished goods would be ₹ 130 each. ABC Ltd. estimates costs to completion and sale of ₹ 50 each and a selling price for the component is estimated to be ₹ 290 each.

(iii) ABC Ltd. sold a machinery Z for ₹ 900 thousand to a new customer. To get into long term relationship with the customer, the terms of sale also include after sales service to be provided for next three years free of cost. The company also sells the sales service contract separately where the customer buys it after the initial warranty period at ₹ 100 thousand.

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 1 to 4 in line with relevant Ind AS:

1. How the long-term loan from State Bank has to be classified in the financials for the year ended 31 March 20X3 in case ABC Ltd. has not negotiated with the bank for rectification of breach?

   (a) Other current liabilities

   (b) Current financial liability

   (c) Non-current financial liability

   (d) Other non-current liability

2. After negotiation with State Bank, how the long-term loan has to be classified in the financials for the year ended 31 March 20X3?

   (a) Other current liabilities

   (b) Current financial liability

   (c) Non-current financial liability

   (d) Other non-current liability

3. At what value the raw material Y be measured in the books of ABC Ltd. as per applicable Ind AS?

(a) ₹ 950 thousand.

(b) ₹ 1,100 thousand.

(c) ₹ 1,000 thousand.

(d) ₹ 1,600 thousand.

4. How should the revenue be recognised in the books of account for the sale of machinery Z?

(a) ₹ 900 thousand is to be recognised as revenue in the year of sale.

(b) ₹ 900 thousand is to be recognised at the end of three years after sale.

(c) ₹ 900 thousand is to be recognised in the year of sale and ₹ 100 thousand to be spread over next three years.

(d) ₹ 810 thousand is to be recognised in the year of sale and ₹ 90 thousand to be spread over next three years.

(4 MCQs x 2 Marks = 8 Marks)

Case Scenario 2

DEF Ltd. is a globally diversified business conglomerate with operations spanning across various business sectors worldwide. The company adheres to Indian Accounting Standards for maintaining its financial records and annually releases its financial statements. As the finance team progresses towards finalizing the financial statements for the fiscal year ending on 31 March 20X3, the team is stuck up in the accounting of the following transactions:

(i) On 1 June 20X2, DEF Ltd. decided to dispose of the business and current and non-current assets of one of its divisions related to specialty chemicals business which it had acquired several years ago. This disposal does not involve DEF Ltd. withdrawing from a particular market sector. The carrying values on 1 June 20X2 of the assets to be disposed of were as follows:

Particulars	₹ in Million
Goodwill	10.0
Property, Plant and Equipment	20.0
Patents and trademarks	8.0

Inventories	15.0
Trade Receivables	10.0

None of the assets of the business had suffered impairment as at 1 June 20X2. At that date the inventories and trade receivables of the business were already stated at no more than their recoverable amounts.

DEF Ltd. offered the business for sale at a price of ₹ 46.5 million, which was considered to be reasonably achievable. DEF Ltd. estimated that the direct costs of selling the business would be ₹ 5,00,000. These estimates have not changed since 1 June 20X2 and DEF Ltd. estimates that the business will be sold by 31 March 20X3 at the latest.

(ii) The government provided DEF Ltd. with a grant of ₹ 21 million to assist it in the development of the factory.

This grant was provided in two parts:

(1) ₹ 6 million of the grant was a payment by the government as an inducement to DEF Ltd. to begin developing the factory. No conditions were attached to this part of the grant.

(2) ₹ 15 million of the grant related to the construction of the factory at a cost of ₹ 60 million. The land was leased so the whole of the ₹ 60 million is depreciable over the estimated 40 year useful life of the factory.

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 5 to 8 in line with relevant Ind AS:

5. Compute the value of Specialty chemical division's Goodwill at the date of classification after re-measurement.

   (a) ₹ 7.3 million

   (b) ₹ 10 Million

   (c) ₹ Nil

   (d) ₹ 8 million

6. Calculate the closing balance of Specialty chemical division's asset – Property, Plant and Equipment at the period end.

   (a) ₹ 21 million

(b) ₹ 17.36 million

(c) ₹ 6 million

(d) ₹ 15 million

7. What amount of grant out of ₹ 15 million with respect to construction of factory be transferred to profit and loss account in the year 20X3-20X4?

(a) ₹ 15 million

(b) ₹ 0.375 million

(c) ₹1.5 million

(d) ₹ 0.125 million

8. What would be the treatment of grant of ₹ 6 million received from the government as an inducement to DEF Ltd. to begin developing the factory?

(a) Grant relating to an inducement to begin developing the factory can be recognized immediately in the Statement of Profit or Loss.

(b) 0.15 million amount is to be credited each year in the income statement over 40 year period.

(c) 1.2 million amount is to be credited each year in the income statement over 40 year period.

(d) Net off the grant received against the cost of the asset and depreciate the net figure over its useful economic life.

(4 MCQs x 2 Marks = 8 Marks)

Case Scenario 3

HIJ Ltd. is a globally diversified business conglomerate with operations spanning multiple business segments across various regions worldwide. For maintaining its financial records, the company follows Indian Accounting Standards. As the finance team diligently finalizes the books of accounts and prepares the financial statements for the financial year ending on 31 March 20X2, it requires insights and accounting suggestions on the following transactions:

(i) On 1 October 20X1, HIJ Ltd. subscribed for 40 million ₹ 1 loan notes in Z Ltd. The loan notes were issued at 90 paise and were redeemable at

₹ 1.20 on 30 September 20X6. Interest is payable on 30 September in arrears at 4% of par value. This represents an effective annual rate of return for HIJ Ltd. of 9.9%. HIJ Ltd.'s intention is to hold the loan notes until redemption.

(ii) On 1st April 20X1, HIJ Ltd. commenced joint construction of a property with G Ltd. For this purpose, an agreement has been entered into that provides for joint operation and ownership of the property. All the ongoing expenditure, comprising maintenance plus borrowing costs, is to be shared equally. The construction was completed on 30th September 20X1 and utilisation of the property started on 1st January 20X2 at which time the estimated useful life of the same was estimated to be 20 years.

Total cost of the construction of the property was ₹ 40 crores. Besides internal accruals, the cost was partly funded by way of loan of ₹ 10 crores taken on 1st January 20X1. The loan carries interest at an annual rate of 10% with interest payable at the end of year on 31st December each year. The company has spent ₹ 4,00,000 on the maintenance of such property.

The company has recorded the entire amount paid as investment in Joint Venture in the books of accounts. Suggest the suitable accounting treatment of the above transaction as per applicable Ind AS.

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 9 to 13 in line with relevant Ind AS:

9. What would be the initial measurement of financial instruments as subscription of loan notes in Z Ltd.?

   (a) ₹ 40 million

   (b) ₹ 37.782 million

   (c) ₹ 38.4 million

   (d) ₹ 36 million

10. What would be the closing balance of financial instruments (as subscription of loan notes in Z Ltd.) as on 31 March 20X2?

(a) ₹ 37.6 million

(b) ₹ 34.218 million

(c) ₹ 37.782 million

(d) ₹ 36.182 million

11. With respect to point (ii), what is the nature of the agreement?

(a) Agreement is in the nature of Joint venture

(b) Agreement is in the nature of Joint Operations

(c) Agreement is in the nature of Holding subsidiary relationship

(d) Agreement is in the nature of Associates

12. What will the initial cost of PPE appearing in the books of HIJ Ltd.?

(a) ₹ 40,50,00,000

(b) ₹ 40,00,00,000

(c) ₹ 20,25,00,000

(d) ₹ 20,00,00,000

13. Calculate the depreciation charge for the year ended 31 March 20X2 to be charged by G Ltd. in its books?

(a) ₹ 50,62,500

(b) ₹ 1,01,25,000

(c) ₹ 1,00,00,000

(d) ₹ 50,00,000 **(5 MCQs x 2 Marks = 10 Marks)**

14. F Ltd. is a first-time adopter of Ind AS. The date of transition is 1st April, 20X1. On 1st April, 20X0, it obtained a 7 year US $1,00,000 loan. It has been exercising the option provided in paras 46/46A of AS 11 and has been amortising the exchange differences in respect of this loan over the balance period of such loan. On the date of transition, the company intends to continue the same accounting policy with regard to amortisation of exchange differences.

State which of the following true with respect to the above transaction:

(a) F Ltd. can continue following the existing accounting policy of amortising the exchange differences in respect of loan over the balance period of such long-term liability routed through statement of profit and loss for the period

(b) F Ltd. can continue following the existing accounting policy of amortising the exchange differences in respect of loan over the balance period of such long-term liability routed through OCI

(c) F Ltd. can continue following the existing accounting policy of amortising the exchange differences in respect of loan over the balance period of such long-term liability routed either through statement of profit and loss or OCI as per the choice of the entity.

(d) F Ltd. cannot continue following the existing accounting policy. **(2 Marks)**

15. X Ltd., a large multinational corporation, needs to prepare its financial statements according to Ind AS. The company has a vast amount of financial data stored in the system in various formats, including spreadsheets, PDFs, and scanned documents. Manually extracting and analysing this data is time consuming and error prone. By implementing AI-driven optical character recognition (OCR) technology, the company automates the data extraction process from diverse sources and converts it into structured formats.

Which of the following problems will not be avoided by implementing AI?

(a) Manually extraction of data will lead to delay in the process.

(b) Analysing the data manually might be error prone

(c) Scanned documents of several years will acquire unnecessary office space.

(d) All of the above **(2 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to 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 answers.

Maximum Marks – 70 Marks

1. A Ltd. (Seller-lessee) sells a building to B Ltd. (Buyer-lessor) for cash of ₹ 60,00,000. Immediately before the transaction, the building is carried at a cost of ₹ 30,00,000. At the same time, A Ltd. enters into a contract with B Ltd. for the right to use the building for 20 years, with annual payments of ₹ 4,00,000 payable at the end of each year.

   The terms and conditions of the transaction are such that the transfer of the building by A Ltd. satisfies the requirements for determining when a performance obligation is satisfied in Ind AS 115 'Revenue from Contracts with Customers'.

   The fair value of the building at the date of sale is ₹ 54,00,000. Initial direct costs, if any, are to be ignored. The interest rate implicit in the lease is 12% p.a., which is readily determinable by A Ltd.

   B Ltd. classifies the lease of the building as an operating lease.

   How should the said transaction be accounted by A Ltd. and B Ltd.?

(14 Marks)

2. (a) D Limited has a policy of providing subsidized loans to its employees for their personal purposes. Mr. Y, an employee of the Company, took a loan of ₹ 12.00 lakhs on the following terms:

   - Interest rate 4% per annum
   - Loan disbursement date: 1st April, 20X1
   - The principal amount of the loan shall be recovered in 4 equal annual installments commencing from 31st March, 20X2
   - The accumulated interest computed on reducing balance at simple interest is collected in 3 equal annual installments after collection of the principal amount

- Mr. Y must remain in service till the principal and interest are paid
- The market rate of a comparable loan to Mr. Y is 9% per annum

The present value of ₹ 1 at 9% per annum at the end of respective years is as follows:

Year ending 31st March	20X2	20X3	20X4	20X5	20X6	20X7	20X8
Present Value	0.9174	0.8417	0.7722	0.7084	0.6499	0.5963	0.5470

Under the assumption that no probable future economic benefits except the return of loan has been guaranteed by the employee, you are required to provide the journal entries at the time of initial recognition of loan on 1st April, 20X1 and as at 31st March, 20X2

(10 Marks)

(b) An entity's accounting year ends is 31st December, but its tax year end is 31st March. The entity publishes an interim financial report for each quarter of the year ended 31st December, 20X1. The entity's profit before tax is steady at ₹ 50,000 each quarter, and the estimated effective tax rate is 25% for the year ended 31st March, 20X1 and 30% for the year ended 31st March, 20X2.

How the related tax charge would be calculated for the year 20X1 and its quarters. **(4 Marks)**

3. (a) B Ltd. prepares consolidated financial statements upto 31st March each year. On 1st July 20X1, B Ltd. acquired 75% of the equity shares of K Ltd. and gained control of K Ltd. the issued shares of K Ltd. is 60,00,000 equity shares. Details of the purchase consideration are as follows:

- On 1st July, 20X1, B Ltd. issued two shares for every three shares acquired in K Ltd. On 1st July, 20X1, the market value of an equity share in B Ltd. was ₹ 6.50 and the market value of an equity share in K Ltd. was ₹ 6.

- On 30th June, 20X2, B Ltd. will make a cash payment of ₹ 35,75,000 to the former shareholders of K Ltd. who sold their shares to B Ltd. on 1st July, 20X1. On 1st July, 20X1, B Ltd. would have to pay interest at an annual rate of 10% on borrowings.
- On 30th June, 20X3, B Ltd. may make a cash payment of ₹ 1,50,00,000 to the former shareholders of K Ltd. who sold their shares to B Ltd. on 1st July, 20X1. This payment is contingent upon the revenues of B Ltd. growing by 15% over the two-year period from 1st July, 20X1 to 30th June, 20X3. On 1st July, 20X1, the fair value of this contingent consideration was ₹ 1,25,00,000. On 31st March, 20X2, the fair value of the contingent consideration was ₹ 1,10,00,000.

On 1st July, 20X1, the carrying values of the identifiable net assets of K Ltd. in the books of that company was ₹ 3,00,00,000. On 1st July, 20X1, the fair values of these net assets was ₹ 3,50,00,000. The rate of deferred tax to apply to temporary differences is 20%.

During the nine months ended on 31st March, 20X2, K Ltd. had a poorer than expected operating performance. Therefore, on 31st March, 20X2 it was necessary for B Ltd. to recognise an impairment of the goodwill arising on acquisition of K Ltd., amounting to 10% of its total computed value.

Compute the impairment of goodwill in the consolidated financial statements of B Ltd. under both the methods permitted by Ind AS 103 for the initial computation of the non-controlling interest in K Ltd. at the acquisition date. **(8 Marks)**

(b) An entity has a contract to purchase one million units of gas at 23p per unit, giving a contract price of ₹ 2,30,000. The current market price for a similar contract is 16p per unit, giving a price of ₹ 1,60,000. All of the gas purchased by the entity is used to generate electricity using dedicated assets.

Determine in the following situations whether the contract is onerous and provision is to be made when:

(i) The electricity is sold at a profit. The electricity is sold to a wide range of customers.

(ii) The electricity is sold at a loss, and the entity makes an overall operating loss. The electricity is sold to a wide range of customers.

(iii) The entity sells the gas under contract, which it no longer needs, to a third party for 18p per unit (5p below cost). The entity determines that it would have to pay ₹ 55,000 to exit the purchase contract. **(6 Marks)**

4. (a) On 1st April 20X1, Investor Ltd. acquires 35% interest in XYZ Ltd. thereby exercising significant influence over XYZ Ltd. Investor Ltd. has paid total consideration of ₹ 47,50,000 for acquisition of its interest in XYZ Ltd. At the date of acquisition, the book value of XYZ Ltd.'s net assets was ₹ 90,00,000 and their fair value was ₹ 1,10,00,000. Investor Ltd. has determined that the difference of ₹ 20,00,000 pertains to an item of property, plant and equipment (PPE) which has remaining useful life of 10 years.

During the year, XYZ Ltd. made a profit of ₹ 9,00,000. XYZ Ltd. paid a dividend of ₹ 10,00,000 on 31st March, 20X2. XYZ Ltd. also holds a long-term investment in equity securities. Under Ind AS, investment is classified as at FVTOCI in accordance with Ind AS 109 and XYZ Ltd. recognized an increase in value of investment by ₹ 2,00,000 in OCI during the year. Ignore deferred tax implications, if any.

Calculate the closing balance of Investor Ltd.'s investment in XYZ Ltd. as at 31st March, 20X2 as per the relevant Ind AS. **(5 Marks)**

(b) Following are the facts given for X Ltd.:

- Income from continuing operations:	₹ 90,00,000
- Loss from discontinued operations:	(₹ 1,08,00,000)
- Net loss:	(₹ 18,00,000)
- Weighted average Number of shares outstanding	10,00,000
- Incremental common shares outstanding relating to stock options	2,00,000

(a) You are required to calculate the basic and diluted EPS for Company XY from the above information.

(b) Assume, if in above case, Loss from continued operations is ₹ 30,00,000 and income from discontinued operations is ₹ 1,08,00,000 calculate the diluted EPS. **(9 Marks)**

5. (a) A Ltd. is a company which is in the business of manufacturing engineering machines and providing after sales services. The company entered into a contract with Mr. Anik to supply and install a machine, namely 'model pi' on 1st April 20X1 and to service this machine on 30th September 20X1 and 1st April 20X2. The cost of manufacturing the machine to A Ltd. was ₹ 1,60,000.

It is possible for a customer to purchase both the machine 'model pi' and the maintenance services separately. Mr. Anik is contractually obliged to pay A Ltd ₹ 4,00,000 on 1st April, 20X2.

The prevailing rate for one-year credit granted to trade customers in the industry is 5 percent per six-month period.

As per the experience, the servicing of the machine 'model pi' sold to Mr. Anik is expected to cost A Ltd. ₹ 30,000 to perform the first service and ₹ 50,000 to perform the second service. Assume actual costs equal expected costs. When A Ltd. provides machine services to customers in a separate transaction it earns a margin of 50% on cost. On 1st April, 20X1, the cash selling price of the machine 'model pi' sold to Mr. Anik is ₹ 2,51,927.

The promised supply of machine 'model pi' and maintenance service obligations are satisfactorily carried out in time by the company.

You are required to:

(i) Segregate the components of the transaction that A Ltd. shall apply to the revenue recognition criteria separately as per Ind AS 115;

(ii) Calculate the amount of revenue which A Ltd. must allocate to each component of the transaction; and

(iii) Prepare journal entries to record the information set out above in the books of accounts of A Ltd. for the years ended 31st March·20X2 and 31st March 20X3. **(9 Marks)**

(b) X Ltd. is a first-time adopter of Ind AS. The date of transition is 1st April, 20X1. It has given 300 stock options to its employees.

Out of these, 100 options have vested on 30th November, 20X0 and the remaining 200 will vest on 30th November, 20X1.

What are the options available to X Ltd. at the date of transition?

(5 Marks)

6. (a) As at 31 March 20X4, M Ltd. had a plan to dispose off its 75% subsidiary D Ltd. This plan had been approved by the board and was reported in the media as well as to the Stock Exchange where M Ltd. was listed. It is expected that J Ltd., the non-controlling shareholder in Di Ltd. holding 25% stake, will acquire the 75% equity interest as well. The sale is expected to be completed by October 20X4. D Ltd. is expected to have substantial trading losses in the period up to the sale. Mr. X, a chartered accountant, who is an employee in the finance department of M Ltd., wishes to show D Ltd. as held for sale in the financial statements and to create a restructuring provision to include the expected costs of disposal and future trading losses. However, the Chief Operating Officer (COO) does not wish D Ltd. to be categorized as held for sale nor to provide for the expected losses. The COO is concerned as to how this may affect the sales and would surely result in bonus targets not being met. He has argued that as the management, it is his duty to secure a high sales price to maximize the return for shareholders of M Ltd. He has also hinted that Mr. X's job could be at stake if such a provision were to be made in the financial statements. The expected costs from the sale are as follows:

Future Trading Losses:	₹ 50 crores
Various legal costs of sale	₹ 3.75 crores
Redundancy costs for D Ltd.'s employees	₹ 10 crores
Impairment losses on Property, Plant and Equipment	₹ 17.50 crores

Required:

(i) Discuss the accounting treatment which M Ltd. should adopt to address the issue above for the financial statements.

(ii) Discuss the ethical issues which may arise in the above scenario, including any actions which M Ltd. and Mr. X should take. **(5 Marks)**

(b) P Ltd., a manufacturing company, prepares consolidated financial statements to 31st March each year. During the year ended 31st March, 20X2, the following events affected the tax position of the group:

- Q Ltd., a wholly owned subsidiary of P Ltd., incurred a loss adjusted for tax purposes of ₹ 10,00,000. Q Ltd. is unable to utilise this loss against previous tax liabilities. Income-tax Act does not allow Q Ltd. to transfer the tax loss to other group companies. However, it allows Q Ltd. to carry the loss forward and utilise it against company's future taxable profits. The directors of P Ltd. do not consider that Q Ltd. will make taxable profits in the foreseeable future.

- During the year ended 31st March, 20X2, P Ltd. capitalised development costs which satisfied the criteria as per Ind AS 38 'Intangible Assets'. The total amount capitalised was ₹ 20,00,000. The development project began to generate economic benefits for P Ltd. from 1st January, 20X2. The directors of P Ltd. estimated that the project would generate economic benefits for five years from that date. The development expenditure was fully deductible against taxable profits for the year ended 31st March, 20X2.

- On 1st April, 20X1, P Ltd. borrowed ₹ 1,00,00,000. The cost to P Ltd. of arranging the borrowing was ₹ 2,00,000 and this cost qualified for a tax deduction on 1st April 20X1. The loan was for a three-year period. No interest was payable on the loan but the amount repayable on 31st March 20X4 will be ₹ 1,30,43,800. This equates to an effective annual interest rate of 10%. As per the Income-tax Act, a further tax deduction of ₹ 30,43,800 will be claimable when the loan is repaid on 31st March, 20X4.

Explain and show how each of these events would affect the deferred tax assets / liabilities in the consolidated balance sheet of P Ltd. group at 31st March, 20X2 as per Ind AS. The rate of corporate income tax is 30%. **(5 Marks)**

(c) **Either**

Entity ABC acquired a building for its administrative purposes and presented the same as property, plant and equipment (PPE) in the financial year 20X1-20X2. During the financial year 20X2-20X3, it relocated the office to a new building and leased the said building to a third party. Following the change in the usage of the building, Entity ABC reclassified it from PPE to investment property in the financial year 20X2-20X3. Should Entity ABC account for the change as a change in accounting policy? **(4 Marks)**

Or

The AGM of ABC Ltd for the year ended 31st March, 20X2 was held on 10th July, 20X2 and Board Meeting has been conducted on 15th May, 20X2. Meanwhile, the company had to disclose certain financial information pertaining to the year ended 31st March, 20X2 to SEBI as per SEBI regulations on 20th April, 20X2. Since, certain financial information pertaining to the year ended 31st March, 20X2 is submitted to SEBI before approval of financial statements by the Board, the management is suggesting that 20th April 20X2 shall be considered as 'after the reporting period'. Whether the management view is correct in accordance with the guidance given in Ind AS 10? **(4 Marks)**

MODEL TEST PAPER 4

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

All MCQs are compulsory.

Case Scenario 1

A Ltd. is a diversified business group operating in multiple business segments across different parts of the world. It maintains its books of accounts and publishes its annual financial statements under Indian Accounting Standards. The finance team has been working on closing the books of accounts and generating financial statements for the year ended 31st March 20X2 and are facing issues in the following transactions while finalization of financial statements:

(i) A Ltd. owns 250 ordinary shares in X Ltd., an unquoted company. X Ltd. has a total share capital of 5,000 shares with nominal value of ₹ 10. X Ltd.'s after-tax maintainable profits are estimated at ₹ 70,000 per year. An appropriate price/earnings ratio determined from published industry data is 15 (before lack of marketability adjustment). A Ltd.'s management estimates that the discount for the lack of marketability of X Ltd.'s shares and restrictions on their transfer is 20%. A Ltd. values its holding in X Ltd.'s shares based on earnings.

(ii) A Ltd. has a telecom segment. It entered into an agreement with B Ltd. which is engaged in generation and supply of power. The agreement provided that A Ltd. will provide 1,00,000 minutes of talk time to employees of B Ltd. in exchange for getting power equivalent to 20,000 units. A Ltd. normally charges ₹ 0.50 per minute and B Ltd. charges ₹ 2.5 per unit.

(iii) A Ltd. began construction of a new building at an estimated cost of ₹ 7 lakh on 1st April, 20X1. To finance construction of the building it obtained a specific loan of ₹ 2 lakh from a financial institution at an interest rate of 9% per annum.

The company's other outstanding loans were:

Amount	Rate of Interest per annum
₹ 7,00,000	12%
₹ 9,00,000	11%

The expenditure incurred on the construction was:

April, 20X1	₹ 1,50,000
August, 20X1	₹ 2,00,000
October, 20X1	₹ 3,50,000
January, 20X2	₹ 1,00,000

The construction of building was completed by 31st January, 20X2.

The construction of building started on 1st April, 20X1 and all the expenditures on construction of building had been incurred at the beginning of the respective month.

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 1 to 6 in line with relevant Ind AS:

1. What is the value of a share of X Ltd.?

   (a) ₹ 8,40,000

   (b) ₹ 10,50,000

   (c) ₹ 8,00,000

   (d) ₹ 10,00,000

2. What is the fair value of A Ltd.'s investment in X Ltd.'s shares?

   (a) ₹ 50,000

   (b) ₹ 42,000

   (c) ₹ 10,50,000

   (d) ₹ 10,00,000

3. By what amount the revenue be measured and recognised by A Ltd. in case of telecom segment?

   (a) ₹ 10,000

   (b) ₹ 2,50,000

   (c) ₹ 2,00,000

   (d) ₹ 50,000

4. What will be the capitalization rate for computation of borrowing cost on the building based on general borrowings?

   (a) 9%

   (b) 11%

   (c) 11.4375%

   (d) 12%

5. What will be the total amount of borrowing cost on specific borrowing?

   (a) ₹ 11,250

   (b) ₹ 13,500

   (c) ₹ 15,000

   (d) ₹ 37,875

6. What will be the total amount of borrowing cost on general borrowing?

   (a) ₹ 22,875

   (b) ₹ 15,000

   (c) ₹ 37,875

   (d) ₹ 13,500 **(6 MCQs x 2 Marks each = 12 Marks)**

Case Scenario 2

D Ltd. is a globally diversified business conglomerate with operations spanning across various business sectors worldwide. The company adheres to Indian Accounting Standards for maintaining its financial records and annually releases its financial statements. As the finance team progresses towards finalizing the financial statements for the fiscal year ending on 31st March 20X2, the team is stuck up in the accounting of the following transactions:

(i) D Ltd., for its dairy business, purchased cattle at an auction on 30th June 20X1

Purchase price at 30th June 20X1	₹ 1,00,000
Costs of transporting the cattle back to the entity's farm	₹ 1,000
Sales price of the cattle at 31st March, 20X2	₹ 1,10,000

The company would have to incur similar transportation costs if it were to sell the cattle at auction, in addition to an auctioneer's fee of 2% of sales price. The auctioneer charges 2% of the selling price, from both, the buyer as well as the seller.

(ii) D Ltd. has certain financial instruments:

- Irredeemable preference shares with face value of ₹ 10 each and premium of ₹ 90. These shares carry dividend @ 8% per annum, however dividend is paid only when D Ltd declares dividend on equity shares.
- Borrowings from Z Ltd. for ₹ 10,00,000 with settlement against issue of a certain number of equity shares of D Ltd. whose value equals ₹ 10,00,000. Fair value per share (to determine total number of equity shares to be issued) be determined based on the market price of the shares of D Ltd. at a future date, upon settlement of the contract.

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 7 to 10 in line with relevant Ind AS:

7. What will be the gain/(loss) on initial recognition of biological asset i.e. cattle at the time of purchase on 30th June 20X1?

   (a) Gain on initial recognition of biological asset ₹ 9,800

   (b) Loss on initial recognition of biological asset ₹ 9,800

   (c) Gain on initial recognition of biological asset ₹ 6,000

   (d) Loss on initial recognition of biological asset ₹ 6,000

8. What will be the gain/(loss) on remeasurement of biological asset i.e. cattle at the time of sale on 31st March 20X2?

(a) Gain on remeasurement of biological asset ₹ 9,800

(b) Loss on remeasurement of biological asset ₹ 9,800

(c) Gain on remeasurement of biological asset ₹ 6,000

(d) Loss on remeasurement of biological asset ₹ 6,000

9. Irredeemable preference shares would be accounted for in the books of D Ltd. as

(a) Financial Asset

(b) Financial Liability

(c) Equity

(d) Will not be accounted for in the books

10. Borrowings from Z Ltd. for ₹ 10,00,000 with settlement against issue of a certain number of equity shares of D Ltd. would be accounted for in the books of D Ltd. as

(a) Financial Asset

(b) Financial Liability

(c) Equity

(d) Will not be accounted for in the books

(4 MCQs x 2 Marks each = 8 Marks)

Case Scenario 3

H Ltd. is a globally diversified business conglomerate with operations spanning multiple business segments across various regions worldwide. For maintaining its financial records, the company follows Indian Accounting Standards. As the finance team diligently finalizes the books of accounts and prepares the financial statements for the financial year ending on 31st March 20X2, it requires insights and accounting suggestions on the following transactions:

(i) H Ltd. holds 12% of the voting shares in Z Ltd. Z Ltd.'s board comprises of eight members and two of these members are appointed by H Ltd. casting significant influence. Each board member has one vote at the meeting.

(ii) H Ltd. holds 10% of the voting power of G Ltd. The balance 90% voting power is held by nine other investors each holding 10%.

The decisions about the relevant activities (except decision about taking borrowings) of G Ltd. are taken by the members holding majority of the voting power. The decisions about taking borrowings are required to be taken by unanimous consent of all the investors. Further, decisions about taking borrowing are not the decisions that most significantly affect the returns of G Ltd.

(iii) H Ltd. is also engaged in the business of pharmaceuticals. It has invested in the share capital of Y Ltd. and is holding 15% of Y Ltd.'s total voting power.

Y Ltd. is engaged in the business of producing packing materials for pharmaceutical entities. One of the incentives for H Ltd. to invest in Y Ltd. was the fact that Y Ltd. is engaged in the business of producing packing materials which is also useful for H Ltd. Since last many years, almost 90% of the output of Y Ltd. is procured by H Ltd.

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 11 to 13 in line with relevant Ind AS:

11. What is the relationship of Z Ltd. with H Ltd.?

    (a) Z Ltd. is a subsidiary of H Ltd.

    (b) Z Ltd. is an associate of H Ltd.

    (c) Z Ltd. is in joint arrangement with H Ltd.

    (d) H Ltd. has invested in Z Ltd. with no further relationship as subsidiary, associate or joint arrangement.

12. What is the relationship of G Ltd. with H Ltd.?

    (a) G Ltd. is a subsidiary of H Ltd.

    (b) G Ltd. is an associate of H Ltd.

    (c) G Ltd. is in joint arrangement with H Ltd.

    (d) H Ltd. has invested in G Ltd. with no further relationship as subsidiary, associate or joint arrangement.

13. What is the relationship of Y Ltd. with H Ltd.?

(a) Y Ltd. is a subsidiary of H Ltd.

(b) Y Ltd. is an associate of H Ltd.

(c) Y Ltd. is in joint arrangement with H Ltd.

(d) H Ltd. has invested in Y Ltd. with no further relationship as subsidiary, associate or joint arrangement.

(3 MCQs x 2 Marks each = 6 Marks)

14. With respect to the best practices applicable to all companies, which of the following statements is incorrect?

    (a) Comply with the standards and regulations but also ensure that financial statements are an effective part of wider communication with stakeholders.

    (b) Disclose complete information in the financial to avoid any further cross questioning in the mind of the users.

    (c) Reduce generic disclosures and focus on company specific disclosures that explain how the company applies the policies.

    (d) Do not disclose assumptions and bases, so that users are not misled. **(2 Marks)**

15. Which of the following proactive measures do not mitigate cybersecurity risks?

    (a) Ensure that all passwords are simple and are not changed regularly.

    (b) Include procedures for detecting, containing, and mitigating the impact of a cyberattack

    (c) Ensure that firewalls and other security measures are in place to prevent unauthorized access to the network.

    (d) Ensure that data backups are performed regularly and that backups are stored securely **(2 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to 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 answers.

Maximum Marks – 70 Marks

1. On 31st December, 20X1, Entity A issues 2.5 shares in exchange for each ordinary share of Entity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, Entity A issues 150 ordinary shares in exchange for all 60 ordinary shares of Entity B.

The fair value of each ordinary share of Entity B at 31st December, 20X1 is ₹ 40. The quoted market price of Entity A's ordinary shares at that date is ₹ 16.

The fair values of Entity A's identifiable assets and liabilities at 31st December, 20X1 are the same as their carrying amounts, except that the fair value of Entity A's non- current assets at 31st December, 20X1 is ₹ 1,500.

The balance sheets of Entity A and Entity B immediately before the business combination are:

	Entity A (legal parent, accounting acquiree)	**Entity B (legal subsidiary, accounting acquirer)**
Current assets	500	700
Non-current assets	1,300	3,000
Total assets	1,800	3,700
Current liabilities	300	600
Non-current liabilities	400	1,100
Total liabilities	700	1,700
Shareholders' equity		
Retained earnings	800	1,400
Issued equity		
100 ordinary shares	300	
60 ordinary shares		600

Total shareholders' equity	1,100	2,000
Total liabilities and shareholders' equity	1,800	3,700

Assume that Entity B's earnings for the annual period ended 31st March, 20X1 were ₹ 600 and that the consolidated earnings for the annual period ended 31st March, 20X2 were ₹ 800. Assume also that there was no change in the number of ordinary shares issued by Entity B during the annual period ended 31st March, 20X1 and during the period from 1st January, 20X1 to the date of the reverse acquisition on 31st December, 20X1.

Calculate the fair value of the consideration transferred measure goodwill and prepare consolidated balance sheet as on 31st December, 20X1. **(14 Marks)**

2. (a) XYZ Ltd. is a company incorporated in India. It provides ₹ 10,00,000 interest free loan to its wholly owned Indian subsidiary, ABC Ltd. There are no transaction costs.

State how the loan be accounted for, in the separate financial statements of XYZ Ltd., individual financial statements of ABC Ltd. and consolidated financial statements of the group when the loan is repayable after 3 years. The current market rate of interest for similar loan is 10% p.a. for both holding and subsidiary. **(10 Marks)**

(b) **Either**

One of the directors of Buildwell Ltd., Mr. Ben Jones has informed Central Finance team that on 1st January 20X3, his spouse acquired a controlling interest in one of Buildwell Ltd.'s major suppliers, Candour Ltd. Mr. Jones seemed to think that this would have implications on the financial statements of Buildwell Ltd. Buildwell Ltd. has been purchasing goods from Candour Ltd. ₹ 1·5 million per month of the year ended 31st March 20X3. As per the financial statements of Buildwell Ltd., this is a significant amount. While checking all the purchase transactions it was found that all the purchases from Candour Ltd. were made at normal market rates.

How the effect of acquisition of controlling interest in Candour Ltd. by Mr. Ben Jones is to be reflected in the financial statements for the year ending 31st March 20X3? **(4 Marks)**

Or

An entity uses the weighted average cost formula to assign costs to inventories and cost of goods sold for financial reporting purposes, but the reports provided to the chief operating decision maker use the First-In, First-Out (FIFO) method for evaluating the performance of segment operations.

State the cost formula to be used for Ind AS 108 disclosure purposes. **(4 Marks)**

3. (a) One of the subsidiaries of B Ltd. submitted to Central Finance its Summarized Statement of Profit and Loss and Balance Sheet.

Summarized Statement of Profit and Loss for the year ended 31st March 20X3

Particulars	Amount (₹)
Net sales	2,52,00,000
Less: Cash cost of sales	(1,92,00,000)
Depreciation	(6,00,000)
Salaries & wages	(24,00,000)
Operating expenses	(14,00,000)
Provision for taxation	(8,80,000)
Net Operating Profit	7,20,000
Non-recurring income – profit on sale of equipment	1,20,000
	8,40,000
Retained earnings and profit brought forward	15,18,000
	23,58,000
Dividends declared and paid during the year	(7,20,000)
Profit & loss balance as on 31st March 20X3	16,38,000

Summarized Balance Sheet

Assets	31 March 20X2	31 March 20X3
Non-current Assets		
Property, Plant and Equipment:		
Land	4,80,000	9,60,000
Buildings and Equipment	36,00,000	57,60,000

Current Assets		
Cash	6,00,000	7,20,000
Inventories	16,80,000	18,60,000
Trade Receivables	26,40,000	9,60,000
Advances	78,000	90,000
Total Assets	90,78,000	1,03,50,000
Liabilities & Equity		
Share capital	36,00,000	44,40,000
Surplus in profit & loss	15,18,000	16,38,000
Current liability		
Trade Payables	24,00,000	23,40,000
Outstanding expenses	2,40,000	4,80,000
Income tax payable	1,20,000	1,32,000
Accumulated depreciation on buildings and equipment	12,00,000	13,20,000
Total	90,78,000	1,03,50,000

The original cost of equipment sold during the year 20X2-20X3 was ₹ 7,20,000.

Work out a Statement of cash flows (as per indirect method) for the year ended 31st March 20X3. **(8 Marks)**

(b) SA Pvt Ltd is engaged in the business of retail having 100 retail outlets across Northern and Southern India. The company's head office is located at Chennai.

SA Pvt Ltd is a subsidiary of SAG Ltd. SAG Ltd is listed on the National Stock Exchange in India.

Following information is available for SA Pvt Ltd:

<u>Plan Assets</u>

At 1st April, 20X1, the fair value of plan assets was ₹ 10,000.

Contribution to the plan assets done on 31st March, 20X2 – ₹ 3,000

Amount paid on 31st March, 20X2 – ₹ 300

At 31st March, 20X2, the fair value of plan assets was ₹ 14,700

Actual return on plan assets – ₹ 2,000

Defined Benefit Obligation

At 1st April, 20X1, present value of the defined benefit obligation was ₹ 12,000.

At 31st March, 20X2, present value of the defined benefit obligation was ₹ 15,500.

Actuarial losses on the obligation for the year ended 31st March, 20X2 were ₹ 100.

Current Service Cost – ₹ 2,500

Benefit paid – ₹ 300

Discount rate used to calculate defined benefit liability - 10%.

Suggest the amount that would be taken to other comprehensive income (with workings). Also compute net interest on the net defined benefit liability (asset). **(6 Marks)**

4. (a) PQR Ltd., a manufacturing company, prepares consolidated financial statements to 31st March each year. During the year ended 31st March, 20X2, the following events affected the tax position of the group:

i QPR Ltd., a wholly owned subsidiary of PQR Ltd., incurred a loss adjusted for tax purposes of ₹ 30,00,000. QPR Ltd. is unable to utilise this loss against previous tax liabilities. Income-tax Act does not allow QPR Ltd. to transfer the tax loss to other group companies. However, it allows QPR Ltd. to carry the loss forward and utilise it against company's future taxable profits. The directors of PQR Ltd. do not consider that QPR Ltd. will make taxable profits in the foreseeable future.

ii During the year ended 31st March, 20X2, PQR Ltd. capitalised development costs which satisfied the criteria as per Ind AS 38 'Intangible Assets'. The total amount capitalised was ₹ 16,00,000. The development project began to generate economic benefits for PQR Ltd. from 1st January, 20X2. The directors of PQR Ltd. estimated that the project would generate economic benefits for five years from that date. The development expenditure was fully deductible against taxable profits for the year ended 31st March, 20X2.

iii On 1st April, 20X1, PQR Ltd. borrowed ₹ 1,00,00,000. The cost to PQR Ltd. of arranging the borrowing was ₹ 2,00,000 and this cost qualified for a tax deduction on 1st April 20X1. The loan was for a three-year period. No interest was payable on the loan but the amount repayable on 31st March 20X4 will be ₹ 1,30,43,800. This equates to an effective annual interest rate of 10%. As per the Income-tax Act, a further tax deduction of ₹ 30,43,800 will be claimable when the loan is repaid on 31st March, 20X4.

Explain and show how each of these events would affect the deferred tax assets / liabilities in the consolidated balance sheet of PQR Ltd. group at 31st March, 20X2 as per Ind AS. The rate of corporate income tax is 30%. **(8 Marks)**

(b) An entity enters into a contract with a customer on 1st April, 20X1 for the sale of a machine and spare parts. The manufacturing lead time for the machine and spare parts is two years.

Upon completion of manufacturing, the entity demonstrates that the machine and spare parts meet the agreed-upon specifications in the contract. The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time. On 31st March, 20X3, the customer pays for the machine and spare parts, but only takes physical possession of the machine. Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its close proximity to the customer's factory. The customer has legal title to the spare parts and the parts can be identified as belonging to the customer. Furthermore, the entity stores the spare parts in a separate section of its warehouse and the parts are ready for immediate shipment at the customer's request. The entity expects to hold the spare parts for two to four years and the entity does not have the ability to use the spare parts or direct them to another customer.

How will the Company recognize revenue for sale of machine and spare parts? Is there any other performance obligation attached to this sale of goods? **(6 Marks)**

5. (a) ABC Ltd is a government company and is a first-time adopter of Ind AS. As per the previous GAAP, the contributions received by ABC Ltd. from the government (which holds 100% shareholding in ABC Ltd.) which is in the nature of promoters' contribution have been recognised in capital reserve and treated as part of shareholders' funds in accordance with the provisions of AS 12, Accounting for Government Grants.

State whether the accounting treatment of the grants in the nature of promoters' contribution as per AS 12 is also permitted under Ind AS 20 Accounting for Government Grants and Disclosure of Government Assistance. If not, then what will be the accounting treatment of such grants recognised in capital reserve as per previous GAAP on the date of transition to Ind AS. **(4 Marks)**

(b) Feel Fresh Limited (the Company) is into manufacturing and retailing of FMCG products listed on stock exchanges in India. One of its products is bathing soap which the Company sells under the brand name 'Feel Fresh'. The Company does not have its own manufacturing facilities for soap and therefore it enters into arrangements with a third party to procure the soaps. The Company entered into a long-term purchase contract of 10 years with M/s. Radhey. Following are the relevant terms of the contract with M/s. Radhey.

(i) M/s. Radhey has to purchase a machine costing ₹ 10,00,000 from the supplier as specified by the Company. The machine will be customized to produce the soaps as designed by the Company. This machine cannot be used by M/s. Radhey to produce the soaps for buyer other than the Company due to the design specifications. The machine has a useful life of 10 years and the straight line method of depreciation is best suited considering the use of the machine.

(ii) The Company will pay ₹ 4.75 per soap for the first year of contract. This is calculated based on the budgeted annual purchase of 7,00,000 soaps as follows:

Particulars	Per soap price
Variable cost of manufacturing	4.00

Cost of machine (₹ 1,74,015/7,00,000 soaps)	0.25
M/s. Radhey's margin	0.50
Per soap cost to the Company	4.75

In case the Company purchases more than 7,00,000 (i.e. budgeted number of soaps) soaps in the first year then the cost of the machine (i.e. 0.25 per soap) will not be paid for soaps procured in excess of 7,00,000 units. However, in case Company procures less than budgeted number of soaps, then the Company will pay the differential unabsorbed cost of the machine, at the end of the year. For example, if the Company purchases only 6,00,000 soaps in first year then the differential amount of ₹ 24,015 (1,74,015 - (6,00,000 x 0.25)) will be paid by the Company to M/s. Radhey at the end of the year. Variable cost will be actualized at the end of the year.

(iii) The cost per soap will be calculated for each year in advance based on the budgeted number of soaps to be produced each year. An amount of ₹ 1,74,015 shall be considered each year for the cost of machine for year 1 to year 8 while calculating the cost per soap. Any differential under absorbed amount shall be paid by the Company to M/s. Radhey at the end of that year. A charge of ₹ 1,74,015 per annum for the machine is derived using borrowing cost of 8% p.a. For year 9 and year 10, only variable cost and margins will be paid.

(iv) M/s. Radhey does not have any right to terminate the contract but the Company has the right to terminate the contract at the end of each year. However, if the Company terminates the contract, it has to compensate M/s. Radhey for any unabsorbed cost of Machine. For example, if the Company terminates the contract at the end of second year then it has to pay ₹ 10,44,090 (i.e. 1,74,015 per year x 6 remaining years). If it terminates the contract after the 8^{th} year then the Company does not have to pay the compensation since the cost of the machine would have been absorbed.

(v) In the first year, the Company purchases 5,50,000 soaps at ₹ 4.75 per soap.

Analyze the contract of the Company with M/s. Radhey and provide necessary accounting entries for first year in accordance with Ind AS with working notes. Assume all cash flows occur at the end of the year. **(10 Marks)**

6. (a) Venus Ltd. is a multinational entity that owns three properties. All three properties were purchased on 1st April, 20X1. The details of purchase price and market values of the properties are given as follows:

Particulars	**Property 1** Factory	**Property 2** Factory	**Property 3** Let-Out
Purchase price	15,000	10,000	12,000
Market value 31.03.20X2	16,000	11,000	13,500
Life	10 Years	10 Years	10 Years
Subsequent Measurement	Cost Model	Revaluation Model	Revaluation Model

Property 1 and 2 are used by Venus Ltd. as factory building whilst property 3 is let-out to a non-related party at a market rent. The management presents all three properties in balance sheet as 'property, plant and equipment'.

The Company does not depreciate any of the properties on the basis that the fair values are exceeding their carrying amount and recognise the difference between purchase price and fair value in Statement of Profit and Loss.

Analyse whether the accounting policies adopted by the Venus Ltd. in relation to these properties is in accordance with Ind AS. If not, advise the correct treatment alongwith working for the same.

(9 Marks)

(b) Infostar Ltd. is a listed company engaged in the provision of IT services in India. The directors are paid a bonus based on the profits achieved by the company during the year as per the bonus table given below:

Profit Range	Bonus to Directors
NIL < Profit < ₹ 1 crore	NIL
₹ 1 crore < Profit < ₹ 5 crores	2% of Net Profit
₹ 5 crores < Profit < ₹ 10 crores	4% of Net Profit
₹ 10 crores < Profit < ₹ 20 crores	6% of Net Profit
₹ 20 crores < Profit < ₹ 30 crores	8% of Net Profit
Profit > ₹ 30 crores	10% of Net Profit

The draft Statement of Profit and Loss for the year ended 31 March 20X2 currently shows a profit of ₹ 2 crores.

Issue:

The employees of Infostar Ltd. have historically been paid an individual-performance-based discretionary incentive for the last 15 years. Based on the past trends and performance, the bonus amount for the year 20X1-20X2 would be ₹ 3 crores. In view of the possibility of the directors not receiving the bonus on account of the company's poor performance, Infostar Ltd.'s Chief Financial Officer (CFO), who is a chartered accountant, has suggested that the discretionary incentive usually payable to the employees could be avoided in the current year, which would result in the company reporting profits. As a part of its annual report, Infostar Ltd. reports employee satisfaction scores, staff attrition rates, gender equality and employee absenteeism rates as non-financial performance measures. The CFO has also told the directors over mail that no stakeholder reads the non-financial information anyway, and thus his aforesaid suggestion of not paying the discretionary incentive would not impact the company greatly.

Discuss the ethical and accounting implications of the above issues, referring to the relevant Ind AS wherever appropriate from perspective of CA. Sushil Bhupathy. **(5 Marks)**

MODEL TEST PAPER 5

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

All MCQs are compulsory.

Case Scenario 1

ABC Ltd. maintains its accounts and prepares its annual financial statements in accordance with Indian Accounting Standards (Ind AS). It is a diversified global business group with operations spanning multiple sectors. The finance team while working on finalizing the books for the year ending 31st March, 20X3, encountered challenges with the following transactions:

(i) ABC Ltd. manufactures automobile parts. It has shown a net profit of ₹ 20,00,000 for the third quarter of 20X2-20X3.

Following adjustments are made while computing the net profit:

(1) Bad debts of ₹ 1,00,000 incurred during the quarter. 50% of the bad debts have been deferred to the next quarter.

(2) ₹ 5,00,000 expenditure on account of administrative expenses pertaining to the third quarter is deferred on the argument that the fourth quarter will have more sales; therefore, fourth quarter should be debited by higher expenditure. The expenditures are uniform throughout all quarters.

(ii) ABC Ltd. enters into a contract to build a power plant for a customer. The entity will be responsible for the overall management of the project including services to be provided like engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment and finishing.

(iii) In financial year 20X1-20X2, ABC Ltd. incurred the following expenditure in acquiring property consisting of 6 identical houses each with separate legal title including the land on which it is built.

The expenditure incurred on various dates is given below:

- On 1st April, 20X2 - Purchase cost of the property ₹ 1,80,00,000
- On 1st April, 20X2 – Non-refundable transfer taxes ₹ 20,00,000 (not included in the purchase cost)
- On 2nd April, 20X2- Legal cost related to property acquisition ₹ 5,00,000
- On 6th April, 20X2- Advertisement campaign to attract tenants ₹ 3,00,000
- On 8th April, 20X2- Opening ceremony function for starting business ₹ 1,50,000

Throughout 20X2-20X3, incurred ₹ 1,00,000 towards day-to-day repair maintenance and other administrative expenses.

ABC Ltd. uses one of the six houses for office and accommodation of its few staffs. The other five houses are rented to various independent third parties.

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 1 to 6 in line with relevant Ind AS:

1. What will be the treatment of bad debts incurred during the third quarter?

The treatment of bad debts is not correct as the expenses incurred during an interim reporting period should be recognised in the same period. Accordingly, ₹ 50,000 should be deducted from ₹ 20,00,000.

(a) Bad debts expenses incurred during third quarter should be recognised in the same quarter. Accordingly, ₹ 50,000 should be deducted from ₹ 20,00,000.

(b) Bad debts expenses incurred during third quarter should be recognised equally in the third and fourth quarter. Accordingly, the treatment done in the books is correct and no further adjustment in this regard is required.

(c) Bad debts expenses incurred during third quarter should be recognised at the end of the financial year in the last quarter. Accordingly, ₹ 50,000 already deducted should be added back from ₹ 20,00,000.

(d) No bad debt accounted in the interim financial statements in any of the quarter.

2. The correct net profits to be shown in Interim Financial Report of the third quarter shall be

(a) ₹ 15,00,000

(b) ₹ 20,00,000

(c) ₹ 19,50,000

(d) ₹ 14,50,000

3. How many performance obligations does the entity have?

(a) Three performance obligations

(b) Two performance obligations

(c) A single performance obligation

(d) More than three performance obligations

4. What is the cost of the entire property?

(a) ₹ 1,80,00,000

(b) ₹ 2,05,00,000

(c) ₹ 2,06,00,000

(d) ₹ 1,85,00,000

5. What is the cost of the investment property?

(a) ₹ 1,70,83,333

(b) ₹ 2,05,00,000

(c) ₹ 34,16,667

(d) ₹ 1,80,00,000

6. What is the cost of the owner-occupied property?

(a) ₹ 1,70,83,333

(b) ₹ 2,05,00,000

(c) ₹ 34,16,667

(d) ₹ 1,80,00,000 **(6 x 2 Marks = 12 Marks)**

Case Scenario 2

DEF Ltd. is a diversified business group operating in multiple business segments across different parts of the world with multiple subsidiaries. It maintains its books of accounts and publishes its annual financial statements under Indian Accounting Standards. The finance team has been working on closing the books of accounts and generating financial statements for the year ended 31st March 20X1 and are facing issues in the following transactions while finalization of financial statements:

(i)

Profit attributable to ordinary equity holders of the parent entity for year 20X1	₹ 1,200,000
Weighted average number of ordinary shares outstanding during year 20X1	500,000 shares
Average market price of one ordinary share during year 20X1	₹ 20.00
Weighted average number of shares under option during year 20X1	100,000 shares
Exercise price for shares under option during year 20X1	₹ 15.00

(ii) DEF Ltd. enters into a contract to buy 100 tonnes of cocoa beans at 1,000 per tonne for delivery in 12 months. On the settlement date, the market price for cocoa beans is 1,500 per tonne. The contract cannot be settled net in cash and is entered for delivery of cocoa beans in line with DEF Ltd.'s expected purchase/ usage requirements.

(iii) DEF Ltd. invests in compulsorily convertible preference shares (CCPS) issued by its subsidiary B Ltd. at ₹ 1,000 each (₹ 10 face value + ₹ 990 premium). Under the terms of the instrument, each CCPS is compulsorily convertible into one equity share of B Ltd at the end of 5 years. Such CCPS carry dividend @ 12% per annum, payable only when declared at the discretion of B Ltd.

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 7 to 10 in line with relevant Ind AS:

7. Based on the facts given in scenario (i), what will be basic EPS of the entity?

   (a) 2.29

   (b) 2.40

   (c) 2.00

   (d) 1.77

8. Based on the facts given in scenario (i), what will be diluted EPS of the entity?

   (a) 2.29

   (b) 2.40

   (c) 2.00

   (d) 1.77

9. What is the nature of the contract entered into for cocoa beans?

   (a) Cash contract

   (b) Non-executory and derivative contract

   (c) Derivative contract

   (d) Executory and non-derivative contract

10. What is the nature of the financial instrument mentioned in point (iii)?

    (a) Financial Asset

    (b) Financial Liability

    (c) Equity

    (d) Not a financial instrument **(4 x 2 Marks = 8 Marks)**

Case Scenario 3

PQR Ltd. is required to adopt Ind AS from 1st April, 20X1, with comparatives for one year, i.e., for 20X0-20X1. On 1st April, 20X1, PQR Ltd. acquired 30% of the voting ordinary shares of XYZ Ltd. for ₹ 8,000 crore. PQR Ltd. accounts its investment in XYZ Ltd. using equity method as prescribed under Ind AS 28. At 31st March, 20X2, PQR Ltd. recognised its share of the net asset changes of XYZ Ltd. using equity accounting as follows:

	(₹ in crore)
Share of profit or loss	700
Share of exchange difference in OCI	100
Share of revaluation reserve of PPE in OCI	50

The carrying amount of the investment in the associate on 31st March, 20X2 was therefore ₹ 8,850 crore (8,000 + 700 + 100 + 50).

On 1st April, 20X2, PQR Ltd. acquired the remaining 70% of XYZ Ltd. for cash ₹ 25,000 crore. The following additional information is relevant at that date:

	(₹ in crore)
Fair value of the 30% interest already owned	9,000
Fair value of XYZ's identifiable net assets	30,000

Analyze the transactions mentioned above and choose the most appropriate option in the below questions 11 to 15 in line with relevant Ind AS:

11. What is the fair value of the total consideration transferred by PQR Ltd. to XYZ Ltd.?

    (a) ₹ 34,000 crores

    (b) ₹ 33,850 crores

    (c) ₹ 33,000 crores

    (d) ₹ 25,000 crores

12. What is the amount of goodwill in the said business combination?

    (a) ₹ 3,000 crores

    (b) ₹ 4,000 crores

    (c) ₹ 2,150 crores

    (d) ₹ 3,850 crores

13. What is the gain on previously held interest in XYZ Ltd. recognised in profit or loss?

(a) ₹ 150 crores

(b) ₹ 100 crores

(c) ₹ 250 crores

(d) Nil

14. What is the transition date for PQR Ltd. for adopting Ind AS?

(a) 1st April, 20X0

(b) 1st April, 20X1

(c) 1st April, 20X2

(d) 1st April, 20X3

15. PQR Ltd. present its comparatives financial statements for the year-

(a) 20X1-20X2

(b) 20X2-20X3

(c) 20X0-20X3

(d) 20X0-20X1 **(5 x 2 Marks = 10 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to 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 answers.

Maximum Marks – 70 Marks

1. DEF Ltd. acquired 100% ordinary shares of ₹ 100 each of XYZ Ltd. on 1st October 20X1. On 31st March, 20X2 the summarised Balance Sheets of the two companies were as given below:

	DEF Ltd.	**XYZ Ltd.**
Assets		
Property Plant Equipment		
Land & Buildings	15,00,000	18,00,000
Plant & Machinery	24,00,000	13,50,000

Investment in XYZ Ltd.	34,00,000	-
Inventory	12,00,000	3,64,000
Financial Assets		
Trade Receivable	5,98,000	4,00,000
Cash	1,45,000	80,000
Total	**92,43,000**	**39,94,000**
Equity & Liabilities		
Equity Capital (Shares of ₹ 100 each fully paid)	50,00,000	20,00,000
Other Equity		
Other reserves	24,00,000	10,00,000
Retained Earnings	5,72,000	8,20,000
Financial Liabilities		
Bank Overdraft	8,00,000	-
Trade Payable	4,71,000	1,74,000
Total	**92,43,000**	**39,94,000**

The retained earnings of XYZ Ltd. showed a credit balance of ₹ 3,00,000 on 1st April 20X1 out of which a dividend of 10% was paid on 1st November; DEF Ltd. has recognised the dividend received to profit or loss account; Fair Value of P&M as on 1st October 20X1 was ₹ 20,00,000. The rate of depreciation on plant & machinery is 10%.

Following are the increases on comparison of fair value as per respective Ind AS with book value as on 1st October 20X1 which are to be considered while consolidating the Balance Sheets.

Liabilities	Amount	Assets	Amount
Trade Payables	1,00,000	Land & Buildings	10,00,000
		Inventories	1,50,000

Notes:

a) It may be assumed that the inventory is still unsold on balance sheet date and the Trade Payables are also not yet settled.

b) Also assume that the Other Reserves of both the companies as on 31st March 20X2 are the same as was on 1st April 20X1.

c) All fair value adjustments have not yet started impacting consolidated post-acquisition profits.

Prepare Consolidated Balance Sheet as at 31st March, 20X2.

(14 Marks)

2. (a) Wheel Co. Limited borrowed ₹ 500,000,000 from a bank on 1 January 20X1. The original terms of the loan were as follows:

- Interest rate: 11%
- Repayment of principal in 5 equal instalments
- Payment of interest annually on accrual basis
- Upfront processing fee: ₹ 5,870,096

Effective interest rate on loan: 11.50%

On 31 December 20X2, Wheel Co. Limited approached the bank citing liquidity issues in meeting the cash flows required for immediate instalments and re-negotiated the terms of the loan with banks as follows:

- Interest rate 15%
- Repayment of outstanding principal in 10 equal instalments starting 31 December 20X3
- Payment of interest on an annual basis

Record journal entries in the books of Wheel Co. Limited till 31 December 20X3, after giving effect of the changes in the terms of the loan on 31 December 20X2 **(10 Marks)**

(b) An entity manufactures passenger vehicles. The time between purchasing of underlying raw materials to manufacture the passenger vehicles and the date the entity completes the production and delivers to its customers is 11 months. Customers settle the dues after a period of 8 months from the date of sale.

(i) Will the inventory and the trade receivables be current in nature?

(ii) Assuming that the production time was say 15 months and the time lag between the date of sale and collection from customers is 13 months, will the answer be different?

(4 Marks)

3. (a) On 1st September, 20X1, entity X plans to sell a group of assets and liabilities, which is classified as a disposal group. On 31st October, 20X1, the Board of Directors approves and becomes committed to the plan to sell the manufacturing unit by entering into a firm purchase commitment with entity Y. However, since the manufacturing unit is regulated, the approval from the regulator is needed for sale. The approval from the regulator is customary and highly probable to be received by 30th February, 20X2 and the sale is expected to be completed by 30th June, 20X2.

The assets and liabilities attributable to this manufacturing unit are as under: **(Amount in ₹)**

Particulars	**Carrying value as on 31st March, 20X1**	**Carrying value as on 31st October, 20X1**
Goodwill	500	500
Plant and Machinery	1,000	900
Building	2,000	1,850
Debtors	850	1,050
Inventory	700	400
Creditors	(300)	(250)
Loans	(2,000)	(1,850)
	2,750	2,600

The fair value of the manufacturing unit as on 31st March, 20X1 is ₹ 2,000 and as on 31st October, 20X1 is ₹ 1,850. The cost to sell is ₹ 100 on both these dates. The disposal group is not sold at the period end i.e., 31st March, 20X2. The fair value as on 31st March, 20X2 is lower than the carrying value of the disposal group as on that date.

1. Assess whether the manufacturing unit can be classified as held for sale and reasons there for. If yes, then at which date?

2. Measure the manufacturing unit on the date of classification as held for sale.

3. Measure the manufacturing unit at the end of the financial year. **(8 Marks)**

(b) On 30th January, 20X1, A Ltd. purchased a machinery for $ 5,000 from USA supplier on credit basis. A Ltd.'s functional currency is Rupees. The exchange rate on the date of transaction is 1 $ = ₹ 60. The fair value of the machinery determined on 31st March, 20X1 is $ 5,500. The exchange rate on 31st March, 20X1 is 1$ = ₹ 65. The payment to overseas supplier done on 31st March 20X2 and the exchange rate on 31st March 20X2 is 1$ = ₹ 67. The fair value of the machinery remains unchanged for the year ended on 31st March 20X2. Tax rate is 30%. A Ltd. follows revaluation method in respect of Plant & Machinery.

Pass the Journal entries for the year ended on 31st March 20X1 and year 20X2 according to Ind AS 21. **(6 Marks)**

4. (a) A Ltd. purchased some Property, Plant and Equipment on 1st April, 20X1, and estimated their useful lives for the purpose of financial statements prepared on the basis of Ind AS. Following were the original cost, and useful life of the various components of property, plant, and equipment assessed on 1st April, 20X1:

Property, Plant and Equipment	**Original Cost**	**Estimated useful life**
Buildings	₹ 15,000,000	15 years
Plant and machinery	₹ 10,000,000	10 years
Furniture and fixtures	₹ 3,500,000	7 years

A Ltd. uses the straight-line method of depreciation. On 1st April, 20X4, the entity reviewed the following useful lives of the property, plant, and equipment through an external valuation expert:

Buildings	10 years
Plant and machinery	7 years
Furniture and fixtures	5 years

There were no salvage values for the three components of the property, plant, and equipment either initially or at the time the useful lives were revised.

Examine the impact of revaluation of useful life on the Statement of Profit and Loss for the year ending 31st March, 20X5. **(6 Marks)**

(b) P Ltd. granted 400 stock appreciation rights (SAR) each to 75 employees on 1st April 20X1 with a fair value ₹ 200. The terms of the award require the employee to provide service for four years in order to earn the award. The fair value of each SAR at each reporting date is as follows:

31st March 20X2	₹ 210
31st March 20X3	₹ 220
31st March 20X4	₹ 215
31st March 20X5	₹ 218

What would be the difference if at the end of the second year of service (i.e. at 31st March 20X3), P Ltd. modifies the terms of the award to require only three years of service? **(8 Marks)**

5. (a) AST Limited enters into a contract with a customer to build a manufacturing facility. The entity determines that the contract contains one performance obligation satisfied over time.

Construction is scheduled to be completed by the end of the 36th month for an agreed-upon price of ₹ 25 crore.

The entity has the opportunity to earn a performance bonus for early completion as follows:

- 15 percent bonus of the contract price if completed by the 30th month (25% likelihood)
- 10 percent bonus if completed by the 32nd month (40% likelihood)
- 5 percent bonus if completed by the 34th month (15% likelihood)

In addition to the potential performance bonus for early completion, AST Limited is entitled to a quality bonus of ₹ 2 crore if a health and safety inspector assigns the facility a gold star rating as defined by the agency in the terms of the contract. AST Limited concludes that it is 60% likely that it will receive the quality bonus.

Determine the transaction price. **(6 Marks)**

(b) Mumbai Challengers Ltd., a listed entity, is a sports organization owning several cricket and hockey teams. The issues below pertain to the reporting period ending 31 March 20X2.

Mumbai Challengers Ltd. acquires and sells players' registrations on a regular basis. For a player to play for its team, Mumbai Challengers Ltd. must purchase registrations for that player. These player registrations are contractual obligations between the player and the company. The costs of acquiring player registrations include transfer fees, league levy fees, and player agents' fees incurred by the club.

At the end of each season, which happens to also be the reporting period end for Mumbai Challengers Ltd., the club reviews its contracts with the players and makes decisions as to whether they wish to sell/transfer any players' registrations. The company actively markets these registrations by circulating with other clubs a list of players' registrations and their estimated selling price. Players' registrations are also sold during the season, often with performance conditions attached. In some cases, it becomes clear that a player will not play for the club again because of, for example, a player sustaining a career threatening injury or being permanently removed from the playing squad for any other reason. The playing registrations of certain players were sold after the year end, for total proceeds, net of associated costs, of ₹ 175 crores. These registrations had a net book value of ₹ 49 crores.

Mumbai Challengers Ltd. seeks your advice on the treatment of the acquisition, extension, review and sale of players' registrations in the circumstances outlined above. **(4 Marks)**

(c) Explain the five fundamental principles of ethics for Chartered Accountants. **(4 Marks)**

6. (a) (i) Entity A owns 250 ordinary shares in company XYZ, an unquoted company. Company XYZ has a total share capital of 5,000 shares with nominal value of ₹ 10. Entity XYZ's after-tax maintainable profits are estimated at ₹ 70,000 per

year. An appropriate price/earnings ratio determined from published industry data is 15 (before lack of marketability adjustment). Entity A's management estimates that the discount for the lack of marketability of company XYZ's shares and restrictions on their transfer is 20%. Entity A values its holding in company XYZ's shares based on earnings. Determine the fair value of Entity A's investment in XYZ's shares.

(ii) Based on the facts given in the aforementioned part (i), assume that, Entity A estimates the fair value of the shares it owns in company XYZ using a net asset valuation technique. The fair value of company XYZ's net assets including those recognised in its balance sheet and those that are not recognised is ₹ 8,50,000. Determine the fair value of Entity A's investment in XYZ's shares.

(5 Marks)

(b) **Either**

Following is a snapshot of audited balance sheet of company A as on 31st March 2014. Company A's equity shares are listed on Bombay Stock Exchange since 2010.

Liabilities	**₹ in crores**	**Assets**	**₹ in crores**
Equity Share Capital	160	Fixed Assets	455
Securities Premium	200	Investments	200
General Reserve	150	Current Assets	50
Revaluation Reserve	40	Miscellaneous Expenditure not written off	80
Profit and Loss A/c	75		
Liabilities	160		
Total	**785**	**Total**	**785**

As per roadmap, which Phase company A fall into? Will your answer change if Company A is an unlisted company? **(5 Marks)**

Or

As at 31st March 20X2, Natasha Ltd. carried trade receivables of ₹ 280 crores in its balance sheet. At that date, Natasha Ltd. entered into a factoring agreement with Samantha Ltd., a financial institution, according to which it transferred the trade receivables in exchange for an immediate cash payment of ₹ 250 crores. As per the factoring agreement, any shortfall between the amount collected and ₹ 250 crores will be reimbursed by Natasha Ltd. to Samantha Ltd. Once the trade receivables have been collected, any amounts above ₹ 250 crores, less interest on this amount, will be repaid to Natasha Ltd. The directors of Natasha Ltd. are of the opinion that the trade receivables should be derecognized.

You are required to explain the appropriate accounting treatment of this transaction in the financial statements for the year ending 31st March 20X2, and also evaluate this transaction in the context of the Conceptual Framework. **(5 Marks)**

(c) Under new legislation, an entity is required to fit smoke filters to its factories by 30th September, 20X1. The entity has not fitted the smoke filters. It is assumed that a reliable estimate can be made of any outflows expected.

Determine whether any provision is required to be made by the entity on

(a) At 31st March, 20X1, the end of the reporting period

(b) At 31st March, 20X2, the end of the reporting period

(4 Marks)

MODEL TEST PAPER 6

FINAL COURSE GROUP - I

PAPER – 1: FINANCIAL REPORTING

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

1. ***The question paper comprises two parts, Part I and Part II.***
2. ***Part I comprises Case Scenario based Multiple Choice Questions (MCQs). Each MCQ is of 2 Marks.***
3. ***Part II comprises questions which require descriptive type answers.***

PART I – Case Scenario based MCQs (30 Marks)

All MCQs are compulsory.

Case Study 1

Tara Ltd. is engaged in mining and many other industries and prepares its financial statements following Indian Accounting Standards and follows April-March as their financial year. During the year 20X3-20X4, the Company has faced some issues and for their solution seeks your professional advice.

(i) Tara Ltd. and Zara Ltd. are partners of a joint operation engaged in the business of mining precious metals. The entity uses a jointly owned drilling plant in its operations. During the year ended 31st March, 20X4, an inspection was conducted by the government authorities in the mining fields. The inspection authorities concluded that adequate safety measures were not followed by the entity. As a consequence, a case was filed and a penalty of ₹ 100 crores has been demanded from Tara Ltd. on 1st September, 20X3.

The legal counsel of the company has assessed the demand and opined that appeals may not be useful, and the appeal orders will be unfavourable to the joint arrangement. As per the terms of the joint operations agreement, out of ₹ 100 crores (to be paid by Tara Ltd.), ₹ 60 crores will be reimbursed by Zara Ltd. to Tara Ltd. within three months from the date of any demand made in respect of joint operations by any government authorities. However, till the year end, actual reimbursement was not received from Zara Ltd.

(ii) Tara Ltd. issued on 1st April 20X2, 10% (interest paid annually and having maturity period of 4 years) bonds with a face value of ₹ 2,00,000 at a discount of 10% to finance a qualifying asset which is ready for intended use at the end of year 2. The company amortizes discount using Effective Interest Rate (EIR) method by applying 13.39% p.a. of EIR.

(iii) Tara Ltd. has invested in debentures whose interest rate is floating in nature and as per terms of the instrument, interest will be reset every month. As per terms, rate of interest is MIBOR plus 2%. It has invested in the debentures to take the advantage of leverage of interest.

(iv) On 1st January, 2024, Tara Ltd. took a contract for installation of new elevator at a factory of its customer. The entity estimates the following with respect to the contract:

Particulars	**Amount (₹)**
Transaction price	30,00,000
Expected costs:	
(a) Elevators	10,00,000
(b) Other costs	12,00,000
Total	22,00,000

It purchased the elevator and delivered the same to the site six months before it is required for installation. The entity uses an input method based on cost to measure progress towards completion. Tara Ltd. has incurred actual other costs of ₹ 3,00,000 by 31st March, 2024.

(v) Tara Ltd. has classified its business in 5 operating segments namely A, B, C, D and E. The profit/(loss) of respective segments for the year ended 31st March, 2024, are as follow:

Segment Profit/ (Loss)	**(₹ in lakhs)**
A	1,280
B	2,624
C	(280)

D	315
E	(2,620)
Total	**1,319**

On the basis of the information provided above, you are required to choose the most appropriate answer to the below-mentioned questions 1 to 5 in line with the relevant Ind AS:

1. With respect to a joint operation engaged in the business of mining precious metals, how will the liability be disclosed in the books of Tara Ltd.?

   (a) Provision for ₹ 40 crores and a contingent liability for ₹ 60 crores.

   (b) Contingent Liability for ₹ 100 crores.

   (c) Provision for ₹ 60 crores and a contingent liability for ₹ 40 crores.

   (d) Provision for ₹ 100 crores.

2. Classify the financial asset and determine the subsequent measurement for the aforesaid debenture instrument?

   (a) Financial asset measured at amortised cost

   (b) Financial asset measured at FVOCI without recycling

   (c) Financial asset measured at FVTPL

   (d) Financial asset measured at FVOCI with recycling

3. Which of the following option will be considered as Reportable Segments for Tara Ltd.?

   (a) A, B, D and E

   (b) A, B and E

   (c) A and E

   (d) B and E

4. Compute the amount of borrowing costs to be capitalized related to qualifying assets.

   (a) ₹ 48,753

   (b) ₹ 24,651

(c) ₹ 24,102

(d) ₹ Nil

5. What is the amount of revenue to be recognized by Tara Ltd. for elevator contract during the financial year 20X3-20X4?

(a) ₹ 8,00,000

(b) ₹ Nil

(c) ₹ 15,00,000

(d) ₹ 18,00,000 **(5 x 2 = 10 Marks)**

You are required to choose the most appropriate answer to the below mentioned questions (6 to 8) in line with the relevant Ind AS:

6. When should the government grant be recognized by an entity according to Ind AS 20?

(a) As soon as the grant is offered by the government

(b) Once the entity fulfills the conditions attached to the grant

(c) When there is reasonable assurance that the entity will comply with the conditions and receive the grants

(d) After entity has received the grants **(2 Marks)**

7. What is the stance of a Chartered Accountant regarding conflicts of interest?

(a) Conflicts of interest should not compromise professional or business judgement

(b) Conflicts of interest are acceptable if managed properly

(c) Conflicts of interest are unavoidable and should be accepted

(d) Conflicts of interest should be disclosed but can still compromise judgement **(2 Marks)**

8. Following statements are given to you in context of Ind AS 101 'First Time Adoption of Ind AS':

(i) An entity shall not make estimates in accordance with Ind AS at the date of transition to Ind AS that were not required at that date under previous GAAP.

(ii) In particular, estimates at the date of transition to Ind AS of market prices, interest rates or foreign exchange rates shall reflect market conditions at that date.

(iii) An entity may need to make estimates in accordance with Ind AS at the date of transition in Ind AS that were not required at that date under previous GAAP.

(iv) To achieve consistency with Ind AS 10, estimates in accordance with Ind AS shall reflect conditions that existed at the date of transition to Ind AS.

Which of the above statements are true in context of Ind AS 101?

(a) Only (i), (ii) and (iii) are true

(b) Only (i) and (ii) are true

(c) Only (ii), (iii) and (iv) are true

(d) Only (iii) and (iv) are true **(2 Marks)**

Case Study 2

Planet Ltd. is a multinational company engaged into the business of manufacturing of various products of different segments. One of the segments is the manufacturing of agricultural equipment. The company raised a term loan for ₹ 1 crore from a Nationalized Indian Bank to purchase certain plant and machinery for agricultural segment during the year ended 31st March, 20X3. The loan is repayable over a period of 5 years. The terms and conditions of the loan agreement is that the company should maintain a current ratio of 1.5:1 and debt-equity ratio of 1:2. If these covenants fall below this level, then the bank has a right to recall the entire loan.

The unpaid loan as on 31st March, 20X4 was ₹ 85 lakhs. The current ratio of Planet Ltd. was 0.9:1 and debt-equity ratio was 0.65:2. The bank has sent a notice on 7th April, 20X4 demanding repayment of loan, on account of breach of terms of the loan agreement. The financials of the company were approved and signed on 15th May, 20X4.

After receiving the notice, the Chief Finance Officer of the company contacted the bank and ensured to rectify the breach. Consequently, on 28th May, 20X4, the Bank agreed not to recall the loan and allowed the company to achieve the contracted current and debt equity ratio by the year ending on 31st March, 20X5

Planet Ltd. has recently acquired shares in Bean Ltd. and Camel Ltd. and prepared draft consolidated financial statements in accordance with Ind AS for the year ended on 31st March, 2024. It is the group's policy to value its non-controlling interests at fair value. The fair value of the non-controlling interest in Bean Ltd. on the date of acquisition was measured at ₹ 1,430 lakhs. The following information is relevant regarding the acquisition of shares in Bean Ltd. and Camel Ltd.:

Date of acquisition	**Holding acquired** %	**Retained earnings at acquisition date** ₹ (in lakhs)	**Purchase consideration** ₹ (in lakhs)
Bean Ltd - 1.4.20X3	85	5,400	10,200
Camel Ltd - 1.4.20X3	40	6,240	5,760

In the draft Consolidated Financial Statements prepared on 31st March, 2024 the financials relating to Bean Ltd. and Camel Ltd. appeared as follows:

	Bean Ltd. (₹ in lakhs)	**Camel Ltd. (₹ in lakhs)**
Issued ordinary shares of ₹ 10 each	3,600	4,000
Retained earnings	7,200	7,400

Bean Ltd. and Camel Ltd. have not issued any share capital since the acquisition of shareholding by Planet Ltd. The fair value of the net assets of Bean Ltd. and Camel Ltd. were the same as their carrying amounts at the date of acquisition. Planet Ltd. has significant influence over Camel Ltd. An impairment loss of ₹ 204 lakhs have been identified in respect of goodwill arising on the acquisition of Bean Ltd. for the year ended on 31st March, 2024. The recoverable amount of net assets of Camel Ltd. has been deemed to be ₹ 11,760 lakhs as on 31st March, 2024.

On 1st January, 2024, Planet Ltd. sold inventory costing ₹ 45 lakhs to Camel Ltd. for ₹ 63 lakhs. The inventory was still unsold by Camel Ltd. at 31st March, 2024. This inventory was sold by Camel Ltd. to third party on 8th April, 2024.

Planet Ltd. has constructed a shopping mall earlier. The company renovated a portion of mall by constructing a food court, spa and gaming zone. The food court and gaming zone are expected to result in a significant increase in sales for the shops and outlets of the mall.

On the basis of the information provided above, you are required to choose the most appropriate answer to the below-mentioned questions 9 to 12 in line with the relevant Ind AS:

9. After negotiation with the Nationalized Bank, how long-term loan has to be classified in financials for the year ended on 31st March, 2024?
   (a) Non-current financial liability
   (b) Other non-current liability
   (c) Current financial liability
   (d) Other current liability

10. What will be the impairment loss from investment in associate for the year ending 31st March, 2024?
   (a) ₹ 1,440 lakhs
   (b) ₹ 1,432.80 lakhs
   (c) ₹ 1,055.20 lakhs
   (d) ₹ 1,512.80 lakhs

11. What will be the amount of Goodwill as on 31st March, 2024, arising from the acquisition of Bean Ltd.?
   (a) ₹ 2,530 lakhs
   (b) ₹ 2,630 lakhs
   (c) ₹ 2,426 lakhs
   (d) ₹ 2,326 lakhs

12. What should be the accounting treatment for the cost incurred for the renovation?
   (a) Expenses incurred for food court and gaming should be capitalized
   (b) Expenses incurred for food court, spa and gaming should be capitalized
   (c) Expenses incurred for food court and gaming zone should be charged to statement of profit and loss
   (d) Expenses incurred for food court, spa and gaming zone should be charged to statement of profit and loss **(4 x 2 = 8 Marks)**

Case Study 3

Nikhil Pvt. Ltd. acquired 100% of Pranav Pvt. Ltd. on 1st January, 20X3. The fair value of the purchase consideration was ₹ 20 crores consisting of ordinary shares of ₹ 100 each of Nikhil Pvt. Ltd. The fair value of the net assets acquired was ₹ 15 crores. At the time of the acquisition, the value of the ordinary shares of Nikhil Pvt. Ltd. and the net assets of Pranav Pvt. Ltd. were only provisionally determined.

On 30th November, 20X3, it was finally determined that the fair value of Nikhil Pvt. Ltd.'s shares was ₹ 22 crores and the fair value of net assets of Pranav Pvt. Ltd. was ₹ 16 crores.

However, the directors of Nikhil Pvt. Ltd. have seen the fair value of the company's shares decline since 1st January, 20X3, and wanted to adopt the fair value of the shares as of 1st February, 20X4, which will result in the fair value of consideration at being value date ₹ 18 crores.

In addition to the above Purchase Consideration, the acquisition agreement states that an additional ₹ 4 crores will be paid if Pranav Pvt. Ltd. achieves a turnover of ₹ 160 crores in the next two years. On the date of acquisition, the fair value of the said consideration was ₹ 3 crores. In February 2024, due to decline in performance of Pranav Pvt. Ltd., it is determined that it is unlikely that it would meet budgeted turnover of ₹ 160 crores.

On the basis of the information provided above, you are required to choose the most appropriate answer to the below mentioned questions 13 to 15 in line with the relevant Ind AS:

13. The Net Assets Value will be-

    (a) ₹ 15 crores

    (b) ₹ 16 crores

    (c) ₹ 20 crores

    (d) ₹ 19 crores

14. The value of Purchase Consideration will be-

    (a) ₹ 18 crores

    (b) ₹ 20 crores

    (c) ₹ 22 crores

    (d) ₹ 25 crores

15. How should Nikhil Pvt. Ltd. treat the contingent consideration linked to achieving sales?

    (a) Nikhil Pvt. Ltd. should not recognize the consideration as it is unlikely that it would be paid.

    (b) Nikhil Pvt. Ltd. should disclose the consideration as it is contingent liability in its financial statements which will be met only upon Pranav Pvt. Ltd. earning a turnover of ₹ 160 crores.

    (c) Nikhil Pvt. Ltd. should recognise the fair value of the consideration as part of the business combination, thus increasing goodwill and re-measure it at the end of each reporting period. The impact of change in fair value is recognised in the statement of profit and loss.

    (d) There is no specific treatment prescribed under Ind AS. Nikhil Pvt. Ltd. should decide the appropriate accounting treatment based on the facts and circumstances of the case. **(3 x 2 = 6 Marks)**

PART-II Descriptive Questions

*Question No.**1** is compulsory. Candidates are required to answer any **four** questions from the remaining **five** questions.*

Working notes should form part of the answer.

Maximum Marks – 70 Marks

1. The balance sheets of H Ltd. and S Ltd. as on 31st March, 2024 were as follows:

Particulars	**H Ltd.**	**S Ltd.**
	₹ in Lakhs	
Assets:		
Non-Current Assets		
Property, plant and equipment	14,800	6,000
Financial Assets: Investment		
Investment in S Ltd.	5,800	
1,000 Debentures in S Ltd.	1,500	
Current Assets		
Inventories	2,600	2,000
Financial Assets		

Trade receivables	4,000	3,000
(due from S Ltd. ₹ 160 lakh)		
Dividend receivable	320	-
Cash and cash equivalent	500	2,000
Total	**29,520**	**13,000**
Equity and Liabilities		
Equity		
Equity Share Capital (₹ 10 per share)	10,000	4000
Other Equity (Retained Earnings)	16,320	5,000
Non-current Liabilities		
13% Debenture of ₹ 100 each		3,000
Current Liabilities		
Financial Liabilities:		
Trade Payables	1,700	600
(due to H Ltd. ₹ 120 lakh)		
Dividend Payable		400
Other Liabilities	1,500	
Total	**29,520**	**13,000**

Additional Information:

(i) On 1st April, 20X3, S Ltd. had 400 lakh shares of ₹ 10 each and ₹ 3,000 lakh in its Retained Earnings in Other Equity. H Ltd. acquired 80% share of S Ltd. on 1st April, 20X3 at a consideration of ₹ 5,800 lakh in cash.

(ii) The following changes in book value of identifiable net assets of S Ltd. as on 1st April, 20X3 are to be considered for arriving the fair value of identifiable net assets and to record the changes in their fair value on the said date. These changes in fair values are to be considered while drawing consolidated Financial Statement of the Group.

Assets	Book value	Fair value
PPE	₹ 2,500 lakhs	₹ 2,800 lakhs
Inventory	₹ 500 lakhs	₹ 200 lakhs

The rate of depreciation on PPE is 10% p.a.

(iii) NCI was to be measured at fair value based on purchase consideration.

(iv) Goodwill was impaired by ₹ 100 lakh.

(v) H Ltd. sold goods costing ₹ 200 lakh, to S Ltd. on credit at a profit of 20% on sales. 50% of the goods were still lying unsold.

(vi) S Ltd. issued a cheque of ₹ 40 lakh in favour of H Ltd. as a part payment of the goods purchased from it in March, 2024. The cheque is yet to be received by H Ltd.

(vii) Dividend payable represents the dividend declared out of pre-acquisition profit. H Ltd. credited its share of dividend from S Ltd. to its profits.

Prepare the Consolidated Balance Sheet of the Group as at 31st March, 2024. **(14 Marks)**

2. (a) On 1st January, 20X3, Joe & Co Ltd., an Indian company which prepares its financial statements on a quarterly basis has entered into a written put option for USD ($) 40,000 with Box Ltd. to be settled in future on 31st December, 20X3 for a rate equal to ₹ 78 per USD at the option of Box Ltd. Joe & Co. Ltd. did not receive any amount upon entering into the contract.

For the purpose of accounting, use the following information representing marked to market fair value of put option contract at each reporting date.

As at 31st March, 20X3	- ₹ (50,000)
As at 30th June, 20X3	- ₹ (30,000)
As at 30th September, 20X3	- ₹ NIL
Spot rate of USD on 31st December, 20X3	- ₹ 76 per USD.

Evaluate and explain whether the above option meets the definition of derivatives as laid down in Ind AS 109 and record the entries for each quarter ended till the date of actual purchase of USD.

(10 Marks)

(b) Spicer Ltd., a listed company, prepares interim financial reports at the end of each quarter.

The following information is provided:

(i) On 1st April, 20X3, Spicer Ltd. has brought forward losses of ₹ 620 lakh under Income Tax Act. No Deferred Tax Asset has been recognized by the management of the company for such losses in view of the uncertainty over company's ability to earn profits in the foreseeable future and set off these losses.

(ii) Due to sudden change in government policies, the company's business turned around and it has reported quarterly earnings of ₹ 650 lakh and ₹ 360 lakh respectively for the first two quarters of financial year 20X3-20X4 and anticipates net earnings of ₹ 720 lakh in the coming half year ended March 20X4 of which ₹ 160 lakh will be the loss in the quarter ended December 20X3.

(iii) The tax rate for the company is 25% with a 10% surcharge.

You are required to calculate the amount of Tax Expenses to be reported for each quarter of the financial year 20X3-20X4.

(4 Marks)

3. (a) Anand Ltd. owns a Building X which is specifically used for the purpose of earning rentals. The Company has not been using the Building X or any of its facilities for its own use for a long time. The company is also exploring the opportunities to sell the building if it gets the reasonable amount in consideration.

Following information is relevant for Building X for the year ending 31st March, 2024:

Building X was initially purchased at the cost of ₹ 120 crores. At that time, the useful life of the building was estimated to be 10 years; out of which 5 years have been expired as on 1st April, 20X3: The company follows straight line method for depreciation.

During the year, the company has invested in another Building Y with the purpose to hold it for capital appreciation. The property was purchased on 1st April, 20X3 at the cost of ₹ 20 crores. Expected life of the building is 20 years. As usual, the company follows straight line method of depreciation

Further, during the year 20X3-20X4, the company earned/incurred the following, directly relating to Building X and Building Y:

Rental income from Building X = ₹ 15 crores

Rental income from Building Y	= ₹ 5 crores
Sales promotion expenses	= ₹ 0.50 crores
Fees and Taxes	= ₹ 0.10 crores
Ground Rent	= ₹ 0.25 crores
Repairs and Maintenance	= ₹ 0.15 crores
Legal and Professional	= ₹ 0.20 crores
Commission and Brokerage	= ₹ 0.10 crores

The company does not have any restrictions and contractual obligations against Property X and Y. For complying with the requirements of Ind AS, the management sought an independent report from the specialists so as to ascertain the fair value of buildings X and Y. The independent valuer has valued the fair value of property as per the valuation model recommended by international valuation standards committee. Fair value has been computed by the method by streamlining present value of future cash flows namely, discounted cash flow method.

The estimated rent per month per square feet for the period is expected to be in range of ₹ 50 to ₹ 60. And it is further expected to grow at the rate of 10 percent per annum for each of 3 years. The weightage discount rate used is 12% to 13%.

Assume that the fair value of properties based on discounted cash flow method is measured at ₹ 105 crores. The treatment of fair value of properties is to be given in the financials as per the requirements of Indian Accounting Standards

You are required to:

(i) Show how the Building X and Building Y would be the treated in the Balance Sheet of Anand Ltd. and how the income generated and expenses incurred on this building be presented in Profit and Loss Account.

(ii) Provide detailed disclosures and computations in line with relevant Ind AS. (Treat it as if you are preparing a separate note or schedule of the given assets in the Balance Sheet.)

(8 Marks)

(b) Mahadev Ltd. has a block of assets with a written down value of ₹ 5,00,000 on 1st April, 20X2 for tax purposes. The book value of the assets for accounting purposes is also ₹ 5,00,000. Depreciation is charged on written down value @ 20% p.a. for both accounting and tax purposes. Of the entire block, assets costing ₹ 50,000 on 1st April, 20X2 were sold for ₹ 1,00,000 on 31st March, 20X4. You are required to compute the deferred tax asset/liability assuming tax rate of 35%. **(6 Marks)**

4. (a) On 1st April, 20X0, Peacock Ltd. started its manufacturing operations by installing a machine in the rented premises. The estimated life of the machine is 4 years. As per the terms of the rent agreement, Peacock Ltd. has a present obligation to dismantle the machine and restore the premises into its original shape. The company estimates to incur ₹ 6,00,000 at the end of 4th year to restore the premises into the original shape. The borrowing rate applicable to the company is 8%.

(Note: PV Factor for 4th year discounted @ 8% = 0.735)

You are required to:

(i) Advise the accounting treatment of the above; and

(ii) Pass necessary journal entries across all four years.

(6 Marks)

(b) Greater Ltd., in order to reward its employees launched a scheme effective from 1st April, 20X1, in which employees will be granted equity shares of the company at a price less than the market price subject to satisfaction of certain conditions. Following details are provided to you:

(a) According to scheme, each employee has an option to purchase 250 equity shares of the company at ₹ 45 per share provided that the employee does not leave the company for 3 years from the date of launch of the scheme i.e. up to 31st March, 2024.

(b) Once 3 years are completed by an employee, the employee can exercise the option within 1 year i. e. by 31st March, 2025.

(c) The closing share price on stock exchange as at 1st April, 20X1 is ₹ 91 per share with face value of ₹ 10 per share. A registered valuer has been appointed by the company who derived the price of option at ₹ 75 using Black Scholes model of option pricing.

(d) There are 750 employees eligible for the scheme. As at 31st March, 20X2, 25 employees left the company and further 35 employees are expected to leave over the next 2 years. During the year 20X2-20X3, a foreign based company entered into the market and started hiring experienced employees and therefore retention of existing employees has been problematic and a high attrition rate is observed in the market. 275 employees left the company during the year ended 31st March, 20X3 and further 135 employees are expected to leave in the next one year. As at 31st March, 20X4, only 400 employees remained with the company out of 750 employees.

(e) Out of it only 375 employees exercised the option to purchase the equity shares during the year ended 31st March, 2024.

You are required to provide necessary accounting entries during the life of share-based payment scheme to account the scheme implemented by the company. **(8 Marks)**

5. (a) Big Deal Ltd. is a marketing company having its departmental stores in 'A' class city of India. The company sells diversified products. For the purpose of increasing sales and attract customers, the company during the financial year 20X3-20X4, has adopted the following policy:

(i) For every purchase of ₹ 400 the customer is awarded with 6 points.

(ii) Each point is redeemable on any future purchases of company's same departmental store situated in any of 'A' class city within 3 years i.e. up to 31st March, 2026

(iii) Value of each award point is ₹ 0.60

During the financial year 20X3-20X4, the Big Deal Ltd:

(i) Assessed that the sales of the company during the year 20X3-20X4 is ₹ 150 lakhs.

(ii) Awarded 2,25,000 points to various customers during the year.

(iii) Estimated that out of the awarded points, 54,000 points will remain unredeemed as at 31st March, 20X4 which shall be eligible for redemption till 31st March, 20X6 and;

(iv) Expects only 75% points will be redeemed in the future.

As an accountant of the company, you are required to suggest accounting treatment (Consolidated Journal Entries) in the following case:

How should the sales and redemption transactions be recognized and recorded as independent transactions in the FY 20X3-20X4 as per Ind AS 115? **(5 Marks)**

(b) Z Ltd. having net worth of ₹ 25 crores has opted voluntarily to adopt Ind AS from 1st April, 20X2 in accordance with the Companies (Indian Accounting Standard) Rules 2015.

Mr. A, the senior manager, of Z Ltd. has identified following issues which need specific attention of CFO so that opening Ind AS balance sheet as on the date of transition can be prepared:

(i) As part of Property, Plant and Equipment, Company has elected to measure land at its fair value and want to use this fair value as deemed cost on the date of transition. The land was acquired for a consideration of ₹ 5,00,000. However, the fair value of land as on the date of transition was ₹ 6,00,000.

(ii) Company had taken a loan from another entity. The loan carries an interest rate of 7% and it had incurred certain transaction costs while obtaining the same. It was carried at cost on its initial recognition. The principal amount is to be repaid in equal instalments over the period of loan. Interest is also payable at each year end. The fair value of loan as on the date of transition is ₹ 2,80,000 as against the carrying amount of loan which at present equals ₹ 3,00,000,

Management wants to know the impact of Ind AS in the financial statements of company for its general understanding. Prepare Ind AS Impact Analysis Report (Extract) for Z Ltd. for presentation to the management wherein you are required to discuss the corresponding differences between Earlier IGAAP (AS) and Ind AS against each identified issue and its impact there upon for preparation of transition date balance sheet.

Also pass journal entry for each of the issues mentioned above. **(5 Marks)**

(c) Define the concept of 'Offsetting'. In offsetting permitted under the following circumstances:

(a) Whether profit on sale of an asset against loss on sale of another asset can be offset?

(b) Expenses incurred by a holding company on behalf of subsidiary, which is reimbursed by the subsidiary - whether in the separate books of the holding company, the expenditure and related reimbursement of expenses can be offset?

(c) When services are rendered in a transaction with an entity and services are received from the same entity in two different arrangements, can the receivable and payable be offset?

Or

Explain how enhancing qualitative characteristics can improve the usefulness of financial information. **(4 Marks)**

6. (a) An entity provides broadband services to its customers along with voice call service. Customer buys modem from the entity. However, customer can also get the connection from the entity and modem from any other vendor. The installation activity requires Ltd. effort and the cost involved is almost insignificant. It has various plans where it provides either broadband services or voice call services or both.

Comment on how to identify whether the performance obligations under the contract are distinct by using an automated process?

(5 Marks)

(b) Creative Ltd. performed a revaluation of all of its plant and machinery at the beginning of 1st April, 2024. The following information relates to one of its Machinery:

	Amount in ₹
Gross carrying amount	4,00,000
Accumulated depreciation (straight-line method)	1,60,000
Net carrying amount	2,40,000
Fair Value	3,00,000

The useful life of the machinery is 10 years, and the company uses Straight line method of depreciation. The revaluation was performed at the end of 4 years.

You are required to advise how the company should account for revaluation of plant and machinery and depreciation subsequent to revaluation. Also pass journal entries in relation to the above.

(5 Marks)

(c) You are required to analyse the following cases and advise whether they are related with prior period errors or change in accounting estimate

(a) As per the judgement of the court an arrear of salaries and wages relating to previous year amounting to ₹ 15,00,000 will be paid in the current year. At the end of the previous year, the management of the company was of the opinion that arrears of salaries and wages would not be required to be paid and accordingly no provision was made at the end of previous year.

(b) Expenses of ₹ 1,50,000 of the previous year which were omitted from books of accounts of the previous year due to an oversight.

(c) The amount of provision for doubtful debts as at the end of the previous year was ₹ 10,00,000 of which debts of ₹ 6,00,000 were realized during the current year.

(d) Company had taken a Group Insurance policy. During the previous year due to a mistake of Insurance Company the company paid less premium, which insurance company is demanding to pay now. **(4 Marks)**

MODEL TEST PAPER 1

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

Part I is compulsory.

Case Scenario I

Grow More Ltd. an NBFC is in the need of funds and hence it sold its receivables to MAC Financial Corporation (MFC) for ₹ 100 million. MFC created a trust for this purpose called General Investment Trust (GIT) through which it issued securities carrying a different level of risk and return to the investors. Further, this structure also permits the GIT to reinvest surplus funds for short term as per their requirement.

MFC also appointed a third party, Safeguard Pvt. Ltd. (SPL) to collect the payment due from obligor(s) and passes it to GIT. It will also follow up with defaulting obligor and if required initiate appropriate legal action against them.

Based on above case scenario, choose the most appropriate answer of the following:

1. The securitized instrument issued for ₹ 100 million by the GIT falls under category of ……….

    (a) Pass Through certificate (PTCs)

    (b) Pay Through Security (PTS)

    (c) Stripped Security

    (d) Debt Fund.

2. In the above scenario, the Originator is…………………

    (a) Grow More Ltd.

    (b) MAC Financial Corporation (MFC)

(c) General Investment Trust (GIT)

(d) Safeguard Pvt. Ltd.

3. In the above scenario, the General Investment Trust (GIT) is a/an................

(a) Obligor

(b) Originator

(c) Special Purpose Vehicle (SPV)

(d) Receiving and Paying Agent (RPA)

4. In the above scenario, the Safeguard Pvt. Ltd. (SPL) is a/an.................

(a) Obligor

(b) Originator

(c) Special Purpose Vehicle (SPV)

(d) Receiving and Paying Agent (RPA)

5. Which of the following statement holds true?

(a) When Yield to Maturity in market rises, prices of Principle Only (PO) Securities tend to rise.

(b) When Yield to Maturity in market rises, prices of Principle Only (PO) Securities tend to fall.

(c) When Yield to Maturity in market falls, prices of Principle Only (PO) Securities tend to fall.

(d) When Yield to Maturity in market falls, prices of Principle Only (PO) Securities remain the same. **(5 x 2 = 10 Marks)**

Case Scenario II

You are a financial analyst at a prominent investment firm and have been tasked with empirically verifying the weak form of Efficient Market Hypothesis (EMH) Theory for the XYZ Stock Index, a collection of diverse stocks. You decided to conduct three different tests to assess whether the stock market follows the principles of the weak form of EMH.

Test 1

For the past five years, you collected daily price changes of the stocks in the XYZ Stock Index. You calculated correlation coefficients for different lag periods and analyzed whether past price changes exhibit any significant correlation with future price changes. You considered price changes to be serially independent. The results indicated that most auto correlation coefficients are close to zero and statistically insignificant, suggesting those past price changes do not predict future price changes.

Test 2

You further investigated the randomness of price changes in the XYZ Stock Index. Analyzing the sequence of daily price changes, you count the number of runs where price changes are consistently positive or negative. Upon comparing the observed number of runs with the expected number based on randomness, you find that they align closely, supporting the idea that price changes follow a random pattern.

Test 3

To examine the efficacy of trading strategies based on historical price trends, you implemented a simple trading rule for the XYZ Stock Index. The rule involves buying when the price crosses a moving average of 5% threshold and selling when it crosses another 7% threshold. Over a period of testing, you computed the returns generated by the trading strategy. The results revealed that the returns are not consistently better than random chance, implying that past price trends do not reliably predict future price movements.

Conclusion:

After conducting the three tests the evidence supports the weak form of Efficient Market Theory for the XYZ Stock Index you concluded that past price trends do not reliably predict future price movements.

Based on above case scenario, choose the most appropriate answer of the following:

6. Test 1 is …………………

   (a) Serial Correlation test

   (b) Filter Rules test

   (c) Run test

(d) Variance Ratio test

7. Test 2 is ………………….

(a) Serial Correlation test

(b) Filter Rules test

(c) Run test

(d) Variance Ratio test

8. Test 3 is ………………

(a) Serial Correlation test

(b) Filter Rules test

(c) Run test

(d) Variance Ratio test.

9. The Filter Rule Test should not be applied for buy and hold strategy if…………….

(a) the behavior of stock price changes is predictable.

(b) the behavior of stock price changes is dependent on past trends.

(c) the behavior of stock price changes is correlated.

(d) the behavior of stock price changes is random.

10. Results of your studies support the…………..

(a) Semi-strong EMH Theory

(b) Strong EMH Theory

(c) Random Walk Theory

(d) Markowitz Theory **(5 x 2 = 10 Marks)**

Case Scenario III

Hari is acquiring the share of XYZ Ltd. The company has also issued 12% Convertible Debenture.

The data related to such convertible debenture is as follows:

Face value	₹ 1000
No. of shares per debenture	20
Market price of per share of XYZ Ltd.	₹ 48
Straight value of debenture	₹ 940
Market price of convertible debenture	₹ 1060

From the above case scenario, choose the most appropriate answer of following MCQs.

11. Stock value of debenture is……………….

    (a) ₹ 1000

    (b) ₹ 1060

    (c) ₹ 940

    (d) ₹ 960

12. Considering the basis of Market Price of Debenture percentage of downside risk shall be approximately…………….

    (a) 12%

    (b) 12.77%

    (c) 11.32%

    (d) 10.42%

13. Conversion Premium shall be approximately…………….

    (a) 12%

    (b) 12.77%

    (c) 10.63%

    (d) 10.42%

14. The conversion parity price of the stock shall be approximately…………….

    (a) ₹ 50

    (b) ₹ 53

    (c) ₹ 48

    (d) ₹ 47

15. Premium over Straight Value of Debenture shall be approximately …………….

(a) 12%

(b) 12.77%

(c) 10.63%

(d) 10.42% **(5 x 2 = 10 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to answer any four questions from the remaining five questions.

Working notes should form part of the answers.

Maximum Marks – 70 Marks

1. (a) Shashi Co. Ltd has projected the following cash flows from a project under evaluation:

Year	0	1	2	3
₹ (in lakhs)	(72)	30	40	30

The above cash flows have been made at expected prices after recognizing inflation. The firm's cost of capital is 10%. The expected annual rate of inflation is 5%. Show how the viability of the project is to be evaluated. PVF at 10% for 1-3 years are 0.909, 0.826 and 0.751. **(6 Marks)**

(b) You sold Hong Kong Dollar 1,00,00,000 value spot to your customer at ₹ 5.70 & covered yourself in London market on the same day, when the exchange rates were

US$ 1 = H.K.$ 7.5880 7.5920

Local inter bank market rates for US$ were

Spot US$ 1 = ₹ 42.70 42.85

Calculate cover rate and ascertain the profit or loss in the transaction. Ignore brokerage. **(4 Marks)**

(c) "Financial projections include three basic documents that make up a business's financial statements." Explain these documents.

(4 Marks)

2. (a) A Ltd. of U.K. has imported some chemical worth of USD 3,64,897 from one of the U.S. suppliers. The amount is payable in six months time. The relevant spot and forward rates are:

Spot rate	USD 1.5617-1.5673
6 months' forward rate	USD 1.5455 –1.5609

The borrowing rates in U.K. and U.S. are 7% and 6% respectively and the deposit rates are 5.5% and 4.5% respectively.

Currency options are available under which one option contract is for GBP 12,500. The option premium for GBP at a strike price of USD 1.70/GBP is USD 0.037 (call option) and USD 0.096 (put option) for 6 months period.

The company has 3 choices:

(i) Forward cover

(ii) Money market cover, and

(iii) Currency option

Which of the alternatives is preferable by the company? **(10 Marks)**

(b) Explain the main features of Value at Risk (VaR). **(4 Marks)**

3. (a) Mr. FedUp wants to invest an amount of ₹ 520 lakhs and had approached his Portfolio Manager. The Portfolio Manager had advised Mr. FedUp to invest in the following manner:

Security	**Moderate**	**Better**	**Good**	**Very Good**	**Best**
Amount (in ₹ Lakhs)	60	80	100	120	160
Beta	0.5	1.00	0.80	1.20	1.50

You are required to advise Mr. FedUp regarding the following, using Capital Asset Pricing Methodology:

(i) Expected return on the portfolio, if the Government Securities are at 8% and the NIFTY is yielding 10%.

(ii) Advisability of replacing Security 'Better' with NIFTY.

(6 Marks)

(b) Sensex futures are traded at a multiple of 50. Consider the following quotations of Sensex futures in the 10 trading days during February, 2009:

Day	High	Low	Closing
4-2-09	3306.4	3290.00	3296.50
5-2-09	3298.00	3262.50	3294.40
6-2-09	3256.20	3227.00	3230.40
7-2-09	3233.00	3201.50	3212.30
10-2-09	3281.50	3256.00	3267.50
11-2-09	3283.50	3260.00	3263.80
12-2-09	3315.00	3286.30	3292.00
14-2-09	3315.00	3257.10	3309.30
17-2-09	3278.00	3249.50	3257.80
18-2-09	3118.00	3091.40	3102.60

Abshishek bought one sensex futures contract on February, 04. The average daily absolute change in the value of contract is ₹ 10,000 and standard deviation of these changes is ₹ 2,000. The maintenance margin is 75% of initial margin.

You are required to determine the daily balances in the margin account and payment on margin calls, if any. **(8 Marks)**

4. (a) The valuation of Hansel Limited has been done by an investment analyst. Based on an expected free cash flow of ₹ 54 lakhs for the following year and an expected growth rate of 9 percent, the analyst has estimated the value of Hansel Limited to be ₹ 1800 lakhs. However, he committed a mistake of using the book values of debt and equity.

The book value weights employed by the analyst are not known, but you know that Hansel Limited has a cost of equity of 20 percent and post tax cost of debt of 10 percent. The value of equity is thrice its book value, whereas the market value of its debt is nine-tenths of its book value. What is the correct value of Hansel Ltd? **(6 Marks)**

(b)

BSE	5000
Value of portfolio	₹ 10,10,000
Risk free interest rate	9% p.a.
Dividend yield on Index	6% p.a.
Beta of portfolio	1.5

We assume that a future contract on the BSE index with four months maturity is used to hedge the value of portfolio over next three months. One future contract is for delivery of 50 times the index.

Based on the above information calculate:

(i) Price of future contract.

(ii) The gain on short futures position if index turns out to be 4,500 in three months. **(4 Marks)**

(c) Either

Explain three basic questions a Corporate level strategy should be able to answer. **(4 Marks)**

(c) **Or**

Explain the purposes for trading in Futures. **(4 Marks)**

5. (a) Abhiman Ltd. is a subsidiary of Janam Ltd. and is acquiring Swabhiman Ltd. which is also a subsidiary of Janam Ltd. The following information is given:

	Abhiman Ltd.	**Swabhiman Ltd.**
% Shareholding of promoter	50%	60%
Share capital	₹ 200 lacs	100 lacs
Free Reserves and surplus	₹ 900 lacs	600 lacs
Paid up value per share	₹ 100	10

Free float market capitalization	₹ 500 lacs	156 lacs
P/E Ratio (times)	10	4

Janam Ltd., is interested in doing justice to both companies. The following parameters have been assigned by the Board of Janam Ltd., for determining the swap ratio:

Book value 25%

Earning per share 50%

Market price 25%

You are required to compute

(i) The swap ratio.

(ii) The Book Value, Earning Per Share and Expected Market Price of Swabhiman Ltd., (assuming P/E Ratio of Abhiman remains the same and all assets and liabilities of Swabhiman Ltd. are taken over at book value.) **(10 Marks)**

(b) Equity share of PQR Ltd. is presently quoted at ₹ 320. The Market Price of the share after 6 months has the following probability distribution:

Market Price ₹	180	260	280	320	400
Probability	0.1	0.2	0.5	0.1	0.1

A put option with a strike price of ₹ 300 can be written.

You are required to find out expected value of option at maturity (i.e. 6 months) **(4 Marks)**

6. (a) ABC Ltd. has ₹ 300 million, 12 per cent bonds outstanding with six years remaining to maturity. Since interest rates are falling, ABC Ltd. is contemplating of refunding these bonds with a ₹ 300 million issue of 6 year bonds carrying a coupon rate of 10 per cent. Issue cost of the new bond will be ₹ 6 million and the call premium is 4 per cent. ₹ 9 million being the unamortized portion of issue cost of old bonds can be written off no sooner the old bonds are called off. Marginal tax rate of ABC Ltd. is 30 per cent. You are required to analyse the bond refunding decision. **(8 Marks)**

(b) M/s. Parker & Co. is contemplating to borrow an amount of ₹60 crores for a Period of 3 months in the coming 6 month's time from now. The current rate of interest is 9% p.a., but it may go up in 6 month’s time. The company wants to hedge itself against the likely increase in interest rate.

The Company's Bankers quoted an FRA (Forward Rate Agreement) at 9.30% p.a.

What will be the Final settlement amount, if the actual rate of interest after 6 months happens to be (i) 9.60% p.a. and (ii) 8.80% p.a.? **(6 Marks)**

MODEL TEST PAPER - 2

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

Part I is compulsory.

Case Scenario I

P Ltd. is studying the possible acquisition of Q Ltd. which is also in same industry by way of merger. The following data are available:

Firm	After-tax earnings	No. of equity shares	Market price per share	Book Value Per share
P Ltd.	₹ 10,00,000	2,00,000	₹ 75	₹ 210
Q Ltd.	₹ 3,00,000	50,000	₹ 60	₹ 105

The merger shall be gone through by exchange of equity shares and the exchange ratio is set according to different weights assigned to different basis as mentioned below :-

EPS	50%
Market Price	25%
Book Value	25%

1. The swap ratio based on given weights shall be.......................................
   (a) 0.825
   (b) 0.925
   (c) 0.952
   (d) 0.752
2. Based on swap ratio as per assigned weights the total number of shares issued by P Ltd to Q Ltd. shall be............

(a) 46250

(b) 41250

(c) 47600

(d) 37600

3. Post merger the EPS of the P Ltd. shall be.................

(a) 5.39

(b) 5.25

(c) 5.28

(d) 5.47

4. In case P Ltd. wants to be sure that its EPS is not diminished by the merger, the relevant exchange ratio to achieve the same objective should be...................

(a) 0.33

(b) 1.20

(c) 1.30

(d) 1.10

5. In case Q Ltd. wants to be sure that its EPS is not diminished by the merger, the relevant exchange ratio to achieve the same objective should be...................

(a) 0.33

(b) 1.20

(c) 1.30

(d) 1.10

6. The type of Merger of P Ltd. & Q Ltd. shall be ……………………….

(a) Horizontal Merger

(b) Vertical Merger

(c) Congeneric Merger

(d) Reverse Merger **(6 x 2 = 12 Marks)**

Case Scenario II

Mr. A is interested in investing ₹ 1,00,000 for which he is considering following three alternatives:

(i) Invest ₹ 1,00,000 in Mutual Fund X (MFX)

(ii) Invest ₹ 1,00,000 in Mutual Fund Y (MFY)

(iii) Portfolio - Invest ₹ 60,000 in Mutual Fund X (MFX) and ₹ 40,000 in Mutual Fund Y (MFY)

Average annual return earned by MFX and MFY is 12% and 11% respectively. Risk free rate of return is 8% and market rate of return is 10%.

Covariance of returns of MFX, MFY and market portfolio Mix are as follow:

	MFX	MFY	Mix
MFX	4.400	4.300	3.370
MFY	4.300	4.200	2.800
Mix	3.370	2.800	4.200

Based on the above information answer the following questions:

7. Standard Deviation of MFX is ....

   (a) 2.0736

   (b) 2.0976

   (c) 1.8358

   (d) 2.0494

8. Portfolio return would be ....

   (a) 11.00%

   (b) 12.00%

   (c) 11.50%

   (d) 11.60%

9. Based on Standard Deviation, the optimum investment for Mr. A would be ....

   (a) Portfolio

   (b) All investment in MFX

(c) All investment in MFY

(d) Both MFY and mix are indifferent

10. Standard Deviation of Market Mix Portfolio is ....

(a) 2.0736

(b) 2.0976

(c) 1.8358

(d) 2.0494

11. Beta of MFY will be approximately.....................

(a) 1.024

(b) 1.048

(c) 1.065

(d) 0.667 **(5 x 2 = 10 Marks)**

Case Scenario III

X and Y are two friends. Since Y has earned a lot of profit from trading in financial derivative market, X is also considering speculating on Gamma Corporation's shares which is currently trading at ₹ 700 per share through taking positions in options in stocks of same company. Accordingly, X took following contract positions in the options on Gama Corporation's stock:

(i) Purchasing one contract of 2-month call option with a premium of ₹ 35 and an exercise price of ₹ 750.

(ii) Purchasing one contract of 2-month put option with a premium of ₹ 25 and an exercise price of ₹ 600.

After some time, trading in Option Market and understanding the nitty-gritties of same, X being CEO in an organization advised his team to implement the concept of Financial Options in the Capital Budgeting decisions called 'Real Option'.

Based on the above information answer the following questions:

12. Assuming that the contract size of each option contract is 100 and the price of Gama Corporation's share after two months falls to ₹ 550, the net pay-off of X will be.........

(a) ₹ 1,000 loss

(b) ₹ 1,000 profit

(c) ₹ 3,000 profit

(d) ₹ 3,000 loss

13. The per share price of Gama Corporation's stock after 2 months at which X shall be at Break Even is…..

(a) ₹ 540

(b) ₹ 600

(c) ₹ 625

(d) ₹ 785

14. Which of the following statement is false regarding Real Options?

(a) Real Options methodology is an approach to capital budgeting that relies on Option Pricing theory to evaluate projects.

(b) Real options approach is intended to supplement, and not replace, capital budgeting analyses based on standard Discounted Cash Flow (DCF) methodologies.

(c) Real options are different from financial options as their periods start from the end of 1st year and are higher than financial options.

(d) Real options are normally traded in the market and are priced.

15. Which of the following is not a necessary condition to introduce Commodity Derivatives?

(a) a commodity should be durable, and it should be possible to store it;

(b) units must be heterogenous;

(c) the commodity must be subject to frequent price fluctuations with wide amplitude;

(d) supply and demand must be at large. **(4 x 2 = 8 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to answer any four questions from the remaining five questions.

Working notes should form part of the answers.

Maximum Marks – 70 Marks

1. (a) KLM Ltd., is considering taking up one of the two projects-Project-K and Project-So Both the projects having same life require equal investment of ₹ 80 lakhs each. Both are estimated to have almost the same yield. As the company is new to this type of business, the cash flow arising from the projects cannot be estimated with certainty. An attempt was therefore, made to use probability to analyse the pattern of cash flow from other projects during the first year of operations. This pattern is likely to continue during the life of these projects. The results of the analysis are as follows:

Project K		Project S	
Cash Flow (in ₹)	**Probability**	**Cash Flow (in ₹)**	**Probability**
11	0.10	09	0.10
13	0.20	13	0.25
15	0.40	17	0.30
17	0.20	21	0.25
19	0.10	25	0.10

Required:

(i) Calculate variance, standard deviation and co-efficient of variance for both the projects.

(ii) Which of the two projects is riskier? **(6 Marks)**

(b) In International Monetary Market an international forward bid for December, 15 on pound sterling is \$ 1.2816 at the same time that the price of IMM sterling future for delivery on December, 15 is \$ 1.2806. The contract size of pound sterling is £ 62,500. How could the dealer use arbitrage in profit from this situation and how much profit is earned? **(4 Marks)**

(c) State the difference between Peer- to-peer lending and Crowdfunding? **(4 Marks)**

2. (a) EFD Ltd. is an export business house. The company prepares invoice in customers' currency. Its debtors of US$. 10,000,000 is due on April 1, 2015.

Market information as at January 1, 2015 is:

Exchange rates US$/INR		**Currency Futures US$/INR**	
Spot	0.016667	Contract size: ₹ 24,816,975	
1-month forward	0.016529	1-month	0.016519
3-months forward	0.016129	3-month	0.016118
	Initial Margin	**Interest rates in India**	
1-Month	₹ 17,500	6.5%	
3-Months	₹ 22,500	7%	

On April 1, 2015, the spot rate US$/INR is 0.016136 and currency future rate is 0.016134.

Which of the following methods would be most advantageous to EFD Ltd?

(i) Using forward contract

(ii) Using currency futures

(iii) Not hedging the currency risk **(10 Marks)**

(b) Financial Risk can be evaluated from different points of views. Explain. **(4 Marks)**

3. (a) Following Financial data are available for PQR Ltd. for the year 2008:

	(₹ in lakh)
8% debentures	125
10% bonds (2007)	50
Equity shares (₹ 10 each)	100
Reserves and Surplus	300
Total Assets	600

Assets Turnovers ratio	1.1
Effective interest rate	8%
Effective tax rate	40%
Operating margin	10%
Dividend pay-out ratio	16.67%
Current market Price of Share	₹ 14
Required rate of return of investors	15%

You are required to:

(i) Draw income statement for the year

(ii) Calculate its sustainable growth rate of earnings

(iii) Calculate the fair price of the Company's share using dividend discount model, and

(iv) What is your opinion on investment in the company's share at current price? **(10 Marks)**

(b) Explain the various types of risks in any Securitisation transaction.

(4 Marks)

4. (a) Eagle Ltd. reported a profit of ₹ 77 lakhs after 30% tax for the financial year 2011-12. An analysis of the accounts revealed that the income included extraordinary items of ₹ 8 lakhs and an extraordinary loss of ₹10 lakhs. The existing operations, except for the extraordinary items, are expected to continue in the future. In addition, the results of the launch of a new product are expected to be as follows:

	₹ In lakhs
Sales	70
Material costs	20
Labour costs	12
Fixed costs	10

You are required to:

Calculate the value of the business, given that the capitalization rate is 14%. **(6 Marks)**

(b) State the challenges to the Efficient Market Theory. **(4 Marks)**

Either

(c) State the key decisions falling within the scope of financial strategy.

Or

What do you mean by CDSs? List the main purposes for which CDS can be used. (**4 Marks)**

5. (a) A multinational company is planning to set up a subsidiary company in India (where hitherto it was exporting) in view of growing demand for its product and competition from other MNCs. The initial project cost (consisting of Plant and Machinery including installation) is estimated to be US$ 500 million. The net working capital requirements are estimated at US$ 50 million. The company follows straight line method of depreciation. Presently, the company is exporting two million units every year at a unit price of US$ 80, its variable cost per unit being US$ 40.

The Chief Financial Officer has estimated the following operating cost and other data in respect of proposed project:

(i) Variable operating cost will be US $ 20 per unit of production;

(ii) Additional cash fixed cost will be US $ 30 million p.a. and project's share of allocated fixed cost will be US $ 3 million p.a. based on principle of ability to share;

(iii) Production capacity of the proposed project in India will be 5 million units;

(iv) Expected useful life of the proposed plant is five years with no salvage value;

(v) Existing working capital investment for production & sale of two million units through exports was US $ 15 million;

(vi) Export of the product in the coming year will decrease to 1.5 million units in case the company does not open subsidiary company in India, in view of the presence of competing MNCs that are in the process of setting up their subsidiaries in India;

(vii) Applicable Corporate Income Tax rate is 35%, and

(viii) Required rate of return for such project is 12%.

Assuming that there will be no variation in the exchange rate of two currencies and all profits will be repatriated, as there will be no withholding tax, estimate Net Present Value (NPV) of the proposed project in India.

Present Value Interest Factors (PVIF) @ 12% for five years are as below:

Year	1	2	3	4	5
PVIF	0.8929	0.7972	0.7118	0.6355	0.5674

(10 Marks)

(b) Which position on the index future gives a speculator, a complete hedge against the following transactions:

(i) The share of Right Limited is going to rise. He has a long position on the cash market of ₹ 50 lakhs on the Right Limited. The beta of the Right Limited is 1.25.

(ii) The share of Wrong Limited is going to depreciate. He has a short position on the cash market of ₹ 25 lakhs on the Wrong Limited. The beta of the Wrong Limited is 0.90. **(4 Marks)**

6. (a) Mr. A will need ₹ 1,00,000 after two years for which he wants to make one time necessary investment now. He has a choice of two types of bonds. Their details are as below:

	Bond X	**Bond Y**
Face value	₹ 1,000	₹ 1,000
Coupon	7% payable annually	8% payable annually
Years to maturity	1	4
Current price	₹ 972.73	₹ 936.52
Current yield	10%	10%

Advice Mr. A whether he should invest all his money in one type of bond or he should buy both the bonds and, if so, in which quantity? Assume that there will not be any call risk or default risk. **(8 Marks)**

(b) Suppose a dealer quotes 'All-in-cost' for a generic swap at 8% against six month LIBOR flat. If the notional principal amount of swap is ₹ 5,00,000.

(i) Calculate semi-annual fixed payment.

(ii) Find the first floating rate payment for (i) above if the six month period from the effective date of swap to the settlement date comprises 181 days and that the corresponding LIBOR was 6% on the effective date of swap.

In (ii) above, if the settlement is on 'Net' basis, how much the fixed rate payer would pay to the floating rate payer?

Generic swap is based on 30/360 days basis. **(6 Marks)**

MODEL TEST PAPER 3

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

Part I is compulsory.

Case Scenario I

During one business meeting at XYZ Ltd., one of the member pointed out that while evaluating the performance of any company one should not only see its Operating Income but should also analyse its Capital structure as well. Weighted Average Cost of Capital changes on the basis of capital structure keeping all other factors unchanged.

He presented data relating to 3 companies Alpha Ltd., Beta Ltd. and Gama Ltd. whose operating Income are equal, but their capital structure is different.

The following information relating to these 3 companies is as follows:

(in ₹ 000)

	Alpha Ltd.	Beta Ltd.	Gama Ltd.
Total invested capital	20,00,000	20,00,000	20,00,000
Debt/Assets ratio	0.8	0.5	0.2
Shares outstanding	61,000	83,000	1,00,000
Pre-tax Cost of Debt	16%	13%	15%
Cost of Equity	26%	22%	20%
Operating Income (EBIT)	5,00,000	5,00,000	5,00,000

The Tax rate is uniform 35% in all cases. The industry PE ratio is 11.

Based on above case scenario, choose the most appropriate answer of the following:

1. The weighted average cost of capital of Alpha Ltd. shall approximately be ………………..
   (a) 13.520%
   (b) 15.225%
   (c) 17.950%
   (d) 18.000%
2. The Economic Valued Added (EVA) for Beta Ltd. is……………
   (a) ₹ 54,600 Thousand
   (b) ₹ 20,500 Thousand
   (c) (-) ₹ 34,000 Thousand
   (d) ₹ 21500 Thousand
3. The price per share of Gama Ltd. shall be ……………..
   (a) ₹ 28.60
   (b) ₹ 31.90
   (c) ₹ 31.46
   (d) ₹ 29.45
4. The estimated market capitalisation for Alpha Ltd. is……………
   (a) ₹ 26,47,700 Thousand
   (b) ₹ 31,46,000 Thousand
   (c) ₹ 17,44,600 Thousand
   (d) ₹ 23,73,800 Thousand
5. Earning per share of Beta Ltd. is…………….
   (a) ₹ 2.60
   (b) ₹ 2.90
   (c) ₹ 2.86
   (d) ₹ 2.15
6. The Economic Valued Added (EVA) for Alpha Ltd. is……………
   (a) ₹ 54,600 Thousand

(b) ₹ 20,500 Thousand

(c) (-) ₹ 34,000 Thousand

(d) ₹ 21,500 Thousand **(6 x 2 = 12 Marks)**

Case Scenario II

Bank A is in need of fund for a period of 14 days. To meet this financial need on 20th September 2013 Bank A enters into an agreement with Bank B under which it will sell 10% Government of India Bonds issued on 1st January 2013 @ 5.65% for ₹ 8 crore (Face value is ₹ 1,00,000 per Bond).

The clean price of same Bond is ₹ 99,420 and the Initial Margin be 2% and the maturity date of Bond is 31st December 2018. Consider 360 days in a year and interest is payable annually.

Based on above Case Scenario, answer the following questions:

7. The arrangement entered between Bank A and Bank B will be called …………

   (a) Call Money Arrangement

   (b) Commercial Bill Arrangement

   (c) Commercial Paper

   (d) Repurchase Option

8. Dirty Price of the Bond will approximately be………………………

   (a) ₹ 103,530

   (b) ₹ 106,700

   (c) ₹105,000

   (d) ₹ 108,160

9. The start proceeds of the transaction shall be approximately …………………

   (a) ₹ 8,38,36,604

   (b) ₹ 8,36,52,800

   (c) ₹ 8,58,36,804

   (d) ₹ 8,48,52,585

10. The second leg of the transaction shall be approximately...................

 (a) ₹ 8,38,36,604

 (b) ₹ 8,36,52,800

 (c) ₹ 8,58,36,804

 (d) ₹ 8,48,52,585

11. The amount of Accrued Interest per Bond shall be approximately ....

 (a) ₹ 7280

 (b) ₹ 7200

 (c) ₹ 7340

 (d) ₹ 7140 **(5 x 2 = 10 Marks)**

Case Scenario III

ABC Ltd. is planning to expand its business and therefore raising fund by issuing a convertible bond of ₹ 10 crore. An investor "Mr. X" is interested to invest in the bond of ABC Ltd. Mr. X has following data related to the convertible bond.

The data given below relates to a convertible bond:

Face value	₹ 250
Coupon rate	12%
No. of shares per bond	20
Market price of share	₹ 12
Straight value of bond	₹ 235
Market price of convertible bond	₹ 265
Maturity	5 Years

You, being an expert of the matter, are required to answer his questions. Select the most appropriate alternative:

12. The percentage of downside risk of the bond is approximately................

 (a) 10.42%

 (b) 6.38%

 (c) 2.13%

 (d) 12.77%

13. The conversion premium in percentage term of the bond is…………….

    (a) 12.77%

    (b) 10.42%

    (c) 2.18%

    (d) 13.45%

14. The conversion parity price of the stock is…………….

    (a) ₹ 11.75

    (b) ₹ 12.00

    (c) ₹ 13.25

    (d) ₹ 12.50

15. If he wants a yield of 15% the maximum price he should be ready to pay for is…………….

    (a) 217.41

    (b) 224.81

    (c) 240.00

    (d) 232.32 **(4 x 2 = 8 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to answer any four questions from the remaining five questions.

Working notes should form part of the answers.

Maximum Marks – 70 Marks

1. (a) Red Ltd. is considering a project with the following Cash flows:

₹

Years	Cost of Plant	Recurring Cost	Savings
0	10,000	-	-
1	-	4,000	12,000
2	-	5,000	14,000

The cost of capital is 9%. Measure the sensitivity of the project to changes in the levels of plant value, running cost and savings (considering each factor at a time) such that the NPV becomes zero. The P.V. factor at 9% are as under:

Year	**Factor**
0	1
1	0.917
2	0.842

Which factor (except time period) is the most sensitive to affect the acceptability of the project if they vary adversely by 10%?

(6 Marks)

(b) Following are the details of cash inflows and outflows in foreign currency denominations of MNP Co. an Indian export firm, which have no foreign subsidiaries:

Currency	Inflow	Outflow	Spot rate	Forward rate
US $	4,00,00,000	2,00,00,000	48.01	48.82
French Franc	2,00,00,000	80,00,000	7.45	8.12
U.K. £	3,00,00,000	2,00,00,000	75.57	75.98
Japanese Yen	1,50,00,000	2,50,00,000	3.20	2.40

Determine the net exposure of each foreign currency in terms of Rupees. **(4 Marks)**

(c) List out the various stages of Funding for VC. **(4 Marks)**

2. (a) M/s Omega Electronics Ltd. exports air conditioners to Germany by importing all the components from Singapore. The company is exporting 2,400 units at a price of Euro 500 per unit. The cost of imported components is $ 800 per unit. The fixed cost and other variables cost per unit are ₹ 1,000 and ₹ 1,500 respectively. The cash flows in Foreign currencies are due in six months. The current exchange rates are as follows:

₹/Euro	51.50/55
₹/$	27.20/25

After six months the exchange rates turn out as follows:

₹/Euro	52.00/05
₹/$	27.70/75

(i) You are required to calculate loss/gain due to transaction exposure.

(ii) Based on the following additional information calculate the loss/gain due to transaction and operating exposure if the contracted price of air conditioners is ₹ 25,000:

A. the current exchange rate changes to

₹/Euro	51.75/80
₹/$	27.10/15

B. Price elasticity of demand is estimated to be 1.5

C. Payments and receipts are to be settled at the end of six months. **(10 Marks)**

(b) Explain the areas of the applications of Value at Risk (VAR).

(4 Marks)

3. (a) Consider the following information on two stocks, A and B:

Year	Return on A (%)	Return on B (%)
2006	10	12
2007	16	18

You are required to determine:

(i) The expected return on a portfolio containing A and B in the proportion of 40% and 60% respectively.

(ii) The Standard Deviation of return from each of the two stocks.

(iii) The covariance of returns from the two stocks.

(iv) Correlation coefficient between the returns of the two stocks.

(v) The risk of a portfolio containing A and B in the proportion of 40% and 60%. **(10 Marks)**

(b) Who are the secondary Participants involved in Securitisation process. **(4 Marks)**

4. (a) The valuation of Hansel Limited has been done by an investment analyst. Based on an expected free cash flow of ₹ 54 lakhs for the following year and an expected growth rate of 9 percent, the analyst has estimated the value of Hansel Limited to be ₹ 1800 lakhs. However, he committed a mistake of using the book values of debt and equity.

The book value weights employed by the analyst are not known, but you know that Hansel Limited has a cost of equity of 20 percent and post tax cost of debt of 10 percent. The value of equity is thrice its book value, whereas the market value of its debt is nine-tenths of its book value.

What is the correct value of Hansel Ltd? **(6 Marks)**

(b) According to Eugene Fama, there exist three levels of market efficiency. Explain. **(4 Marks)**

Either

(c) Traditionally, the main role of CFOs was focused on maximizing wealth for shareholders by maintaining the financial health of an organization. In recent times, the role of CFOs has expanded drastically into several areas. Explain these areas.

Or

Stock index futures is most popular financial derivatives over stock future.

Present your logical arguments to support the statement. (**4 Marks)**

5. (a) XYZ Ltd., a company based in India, manufactures very high quality modem furniture and sells to a small number of retail outlets in India and Nepal. It is facing tough competition. Recent studies on marketability of products have clearly indicated that the customers are now more interested in variety and choice rather than exclusivity and exceptional quality. Since the cost of quality wood in India is very high, the company is reviewing the proposal for import of woods in bulk from Nepalese supplier.

The estimate of net Indian (₹) and Nepalese Currency (NC) cash flows in Nominal terms for this proposal is shown below:

	Net Cash Flow (in millions)			
Year	**0**	**1**	**2**	**3**
NC	-25.000	2.600	3.800	4.100
Indian (₹)	0	2.869	4.200	4.600

The following information is relevant:

(i) XYZ Ltd. evaluates all investments by using a discount rate of 9% p.a. All Nepalese customers are invoiced in NC. NC cash flows are converted to Indian (₹) at the forward rate and discounted at the Indian rate.

(ii) Inflation rates in Nepal and India are expected to be 9% and 8% p.a. respectively. The current exchange rate is ₹ 1= NC 1.6

Assuming that you are the finance manager of XYZ Ltd., calculate the net present value (NPV) and modified internal rate of return (MIRR) of the proposal.

You may use following values with respect to discount factor for ₹ 1 @9%.

	Present Value	**Future Value**
Year 1	0.917	1.188
Year 2	0.842	1.090
Year 3	0.772	1

(10 Marks)

(b) A trader is having in its portfolio shares worth ₹ 85 lakhs at current price and cash ₹ 15 lakhs. The beta of share portfolio is 1.6. After 3 months the price of shares dropped by 3.2%.

Determine:

(i) Current portfolio beta

(ii) Portfolio beta after 3 months if the trader on current date goes for long position on ₹ 100 lakhs Nifty futures. **(4 Marks)**

6. (a) Consider the following quotations of Sensex futures in the 10 trading days during February, 2009:

Day	High	Low	Closing
04-02-09	3306.4	3290.00	3296.50
05-02-09	3298.00	3262.50	3294.40
06-02-09	3256.20	3227.00	3230.40
07-02-09	3233.00	3201.50	3212.30
10-02-09	3281.50	3256.00	3267.50
11-02-09	3283.50	3260.00	3263.80
12-02-09	3315.00	3286.30	3292.00
14-02-09	3315.00	3257.10	3309.30
17-02-09	3278.00	3249.50	3257.80
18-02-09	3118.00	3091.40	3102.60

Mr. A bought one Sensex Futures contract on February, 04. The average daily absolute change in the value of contract is ₹ 10,000 and standard deviation of these changes is ₹ 2,000. The maintenance margin is 75% of initial margin.

You are required to determine the daily balances in the margin account and payment on margin calls, if any. Sensex futures are traded at a multiple of 50. **(8 Marks)**

(b) XYZ Limited borrows £ 15 Million of six months LIBOR + 10.00% for a period of 24 months. The company anticipates a rise in LIBOR, hence it proposes to buy a Cap Option from its Bankers at the strike rate of 8.00%. The lump sum premium is 1.00% for the entire reset periods and the fixed rate of interest is 7.00% per annum. The actual position of LIBOR during the forthcoming reset period is as under:

Reset Period	LIBOR
1	9.00%
2	9.50%
3	10.00%

You are required to show how far interest rate risk is hedged through Cap Option.

For calculation, work out figures at each stage up to three decimal points and amount nearest to £. It should be part of working notes.

(6 Marks)

MODEL TEST PAPER 4

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

Part I is compulsory.

Case Scenario I

Two friend Mr. A and Mr. N were discussing about the risks of market. While Mr. A is sort of risk averse, Mr. N is an aggressive investor and believes in taking risk.

Mr. N said we cannot diversify the market risk at all and he quoted the Modern Portfolio Approach. Both of these friend analyse the market data for the few month and came out with expected returns on two stocks for a particular market.

Market Return	Aggressive	Defensive
7%	4%	9%
25%	40%	18%

Based on the above information, choose the most appropriate alternative:

1. The Beta of Defensive stock is…………

   (a) 2

   (b) 0.5

   (c) 4

   (d) 1

2. Expected return of Aggressive stock if the market return is equally likely to be 7% or 25%. shall be……..

   (a) 18%

(b) 13.5%

(c) 22%

(d) 11%

3. The Alpha of the Defensive stocks is..................

(a) -10%

(b) 22%

(c) 5.5%

(d) 12%

4. The Modern Portfolio Theory is propounded by ....

(a) William Sharpe

(b) Black Scholes

(c) Stephen Ross

(d) Harry Markowitz

5. As per Capital Market Line (CML) Theory the Portfolios lying on the CML over the market portfolio are called ....

(a) Lending Portfolio

(b) Borrowing Portfolio

(c) Diversified Portfolio

(d) Risk- Free Portfolio **(5 x 2 = 10 Marks)**

Case Scenario II

XYZ Ltd. is in need of funds for a short tenure. Some functional level manager suggested about the Bank Loan option. On conforming from Finance Department, it was found that company exhausted its bank loan limited due to recent huge Capex. Then CA X, CFO suggested the idea of floating Commercial papers by XYZ Ltd.

Accordingly, XYZ Ltd. is planning to issue Commercial Paper (CP), the details of which is given below:

Issue Price of CP	₹ 97,550
Face Value	₹ 1,00,000

Maturity Period	3 Months
Issue Expense	
Brokerage	0.15%for 3 months
Rating charges	0.50% p.a.
Stamp Duty	0.175% for 3 months

Based on above case scenario answer the following questions:

6. The Bond Equivalent yield of the same Commercial Paper shall be approximately…………….

   (a) 2.51%

   (b) 10.05%

   (c) 7.53%

   (d) 11.05%

7. The Effective Interest Rate per annum of same CP shall approximately be…………………

   (a) 10.44%

   (b) 10.05%

   (c) 2.51%

   (d) 11.05%

8. The total cost of funds to the company shall approximately be………………………

   (a) 11.27%

   (b) 11.85%

   (c) 12.24%

   (d) 10.88%

9. Which of the following instruments cannot be used by a bank to meet its short-term funding requirements?

   (a) Call/Notice Money

   (b) Commercial Paper

(c) Certificate of Deposit

(d) Repurchase Agreement (Repo)

10. The period of Commercial Paper ranges from……………….

(a) 14 days to 364 days

(b) 3 months to 6 months

(c) 7 days to 1 year

(d) 1 year to 3 years **(5 x 2 = 10 Marks)**

Case Scenario III

Mr. X on 1.7.2021, during the initial offer of some Mutual Fund invested in 10,000 units having face value of ₹ 10 for each unit. On 31.3.2022, the dividend paid by the M.F. was 10% and Mr. X found that his annualized yield was 153.33%. On 31.12.2023, 20% dividend was given. On 31.3.2010, Mr. X redeemed all his balance of 11,296.11 units when his annualized yield was 73.52%.

11. NAV as on 31/03/2022 shall be approximately………………

(a) ₹ 19.50

(b) ₹ 20.50

(c) ₹ 21.50

(d) ₹ 22.50

12. Total number of units as on 31/03/2022 shall be approximately…………

(a) 10487.80 units

(b) 12585.65 units

(c) 9465.35 units

(d) 11575.40 units

13. Dividend as on 31/03/2023 shall be ………………

(a) ₹ 20625.50

(b) ₹ 20870.45

(c) ₹ 20975.60

(d) ₹ 21565.75

14. NAV as on 31/03/2023 shall be approximately.................

    (a) 24.65

    (b) 24.85

    (c) 25.95

    (d) 26.45

15. NAV as on 31/03/2024 shall be approximately.................

    (a) 20.50

    (b) 25.95

    (c) 26.75

    (d) 27.20 **(5 x 2 = 10 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to answer any four questions from the remaining five questions.

Working notes should form part of the answers.

Maximum Marks – 70 Marks

1. (a) An importer booked a forward contract with his bank on 10th April for USD 2,00,000 due on 10th June @ ₹ 64.4000. The bank covered its position in the market at ₹ 64.2800.

The exchange rates for dollar in the interbank market on 10th June and 13th June were:

	10th June	13th June
Spot USD 1=	₹ 63.8000/8200	₹ 63.6800/7200
Spot/June	₹ 63.9200/9500	₹ 63.8000/8500
July	₹ 64.0500/0900	₹ 63.9300/9900
August	₹ 64.3000/3500	₹ 64.1800/2500
September	₹ 64.6000/6600	₹ 64.4800/5600

Exchange Margin 0.10% and interest on outlay of funds @ 12%. The importer requested on 14th June for extension of contract with due date on 10th August.

Rates to be rounded off to 4 decimals in multiples of 0.0025.

On 10th June, Bank Swaps by selling spot and buying one month forward.

Calculate:

(i) Cancellation rate

(ii) Amount payable on $ 2,00,000

(iii) Swap loss

(iv) Interest on outlay of funds, if any

(v) New contract rate

(vi) Total Cost **(10 Marks)**

(b) Explain the categories in which Financial Risk can be divided.

(4 Marks)

2. (a) A company is considering Projects X and Y with following information:

Project	Expected NPV (₹)	Standard deviation
X	1,22,000	90,000
Y	2,25,000	1,20,000

(i) Which project will you recommend based on the above data?

(ii) Explain whether your opinion will change, if you use coefficient of variation as a measure of risk.

(iii) Which measure is more appropriate in this situation and why? **(6 Marks)**

(b) ABC Ltd. of UK has exported goods worth Can $ 5,00,000 receivable in 6 months. The exporter wants to hedge the receipt in the forward market. The following information is available:

Spot Exchange Rate	Can $ 2.5/£
Interest Rate in UK	12%
Interest Rate In Canada	15%

The forward rates truly reflect the interest rates differential. Find out the gain/loss to UK exporter if Can $ spot rates (i) declines 2%, (ii) gains 4% or (iii) remains unchanged over next 6 months. **(4 Marks)**

(c) Explain the structure of Venture Capital Fund in India. **(4 Marks)**

3. (a) Following information are available in respect of XYZ Ltd. which is expected to grow at a higher rate for 4 years after which growth rate will stabilize at a lower level:

Base year information:

Revenue	- ₹ 2,000 crores
EBIT	- ₹ 300 crores
Capital expenditure	- ₹ 280 crores
Depreciation	- ₹200 crores

Information for high growth and stable growth period are as follows:

	High Growth	Stable Growth
Growth in Revenue & EBIT	20%	10%
Growth in capital expenditure and depreciation	20%	Capital expenditure are offset by depreciation
Risk free rate	10%	9%
Equity beta	1.15	1
Market risk premium	6%	5%
Pre-tax cost of debt	13%	12.86%
Debt equity ratio	1 : 1	2 : 3

For all time, working capital is 25% of revenue and corporate tax rate is 30%.

What is the value of the firm? **(10 Marks)**

Either

(b) In post-pandemic time their role has been advanced in the different areas in addition to traditional role. Give your views to support the statement.

Or

What do you mean by Credit Default Swap (CDS)? Who are the parties involved in CDS? **(4 Marks)**

4. (a) The following information is provided relating to the acquiring company E Ltd., and the target company H Ltd:

Particulars	**E Ltd. (₹)**	**H Ltd. (₹)**
Number of shares (Face value ₹ 10 each)	20 Lakhs	15 Lakhs
Market Capitalization	1000 Lakhs	1500 Lakhs
P/E Ratio (times)	10.00	5.00
Reserves and surplus in ₹	600.00 Lakhs	330.00 Lakhs
Promoter's Holding (No. of shares)	9.50 Lakhs	10.00 Lakhs

The Board of Directors of both the companies have decided to give a fair deal to the shareholders. Accordingly, the weights are decided as 40%, 25% and 35% respectively for earnings (EPS), book value and market price of share of each company for swap ratio.

Calculate the following:

(i) Market price per share, earnings per share and Book Value per share;

(ii) Swap ratio;

(iii) Promoter's holding percentage after acquisition;

(iv) EPS of E Ltd. after acquisitions of H Ltd;

(v) Expected market price per share and market capitalization of E Ltd.; after acquisition, assuming P/E ratio of E Ltd. remains unchanged; and

(vi) Free float market capitalization of the merged firm. **(10 Marks)**

(b) List the similarities between Tokenization and Securitization.

(4 Marks)

5. (a) Suppose MIS Ltd. is considering installation of solar electricity generating plant for light the staff quarters. The plant shall cost ₹ 2.50 crore and shall lead to saving in electricity expenses at the current tariff by ₹ 21 lakh per year forever.

However, with change in Government in state, the rate of electricity is subject to change. Accordingly, the saving in electricity can be of ₹ 12 lakh or ₹ 35 lakh per year and forever.

Assuming WACC of MIS Ltd. is 10% and risk-free rate of rate of return is 8%.

Decide whether MIS Ltd. should accept the project or wait and see.

(8 Marks)

(b) Suppose a dealer quotes 'All-in-cost' for a generic swap at 8% against six month LIBOR flat. If the notional principal amount of swap is ₹ 5,00,000.

(i) Calculate semi-annual fixed payment.

(ii) Find the first floating rate payment for (i) above if the six month period from the effective date of swap to the settlement date comprises 181 days and that the corresponding LIBOR was 6% on the effective date of swap.

In (ii) above, if the settlement is on 'Net' basis, how much the fixed rate payer would pay to the floating rate payer?

Generic swap is based on 30/360 days basis. **(6 Marks)**

6. (a) XY Limited is engaged in large retail business in India. It is contemplating for expansion into a country of Africa by acquiring a group of stores having the same line of operation as that of India.

The exchange rate for the currency of the proposed African country is extremely volatile. Rate of inflation is presently 40% a year. Inflation in India is currently 10% a year. Management of XY Limited expects these rates likely to continue for the foreseeable future.

Estimated projected cash flows, in real terms, in India as well as African country for the first three years of the project are as follows:

	Year – 0	Year – 1	Year – 2	Year – 3
Cash flows in Indian ₹ (000)	-50,000	-1,500	-2,000	-2,500
Cash flows in African Rands (000)	-2,00,000	+50,000	+70,000	+90,000

XY Ltd. assumes the year 3 nominal cash flows will continue to be earned each year indefinitely. It evaluates all investments using nominal cash flows and a nominal discounting rate. The present exchange rate is African Rand 6 to ₹ 1.

You are required to calculate the net present value of the proposed investment considering the following:

(i) African Rand cash flows are converted into rupees and discounted at a risk adjusted rate.

(ii) All cash flows for these projects will be discounted at a rate of 20% to reflect its high risk.

(iii) Ignore taxation.

	Year - 1	Year – 2	Year - 3
PVIF @ 20%	0.833	0.694	0.579

(8 Marks)

(b) You as an investor had purchased a 4-month call option on the equity shares of X Ltd. of ₹ 10, of which the current market price is ₹ 132 and the exercise price ₹ 150. You expect the price to range between ₹ 120 to ₹ 190. The expected share price of X Ltd. and related probability is given below:

Expected Price (₹)	120	140	160	180	190
Probability	0.05	0.20	0.50	0.10	0.15

Compute the following:

(i) Expected Share price at the end of 4 months.

(ii) Value of Call Option at the end of 4 months, if the exercise price prevails.

(iii) In case the option is held to its maturity, what will be the expected value of the call option? **(6 Marks)**

MODEL TEST PAPER - 5

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

Part I is compulsory.

Case Scenario I

SM Limited has a market capitalization of ₹ 3,000 crore and the current earnings per share (EPS) is ₹ 200 with a price earnings ratio (PER) of 15. The Board of directors is considering a proposal to buy back 20% of the shares at a premium which can be supported by the financials of the company. The Boards expects post buy back market price per share (MPS) of ₹ 3057. Post buy back PER will remain same. The company proposes to fund the buy back by availing 8% bank loan since available resources are committed for expansion plans.

Applicable income tax rate is 30%.

Based on above Case Scenario, select the most appropriate alternative.

1. The number of shares proposed to be bought back is…………….

   (a) 12 lakhs

   (b) 15 lakhs

   (c) 20 lakhs

   (d) 22 lakhs

2. The interest amount which can be paid for availing the bank loan

   (a) ₹ 5,280.00 Lakhs

   (b) ₹ 5,575.00 Lakhs

   (c) ₹ 4865.00 Lakhs

   (d) ₹ 6485.00 Lakhs

3. The loan amount to be raised and
   (a) ₹ 55650 Lakhs
   (b) ₹ 62300 Lakhs
   (c) ₹ 66000 Lakhs
   (d) ₹ 72450 Lakhs
4. The premium per share paid over the current MPS
   (a) ₹ 200
   (b) ₹ 250
   (c) ₹ 300
   (d) ₹ 350
5. % premium over CMP shall be ………….
   (a) 12%
   (b) 14%
   (c) 10%
   (d) 15% **(5 x 2 = 10 Marks)**

Case Scenario III

You are a financial analyst at a prominent investment firm tasked with empirically verifying the weak form of Efficient Market Theory (EMT) for the XYZ Stock Index, a collection of diverse stocks. You decide to conduct three different tests to assess whether the stock market follows the principles of the weak form of EMT.

Test 1

For the past five years, you collect daily price changes of the stocks in the XYZ Stock Index. You calculate autocorrelation coefficients for different lag periods and analyze whether past price changes exhibit any significant correlation with future price changes. The results indicate that most autocorrelation coefficients are close to zero and statistically insignificant, suggesting those past price changes do not predict future price changes.

Test 2

You further investigate the randomness of price changes in the XYZ Stock Index. Analyzing the sequence of daily price changes, you count the number of runs where price changes are consistently positive or negative. Upon comparing the observed number of runs with the expected number based on randomness, you find that they align closely, supporting the idea that price changes follow a random pattern.

Test 3

To examine the efficacy of trading strategies based on historical price trends, you implement a simple trading rule for the XYZ Stock Index. The rule involves buying when the price crosses a certain moving average % threshold and selling when it crosses another % threshold. Over a period of testing, you compute the returns generated by the trading strategy. The results reveal that the returns are not consistently better than random chance, implying that past price trends do not reliably predict future price movements.

Conclusion:

After conducting the three tests the evidence supports the weak form of Efficient Market Theory for the XYZ Stock Index. The lack of correlation, the randomness of price change patterns, and the inability of the trading strategy to consistently outperform random chance suggests that past price trends do not reliably predict future price movements.

Based on the above information answer the following questions:

6. What does the serial correlation test assess in the context of the weak form of Efficient Market Theory?

   (a) The randomness in stock price changes

   (b) The correlation between different stocks in the XYZ Stock Index.

   (c) The impact of economic events on stock prices.

   (d) The effectiveness of technical analysis strategies.

7. Test 2 is called as:

   (a) Serial Correlation test.

   (b) Run test.

   (c) Filter Rules test.

(d) Variance Ratio test.

8. In the filter rule test, filter rules do not apply if:

(a) the behavior of stock price changes is predictable.

(b) the behavior of stock price changes is dependent on past trends.

(c) the behavior of stock price changes is correlated.

(d) the behavior of stock price changes is random.

9. Based on the results of the three tests, what conclusion can be drawn about the weak form of Efficient Market Theory for the XYZ Stock Index?

(a) Past price changes predict future price changes reliably.

(b) Stock prices do not reflect available information.

(c) The stock market follows a random pattern of price changes.

(d) Technical analysis strategies consistently outperform randomness.

10. Test 1 is called as:

(a) Serial Correlation test.

(b) Filter Rules test.

(c) Run test.

(d) Variance Ratio test.

11. Test 3 is called as:

(a) Serial Correlation test.

(b) Filter Rules test.

(c) Run test.

(d) Variance Ratio test. **(6 x 2 = 12 Marks)**

Case Scenario III

The Asset Management Company of the mutual fund (MF) has declared a dividend of 9.98% on the units under the dividend reinvestment plan for the year ended 31st March 2021. The investors are issued additional units for the dividend at the rate of closing Net Asset Value (NAV) for the year as per the conditions of the scheme.

The closing NAV was ₹ 24.95 as on 31st March 2021. An investor Mr. X who is having 20,800 units at the year-end has made an investment in the units before the declaration of the dividend and at the rate of opening NAV plus an entry load of ₹ 0.04. The NAV has appreciated by 25% during the year.

Assume the face value of the unit as ₹ 10.00.

Based on above Case Scenario, select the most appropriate alternative.

12. The Opening NAV of the Asset Management Company shall be ....
    - (a) ₹ 20.24
    - (b) ₹ 19.96
    - (c) ₹ 18.75
    - (d) ₹ 17.65

13. The Number of the units purchased shall be ....
    - (a) 18750
    - (b) 17500
    - (c) 20450
    - (d) 20000

14. Original amount of the investment shall be ....
    - (a) ₹ 4,00,000
    - (b) ₹ 6,50,000
    - (c) ₹ 3,55,000
    - (d) ₹ 5,65,000

15. Which of the following statement about Expense ratio is/ are incorrect:
    - (i) It is the percentage of income that were spent to run a mutual fund.
    - (ii) It includes advisory fees, travel costs, registrar fees , custodian fees, etc.
    - (iii) It includes Brokerage costs for trading of Portfolio.
    - (iv) High Expense Ratio can seriously undermine the performance of a mutual fund scheme.
    - (a) (i), (ii), (iii)

(b) (i), (iii)

(c) only (iii)

(d) only (i) **(4 x 2 = 8 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to answer any four questions from the remaining five questions.

Working notes should form part of the answers.

Maximum Marks – 70 Marks

1. (a) Project X and Project Y are under the evaluation of XY Co. The estimated cash flows and their probabilities are as below:

Project X: Investment (year 0) ₹ 70 lakhs

Probability weights	0.30	0.40	0.30
Years	**₹ lakhs**	**₹ lakhs**	**₹ lakhs**
1	30	50	65
2	30	40	55
3	30	40	45

Project Y: Investment (year 0) ₹ 80 lakhs.

Probability weighted	Annual cash flows through life
	₹ lakhs
0.20	40
0.50	45
0.30	50

(i) Which project is better based on NPV, criterion with a discount rate of 10%?

(ii) Compute the standard deviation of the present value distribution and analyse the inherent risk of the projects.

(6 Marks)

(b) An importer booked a forward contract with his bank on 10th April for USD 2,00,000 due on 10th June @ ₹ 64.4000. The bank covered its position in the market at ₹ 64.2800.

The exchange rates for dollar in the interbank market on 10th June and 13th June were:

	10th June	13th June
Spot USD 1=	₹ 63.8000/8200	₹ 63.6800/7200
Spot/June	₹ 63.9200/9500	₹ 63.8000/8500
July	₹ 64.0500/0900	₹ 63.9300/9900
August	₹ 64.3000/3500	₹ 64.1800/2500
September	₹ 64.6000/6600	₹ 64.4800/5600

Exchange Margin 0.10% and interest on outlay of funds @ 12%. The importer requested on 14th June for extension of contract with due date on 10th August.

Rates to be rounded off to 4 decimals in multiples of 0.0025.

On 10th June, Bank Swaps by selling spot and buying one month forward.

Calculate:

(i) Cancellation rate

(ii) Amount payable on $ 2,00,000 **(4 Marks)**

(c) What do you mean by Pitch Presentation? What are the points that should be kept in mind while preparing a Pitch Presentation.

(4 Marks)

2. (a) An Indian exporting firm, Rohit and Bros., would be covering itself against a likely depreciation of pound sterling. The following data is given:

Receivables of Rohit and Bros	:	£500,000
Spot rate	:	₹ 56.00/£
Payment date	:	3-months

3 months interest rate	:	India: 12 per cent per annum
	:	UK: 5 per cent per annum

What should the exporter do? **(6 Marks)**

(b) You sold Hong Kong Dollar 1,00,00,000 value spot to your customer at ₹ 5.70 & covered yourself in London market on the same day, when the exchange rates were

US$ 1 = H.K.$ 7.5880 7.5920

Local inter bank market rates for US$ were

Spot US$ 1 = ₹ 42.70 42.85

Calculate cover rate and ascertain the profit or loss in the transaction. Ignore brokerage. **(4 Marks)**

(c) What are the major components of Financial planning. **(4 Marks)**

3. (a) Mr. X owns a portfolio with the following characteristics:

	Security A	Security B	Risk Free security
Factor 1 sensitivity	0.80	1.50	0
Factor 2 sensitivity	0.60	1.20	0
Expected Return	15%	20%	10%

It is assumed that security returns are generated by a two factor model.

(i) If Mr. X has ₹ 1,00,000 to invest and sells short ₹ 50,000 of security B and purchases ₹ 1,50,000 of security A what is the sensitivity of Mr. X's portfolio to the two factors?

(ii) If Mr. X borrows ₹ 1,00,000 at the risk free rate and invests the amount he borrows along with the original amount of ₹ 1,00,000 in security A and B in the same proportion as described in part (i), what is the sensitivity of the portfolio to the two factors?

(iii) What is the expected return premium of factor 2?**(10 Marks)**

(b) What are the areas where Application of Blockchain can be noticed?

(4 Marks)

4. (a) Tender Ltd has earned a net profit of ₹ 15 lacs after tax at 30%. Interest cost charged by financial institutions was ₹ 10 lacs. The invested capital is ₹ 95 lacs of which 55% is debt. The company maintains a weighted average cost of capital of 13%. Required,

(i) Compute the operating income.

(ii) Compute the Economic Value Added (EVA).

(iii) Tender Ltd. has 6 lac equity shares outstanding. How much dividend can the company pay before the value of the entity starts declining? **(6 Marks)**

(b) What are the factors affecting Economic Analysis? **(4 Marks)**

(c) What are the techniques to manage Counter Party Risk?

Or

What are the main types of risk associated with investment in Collateralized Debt Obligation (CDOs)? **(4 Marks)**

5. (a) Perfect Inc., a U.S. based Pharmaceutical Company has received an offer from Aidscure Ltd., a company engaged in manufacturing of drugs to cure Dengue, to set up a manufacturing unit in Baddi (H.P.), India in a joint venture.

As per the Joint Venture agreement, Perfect Inc. will receive 55% share of revenues plus a royalty @ US $0.01 per bottle. The initial investment will be ₹ 200 crores for machinery and factory. The scrap value of machinery and factory is estimated at the end of five (5) year to be ₹ 5 crores. The machinery is depreciable @ 20% on the value net of salvage value using Straight Line Method. An initial working capital to the tune of ₹ 50 crores shall be required and thereafter ₹ 5 crores each year.

As per GOI directions, it is estimated that the price per bottle will be ₹ 7.50 and production will be 24 crores bottles per year. The price in addition to inflation of respective years shall be increased by ₹ 1 each year. The production cost shall be 40% of the revenues.

The applicable tax rate in India is 30% and 35% in US and there is Double Avoidance Agreement between India and US. According to the agreement tax credit shall be given in US for the tax paid in

India. In both the countries, taxes shall be paid in the following year in which profit have arisen/ remittance received.

Spot rate of $ is ₹ 57. The inflation in India is 6% (expected to decrease by 0.50% every year) and 5% in US.

As per the policy of GOI, only 50% of the share can be remitted in the year in which they are realised and remaining in the following year.

Though WACC of Perfect Inc. is 13% but due to risky nature of the project it expects a return of 15%.

Determine whether Perfect Inc. should invest in the project or not (from subsidiary point of view). **(10 Marks)**

(b) A Mutual Fund is holding the following assets in ₹ Crores :

Investments in diversified equity shares	90.00
Cash and Bank Balances	10.00
	100.00

The Beta of the equity shares portfolio is 1.1. The index future is selling at 4300 level. The Fund Manager apprehends that the index will fall at the most by 10%. How many index futures he should short for perfect hedging? One index future consists of 50 units.

Substantiate your answer assuming the Fund Manager's apprehension will materialize. **(4 Marks)**

6. (a) Details about portfolio of shares of an investor is as below:

Shares	No. of shares (lakh)	Price per share	Beta
A Ltd.	3.00	₹ 500	1.40
B Ltd.	4.00	₹ 750	1.20
C Ltd.	2.00	₹ 250	1.60

The investor thinks that the risk of portfolio is very high and wants to reduce the portfolio beta to 0.91. He is considering two below mentioned alternative strategies:

(i) Dispose off a part of his existing portfolio to acquire risk free securities, or

(ii) Take appropriate position on Nifty Futures which are currently traded at 8125 and each Nifty points is worth ₹ 200.

You are required to determine:

(1) portfolio beta,

(2) the value of risk free securities to be acquired,

(3) the number of shares of each company to be disposed off,

(4) the number of Nifty contracts to be bought/sold **(8 Marks)**

(b) A textile manufacturer has taken floating interest rate loan of ₹ 40,00,000 on 1st April, 2012. The rate of interest at the inception of loan is 8.5% p.a. interest is to be paid every year on 31st March. In the month of October 2012, the Central bank of the country releases following projections about the interest rates likely to prevail in future.

(i) On 31st March, 2013, at 8.75%; on 31st March, 2014 at 10% on 31st March, 2015 at 10.5% and on 31st March, 2016 at 7.75%. Show how the borrower can hedge the risk using Option Cap arising out of expected rise in the rate of interest when he wants to peg his interest cost at 8.50% p.a.

(ii) Assume that the premium negotiated by both the parties is 0.75% to be paid at once on 1st October, 2012 and the actual rate of interest on the respective due dates happens to be as: on 31st March, 2013 at 10.2%; on 31st March, 2014 at 11.5%; on 31st March, 2015 at 9.25%; on 31st March, 2016 at 8.25%. Show how the settlement will be executed on the perspective interest due dates. **(6 Marks)**

MODEL TEST PAPER 6

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

Part I is compulsory.

Case Scenario I

Mr. Y has invested in the three mutual funds (MF) as per the following details:

Particulars	MF 'X'	MF 'Y'	MF 'Z'
Amount of Investment (₹)	4,00,000	8,00,000	4,00,000
Net Assets Value (NAV) at the time of purchase (₹)	10.30	10.10	10
Dividend Received up to 31.03.2023 (₹)	9,000	0	6,000
NAV as on 31.03.2023 (₹)	10.35	10	10.30
Effective Yield per annum as on 31.03.2023 (percent)	9.66	-11.66	24.15

Assume 1 Year = 365 days

On the basis of above information, choose the most appropriate answer to the following questions:

1. Total NAV of MF 'Y' as on 31.03.2023 would be approximately ……………
   (a) ₹ 401941.73
   (b) ₹ 412000.00
   (c) ₹ 792079.20
   (d) ₹ 82500.00
2. Total Yield of MF 'X' in terms of ₹ would be approximately ……………..
   (a) ₹ 10941.73
   (b) ₹ 7,920.80

(c) ₹ 18,000.00

(d) ₹ 12450.45

3. Number of days for which MF 'X' is held would be approximately............

(a) 31 Days

(b) 68 Days

(c) 103 Days

(d) 85 Days

4. Number of days for which MF 'Y' is held would be............

(a) 31 Days

(b) 68 Days

(c) 103 Days

(d) 85 Days **(4 x 2 = 8 Marks)**

Case Scenario II

The data given below relates to a convertible bond:

Face value	₹ 450
Coupon rate	15%
No. of shares per bond	25
Market price of share	₹ 20
Straight value of bond	₹ 400
Market price of convertible bond	₹ 550

From the information given above, choose the correct answer to the following questions:

5. The stock value of bond would be ....

(a) ₹ 500

(b) ₹ 400

(c) ₹ 550

(d) ₹ 450

6. The percentage of downside risk based on market price of convertible bond is............

(a) 10%

(b) 27.27%

(c) 18.18%

(d) 11.11%

7. The conversion premium is ………….

(a) 10%

(b) 27.27%

(c) 18.18%

(d) 11.11%

8. The conversion parity price of the stock is …………..

(a) ₹ 25

(b) ₹ 20

(c) ₹ 22

(d) ₹ 24 **(4 x 2 = 8 Marks)**

Case Scenario III

Suppose you are a financial consultant and following 3 clients have approached to you seeking advise on the investment to be made in securities. All these clients have different background and risk appetite as well as perception to the market.

❖ Client A wants to invest in Fixed income avenues and therefore he is looking at the credit rating of the securities as well as financial ratios such as interest coverage, earning power etc and the general prospect of the industry.

❖ Client B wants to earn a fixed income over a period of time by holding the security till its maturity.

❖ Client C wants to earn more by taking more risk. Therefore, he is more interested to invest in stocks. He believes that Price reflects all information found in the record of past prices and volumes.

On the basis of above information, choose the most appropriate answer to the MCQs.

9. The main factor to be considered in selecting fixed income avenue for client A shall be……………….

   (a) Yield to maturity

   (b) Risk of Default

   (c) Tax Shield

   (d) Liquidity

10. The main factor that have to be evaluated in the selection of Bond for Client B shall be……………….

    (a) Yield to maturity

    (b) Risk of Default

    (c) Tax Shield

    (d) Liquidity

11. If Weak form efficiency is prevailing in the market then which approach is best for selection of Equity Shares?

    (a) Technical Analysis

    (b) Fundamental Analysis

    (c) Random selection Analysis

    (d) None of the above. **(3 x 2 = 6 Marks)**

Case Scenario IV

AES Ltd. wants to acquire DNF Ltd. and has offered a swap ratio of 1:2 (0.5 shares for every one share of DNF Ltd.). Following information is provided:

	AES Ltd.	**DNF Ltd.**
Profit after tax	₹ 36,00,000	₹ 7,20,000
Equity shares outstanding (Nos.)	12,00,000	3,60,000
PE Ratio	10 times	7 times
Market price per share	₹ 30	₹ 14

On the basis of above information, choose the most appropriate answer to the following questions:

12. The number of equity shares to be issued by AES Ltd. for acquisition of DNF Ltd. would be………………

(a) 1,68,000

(b) 1,80,000

(c) 2,40,000

(d) 3,00,000

13. The EPS of AES Ltd. after the acquisition would be………………

(a) ₹ 2

(b) ₹ 3

(c) ₹ 3.13

(d) ₹ 4.00

14. The equivalent earnings per share of DNF Ltd. would be……….

(a) ₹ 1

(b) ₹ 1.50

(c) ₹ 1.57

(d) ₹ 2.00

15. If AES Ltd. PE multiple remains unchanged then its expected market price per share after the acquisition would be………………

(a) ₹ 14

(b) ₹ 30

(c) ₹ 31.30

(d) ₹ 40.00 **(4 x 2 = 8 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to answer any four questions from the remaining five questions.

Working notes should form part of the answers.

Maximum Marks – 70 Marks

1. (a) XYZ Ltd. an Indian firm needs to pay JAPANESE YEN (JY) 1 crore on 30th June. In order to hedge the risk involved in foreign currency transaction, the firm is considering two alternative methods i.e.

forward market cover and currency option contract.

On 1st April, following quotations (JY/INR) are made available:

Spot	3 months forward
1.7825/1.8245.	1.8726./1.8923

The prices for forex currency option on purchase are as follows:

Strike Price	JY 1.8855
Call option (June)	JY 0.047
Put option (June)	JY 0.098

For excess or balance of JY covered, the firm would use forward rate as future spot rate.

You are required to recommend cheaper hedging alternative for XYZ LTD.

Note: Except rates round off other calculations to nearest rupees.

(6 Marks)

(b) The expected returns and Beta of three stocks are given below

Stock	A	B	C
Expected Return (%)	20	13	17
Beta Factor	1.9	0.8	1.4

If the risk-free rate is 9% and the expected rate of return on the market portfolio is 14%, examine which of the above stocks are over, under or correctly valued in the market? What shall be the strategy? **(4 Marks)**

(c) What do you mean by the term Unicorn? State the features a Start-up should possess to be referred as a Unicorn? **(4 Marks)**

2. (a) DK Ltd. is considering an investment proposal in Sri Lanka involving an initial investment of LKR 25 billion. The current spot exchange rate is INR/LKR 0.370. The risk free rate in India is 6% and the same in Sri Lanka is 5.02%.

The project will generate a cash flow of LKR 5 billion in the first year. The cash flow will increase by LKR 1 billion each year for the next

4 years. The project will wind up on completion of 5 years with no salvage value. The required rate of return for the project is 8%

(i) You are required to find out the investment worth of the project by using

(1) Home Currency Approach

(2) Foreign Currency Approach

(ii) Compare the outcome under both the approaches.

Given:

PVIF (8%, t)	0.92593	0.85734	0.79383	0.73503	0.68058
PVIF (7%, t)	0.93457	0.87344	0.81630	0.76290	0.71299

Note: Excepts rates show all calculations in Billion upto four decimal points. **(6 Marks)**

(b) On the basis of the following information:

Current dividend (Do) = ₹ 5

Discount rate (k) = 10.5%

Growth rate (g) = 4%

(i) Calculate the present value of stock of ABC Ltd.

(ii) Evaluate whether the stock is overvalued if stock price is ₹ 70, ROE = 18% and EPS (E_0) = ₹ 4.50 applying:

(1) PE Multiple Approach and

(2) Earning Growth Model (using discount rate of 10.5%).

(4 Marks)

(c) Explain the concept of Sustainable Growth Rate and also state assumptions of Sustainable growth model. **(4 Marks)**

3. (a) Mr. X is interested in investing ₹ 4,00,000 for which he is considering following three alternatives:

(i) Invest ₹ 4,00,000 in Security A

(ii) Invest ₹ 4,00,000 in Security B

(iii) Invest ₹ 2,40,000 in Security A and ₹ 1,60,000 in Security B

Average annual return earned on Security A and Security B is 15% and 14% respectively. Risk free rate of return is 10% and Market Rate of Return is 12%.

Covariance of returns of Security A , Security B and Market portfolio are as follows:

	Security A	Security B	Market
Security A	4.800	4.300	3.370
Security B	4.300	4.250	2.800
Market	3.370	2.800	3.100

On the basis of above information evaluate the following:

(i) Expected Return of Security A, B and Portfolio.

(ii) Variance of return of Security A, Security B and Market.

(iii) Variance and Standard Deviation of Portfolio.

(iv) Systematic and Unsystematic Risks of Security A, Security B and Portfolio. **(10 Marks)**

(b) Either

Tokenization to some extent resembles the process of Securitization. Explain the term "Tokenization" and also illustrate the similarities between Tokenization and Securitization. **(4 Marks)**

(b) Or

While in securitization the securities issued by SPV are backed by the loans and receivables the CDOs are backed by pool of bonds, asset backed securities, REITs, and other CDOs. Describe the main types of risk associated with investment in CDOs. **(4 Marks)**

4. (a) ABC Ltd. has ₹ 600 million, 12 per cent bonds outstanding with six years remaining to maturity. Since interest rates are falling, ABC Ltd. is contemplating of refunding these bonds with a ₹ 600 million issue of 6 year bonds carrying a coupon rate of 10 per cent. Issue cost of the new bond will be ₹ 12 million and the call premium is 4 per cent. ₹ 18 million being the unamortized portion of issue cost of old bonds can be written off no sooner the old bonds are called off. Marginal tax rate of ABC Ltd. is 30 per cent. Examine the bond refunding decision.

[PVIFA (7%, 6 years) = 4.766]

Note: Carry out calculations in ₹ Million and round off calculations upto 4 decimal points. **(6 Marks)**

(b) Mr. A established the following strategy on the stock of D Ltd. which is currently trading at ₹ 1000 per share:

(1) Purchased one 3-month call option with a premium of ₹ 60 at an exercise price of ₹ 1100 per share.

(2) Purchased one 3-month put option with a premium of ₹ 10 at an exercise price of ₹ 900 per share.

Appraise the position of Mr. A if after 3-months the price of D Ltd. stock:

(i) remains at ₹ 1000.

(ii) falls at ₹ 700.

(iii) rises to ₹ 1300.

Assume the option size is 100 shares of D Ltd. **(4 Marks)**

(c) List out the areas where the concept of Value at Risk (VAR) can be applied? **(4 Marks)**

5. (a) Following information is given in respect of Alpha Ltd., which is expected to grow at a rate of 20% p.a. for the next three years, after which the growth rate will stabilize at 8% p.a. normal level, in perpetuity.

	For the year ended March 31, 2023
Revenues	₹ 15,000 Crores
Cost of Goods Sold (COGS)	₹ 6,000 Crores
Operating Expenses	₹ 4,500 Crores
Capital Expenditure	₹ 1,500 Crores
Depreciation (included in Operating Expenses)	₹ 1,200 Crores

During high growth period, Revenues & Earnings before Interest & Tax (EBIT) will grow at 20% p.a. and capital expenditure net of depreciation will grow at 15% p.a.

From year 4 onwards, i.e. normal growth period revenues and EBIT will grow at 8% p.a. and incremental capital expenditure will be offset by the depreciation. During both high growth & normal growth period, net working capital requirement will be 25% of revenues.

Out of total capital, 60% constitute Equity and rest is Debt. The cost of equity is 17.53% and pre-tax cost of debt is 16%.

Corporate Income Tax rate is 30%.

Required:

Estimate the value of Alpha Ltd. using Free Cash Flows to the Firm (FCFF).

The PVIF @ 15 % for the three years are as below:

Year	t_1	t_2	t_3
PVIF	0.8696	0.7561	0.6575

Note: Carry out calculation in ₹ Crore and round off figures upto two decimal points. **(8 Marks)**

(b) A trader is having in its portfolio shares worth ₹ 170 lakhs at current price and cash ₹ 30 lakhs. The beta of share portfolio is 1.6.

Evaluate:

(i) Current portfolio beta

(ii) Portfolio beta after 3 months if the trader on current date goes for long position on ₹ 200 lakhs Nifty futures and after 3 months the price of shares dropped by 3.2%. **(6 Marks)**

6. (a) Suppose a dealer quotes 'All-in-cost' for a generic swap at 8% against six-month MIBOR flat. If the notional principal amount of swap is ₹ 10,00,000.

(i) Calculate semi-annual fixed payment.

(ii) Produce the first floating rate payment for (i) above if the six month period from the effective date of swap to the settlement date comprises 181 days and that the corresponding MIBOR was 6% on the effective date of swap.

In (ii) above, if the settlement is on 'Net' basis, how much the fixed rate payer would pay to the floating rate payer?

Generic swap is based on 30/360 days basis. **(6 Marks)**

(b) The Textile Manufacturing Company Ltd. is considering one of two mutually exclusive proposals, Projects M and N, which require cash outlays of ₹ 17,00,000 and ₹ 16,50,000 respectively. The certainty-equivalent (C.E) approach is used in incorporating risk in capital budgeting decisions. The current yield on Treasury bond is 6%. The expected net cash flows and their respective certainty equivalents are as follows:

Project M			Project N	
Year-end	**Cash Flow ₹**	**C.E.**	**Cash Flow ₹**	**C.E.**
1	9,00,000	0.8	9,00,000	0.9
2	10,00,000	0.7	9,00,000	0.8
3	10,00,000	0.5	10,00,000	0.7

Present value factors of ₹ 1 discounted at 6% at the end of year 1, 2 and 3 are 0.943, 0.890 and 0.840 respectively.

Required:

(i) Recommend which project should be accepted?

(ii) Suppose if risk adjusted discount rate method is to be used for evaluation then which project would be appraised with a higher discount rate and why? **(8 Marks)**

MODEL TEST PAPER - 7

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

Part I is compulsory.

Case Scenario I

AES Ltd. wants to acquire DNF Ltd. and has offered a swap ratio of 1:2 (0.5 shares for every one share of DNF Ltd.). Following information is provided:

	AES Ltd.	DNF Ltd.
Profit after tax	₹ 36,00,000	₹ 7,20,000
Equity shares outstanding (Nos.)	12,00,000	3,60,000
PE Ratio	10 times	7 times
Market price per share	₹ 30	₹ 14

From the information given above, choose the correct answer to the following questions:

1. The number of equity shares to be issued by AES Ltd. for acquisition of DNF Ltd. would be………………
   (a) 1,68,000
   (b) 1,80,000
   (c) 2,40,000
   (d) 3,00,000
2. The EPS of AES Ltd. after the acquisition would be………………
   (a) ₹ 2
   (b) ₹ 3
   (c) ₹ 3.13

(d) ₹ 4.00

3. The equivalent earnings per share of DNF Ltd. would be...........

(a) ₹ 1

(b) ₹ 1.50

(c) ₹ 1.57

(d) ₹ 2.00

4. If AES Ltd. PE multiple remains unchanged then its expected market price per share after the acquisition would be.................

(a) ₹ 14

(b) ₹ 30

(c) ₹ 31.30

(d) ₹ 40.00

5. If AES Ltd. PE multiple remains unchanged then, the market value of the merged firm would be.........

(a) ₹ 4,14,00,000

(b) ₹ 4,88,28,000

(c) ₹ 3,75,60,000

(d) ₹ 4,31,94,000 **(5 x 2 = 10 Marks)**

Case Scenario II

On 1 October 2023 Mr. X an exporter enters into a forward contract with a BNP Bank to sell US$ 1,00,000 on 31 December 2023 at ₹ 85.40/$. However, due to the request of the importer, Mr. X received the amount on 28 November 2023. Mr. X requested the bank the take delivery of the remittance on 30 November 2023 i.e., before due date. The inter-banking rates on 28 November 2023 was as follows:

Spot	₹ 85.22/85.27
One Month Premium	10/15

Note: (1) Consider 365 days in a year.

(2) Prevailing Prime Lending Rate is 12%

Based on above case scenario, choose the most appropriate answer of the following:

6. The bank may accept the request of customer of delivery before due date of forward contract provided the customer is ready to bear the loss if any consisting of…………

   (a) Swap Difference

   (b) Interest on Outlay of Fund

   (c) Swap Difference Plus Interest on Outlay of Fund

   (d) Fixed Charges Plus Swap Difference and Interest on Outlay of Fund

7. In case of early delivery bank shall charge interest on outlay of fund at a rate not less than……………..

   (a) 8%

   (b) 10%

   (c) 12%

   (d) 18%

8. Swap Difference for US$ 1,00,000 is………………..

   (a) ₹ 5,000

   (b) ₹ 20,000

   (c) ₹ 18,000

   (d) ₹ 8,000

9. Interest on outlay of funds shall be approximately…………………..

   (a) ₹ 92 payable by X

   (b) ₹ 183 payable by X

   (c) ₹ 183 payable by Bank

   (d) ₹ 122 payable by Bank

10. Net inflow to Mr. X is approximately……………..

   (a) ₹ 85,42,183

   (b) ₹ 85,20,000

   (c) ₹ 85,19,817

(d) ₹ 85,40,000 **(5 x 2 = 10 Marks)**

Case Scenario III

A US parent company has subsidiaries in France, Germany, UK and Italy. The amounts due to and from the affiliates is converted into a common currency viz. US dollar and entered in the following matrix.

Inter Subsidiary Payments Matrix **(US $ Thousands)**

		Paying affiliate				
		France	Germany	UK	Italy	**Total**
Receiving affiliate	France	---	80	120	200	400
	Germany	120	---	80	160	360
	UK	160	120	---	140	420
	Italy	200	60	120	---	380
	Total	480	260	320	500	**1560**

The treasurer of US Parent company is suggesting that by applying Multilateral Netting system the company can save a lot of transfer/ exchange costs. The company's Board agreed with Treasurer's proposal.

From the above case scenario, choose the most appropriate answer of following MCQs.

11. Before applying Multilateral Netting it is necessary to apply..................
    - (a) Unilateral Netting
    - (b) Bilateral Netting
    - (c) Multilateral Netting
    - (d) Interest Rate Swapping

12. Through Multinational Netting these transfers will be reduced to ....
    - (a) $ 50,000
    - (b) $ 100,000
    - (c) $ 150,000
    - (d) $ 200,000

13. The Net Payment/ Net Receipts for France after netting off shall be…………….

    (a) Net Receipt $ 40,000

    (b) Net Payment $ 80,000

    (c) Net Payment $ 40,000

    (d) Net Receipt $ 80,000

14. The Net Payment/ Net Receipts for Italy after netting off shall be…………….

    (a) Net Receipt $ 60,000

    (b) Net Payment $ 120,000

    (c) Net Payment $ 60,000

    (d) Net Receipt $ 120,000

15. Suppose if the transfer charges are 0.01% of the amount transferred then by applying multilateral netting techniques there will be reduction in overall cost of transfer by …………..

    (a) US $ 136

    (b) US $ 156

    (c) US $ 1,360

    (d) US $ 1,560 **(5 x 2 = 10 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to answer any four questions from the remaining five questions.

Working notes should form part of the answers.

Maximum Marks – 70 Marks

1. (a) You as an investor had purchased a 4-month call option on the equity shares of ABC Ltd. of ₹ 10, of which the current market price is ₹ 660 per share and the exercise price ₹ 750. You expect the price to range between ₹ 600 to ₹ 950. The expected share price of ABC Ltd. and related probability is given below:

Expected Price (₹)	600	700	800	900	950
Probability	0.05	0.20	0.50	0.10	0.15

Evaluate the following:

(i) Expected Share price at the end of 4 months.

(ii) Value of Call Option at the end of 4 months if the exercise price prevails.

(iii) In case the option is held to its maturity, estimate expected value of the call option? **(6 Marks)**

(b) Share of Beta Ltd. is being quoted at a Price-Earning ratio of 10 times. In the coming year the company is expected to retain ₹ 10 per share which is 45% of its Earning Per Share.

You are required to evaluate:

(i) The cost of equity to the company if the market expects a growth rate of 10% p.a.

(ii) If the anticipated growth rate is 12% per annum, calculate the indicative market price with the same cost of capital.

(4 Marks)

(c) Why is there a need for succession planning in business? Explain.

(4 Marks)

2. (a) On January 28, 2023, an importer customer requested a Bank to remit Singapore Dollar (SGD) 2,500,000 under an irrevocable Letter of Credit (LC). However, due to unavoidable factors, the Bank could affect the remittances only on February 4, 2023. The inter-bank market rates were as follows:

		January 28, 2023	February 4, 2023
US$ 1=		₹ 80.91/80.97	₹ 80.85/80.90
GBP £ 1	=	US$ 1.7765/1.7775	US$ 1.7840/1.7850
GBP £ 1	=	SGD 2. 1380/2.1390	SGD 2.1575/2.1590

The Bank wishes to retain an exchange margin of 0.125% on ₹/ SGD.

Required:

Estimate how much does the customer stand to gain or lose due to the delay?

(Note: Calculate the rate in multiples of 0.0001) **(6 Marks)**

(b) Bank A enter into a Repo for 14 days with Bank B in 10% Government of India Bonds 2028 @ 5.65% for ₹ 8 crore. Assuming that clean price (the price that does not have accrued interest) be ₹ 99.42 and initial Margin be 3% and days of accrued interest be 272 days.

You are required to calculate:

(i) Dirty Price

(ii) Approximate Repayment amount at maturity.

Note: (1) Consider 360 days in a year.

(2) Round off calculations upto 2 decimals points. **(4 Marks)**

(c) What are the parameters to identify currency risk? List out the ways to minimize such risk. **(4 Marks)**

3. (a) Suppose that economy A is growing rapidly, and you are managing a global equity fund and so far you have invested only in developed-country stocks only. Now you have decided to add stocks of economy A to your portfolio. The table below shows the expected rates of return, standard deviations, and correlation coefficients (all estimates are for aggregate stock market of developed countries and stock market of Economy A).

	Developed Country Stocks	**Stocks of Economy A**
Expected rate of return (annualized percentage)	20	30
Risk [Annualized Standard Deviation (%)]	16	30
Correlation Coefficient (ρ) between stock of two economies	0.30	

Assuming the risk-free interest rate to be 6%, you are required to determine:

(i) What percentage of your portfolio should you allocate to stocks of Economy A if you want to increase the expected rate of return on your portfolio by 1%?

(ii) What will be the standard deviation of your portfolio assuming that stocks of Economy A are included in the portfolio as calculated above?

(iii) Also show how well the Fund will be compensated for the risk undertaken due to inclusion of stocks of Economy A in the portfolio? **(6 Marks)**

(b) An investor has two portfolios known to be on minimum variance set for a population of three securities X, Y and Z having below mentioned weights:

	WX	WY	WZ
Portfolio A	0.30	0.40	0.30
Portfolio B	0.20	0.50	0.30

Calculate the weight for each stock for a portfolio constructed by investing ₹ 10,00,000 in portfolio A and ₹ 6,00,000 in portfolio B.

(4 Marks)

(c) Either

Briefly explain Blockchain transaction. List the risks associated with Blockchain. **(4 Marks)**

(c) **Or**

Explain briefly the financial measures that help in evaluation of performance of any Mutual Fund. **(4 Marks)**

4. (a) Your client is holding the following securities:

Particulars of Securities	Cost	Dividends/Interest	Market price at the end of holding period	Beta
	₹	₹	₹	
Equity Shares:				
G Ltd.	20,000	1,450	19,600	0.6

S Ltd.	30,000	1,000	30,400	0.8
B Ltd.	28,000	1,400	32,000	0.6
GOI Bonds	72,000	5,060	71,980	0.01

Evaluate:

(i) Risk free rate of return.

(ii) Expected rate of return of each security (except GOI Bond), using the Capital Asset Pricing Model (CAPM).

Note: (1) Use weighted average Beta in calculations.

(2) Round off calculations upto 3 decimal points. **(6 Marks)**

(b) XYZ Plan, a hedge fund currently has assets of ₹ 40 crore. Mr. A, the manager of fund charges fee of 0.10% of portfolio asset. In addition to it he charges an incentive fee of 2%. The incentive will be linked to gross return each year in excess of the portfolio maximum value since the inception of fund. The maximum value the fund achieved so far since inception of fund about one and half year ago was ₹ 42 crores.

Evaluate:

(i) Benchmark Return to make Mr. A eligible for incentive fee.

(ii) The fee payable to Mr. A if return on the fund this year turns out to be :

(1) 29% (2) 4.5% **(4 Marks)**

(c) What do you mean by Corporate Level Strategy. Also explain three basic questions Corporate Level Strategy should be able to answer.

(4 Marks)

5. (a) T plc wants to acquire L plc. The balance sheet of L plc as on 31st March 2022 is as follows:

Liabilities	£	Assets	£
Equity Capital (35,00,000 shares)	35,00,000	Cash	2,50,000
Retained earnings	15,00,000	Debtors	3,50,000
12% Debentures	15,00,000	Inventories	10,00,000

Creditors and other liabilities	16,00,000	Plants & Eqpt.	65,00,000
	81,00,000		81,00,000

Additional Information:

(i) Shareholders of L plc will get one share in T plc for every two shares. External liabilities are expected to be settled at £ 2.50 Million. Shares of T plc would be issued at its current price of £ 1.50 per share. Debenture holders will get 13% convertible debentures in the purchasing company for the same amount. Debtors and inventories are expected to realize £ 1 Million.

(ii) T plc has decided to operate the business of L plc as a separate division. The division is likely to give cash flows (after tax) to the extent of £ 2.50 Million per year for 6 years. T plc has planned that, after 6 years, this division would be demerged and disposed of for £ 1 Million.

(iii) The company's cost of capital is 16%.

Advise the Board of the company about the financial feasibility of this acquisition.

Net present values for 16% for £ 1 are as follows:

Years	1	2	3	4	5	6
PV	0.862	0.743	0.641	0.552	0.476	0.410

(6 Marks)

(b) A mutual fund company introduces two schemes i.e. Dividend plan (Plan-D) and Bonus plan (Plan-B). The face value of the unit is ₹ 10. On 1-4-2018 Mr. K invested ₹ 2,00,000 each in Plan-D and Plan-B when the NAV was ₹ 38.20 and ₹ 35.60 respectively. Both the plans matured on 31-3-2023.

Particulars of dividend and bonus declared over the period are as follows:

Date	**Dividend %**	**Bonus Ratio**	**Net Asset Value (₹)**	
			Plan D	**Plan B**
30-09-2018	10	---	39.10	35.60

30-06-2019	---	1:5	41.15	36.25
31-03-2020	15	---	44.20	33.10
15-09-2021	13	---	45.05	37.25
30-10-2021	---	1:8	42.70	38.30
27-03-2022	16	---	44.80	39.10
11-04-2022	---	1:10	40.25	38.90
31-03-2023	---	---	40.40	39.70

Evaluate the Effective Yield Per Annum in respect of the above two plans.

Note:

1. Use following PV Factors:

   PVIF (2%,5) = 0.9057, PVIF (4%,5) = 0.8219, PVIF (8%,5) = 0.6806, PVIF (13%,5) = 0.5428

2. Round off calculations upto 2 decimal points. **(8 Marks)**

6. (a) R Ltd. is considering a project with the following Cash flows:

in ₹

Years	Cost of Plant	Recurring Cost	Savings
0	20,000		
1		8,000	24,000
2		10,000	28,000

The cost of capital is 9%.

Evaluate the sensitivity of the project in respect of all factors except time such that:

(i) NPV become zero and

(ii) adversely varying factors value by 10%.

The P.V. factor at 9% are as under:

Year	Factor
0	1
1	0.917
2	0.842

Note: Round off calculation upto 2 decimal points. **(8 Marks)**

(b) Bank entered a plain vanilla swap through on OIS (Overnight Index Swap) on a principal of ₹ 20 crores and agreed to receive MIBOR overnight floating rate for a fixed payment on the principal. The swap was entered into on Monday, 2nd August 2020 and was to commence on 3rd August 2020 and run for a period of 7 days.

Respective MIBOR rates for Tuesday to Monday were:

7.75%, 8.15%, 8.12%, 7.95%, 7.98% and 8.15%.

If Bank received ₹ 634 net on settlement, calculate the applicable Fixed rate for the same swap period.

Notes:

(i) Sunday is Holiday.

(ii) Work in rounded rupees and avoid decimal working.

(iii) Consider 365 days a year. **(6 Marks)**

MODEL TEST PAPER 8

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

Part I is compulsory.

Case Scenario I

Bank A is in need of fund for a period of 14 days. To meet this financial need on 20th September 2023 Bank A enters into an agreement with Bank B under which it will sell 10% Government of India Bonds issued on 1st January 2023 @ 5.65% for ₹ 8 crore (Face value is ₹ 10,000 per Bond).

The clean price of same Bond is ₹ 9,942 and the Initial Margin be 2% and the maturity date of Bond is 31st December 2028. Consider 360 days in a year and interest is payable annually.

Based on above Case Scenario, answer the following questions:

1. The arrangement entered between Bank A and Bank B will be called ……….
   - (a) Call Money Arrangement
   - (b) Commercial Bill Arrangement
   - (c) Commercial Paper
   - (d) Repurchase Option
2. Dirty Price of the Bond will approximately be………………………
   - (a) ₹ 10,353
   - (b) ₹ 10,670
   - (c) ₹ 10,499

(d) ₹ 10,816

3. The start proceeds of the transaction shall be approximately ……………….

 (a) ₹ 8,38,36,804

 (b) ₹ 8,36,53,000

 (c) ₹ 8,58,36,804

 (d) ₹ 8,48,52,585

4. The second leg of the transaction shall be approximately……………….

 (a) ₹ 8,38,36,804

 (b) ₹ 8,36,53,000

 (c) ₹ 8,58,36,804

 (d) ₹ 8,48,52,585

5. The amount of Accrued Interest per Bond shall be approximately ……………

 (a) ₹ 728

 (b) ₹ 720

 (c) ₹ 734

 (d) ₹ 714 **(5 x 2 = 10 Marks)**

Case Scenario II

The Asset Management Company of the mutual fund (MF) has declared a dividend of 9.98% on the units under the dividend reinvestment plan for the year ended 31st March 2021. The investors are issued additional units for the dividend at the rate of closing Net Asset Value (NAV) for the year as per the conditions of the scheme.

The closing NAV was ₹ 24.95 as on 31st March 2021. An investor Mr. X who is having 20,800 units at the year-end has made an investment in the units before the declaration of the dividend at the rate of opening NAV plus an entry load of ₹ 0.04. The NAV has appreciated by 25% during the year.

Assume the face value of the unit as ₹ 10.00.

Based on above Case Scenario, answer the following questions:

6. The Opening NAV of the Asset Management Company shall be ....

   (a) ₹ 20.24

   (b) ₹ 19.96

   (c) ₹ 18.75

   (d) ₹ 17.65

7. The Number of the units purchased shall be ....

   (a) 18750

   (b) 17500

   (c) 20450

   (d) 20000

8. Original amount of the investment shall be ....

   (a) ₹ 4,00,000

   (b) ₹ 6,50,000

   (c) ₹ 3,55,000

   (d) ₹ 5,65,000

9. Which of the following statement about Expense ratio is/ are incorrect:

   (i) It is the percentage of income that were spent to run a mutual fund.

   (ii) It includes advisory fees, travel costs, registrar fees, custodian fees, etc.

   (iii) It includes Brokerage costs for trading of Portfolio.

   (iv) High Expense Ratio can seriously undermine the performance of a mutual fund scheme.

   (a) (i), (ii), (iii)

   (b) (i), (iii)

   (c) only (iii)

   (d) only (i)

10. …………………considers and uses downside deviation instead of total standard deviation in denominator.

    (a) Expense Ratio

    (b) Sharpe Ratio

    (c) Treynor Ratio

    (d) Sortino Ratio **(5 x 2 = 10 Marks)**

Case Scenario III

You as an investor had purchased a 4-month European Call Option on the equity shares of X Ltd. for ₹ 10, of which the current market price is ₹ 132 per share and the exercise price ₹ 150. You expect the price to range between ₹ 120 to ₹ 190. The expected share price of X Ltd. and related probability is given below:

Expected Price (₹)	120	140	160	180	190
Probability	0.05	0.20	0.50	0.10	0.15

Based on above case scenario answer the following questions:

11. Expected price of share of X Ltd. at the end of 4 months shall be…….

    (a) ₹ 160.00

    (b) ₹ 160.50

    (c) ₹ 158.00

    (d) ₹ 140.00

12. Suppose if the exercise price prevails at the end of 4 months the Value of Call Option shall be………..

    (a) ₹ 0

    (b) ₹ 18

    (c) ₹ 10

    (d) ₹ 14

13. In case the option is held to its maturity, the expected value of the call option shall be……………

    (a) ₹ 0

    (b) ₹ 18

(c) ₹ 10

(d) ₹ 14

14. In the given different scenarios of expected prices of share of X Ltd. at the time of maturity the option shall be in-the-money in .... scenarios.

(a) two

(b) three

(c) five

(d) In none of the scenario

15. In the given different scenarios of expected prices of share of X Ltd. at the time of maturity the option shall be at-the-money in .... scenarios.

(a) two

(b) three

(c) five

(d) In none of the scenario **(5 x 2 = 10 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to answer any four questions from the remaining five questions.

Working notes should form part of the answers.

Maximum Marks – 70 Marks

1. (a) On Tuesday morning (before opening of the capital market) an investor, while going through his bank statement, has observed that an amount of ₹ 7 lakhs is lying in his bank account. This amount is available for use from Tuesday till Friday. The Bank requires a minimum balance of ₹ 1000 all the time. The investor desires to take a maximum possible exposure in the market where Value at Risk (VaR) should not exceed the balance lying in his bank account. The standard deviation of index of the same market is 1.5 per cent per day. The required confidence level is 99 per cent.

Given

Standard Normal Probabilities										
z	0.00	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09
2.2	.9861	.9864	.9868	.9871	.9875	.9878	.9881	.9884	.9887	.9890
2.3	.9893	.9896	.9998	.9901	.9904	.9906	.9909	.9911	.9913	.9916
2.4	.9918	.9920	.9922	.9923	.9925	.9929	.9931	.9932	.9934	.9936

You are required to determine the maximum possible exposure investor can take in the market. **(8 Marks)**

(b) MNP Ltd. has declared and paid annual dividend of ₹ 4 per share. It is expected to grow @ 20% for the next two years and 10% thereafter. The required rate of return of equity investors is 15%.

Compute the current price at which equity shares should sell.

Note: Use PVF upto 4 decimal points and round off calculation upto 2 decimal points. **(2 Marks)**

(c) Explain the concept of Unicorn. **(4 Marks)**

2. (a) Mr. H as Treasure for your bank working under you sold HK$ 10 million value Spot to your customer at ₹ 10.55/ HK$ and covered yourself in the London market on the same day when the exchange rates were:

US$ 1 = HK$ 7.8880 / 7.8920

Local interbank market rates for US$ were:

Spot US$ 1 = ₹ 82.70 / 82.85

Required:

(i) Calculate Cover Rate

(ii) Calculate Profit or loss in the transaction

(iii) Do you agree with the views of the Internal Auditor that Mr. H has a speculative nature?

Note: Ignore brokerage. **(6 Marks)**

(b) PFL is already in production of Fertilizer is considering a proposal of building a new plant to produce pesticides. The Net Present Value of proposal is ₹ 200 crore without the abandonment option.

However, if market conditions for pesticide turns out to be favourable the NPV of proposal shall increase by 30%. On the other hand, market conditions remain sluggish the NPV of the proposal shall be reduced by 40%. In case company is not interested in continuation of the project it can be disposed of for ₹ 160 crore.

If the risk-free rate of interest is 8% then what will be value of abandonment option. **(4 Marks)**

(c) Explain the various Qualitative factors that need to be taken into account in addition to Quantitative Factors to evaluate the performance of any Mutual Fund. **(4 Marks)**

3. (a) Mr. A owns a portfolio with the following characteristics:

	Security X	**Security Y**	**Risk Free security**
Factor 1 sensitivity (λ_1)	0.80	1.50	0
Factor 2 sensitivity (λ_2)	0.60	1.20	0
Expected Return*	15%	20%	10%

* Generated by a two-factor model.

Required:

(i) Compute the sensitivity of Mr. A's portfolio to the two factors if Mr. A has ₹ 3,00,000 to invest and sells short ₹ 1,50,000 of security Y and purchases ₹ 4,50,000 of security X.

(ii) Compute the sensitivity of the portfolio to the two factors if Mr. A borrows ₹ 3,00,000 at the risk free rate and invests the amount he borrows along with the original amount of ₹ 3,00,000 in security X and Y in the same proportion as described in part (i).

(iii) Suppose Mr. D, one of the friend of Mr. A says the expected return premium of factor 2 is zero. Do you agree with this statement. Substantiate your answer with required calculations. **(6 Marks)**

(b) There is a privately held company X Pvt. Ltd that is operating into the retail space, and is now scouting for angel investors. The unleveraged beta based on the industry in which it operates is 1.8, and the average debt to equity ratio of X Pvt. Ltd. is hovering at 40:60. The rate of return provided by risk free GOI Bonds is 5%. The rate of market return for the industry is 11%. The FCFs for the next 3 years are as follows:

	Year 1	**Year 2**	**Year 3**
Free Cash Flows (₹ Crore)	10	12	15

The pre-tax cost of debt is 12%. Assume a tax regime of 30%.

Determine the potential value to be placed for X Pvt. Ltd, based on above-mentioned FCFs.

Note: Use PVF and round off calculations upto 3 decimal points.

(4 Marks)

(c) **Either**

Explain various types of Swaps. **(4 Marks)**

(c) **Or**

Explain briefly principles of an Active Portfolio Strategy (APS).

(4 Marks)

4. (a) BDR Ltd. is an Indian export business house. The company prepares invoice in customers' currency. It has debtors amounting US$ 10 Million which are due to be received on April 1, 2023.

Market information as at January 1, 2023 is:

Exchange rates US$/INR		**Currency Futures US$/INR**	
Spot	0.012500	Contract size: ₹ 32,816,474	
1-month forward	0.012422	1-month	0.012417

3-months forward	0.012195	3-month	0.012189
	Initial Margin	**Interest rates in India**	
1-Month	₹ 22,500	6.5%	
3-Months	₹ 27,500	7%	

On April 1, 2023, the spot rate US$/INR is 0.012199 and Currency Futures rate is 0.012198.

Advise which of the following methods would be most advantageous to BDR Ltd. or keep the exposure unhedged.

(i) Using forward contract

(ii) Using currency futures. **(8 Marks)**

(b) A convertible bond with a face value of ₹ 5,000 is issued at ₹ 6,750 with a coupon rate of 10.5%. The conversion rate is 14 shares per bond. The current market price of the bond and share is ₹ 7,375 and ₹ 400 respectively.

Determine:

(i) Stock Value of Bond.

(ii) The premium over conversion value. **(2 Marks)**

(c) Although rating agency is secondary to the process of securitization but it plays a vital role. Explain. **(4 Marks)**

5. (a) During the audit of the Weak Bank (W), RBI suggested that the Bank should either merge with another bank or may close down. Strong Bank (S) has submitted a proposal for the merger of Weak Bank with itself. The relevant information and Balance Sheets of both the companies are as follows:

Particulars	Weak Bank (W)	Strong Bank (S)	Assigned Weights (%)
Gross NPA (%)	8	1	30%
Capital Adequacy Ratio (CAR)	5	16	28%
Market price per Share (MPS) (₹)	12	96	32%

Book value			10%
Trading on Stock Exchange	Irregular	Frequent	

Balance Sheets **(₹ in Lakhs)**

Particulars	Weak Bank (W)	Strong Bank (S)
Paid-up Share Capital (₹ 10/share)	300	1000
Reserves & Surplus	160	11000
Deposits	8000	88000
Other Liabilities	1780	5000
Total Liabilities	10240	105000
Cash in Hand & with RBI	800	5000
Balance with Other Banks	-	4000
Investments	2200	38000
Advances	7000	54000
Other Assets	140	4000
Preliminary Expenses	100	-
Total Assets	10240	105000

You are required to prepare the Balance Sheet after the merger duly supported by adequate workings. **(10 Marks)**

(b) The SWIFT plays an important role in Foreign Exchange dealings. Explain. **(4 Marks)**

6. (a) XYZ Ltd. is considering taking up one of the two projects-Project-X and Project-Y. Both the projects having same life require equal investment of ₹ 1600 lakhs each. Both are estimated to have almost the same yield. As the company is new to this type of business, the cash flow arising from the projects cannot be estimated with certainty. An attempt was therefore, made to use probability to analyse the pattern of cash flow from other projects during the first year of operations. This pattern is likely to continue during the life of these projects. The results of the analysis are as follows:

Project X

Cash Flow (in ₹ Lakh)	Probability
220	0.10
260	0.20
300	0.40
340	0.20
380	0.10

Project Y

Cash Flow (in ₹ Lakh)	Probability
180	0.10
260	0.25
340	0.30
420	0.25
500	0.10

Required:

Evaluate which of the two projects bears more risk for every percent of expected return. **(6 Marks)**

(b) The following data pertains to HPS Inc. engaged in software consultancy business as on 31 December 2023:

($ Million)

Income from consultancy	1870.00
EBIT	360.00
Less: Interest on Loan	36.00
EBT	324.00
Tax @ 35%	113.40
	210.60

Balance Sheet ($ Million)

Liabilities	Amount	Assets	Amount
Equity Stock (20 million share @ $ 10 each)	200	Land and Building Computers & Softwares	400 590
Reserves & Surplus	650	Current Assets:	

Loans Current Liabilities	360 360 1570	Debtors 300 Bank 200 Cash 80	 580 1570

With the above information and following assumption you are required to compute

(i) Economic Value Added

(ii) Market Value Added.

Assuming that:

(1) WACC is 12%.

(2) The share of company currently quoted at $ 50 each.

(4 Marks)

(c) Explain Venture Capital Method of valuing Startups. **(4 Marks)**

MODEL TEST PAPER 9

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

Part I is compulsory.

Case Scenario I

Suppose you are a risk manager at a financial institution, and your company has loaned a significant amount of ₹ 500 crore to a company X Ltd. for a period of 3 years at 6-month at MCLR plus 200 bps. You are concerned about X Ltd.'s ability to repay the debt due to recent market volatility. To protect your institution from potential default, you decide to purchase a Credit Default Swap (CDS) from ABC Bank Ltd. for same notional amount at a premium quoted at 1% per year through cash settlement.

On the respective reset dates for the same period actual MCLR interest rate comes out as follows:

Reset	MCLR
1	9.75%
2	10.00%
3	10.25%
4	10.35%
5	10.50%
6	10.60%

Based on above case scenario answer the following questions:

1. The primary purpose of a Credit Default Swap (CDS) is..................

    (a) to increase the value of bonds.

    (b) to protect against default risk of a debt obligation.

(c) to provide guaranteed profit to the buyer.

(d) to create a new form of loan.

2. Which of the following statements is true about CDS contracts?

(a) CDS contracts cannot be used for speculation.

(b) CDS contracts are governed by government regulations.

(c) CDS contracts are private agreements between two parties.

(d) CDS contracts eliminate all risks for the buyer.

3. Which organization publishes the guidelines and rules for conducting Credit Default Swap transactions?

(a) Federal Reserve

(b) International Swap and Derivative Association (ISDA)

(c) Securities and Exchange Commission (SEC)

(d) World Trade Organization (WTO)

4. Assuming no default occurs the total premium your company will pay during the designated loan period shall be........

(a) ₹ 5 crore

(b) ₹ 10 crore

(c) ₹ 15 crore

(d) ₹ 30 crore

5. Suppose if the lender defaults somewhere in the beginning of third year of loan (after payment of interest upto 2 years) and the market value of a reference loans falls to 75% of its par value, then ABC Bank will pay your company ....in a cash settlement.

(a) ₹ 15 crore

(b) ₹ 30 crore

(c) ₹ 125 crore

(d) ₹ 500 crore **(5 x 2 = 10 Marks)**

Case Scenario II

XYZ Ltd. is a mid-sized manufacturing company that produces industrial equipment. The company is considering a new investment project—a state-of-the-art automated production line, which is expected to improve production efficiency. The details of the same project are as follows:

	₹
Initial Cost of the project	10,00,000
Sales price/unit	60
Cost/unit	40
Sales volumes	
Year 1	20000 units
Year 2	30000 units
Year 3	30000 units

The applicable discount rate is 10% p.a.

Based on above case scenario answer the following questions:

6. Sensitivity analysis helps to identify.......................

   (a) the exact profitability of the project

   (c) the break-even point.

   (c) the degree to which a change in each variable affects the NPV.

   (d) The amount of investment required

7. The sale price per unit so that the project would break even with zero NPV shall be approximately..............

   (a) ₹ 40.00

   (b) ₹ 55.28

   (c) ₹ 60.00.

   (d) ₹ 44.74

8. The cost per unit so that the project would break even with zero NPV shall be approximately..............

   (a) ₹ 40.00

   (b) ₹ 55.28

(c) ₹ 60.00.

(d) ₹ 44.74

9. Overall …………in the sale volume will lead to the project to break even with zero NPV.

(a) increase of 23.68%

(b) fall of 23.68%

(c) Increase of 31.03%

(d) fall of 31.03%

10. A/an …………in the initial outlay will lead to the project to break even with zero NPV.

(a) increase of 23.68%

(b) fall of 23.68%

(c) Increase of 31.03%

(d) fall of 31.03% **(5 x 2 = 10 Marks)**

Case Scenario III

You are an investment analyst working for a financial advisory firm. You have been asked to analyze the bond market's yield curve to assist your clients in making investment decisions. The yield curve represents the relationship between the interest rates (yield) and the time to maturity for debt securities, usually government bonds.

For simplicity, assume the following yield data for government bonds over various maturities (measured in years):

Yield Curve Table

Maturity (Years)	Yield (%)
1 Year	3.00%
2 Years	4.00%
3 Years	5.00%
5 Years	6.00%
7 Years	6.40%
10 Years	7.00%

15 Years	7.40%
30 Years	7.60%

Based on above case scenario answer the following questions:

11. The main characteristic of a normal yield curve is……………….

    (a) Short-term yields are higher than long-term yields.

    (b) Short-term yields are lower than long-term yields.

    (c) Yields remain the same across all maturities.

    (d) Yields fluctuate randomly over different maturities.

12. Based on the revised yield data, what is the yield spread between the 10-year bond and the 1-year bond?

    (a) 2.0%

    (b) 3.5%

    (c) 4.0%

    (d) 5.0%

13. An inverted yield curve typically indicates………………

    (a) Economic growth

    (b) Economic uncertainty

    (c) An upcoming recession

    (d) Inflationary pressure

14. If an investor is looking to invest for 2 years starting 3 years from now, the forward rate he would expect shall be………

    (a) 7.41%

    (b) 7.52%

    (c) 7.76%

    (d) 7.93%

15. If an investor is looking to invest for 2 years starting 5 years from now, the forward rate he would expect shall be………

    (a) 7.41%

(b) 7.52%

(c) 7.76%

(d) 7.93% **(5 x 2 = 10 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to answer any four questions from the remaining five questions.

Working notes should form part of the answers.

Maximum Marks – 70 Marks

1. (a) The ABC Startup has the following expected profits under different scenarios along respective probabilities:

Year	Best Case		Base Case		Worst Case	
	Revenue	**Expenses**	**Revenue**	**Expenses**	**Revenue**	**Expenses**
1	₹ 100,00,000	₹ 80,00,000	₹ 100,00,000	₹ 90,00,000	₹ 100,00,000	₹ 95,00,000
2	₹ 120,00,000	₹ 92,40,000	₹ 110,00,000	₹ 95,70,000	₹ 102,00,000	₹ 98,94,000
3	₹ 144,00,000	₹ 108,00,000	₹ 121,00,000	₹ 102,85,000	₹ 104,04,000	₹ 101,95,920
Probability		30%		60%		10%

You are required to suggest the value of ABC Startup using First Chicago Method assuming that:

(i) Applicable discounting rate is 10%.

(ii) Startup is located in Tax-free Zone.

(iii) The multiple for Terminal is 10.

(iv) No depreciable assets are held by the ABC Startup.

Note: 1. Present Value Factor (PVF)

Year	**1**	**2**	**3**
PVF@20%	0.8333	0.6944	0.5787

2. Round off the calculation to whole numbers. **(8 Marks)**

(b) List out the points to be kept in mind while preparing a Pitch Presentation. What are the basic documents that are included in financial projections that make up a business's financial statement.

(6 Marks)

2. (a) Calculate the value of one equity share of X Ltd. from the following Information:

Profit of the company (Before tax)	₹ 8000 crores
Equity share capital of the Company	₹ 19000 crores
No. of Equity Shares	380 crores
Long run growth rate of the company	7%
Risk free Rate of Return	9.50%
Beta of the company	0.1
Market Risk Premium	3.10%
Total Capital expenditure	₹ 20140 crore
Chargeable Depreciation	₹ 17100 crore
Total Increase in working capital	₹ 1755.60 crore
New Debt to be issued for funding	₹ 2062.108 crore
Tax Rate	30%

Note: All calculation to rounded off upto 4 decimal points and final value of equity share to be rounded off upto 2 decimal points.

(6 Marks)

(b) A multinational company is planning to set up a subsidiary company in India (where hitherto it was exporting) in view of growing demand for its product and competition from other MNCs. The initial project cost (consisting of Plant and Machinery including installation) is estimated to be US$ 500 million. The net working capital requirements are estimated at US$ 50 million. The company follows straight line method of depreciation. Presently, the company is exporting two million units every year at a unit price of US$ 80, its variable cost per unit being US$ 40.

The Chief Financial Officer has estimated the following operating cost and other data in respect of proposed project:

(i) Variable operating cost will be US $ 20 per unit of production;

(ii) Additional cash fixed cost will be US $ 30 million p.a. and project's share of allocated fixed cost will be US $ 3 million p.a. based on principle of ability to share;

(iii) Production capacity of the proposed project in India will be 5 million units;

(iv) Expected useful life of the proposed plant is five years with no salvage value;

(v) Existing working capital investment for production & sale of two million units through exports was US $ 15 million;

(vi) Export of the product in the coming year will decrease to 1.5 million units in case the company does not open subsidiary company in India, in view of the presence of competing MNCs that are in the process of setting up their subsidiaries in India;

(vii) Applicable Corporate Income Tax rate is 35%, and

(viii) Required rate of return for such project is 12%.

Assuming that there will be no variation in the exchange rate of two currencies and all profits will be repatriated, as there will be no withholding tax, estimate Net Present Value (NPV) of the proposed project in India.

Present Value Interest Factors (PVIF) @ 12% for five years are as below:

Year	**1**	**2**	**3**	**4**	**5**
PVIF	0.8929	0.7972	0.7118	0.6355	0.5674

(8 Marks)

3. (a) Following are the details of a portfolio consisting of three shares:

Share	**Portfolio weight**	**Beta**	**Expected return in %**	**Total variance**
A	0.20	0.40	14	0.015
B	0.50	0.50	15	0.025
C	0.30	1.10	21	0.100

Standard Deviation of Market Portfolio Returns = 10%

You are given the following additional data:

Covariance (A, B) = 0.030

Covariance (A, C) = 0.020

Covariance (B, C) = 0.040

Calculate the following:

(i) The Portfolio Beta

(ii) Residual variance of each of the three shares

(iii) Portfolio variance using Sharpe Index Model

(iv) Portfolio variance (on the basis of modern portfolio theory given by Markowitz) **(10 Marks)**

(b) **Either**

Explain briefly various types of interest rate risk faced by companies/ banks. **(4 Marks)**

(b) **Or**

Explain the various areas where Blockchain can be applied.

(4 Marks)

4. (a) On 1st April, an open ended scheme of mutual fund had 300 lakh units outstanding with Net Assets Value (NAV) of ₹ 18.75. At the end of April, it issued 6 lakh units at opening NAV plus 2% load, adjusted for dividend equalization. At the end of May, 3 Lakh units were repurchased at opening NAV less 2% exit load adjusted for dividend equalization. At the end of June, 70% of its available income was distributed.

In respect of April-June quarter, the following additional information are available:

	₹ in lakh
Portfolio value appreciation	425.47
Income of April	22.950
Income for May	34.425
Income for June	45.450

You are required to calculate

(i) Income available for distribution;

(ii) Issue price at the end of April;

(iii) repurchase price at the end of May; and

(iv) net asset value (NAV) as on 30th June. **(10 Marks)**

(b) Followings are the spot exchange rates quoted at three different forex markets:

USD/INR	48.30 in Mumbai
GBP/INR	77.52 in London
GBP/USD	1.6231 in New York

The arbitrageur has USD1,00,00,000. Assuming that there are no transaction costs, explain whether there is any arbitrage gain possible from the quoted spot exchange rates. **(4 Marks)**

5. (a) ICL is proposing to take over SVL with an objective to diversify. While ICL growth rate is 18%, the SVL growth rate is 15%. Both the companies pay dividend regularly. The summarized Profit & Loss Account of both the companies are as follows:

₹ in Crores

Particulars	ICL	SVL
Net Sales	9090	3000
PBIT	5960	1440
Interest	1500	50
Provision for Tax	2880	890
PAT	1580	500
Dividends	470	304.35

	ICL		SVL	
Fixed Assets				
Land & Building (Net)	1440		380	
Plant & Machinery (Net)	1800		700	
Furniture & Fixtures (Net)	60	3300	20	1100
Current Assets		1550		1160
Less: Current Liabilities				
Creditors	460		260	
Overdrafts	70		20	
Provision for Tax	290		100	
Provision for dividends	120	940	100	480

Net Assets		3910		1780
Paid up Share Capital (₹ 10 per share)	500		250	
Reserves and Surplus	2100	2600	1320	1570
Borrowing		1310		210
Capital Employed		3910		1780

Market Price Share (₹)	175	98
Cost of Equity	25%	20%

ICL's Land & Buildings are stated at current prices. SVL's Land & Buildings are revalued three years ago. There has been an increase of 7.65 per cent per year in the value of Land & Buildings.

SVL is expected to grow @ 18 per cent each year, after merger.

ICL is interested to do justice to the shareholders of both the Companies. For the swap ratio weights are assigned to different parameters by the Board of Directors as follows:

Net Worth Per Share*	25%
EPS (Earning per share)	30%
Share price as per Dividend Growth Model	20%
Market Price per share	25%

* After required adjustment.

You are required to suggest the swap ratio based on above weights and total number of shares.

Note: Round off calculations upto two decimal points. **(10 Marks)**

(b) Explain the characteristics of Global Depository Receipts (GDRs). **(4 Marks)**

6. (a) Sensex futures are traded at a multiple of 50. Consider the following quotations of Sensex futures in the 10 trading days during February, 2009:

Day	High	Low	Closing
4-2-09	3306.4	3290.00	3296.50
5-2-09	3298.00	3262.50	3294.40
6-2-09	3256.20	3227.00	3230.40
7-2-09	3233.00	3201.50	3212.30
10-2-09	3281.50	3256.00	3267.50
11-2-09	3283.50	3260.00	3263.80
12-2-09	3315.00	3286.30	3292.00
14-2-09	3315.00	3257.10	3309.30
17-2-09	3278.00	3249.50	3257.80
18-2-09	3118.00	3091.40	3102.60

Abshishek bought one sensex futures contract on February, 04. The average daily absolute change in the value of contract is ₹ 10,000 and standard deviation of these changes is ₹ 2,000. The maintenance margin is 75% of initial margin.

You are required to determine the daily balances in the margin account and payment on margin calls, if any. **(8 Marks)**

(b) "Technical Analysis has several supporters as well several critics." Explain this statement. **(6 Marks)**

MODEL TEST PAPER - 10

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

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

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I – Case Scenario based MCQs (30 Marks)

Part I is compulsory.

Case Scenario I

Following Financial data are available for PQR Ltd. for the financial year ending 2023:

	(₹ in lakh)
8% Debentures	125
10% Bonds (2022)	50
Equity Shares (₹10 each)	100
Reserves and Surplus	300
Total Assets	600
Assets Turnovers ratio	1.1
Effective interest rate	8%
Effective tax rate	40%
Operating margin	10%
Dividend pay-out ratio	16.67%
Current market Price of Share	₹ 14
Required rate of return of investors	15%

From the information given above, choose the correct answer to the following questions:

1. 10% Bonds must have issued in the month of…………….
   - (a) May 2022
   - (b) June 2022

(c) July 2022

(d) August 2022

2. Amount of retailed earning for the financial year 2023 approximately is…………..

(a) ₹ 52.00 lakh

(b) ₹ 31.20 lakh

(c) ₹ 26.00 lakh

(d) ₹ 5.20 lakh

3. Return on Equity (ROE) of PQR Ltd. is………….

(a) 15.00%

(b) 6.50%

(c) 10.00%

(d) 7.80%

4. Sustainable Growth Rate of PQR Ltd. shall be approximately…………..

(a) 15.00%

(b) 6.50%

(c) 10.00%

(d) 7.80%

5. Fair price of share of PQR Ltd. using Dividend Discount Model shall be approximately…………

(a) ₹ 10

(b) ₹ 14

(c) ₹ 6.12

(d) ₹ 6.51 **(5 x 2 = 10 Marks)**

Case Scenario II

An Indian exporting firm, Rohit and Bros. exported good worth of AUD 1 million to an importer in Sydney. Rohit and Bros. are worried about likely depreciation of AUD in near future as it is likely that the export sum will be received after 3 months. Today as such as there is no derivative contract is available in AUD to hedge itself from such depreciation.

The following data is given:

Spot rate	: ₹ 56.00/AUD
3 months interest rate	: India : 12 per cent per annum
	: Australia : 5 per cent per annum

From the information given above, choose the correct answer to the following questions:

6. ………….. hedging technique can be used Rohit and Bros. to hedge itself against the risk of depreciation of AUD.
   (a) Forward Contract
   (b) Future Contract
   (c) Option Contract
   (d) Money Market Hedge

7. Suppose if Rohit and Bros. want to borrow some amount in AUD in such a manner that the receivable amount can be used to repay the amount borrowed along with interest. The amount to be borrowed by Rohit and Bros. shall be approximately………
   (a) AUD 1 million
   (b) AUD 9,87,654
   (c) ₹ 5,53,08,624
   (d) ₹ 5,69,67,882

8. Suppose if Rohit and Bros. borrows a designated amount in AUD for 3 months in such a manner that the receivable amount can be used to repay the amount borrowed along with interest and plan to invest same amount in Indian spot market. The same amount available for investment shall be approximately………
   (a) AUD 1 million
   (b) AUD 9,87,654
   (c) ₹ 5,53,08,624

(d) ₹ 5,69,67,882

9. Suppose if Rohit and Bros. borrows a designated amount for 3 months in AUD in such a manner that the receivable amount can be used to repay the amount borrowed along with interest. Further he plans to invest same amount in Indian spot market. The amount obtained after 3 months of investment shall be approximately………

(a) AUD 1 Million

(b) AUD 9,87,654

(c) ₹ 5,53,08,624

(d) ₹ 5,69,67,883

10. Suppose if Interest Rate Parity theory is held between INR and AUD, then forward rate between INR and AUD for 6 month should be…………..

(a) ₹ 51.54/AUD

(b) ₹ 57.91/AUD

(c) ₹ 52.50/AUD

(d) ₹ 59.73/AUD **(5 x 2 = 10 Marks)**

Case Scenario III

XYZ Ltd. plans to invest ₹ 800,000 in a new unit. The project is expected to have a useful life of 4 years, with no salvage value at the end of its life. The annual depreciation charge for the project is ₹ 200,000.

Projected revenues and costs for the project, ignoring inflation, are provided as follows:

Year	**Revenues (₹)**	**Costs (₹)**
1	600,000	300,000
2	700,000	400,000
3	800,000	400,000
4	800,000	400,000

XYZ Ltd. is subject to a corporate tax rate of 60%, and the cost of capital for the project, including inflation premium, is 10%.

Depreciation provides a tax benefit, and inflation rates for revenues and costs over the project's lifespan are as follows:

Year	Revenue Inflation	Cost Inflation
1	10%	12%
2	9%	10%
3	8%	9%
4	7%	8%

From the information given above, choose the correct answer to the following questions:

11. The depreciation tax benefit for the project per year shall be……………
    - (a) ₹ 120,000
    - (b) ₹ 150,000
    - (c) ₹ 200,000
    - (d) ₹ 180,000

12. The inflation-adjusted revenue in Year 2 shall be……………
    - (a) ₹ 700,000
    - (b) ₹ 839,300
    - (c) ₹ 492,800
    - (d) ₹ 501,760

13. The total cash inflow in Year 1 after adjusting for inflation and tax benefit on depreciation shall be………..
    - (a) ₹ 330,000
    - (b) ₹ 336,000
    - (c) ₹ 249,600
    - (d) ₹ 492,800

14. The inflation-adjusted cost in Year 2 shall be……………
    - (a) ₹ 700,000

(b) ₹ 839,300

(c) ₹ 492,800

(d) ₹ 501,760

15. The present value of cash inflow for the year 3 shall be approximately……

(a) ₹ 213,604

(b) ₹ 226,299

(c) ₹ 226,886

(d) ₹ 239,949 **(5 x 2 = 10 Marks)**

PART – II DESCRIPTIVE QUESTIONS

Question No.1 is compulsory. Candidates are required to answer any four questions from the remaining five questions.

Working notes should form part of the answers.

Maximum Marks – 70 Marks

1. (a) Following information is given in respect of WXY Ltd., which is expected to grow at a rate of 20% p.a. for the next three years, after which the growth rate will stabilize at 8% p.a. normal level, in perpetuity.

	For the year ended March 31, 2014
Revenues	₹ 7,500 Crores
Cost of Goods Sold (COGS)	₹ 3,000 Crores
Operating Expenses	₹ 2,250 Crores
Capital Expenditure	₹ 750 Crores
Depreciation (included in Operating Expenses)	₹ 600 Crores

During high growth period, revenues & Earnings before Interest & Tax (EBIT) will grow at 20% p.a. and capital expenditure net of depreciation will grow at 15% p.a. From year 4 onwards, i.e. normal growth period revenues and EBIT will grow at 8% p.a. and incremental capital expenditure will be offset by the depreciation. During both high growth & normal growth period, net working capital requirement will be 25% of revenues.

The Weighted Average Cost of Capital (WACC) of WXY Ltd. is 15%.

Corporate Income Tax rate will be 30%.

Required:

Estimate the value of WXY Ltd. using Free Cash Flows to Firm (FCFF) & WACC methodology.

The PVIF @ 15 % for the three years are as below:

Year	t_1	t_2	t_3
PVIF	0.8696	0.7561	0.6575

(8 Marks)

(b) Shiva has a fund of ₹ 5 lacs which he wants to invest in share market with rebalancing target after every 15 days to start with for a period of one month from now. The present NIFTY is 17025. The minimum NIFTY within a month can at most be 15322.50. He wants to know as to how he should rebalance his portfolio under the following situations, according to the theory of Constant Proportion Portfolio Insurance Policy, using "2" as the multiplier:

(1) Immediately to start with.

(2) 15 days later-being the 1st day of rebalancing if NIFTY falls to 16321.89.

(3) 15 days further from the above date if the NIFTY touches 17512.14.

Note: Assume that the value of his equity component will change in tandem with that of the NIFTY. **(6 Marks)**

2. (a) Following is the Balance Sheet of M/s. PK Ltd. as on 31-03-2015:

Particulars	**₹ in Lacs**
I. Equity & Liabilities	
Shareholders' Fund	
Equity Share Capital (₹ 10 each)	900.00
10% Preference Share Capital (₹ 100 each)	300.00
Reserves & Surplus	(500.00)
Non-Current Liabilities	
Term Loan	400.00

	Current Liabilities	
	Trade Payables	400.00
	Total (I)	**1500.00**
II.	**Assets**	
	Non-Current Assets	1000.00
	Current Assets :	
	Inventory	300.00
	Trade Receivables	100.00
	Cash & Bank Balance	100.00
	Total (II)	**1500.00**

M/s PK Ltd. did not perform well and has suffered sizeable losses during the last few years. However, it is now felt that the company can be nursed back to health by proper financial restructuring and consequently the following scheme of reconstruction have been designed :

(i) Equity shares are to be reduced to ₹ 2 per share fully paid.

(ii) Preference shares are to be reduced by ₹ 50 per share and rate of dividend on Preference shares is also reduced by 2%.

(iii) Trade Payables have agreed to forego 40% of their existing claims and for the balance 50% they have agreed to convert their claims into equity shares of ₹ 2 each, fully paid.

(iv) In order to make payment for Term Loan, the company issues 200 Lacs equity shares of ₹ 2 each at par. Entire sum is required to be paid on application.

(v) Non-Current Assets is to be revalued at ₹ 500 Lacs.

You are required:

(1) To show the impact of financial restructuring.

(2) To prepare Balance Sheet assuming the scheme of restructuring is implemented. **(10 Marks)**

(b) Explain some of the 'sell-side' imperatives in Mergers & Acquisitions. **(4 Marks)**

3. (a) On the basis of given information, Mr. XLY want to create a portfolio equally as risky as the market and is having ₹ 20,00,000 to invest.

Assets	**Investment**	**Beta**
Stock A	₹ 4,00,000	0.70
Stock B	₹ 5,00,000	1.10
Stock C	?	1.60
Debenture (D)	?	0

How do you recommend and interpret the risk scenario and investment in all the securities? **(6 Marks)**

(b) The following are the details of three mutual funds of MFL:

	Growth Fund	**Balanced Fund**	**Regular Fund**	**Market**
Average Return (%)	7	6	5	9
Variance	92.16	54.76	40.96	57.76
Coefficient of Determination	0.3025	0.6561	0.9604	

The yield on 182 days Treasury Bill is 9 per cent per annum.

You are required to:

(i) Rank the funds as per Sharpe's measure.

(ii) Rank the funds as per Treynor's measure **(4 Marks)**

(c) Explain the conditions that are required to be satisfied by an entity to be Considered as a Startup vide GSR Notification 127 (E) dated 19^{th} February 2019. **(4 Marks)**

OR

Explain briefly the various factors that affect the value of an Option.

(4 Marks)

4. (a) A textile manufacturer has taken floating interest rate loan of ₹40,00,000 on 1st April, 2012. The rate of interest at the inception of loan is 8.5% p.a. interest is to be paid every year on 31st March, and the duration of loan is four years. In the month of October 2012, the Central bank of the country releases following projections about

the interest rates likely to prevail in future.

Dates	Interest Rate
31st March, 2013	8.75%
31st March, 2014	10.00%
31st March, 2015	10.50%
31st March, 2016	7.75%.

(i) Advise how borrower can hedge the risk arising out of expected rise in the rate of interest when he is interested in pegging his interest cost at 8.50% p.a. and if option on Interest Rate is available at 0.75% p.a.

(ii) Assume that the premium negotiated by both the parties at the above-mentioned rate which is to be paid on upfront basis and the actual rate of interest on the respective due dates happens to be as follows:

Dates	Interest Rate
31st March, 2013	10.20%
31st March, 2014	11.50%
31st March, 2015	9.25%
31st March, 2016	8.25%.

Evaluate how the settlement will be executed on the respective interest due dates. **(8 Marks)**

(b) Ram holding shares of Reliance Industries Ltd. which is currently selling at ₹ 1000. He is expecting that this price will further go down due to lower level of profit than expected level to be announced after one month. As on date following option contract are available in Reliance Share.

Strike Price	Option	Premium (₹)
1030	Call	40
1010	Call	35
1000	Call	30
990	Put	35
970	Put	20

950	Put	8
930	Put	5

Ram is interested in selling his stock holding as he cannot afford to lose more than 5% of its value.

Recommend a hedging strategy with option and show how his position will be protected. **(6 Marks)**

5. (a) There are two Mutual Funds viz. D Mutual Fund Ltd. and K Mutual Fund Ltd. Each having close ended equity schemes.

NAV as on 31-12-2014 of equity schemes of D Mutual Fund Ltd. is ₹ 70.71 (consisting 99% equity and remaining cash balance) and that of K Mutual Fund Ltd. is 62.50 (consisting 96% equity and balance in cash).

Following is the other information:

Particular	Equity Schemes	
	D Mutual Fund Ltd.	**K Mutual Fund Ltd.**
Sharpe Ratio	2	3.3
Treynor Ratio	15	15
Standard deviation	11.25	5

There is no change in portfolios during the next month and annual average cost is ₹ 3 per unit for the schemes of both the Mutual Funds.

If Share Market goes down by 5% within a month, calculate expected NAV after a month for the schemes of both the Mutual Funds.

For calculation, consider 12 months in a year and ignore number of days for particular month. **(6 Marks)**

(b) Excel Exporters are holding an Export bill in United States Dollar (USD) 1,00,000 due 60 days hence. They are worried about the falling USD value which is currently at ₹ 45.60 per USD. The concerned Export Consignment has been priced on an Exchange rate of ₹ 45.50 per USD. The Firm's Bankers have quoted a 60-day forward rate of ₹ 45.20.

Calculate:

(i) Rate of discount quoted by the Bank

(ii) The probable loss of operating profit if the forward sale is agreed to. **(4 Marks)**

(c) Explain the various requirements that makes an organisation sustainable. **(6 Marks)**

6. (a) The Management of a multinational company TL Ltd. is engaged in construction of Infrastructure Project. A proposal to construct a Toll Road in Nepal is under consideration of the Management.

The following information is available:

The initial investment will be in purchase of equipment costing USD 250 lakhs. The economic life of the equipment is 10 years. The depreciation on the equipment will be charged on straight line method.

EBIDTA to be collected from the Toll Road is projected to be USD 33 lakhs per annum for a period of 20 years.

To encourage investment Nepalese government is offering a 15 year term loan of USD 150 lakhs at an interest rate of 6 per cent per annum. The interest is to be paid annually. The loan will be repaid at the end of 15 year in one tranche.

The required rate of return for the project under all equity financing is 12 per cent per annum.

Post tax cost of debt is 5.6 per cent per annum.

Corporate Tax Rate is 30 per cent.

All cash Flows will be in USD.

Ignore inflation.

You are required to advise the management on the viability of the proposal by using Adjusted Net Present Value method.

Given

PVIFA (12%, 10) = 5.650, PVIFA (12%, 20) = 7.469, PVIFA (8%,15) = 8.559, PVIF (8%, 15) = 0.315. **(8 Marks)**

(b) You as an investor had purchased a 4 month call option on the equity shares of X Ltd. of ₹ 10, of which the current market price is ₹ 132 and the exercise price ₹ 150. You expect the price to range between ₹ 120 to ₹ 190. The expected share price of X Ltd. and related probability is given below:

Expected Price (₹)	120	140	160	180	190
Probability	0.05	0.20	0.50	0.10	0.15

Compute the following:

(i) Expected Share price at the end of 4 months.

(ii) Value of Call Option at the end of 4 months, if the exercise price prevails. **(4 Marks)**

(c) Explain any Three features of securitization. **(2 Marks)**

MODEL TEST PAPER 1

FINAL COURSE: GROUP I

PAPER-3: ADVANCED AUDITING, ASSURANCE AND PROFESSIONAL ETHICS

Time Allowed- 3 hours **Maximum Marks-100**

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I - Case Scenario based MCQs (30 Marks)

Write the most appropriate answer to each of the following multiple-choice questions by choosing one of the four options given. All MCQs are compulsory and carries 2 Marks each.

1. Rohita & Co. Chartered Accountants, mainly into statutory audit and tax audit, has received an order in writing from the Central Government, in respect of one of its clients, to carry out an investigation. Rohita & Co. is contemplating getting the assistance of an expert with respect to certain matters.

   Can Rohita & Co. take the assistance of experts in pursuing the investigation? Choose the correct reasoning from the below?

   (a) Yes, Rohita & Co. should consider whether the assistance of other experts like engineers, lawyers, etc. is necessary in the interest of a comprehensive and full proof examination of documents and information.

   (b) Yes, SA 620 – Using the work of experts, has a specific paragraph on using an expert's assistance for investigation.

   (c) No, the objective of SA 620 is to use the work of an expert for audit of historical financial statements and not for investigation purposes.

   (d) No, since investigation is analytical in nature and requires a thorough mind, capable of observing, collecting and evaluating facts, the usage of an expert will hinder the independence of the investigator.

2. During the audit of Good Bank Ltd., the auditors and the management had a certain difference of opinion as to the amount and the items which need to be disclosed under the head of contingent liabilities. However, apart from that, the auditors had observed the following:

   - 79 agricultural loan accounts (guaranteed by Government of Delhi) amounting to ₹ 26 lakh were overdue for more than two years.
   - 93 (guaranteed by Government of India) agricultural loan accounts amounting to ₹ 32 lakh were overdue for more than two years.
   - 6 corporate loans accounts (guaranteed three each by Government of India and Government of Delhi) amounting to ₹ 29 lakh for each company were overdue for more than three and a half months.

   What is the total amount of loans that should be classified as NPA by Good Bank?

   (a) ₹ 58 lakh.

   (b) ₹ 145 lakh.

   (c) ₹ 113 lakh.

   (d) ₹ 174 lakh.

3. Sam Ltd. appointed M/s Ajeet & Co., Chartered Accountants as Statutory Auditor. The Statutory Auditor found the Internal Audit function reliable and effective. The Statutory Auditor assigned the task of assessing the inventory levels of a few branches where the Statutory Auditor believed that there might be some risk of material misstatement to one of the Internal Auditor Mr. Krushna. Since the Internal Auditor had recently done such assessment as a part of their Internal Audit program, therefore, the Statutory Auditor believed that they could rely on the former's report. Besides this, because of the paucity of time the Statutory Auditors also requested Mr. Krushna to help them in some paperwork including audit documentation.

   Before the audit was concluded, Mr. Krushna got promoted and shifted to another city. During the audit discussion stage, the lead Statutory Auditor found out that the documentation delegated to Mr. Krushna was not complete. Accordingly, Statutory Auditor further checked the inventory work delegated to the Internal Auditor, however, it was found to be satisfactory.

In view of the above case scenario, state which of the following statement(s) hold true:

(a) The working of Internal Audit function was reliable and satisfactory; therefore, the allocation of inventory level work was within the authority of the Statutory Auditor. This was further confirmed by the satisfactory work of Internal Auditor, as found out later.

(b) The documentation would be considered complete as far as the Statutory Auditor's responsibility is concerned as the missing documentation was because of the oversight of the Internal Auditor.

(c) Since the Internal Audit had conducted the similar inventory level checking activity recently, therefore, because of familiarity with the audit the Statutory Auditor was right in delegating the same to the Internal Auditor.

(d) The Statutory Auditor should not have delegated the inventory level checking to the Internal Auditor, as the risk assessed was material. Further, the audit documents are Statutory Auditor's property and responsibility. Also, the Statutory Auditor should maintain confidentiality during all the stages of the audit. Therefore, it was wrong on the part of the Statutory Auditor to handover the task of audit documentation to the Internal Auditor.

Case Scenario I [MCQ 4-6]

ABC Limited is a public company listed on the National Stock Exchange, having its registered office in Delhi. The company is primarily engaged in the manufacturing of pharmaceutical products. During the preceding financial year, the company recorded a remarkable turnover of ₹ 5000 crores, accompanied by a net profit of ₹ 805 crores. Additionally, the company has secured a loan facility from the State Bank of India amounting to ₹ 1000 crores.

PQR & Co., a firm of chartered accountants based in Delhi, has been appointed as a joint auditor along with PK & Co. and XYZ & Co., an esteemed chartered accountant's firm in the same location i.e. Delhi. ABC Limited has already completed the appointment-related formalities as well as they have also signed engagement letters. The engagement letter contains the details on the objective and scope of the audit, responsibilities of the auditors, management, and identification of the framework applicable. Moreover, while planning the audit, joint auditors have divided the responsibility for conducting audit in accordance with SA 299. Further, the audit team has established ₹ 50 Crore as the materiality threshold, calculated at 1% of turnover.

Now, during the audit, PK & Co. came to know that one of the employees of the company had been involved in fraud amounting to ₹ 201 Lakhs.

Additionally, as a part of the audit procedure, the auditor has also sent confirmation requests to 100 suppliers to confirm the year-end balance. The said requests were designed in such a way that the supplier will directly respond to the auditor indicating that the supplier agrees or disagrees with the same. However, in this regard the confirmation responses were received only from 37 Suppliers.

Moreover, as a part of the audit procedure, auditors of the ABC Limited also wants external confirmation from the 37 Debtors to confirm the year-end balance, however in this process, the management refuses auditors to allow to send the confirmation and after asking the reason for such refusal, auditors came to the conclusion that, such refusal is unreasonable and the auditor is also unable to obtain relevant and reliable audit evidence from alternative audit procedures.

In addition, while forming an opinion, PQR & Co. had a different opinion on the valuation of inventories, but PK & Co. and XYZ & Co. had the same opinion and accordingly, given their majority stance, both PK & Co. and XYZ & Co. assert that PQR & Co. must endorse a Common audit report aligned with their opinion.

Apart from this, XY Private Limited, an associate enterprise of ABC Limited, the company XY Private Limited appoint ZMR & Co., another firm of chartered accountants located in Rajasthan as a statutory auditor of XY Private Limited for the first time for the current financial year. The financial statement of XY Private Limited was audited by its predecessor auditor in the previous financial year. During the audit for the current financial year, ZMR & Co. came across a material misstatement in the opening balance, that affects the current year financial statement. In this regard, the auditor also discusses the said facts with the management. However, the management does not accurately pay attention to the same and does not either adequately account during the year or disclose or present the same in the financial statement of current year.

The Other Important financial information of XY Private Limited is as below:

(₹ in Crores)

Sr. No.	Particulars	Current Year	Previous Year
1.	Paid up Share capital	2.00	2.00
2.	Credit Balance of Profit & Loss Account	1.75	0.75
3.	Turnover	35.00	25.00
4.	Borrowing from Banks and Financial Institutions	3.50	2.50

On the basis of the above-mentioned facts, you are required to answer the following MCQs,

4. In the above given case, what should be the next course of action on the part of auditors of ABC Limited when the auditors conclude that the reason for management's refusal to allow to send the confirmation to the debtors is unreasonable and auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures?

   (a) Auditor should have included the reason for refusal by the management and fact of inability to obtain the relevant and reliable audit evidence from alternative audit procedure in the Key Audit Matter Paragraph as per SA 701.

   (b) Auditor should have included the reason for refusal by the management in the written representation received as per SA 580.

   (c) Auditor shall communicate the matter with TCWG and also determine the implications for the Audit and Auditor's opinion in accordance with SA 705.

   (d) Auditor should have included the reason for refusal by the management and fact of inability to obtain the relevant and reliable audit evidence from alternative audit procedure in the Emphasis on Matter Paragraph as per SA 706.

5. Whether PQR & Co. should adhere to the opinion formulated by PK & Co. and XYZ & Co. or explore alternative options.

   (a) PQR & Co. will have to go with the opinion framed by the majority of auditors.

   (b) PQR & Co. has the option to incorporate a distinct audit opinion paragraph within the Common audit report, accentuating its importance through the emphasis of the matter paragraph.

   (c) PQR & Co. can align with the opinion formed by the majority of auditors. However, any dissenting viewpoint held by PQR & Co. should be prominently highlighted within the emphasis of the matter paragraph.

   (d) PQR & Co. has the discretion to issue a distinct audit report independently. In such a scenario, the reference to the other audit report issued by the majority of auditors should be noted within the 'Other Matter Paragraph'.

6. In the above given case, what should be the course of the action on the part of ZMR & Co., when they found material misstatement which has not been accurately accounted or presented or disclosed in the financial statement of current year?

   (a) ZMR & Co. should not pay attention to the material misstatement found in the opening balance, since they were not auditors for the previous financial year.

   (b) ZMR & Co. should express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705(Revised).

   (c) ZMR & Co. should take such matter in the written representation received from the management and no need to report such fact in audit report.

   (d) ZMR & Co. should disclose such a fact in the Emphasis of Matter paragraph section in the audit report.

Case Scenario II [MCQ 7-10]

MN & Associates, a firm of Chartered Accountants, having CA. M and CA. N as partners, is based at Mumbai. MN & Associates are appointed to conduct statutory audit of Zinc Ltd. Zinc Ltd. is required to appoint an internal auditor as per statutory provisions given in the Companies Act, 2013 and appointed

CA. IA as its internal auditor. MN & Associates asked Mr. IA to provide direct assistance to him regarding evaluating significant accounting estimates by the management and assessing the risk of material misstatements. He also seeks his direct assistance in assembling the information necessary to resolve exceptions in confirmation responses with respect to external confirmation requests and evaluation of the results of external confirmation procedures.

CA. M accepted his appointment as tax auditor of a firm under section 44AB, of the Income-tax Act, and commenced the tax audit within two days of appointment since the client was in a hurry to file Return of Income before the due date. After commencing the audit, CA. M realised his mistake of accepting this tax audit without sending any communication to the previous tax auditor. In order to rectify his mistake, before signing the tax audit report, he sent a registered post to the previous auditor and obtained the postal acknowledgement.

CA. N provides management consultancy and other services to its clients. CA. N was also awarded 'Best Speaker of the year' as gratitude from the Institute. Later on, CA. N posted his framed photograph on his website wherein he was receiving the said award from the Institute.

Upon hearing about the efficient services provided by MN & Associates Chartered accountants, they were approached by XYZ Cooperative Society to act as their statutory auditor for the upcoming financial years. The firm agreed to the offer and had the following options in mind with respect to the fees to be charged from them:

(i) To charge fees as percentage of Net Profits, or

(ii) To charge fees of ₹ 501/-.

Based on the abovementioned facts, you are required to answer the following MCQs:

7. With respect to the fees to be charged for its new assignment, which option can be opted by MN & Associates.?

   (i) To charge fees as percentage of Net Profits, or

   (ii) To charge fees of ₹ 501/-.

   (a) (i) Only.

   (b) (ii) Only.

   (c) Either (i) or (ii).

(d) Neither (i) nor (ii).

8. MN & Associates sought direct assistance from CA. IA, internal auditor as stated in the above scenario. Advise as to whether he is permitted to do so in accordance with relevant Standards on Auditing.

   (a) CA. IA cannot assist MN & Associates in assembling information necessary to resolve exceptions in confirmation responses. However, MN & Associates can ask Mr. IA for direct assistance regarding evaluating significant accounting estimates and assessing the risk of material misstatements as per SA 610.

   (b) MN & Associates cannot ask CA. IA for direct assistance regarding evaluating significant accounting estimates and assessing the risk of material misstatements. However, CA. IA may assist MN & Associates in assembling information necessary to resolve exceptions in confirmation responses as per SA 610

   (c) MN & Associates cannot ask CA. IA for direct assistance regarding evaluating significant accounting estimates and assessing the risk of material misstatements and in assembling the information necessary to resolve exceptions in confirmation responses as per SA 610.

   (d) MN & Associates can ask CA. IA for direct assistance regarding evaluating significant accounting estimates and assessing the risk of material misstatements and in assembling the information necessary to resolve exceptions in confirmation responses as per SA 610.

9. As per the Chartered Accountants Act, 1949, under which clause CA. N is liable for misconduct?

   (a) Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

   (b) Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

   (c) Clause (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

(d) Clause (7) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

10. Before signing the tax audit report, CA. M sent a registered post to the previous auditor and obtained the postal acknowledgement. Will CA. M be held guilty of professional misconduct under the Chartered Accountants Act, 1949?

(a) As per Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949 CA. M will not be held guilty of professional misconduct as he communicated with the previous tax auditor before signing the audit report.

(b) As per Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949, CA. M will be held guilty of professional misconduct since he has accepted the tax audit, without first communicating with the previous auditor in writing.

(c) As per Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949, CA. M will not be held guilty of professional misconduct since the requirement for communicating with the previous auditor being a chartered accountant in practice would apply to statutory audit only.

(d) As per Clause (8) of Part I of Second Schedule to the Chartered Accountants Act, 1949, CA. M will be held guilty of professional misconduct since he has accepted the tax audit, without first communicating with the previous auditor in writing.

Case Scenario III [MCQ 11-15]

Sun Chemicals Ltd., a prominent player in India's industrial landscape, has been etching its mark since its inception in 2008, headquartered in the bustling city of Pune, Maharashtra. Listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange of India (NSE), the company has steadily grown into a multi-faceted entity, catering to diverse industrial needs.

Sun Chemicals Ltd.'s core strength lies in its robust manufacturing capabilities. Spread across multiple state-of-the-art facilities, the company produces a wide range of industrial chemicals, including specialty chemicals, performance chemicals, and basic chemicals. These products find application in various sectors, from pharmaceuticals and textiles to paints and coatings, construction, and agriculture.

RKM & Co., a Chartered Accountancy firm, was appointed as to conduct the statutory audit for F.Y. 2023-24 for the company. Mr. Rahul Dubey was the engagement partner for the said assignment. In the organisational structure, Mr. Rahul noticed that those charged with governance in the company are also involved in managing the entity.

During the on-going engagement of the audit, at the end of the third quarter, during which tenure already two limited review reports were issued by RKM & Co., the management of the company imposed a limitation on the scope of the audit that Mr. Rahul considered likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, and accordingly, he requested that management remove such limitation. But the management refused to remove the said limitation.

After following the due procedures applicable in the circumstances, Finally, Mr. Rahul with his engagement team, derived on a conclusion that the possible effects on the financial statements of undetected misstatements, could be material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation and accordingly, he proposed to withdraw from the engagement after consulting with the senior partners of the firm as on 15th November, 2023. In its resignation letter, the firm mentioned professional pre-occupation as the reason for the resignation.

11. What was the responsibility of Mr. Rahul when the management refused to remove the said limitation?

    (a) To determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

    (b) To communicate the matter to those charged with governance and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

    (c) To determine whether it is possible to perform additional procedures to obtain sufficient appropriate audit evidence.

    (d) To request for written representation from the management for the matters on which limitation is imposed and also communicate the matter to those charged with governance.

12. What was the responsibility of RKM & Co. with respect to the issue of limited review report at the time of resignation?

    (a) Limited review report for third Quarter was required to be issued.

(b) No further limited review report was required to be issued as already it was issued for the second Quarter at the time of resignation.

(c) Limited review report for third Quarter was required to be issued and consequently, after its issue, audit report for the full year is also required to be issued

(d) Limited review report for third Quarter was required to be issued subject to the terms of the audit engagement.

13. Whether in the given circumstance withdrawal from engagement was mandatory and if so, what is the responsibility of the auditor with respect to such withdrawal?

(a) In the given circumstance withdrawal from engagement was not mandatory and in case of withdrawal, the auditor was required to withdraw from the audit, where practicable and possible under applicable law or regulation.

(b) In the given circumstance withdrawal from engagement was mandatory and in case of withdrawal, as the withdrawal from the audit before issuing the auditor's report was not practicable or possible, he was required to disclaim an opinion on the financial statements.

(c) In the given circumstance withdrawal from engagement mandatory was and in case of withdrawal, the auditor was required to withdraw from the audit, where practicable and possible under applicable law or regulation.

(d) In the given circumstance withdrawal from engagement was not mandatory and in case of withdrawal, as the withdrawal from the audit before issuing the auditor's report was not practicable or possible, he was required to disclaim an opinion on the financial statements.

14. Assuming Sun Chemicals Ltd. to be an unlisted company, whether the reason for resignation by RKM & Co. was proper?

(a) No, the auditor should have clearly mentioned the reasons for the resignation in the resignation letter issued to the Company.

(b) Yes, as the requirement for clear mention of reasons is not applicable to unlisted company.

(c) Yes, in the given case, the reason was resignation was due to the limitations imposed by the management and refusal to provide reasons for the same and accordingly, though being an unlisted company, it was totally upon the discretion of the auditor to provide clear reasons or not for resignation.

(d) No, the reasons should have been a little lengthier and further the exact reason must be provided to the new auditor to be appointed by the company.

15. Assuming that the auditor proposed to resign on 14th November before issue of LR for second Quarter, then what was the responsibility of RKM &Co. with respect to withdrawal from engagement and issue of limited review report at the time of resignation?

(a) The auditor shall communicate to those charged with governance the matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion and the imited review reports for second and third Quarter were required to be issued.

(b) The auditor shall communicate to those charged with governance the matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion and the limited review report for second Quarter was required to be issued.

(c) The auditor shall communicate to management and those charged with governance the matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion and the limited review report was not required to be issued.

(d) The auditor shall communicate to those charged with governance that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation and the limited review report for second Quarter was required to be issued.

PART II – Descriptive Question (70 Marks)

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

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

1. (a) While conducting the statutory audit of Tasty Foods Limited, CA. Careful has planned attendance at physical inventory count of the company from 29th March to 31st March 2024. The company is engaged in business of extracting rice from paddy grains and caters to domestic as well as international market particularly in Gulf region. It has its plant spread in area of about 20 acres located in National Capital Region (NCR). Paddy contained in jute bags of nearly standard sizes is purchased from dealers/agents. It is stored in heaps on pallets (kind of wooden structures) in open area covered by protective sheets and in steel silos (silos are huge steel containers with measuring strain gauges) in company's premises.

The company mainly produces three rice brands viz. "Raja" and "Shehzada" (both for the domestic market) and "Badshah" (for the international market). The process of obtaining rice from paddy consists of various steps like cleaning of paddy, removing outer husk layer from paddy grains to obtain brown rice, whitening, polishing, grading and sorting, packaging which is accomplished by means of various types of machineries installed in plant.

The company's management has prepared a set of instructions and procedures to be followed for recording and controlling results of company's physical inventory counting which are listed as under:

- The physical inventory count process is to be supervised by a responsible officer of company responsible for storage functions.
- There should be no disturbance to the routine process of receiving goods and despatch during the counting time period.
- Counting process is to be undertaken by constituting different teams of 3 members each for counting/verifying raw material, work in progress and finished goods.
- Paddy in steel silos is to be estimated using their capacity.

- Quantity of work in progress is to be estimated considering plant capacity as whole.
- The responsible officer should ensure that stocks have been counted/verified in all areas.

Before proceeding to attend physical inventory count process of company, evaluate management's instructions and procedures sent to CA. Careful as stated above. You may suggest modification, addition or removal of such instructions to ensure an effective count process. **(5 Marks)**

(b) While conducting audit of CGX Limited, a listed company, for year 2023-24, CA. Srishti notices that company has extinguished following material liabilities unilaterally without entering into settlement with creditors and reported these amounts as gains under "Other income". The details in this respect are as under: -

S. No.	Particulars	Amount involved
(i)	Liabilities for purchases of raw material were written back on account of poor quality of raw material and difference in rates	₹ 3.50 crores
(ii)	Liabilities for capital goods were written back on account of defects in machinery supplied by creditors	₹ 2.00 crores

The management is of the opinion that these dues are no longer payable. Therefore, retaining these liabilities on financial statements would lead to overstatement of liabilities. Extinguishment of liabilities was made by company in accordance with normal trade practices and outstandings were written back after stopping dealing with such creditors. She wanted to send external confirmation requests to such creditors. However, management informed her that sending such requests may be used by creditors as proof of existence of liability.

She is contemplating inclusion of above matters under "Key Audit Matters" in audit report. Analyse the situation threadbare.

(5 Marks)

(c) FAB Limited is availing the services of Atiya Private Limited for its payroll operations. Payroll cost accounts for 63% of total cost for FAB Limited. Atiya Limited has provided the type 2 report as specified under SA 402 for its description, design, and operating effectiveness of control.

Atiya Private Limited has also outsourced a material part of payroll operation M/s RST & Associates in such a way that M/s RST & Associates is sub-service organization to FAB Limited. The Type 2 report which was provided by Atiya Private Limited was based on carve-out method as specified under SA 402.

CA. Akram while reviewing the unmodified audit report drafted by his assistant found that, a reference has been made to the work done by the service auditor. CA. Akram hence asked his assistant to remove such reference and modify report accordingly.

Comment whether CA. Akram is correct in removing the reference of the work done by service auditor? **(4 Marks)**

2. (a) TPX & Co., Chartered Accountants is a large audit firm. It maintains audit documentation both electronically and in physical form (hard files). The physical files are neither scanned and incorporated into electronic files nor cross-referenced to the electronic files. Further, there are many instances where audit working papers do not contain details as to whether information was obtained from client or prepared by engagement team. How do you view above situation from point of view of quality control system in audit firm? Analyse. **(5 Marks)**

(b) IT dependencies also arise due to "system generated reports" and "interfaces". How do such IT dependencies arise? Why it is important to identify IT dependencies to develop an effective and efficient audit approach? **(4 Marks)**

(c) CA. Gyan is a Chartered Accountant in practice and also an engineer by qualification. He wants to pursue a registered valuer course and work as a registered valuer for plant and machinery under the Companies Act, 2013. Comment on above with reference to provisions of the Chartered Accountants Act, 1949.

(5 Marks)

3. (a) Jagdish Pvt. Ltd. is engaged in the business of real estate. The auditor of the company requested the information from the management to review the outcome of accounting estimates (like estimated costs considered for percentage completion etc.) included in the prior period financial statements and their subsequent re-estimation for the purpose of the current period.

The management has refused the information to the auditor saying that the review of prior period information should not be done by the auditor. Comment **(4 Marks)**

(b) RML & Associates are one of the joint auditors of IND Bank for the year 2023-24. While auditing IND Bank, they are analysing industry data relating to NPAs in select public sector banks as part of risk assessment procedures:

Name of Bank	***Gross NPAs (in ₹ crore)***	***Net NPAs (in ₹ crore)***	***Ratio of Net NPAs to Net advances***
BIC Bank	55,000	13,000	1.72%
ABD Bank	45,000	10,000	2.34%
RIN Bank	55,000	18,000	2.65%
IND Bank	28,000	6,500	3.97%
CRB Bank	35,000	8,800	2.27%

In the above context, what do you understand by "Gross NPAs" and "Net NPAs" as on reporting date in the context of financial statements of a Bank? As an auditor of IND Bank, what inference would you draw by comparing the "Ratio of net NPAs to net advances" with other public sector banks? **(5 Marks)**

(c) Mr. Mayank, a Chartered Accountant was the auditor of 'Chew Limited' for the year 2022-23 and 2023-24. During the financial year, the investment appeared in the Balance Sheet of the company amounting ₹ 7.5 lac and was the same amount as in the last year 2022-23. Later it was found that the company's investments were only for ₹ 56,000, however, the value of investments was inflated for the purpose of obtaining higher amount of Bank loan. Comment with reference to the Chartered Accountants Act, 1949, and Schedules thereto. **(5 Marks)**

4. (a) The audit report of Rare (P) Ltd for F.Y. 2023-24 was issued by SRM & Co. on 23rd July, 2024. However, a case was filed against Rare (P) Ltd on 9th August, 2024, with the Civil Court, with respect to an incident caused in its factory on 24th January, 2024, the future outcome of which may result into paying heavy penalty by Rare (P) Ltd, which was informed to Mr. Rishabh Pandey, the partner of SRM & Co.

Mr. Rishabh discussed the said matter with the management, and it was determined to amend the financial statements for F.Y. 2023-24. Further, Mr. Rishabh inquired how the management intended to address the said matter in the financial statements to which he was told that the said matter was going to be disclosed as a "Contingent Liability for a Court case" to the foot note in the balance sheet with no additional disclosures.

The management told Mr. Rishabh that such disclosure was enough as he would be further going to provide description of the said court case and its outcome in the 'Emphasis of Matter' paragraph in his amended audit report.

In the context of aforesaid case-scenario, please answer to the following questions: -

(i) Whether Mr. Rishabh on behalf of SRM & Co., has properly adhered to his responsibilities in accordance with SA 560, on becoming aware of the court case filed against Rare (P) Ltd?

(ii) Whether the contention of management of Rare (P) Ltd is valid with respect to the disclosure of court case in the financial statements? **(5 Marks)**

(b) CTO Limited is engaged in the fintech business. It is a member of few prominent industry chambers and trade associations and has come under mandatory purview of Business Responsibility and Sustainability Reporting (BRSR) for year 2023-24.

The company had submitted inputs on draft Digital personal data protection bill to concerned Ministry during year 2023-24. It had also submitted to one of the industry chambers during the same year certain key inputs on leveraging India's digital public infrastructure for creating solutions by banks and fintechs together as its taskforce member on the subject. Considering the above, discuss how above information would likely be disclosed by company in "Principle-wise performance disclosures" as part of BRSR for year 2023-24?

Whether information discussed above would require to be disclosed mandatorily? **(4 Marks)**

(c) CA. Navya is the statutory auditor of Lakshay Ltd. for the Financial year 2023-24. In respect of loans and advances of ₹ 75 Lakh given to Hariharan Pvt. Ltd., the Company has not furnished any agreement to CA. Navya and in the absence of the same, he is unable to verify the terms of repayment, chargeability of interest and other terms.

Justify the type of opinion which CA. Navya should give in such a situation. Also, Draft an appropriate Opinion paragraph and Basis of Opinion paragraph. **(5 Marks)**

5. (a) Naresh & Co., Chartered Accountants, have been appointed Statutory Auditors of Suchi Ltd. for the financial year 2023-24. The audit team has completed the audit and is in the process of preparing audit report Management of the company has also prepared draft annual report.

The audit in-charge was going through the draft annual report and observed that the company has included an item in its Annual Report indicating a downward trend in market prices of key commodities/raw material as compared to previous year. However, the actual profit margin of the company as reported in financial statements has gone in the reverse direction. The Audit Manager discussed this issue with a partner of the firm who in reply said that auditors are not covered with such disclosures made by the management in its annual report, it being the responsibility of the management.

Do you think that the partner is correct in his approach on this issue?

Discuss with reference to relevant Standard on Auditing the Auditor's duties with regard to reporting. **(5 Marks)**

(b) Direct Benefit Transfer (DBT) is a major reform initiative of the Government of India to ensure better and timely delivery of benefits from Government to people. It marks a paradigm shift in the process of delivering benefits like wage payments, fuel subsidies, food grain subsidies, etc. directly into the bank accounts of the beneficiaries removing leakages and enhancing financial inclusion.

The office of C & AG of India is likely to undertake a performance audit for a block of years in a state of some selected social security pension schemes and scholarship schemes under DBT. What are likely to be objectives of such performance audit? Explain the meaning of "audit criteria" and discuss how these can be determined in above case. **(5 Marks)**

(c) GeM (e-market place) is a public procurement portal which provides opportunities to start-ups, entrepreneurs etc. to showcase their innovative products and services to government buyers and engage in public procurement. The Government e Marketplace Special Purpose Vehicle (GeM SPV), a 100% government owned and section 8 (Non-Profit) company under the Ministry of Commerce, Government of India has been incorporated under the Companies Act, 2013 to develop, manage and maintain GeM platform. Whether a firm of Chartered Accountants can register on GeM portal for rendering professional services to government departments? **(4 Marks)**

6. (a) When auditor's report on the audited financial statements contains a qualified opinion, but the auditor is satisfied that the summary financial statements are a fair summary of the audited financial statements, in accordance with the applied criteria, which other matters shall the auditor's report on the summary financial statements contain in addition to elements of auditor's report described in SA 810?

If summary financial statements are not a fair summary of the audited financial statements, in accordance with the applied criteria, and management does not agree to make the necessary changes, what are implications for auditor's opinion on summary financial statements? **(5 Marks)**

Or

In a review engagement performed under SRE 2400, practitioner relies mainly on certain procedures. Naming such procedures, discuss importance of these procedures in a review engagement.

Practitioner's report containing outcome of review engagement in form of "conclusion" also contains a description of a review of financial statements and its limitations. Which statements in this respect are to be included in practitioner's report in accordance with SRE 2400? **(5 Marks)**

(b) CA. Z, in practice, is desirous of filling Multi-purpose Empanelment form (MEF) for inclusion of his name in panel for allotment of statutory audit of bank branches web hosted by Professional Development Committee (PDC) of ICAI for financial year 2023-24. The form requires applicants to upload XML files of their personal income tax returns along with computation of income. During relevant year for which information is being sought for by PDC, CA. Z has transacted in futures and options derivatives (equity) and has reflected income from such transactions in his return of income as "Business Income". Analyse the above situation with reference to the provisions of the Chartered Accountants Act, 1949.

Would it make any difference if CA. Z had earned income from transacting in currency derivatives and commodity derivatives?

(5 Marks)

(c) CA. Puranjay is performing a forensic accounting engagement involving gathering of evidence in relation to suspected fraud of substantial amount in a company. He has been appointed under terms of a contractual agreement with the company.

The company operates in an electronic environment. While performing engagement, his team has gathered evidence from electronic records in Enterprise Resource Planning system (ERP), messages in company's e-mail system and also from system logs and audit trails generated by company's computer systems. However, while doing so, team has failed to take care of aspects such as keeping record of each person in team gathering relevant evidence, date and time of collection and storage of such evidence. What implications it may have on forensic accounting engagement as such? **(4 Marks)**

MODEL TEST PAPER 2

FINAL COURSE: GROUP I

PAPER-3: ADVANCED AUDITING, ASSURANCE AND PROFESSIONAL ETHICS

Time Allowed- 3 hours **Maximum Marks-100**

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I - Case Scenario based MCQs (30 Marks)

Write the most appropriate answer to each of the following multiple-choice questions by choosing one of the four options given. All MCQs are compulsory and carries 2 Marks each.

1. An auditor was auditing the quarterly financial results prepared in accordance with Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015. The financial results are prepared using recognition and measurement norms of Ind AS 34 and include disclosures as prescribed by SEBI. These financial results would be hosted on the website of the entity and the stock exchange. Should the auditor include Key Audit Matters in the audit report on such financial results?

   (a) No, SA 701 applies to audit of complete set of general-purpose financial statements of a listed entity.

   (b) Yes, SA 701 applies to audits of any entity.

   (c) No, SA 701 applies to review of the complete set of general-purpose financial statements of any entity.

   (d) Yes, SA 701 applies to any audit of listed entity.

2. CA. Arvind and CA. Deepak were jointly appointed as auditors of Pullcord Ltd. to ensure efficient audit and reporting, Arvind and Deepak took the following steps:

   i. After identification and allocation of work among themselves, the work allocation document was signed by both of them. Since in any case they were jointly responsible, they did not think it necessary to inform those charged with governance about the allocation.

ii. They decided to obtain a common engagement letter since their appointment was common.

iii. Since their area of work was different, they decided to obtain a separate management representation letter so as not to mix up the matters.

Which of the above were not correct in view of SA 299?

(a) i, ii and iii

(b) i and iii

(c) i and ii

(d) ii and iii

3. Mr. L, (friend of Mr. M) a CA in practice invited Mr. M to set up a 'Network Firm' along with 2 more friends. All the four auditors agreed to the same and decided to start a network firm by the name M/s LM & Co. However, one of the auditors suggested that they cannot use the term '& Co.' and it needs to be changed. But Mr. L informed that there is no such regulation regarding the firm's name. After further discussion, a suitable name, in accordance with the provisions of the Chartered Accountant Act, 1949 and Regulation was accepted by all the four partners.

Which among the name shall be suitable to the newly started 'Network Firm'?

(a) LM and Co.

(b) LM & Associates.

(c) LM & Affiliates.

(d) LM and Networks.

Case Scenario I [MCQ 4-8]

Maulik and Javeri Associates is a Firm of Chartered Accountants that provides assurance services to many companies, including listed companies. The Firm have offices across many locations in India, with subject matter experts in most of these locations. The firm has established a comprehensive quality management system covering leadership responsibilities for quality within the firm, ethical requirements, acceptance, and continuance of client relationships and specific engagements based on the SQC 1 issued by the ICAI. During the current year, the audit engagement of a listed company was picked up for an inspection by an appropriate authority. The inspection covered various aspects of the audit of financial statements and included an assessment of the firm's quality control system. The reviewer decided to discuss the following with the audit team members:

1. The reviewer enquired about the roles and responsibilities of CA Maulik. CA. Maulik explained that the engagement team is comprised of him as the engagement partner and other professionals, including the engagement in-charge. CA. Javeri was the engagement control quality reviewer. As the engagement partner, he was responsible for the direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements; and the auditor's report being appropriate in the circumstances take responsibility for reviews being performed in accordance with the Firm's review policies and procedures. He also explained that he has already completed 7 years as an engagement partner and has decided to continue as an engagement partner for the next year as well. The Firm's policy permits that an engagement partner can continue consecutively for 15 years.

2. The reviewer enquired about the roles and responsibilities of CA. Javeri, the engagement control quality reviewer. CA. Javeri explained that the EQCR plays an important role in the quality control process of an audit and is key to safeguarding audit quality. The Firm has established a comprehensive system that prescribes the eligibility of EQCR, the need to maintain objectivity by EQCR, and considerations for carrying out effective EQC reviews. Specifically, in this engagement, CA. Javeri explained that he has rich experience in handling direct and indirect tax matters and was selected by CA. Maulik. There was no formal letter confirming his selection as EQCR. The listed company had significant GST litigations. CA. Javeri ensured that he was involved in forming the audit team's judgments relating to these litigations, including making relevant provisions. CA. Javeri confirmed that the EQC review was conducted in periodic intervals, and the engagement team had resolved all the observations raised during the EQC review.

3. The reviewer enquired about the areas that require discussion with management/ those charged with governance or areas that require

significant efforts. CA. Maulik explained that during the current year, the engagement team observed material prior errors in recognition of revenue, including errors in recognition of revenue on a gross basis instead of a net basis. These errors were identified after the year end and required significant judgement and efforts by the engagement team. After many deliberations, the management agreed to correct the material prior to the period errors by restating the comparative information as per applicable GAAP. Relevant internal controls were accordingly modified after the year end. Considering the complexities involved, the measurement of revenue was identified as a key audit matter.

4. The reviewer enquired about the rationale for material difference between the amount of revenue stated in the financial statements and the corresponding amount in the Board report included as a part of the Annual Report. CA. Maulik explained that auditors are required to comment on the true and fair view of the financial statements and are not required to comment on the Annual Report. He also explained that the Board Report was not provided to the auditor till the date of the audit report. Accordingly, after considering the requirements of SA 720, a specific statement was made in the audit report regarding the non-availability of the Board Report and that the auditor is not responsible to consider the Board Report which is expected to be received the date of the audit report. Thus, any discrepancy between the Board Report and the audited financial statements does not require any consideration. However, as good governance, CA. Maulik has obtained a reconciliation of the amount of revenue between the Board Report and the financial statements.

Based on the abovementioned facts, you are required to answer the following MCQs

4. Whether the selection of EQCR is as per the requirements of SQC 1?

   (a) No. EQCR's objectivity was not maintained since it was selected by the engagement partner, and no formal communication was made regarding such selection.

   (b) Yes. CA. Javeri is a perfect match for the engagement team, as his experience as a tax professional is directly relevant to the company's tax litigations.

(c) No. The EQCR's objectivity could not be maintained since it was selected by the engagement partner and made decisions for the engagement team.

(d) Yes. CA. Javeri is a perfect match for the engagement team, as his experience as a tax professional is directly relevant to tax litigation. The EQC review was conducted in a timely manner before the issuance of the audit report.

5. In the given situation, which threat will be created if CA. Maulik serves for the assurance engagement over a long period of time?

(a) Self-interest threat.

(b) Self-review threat.

(c) Familiarity threat

(d) Intimidation threat

6. Can CA. Maulik serve another year as the engagement partner?

(a) Yes. The Companies Act, 2013 do not provide for mandatory rotation of engagement partner.

(b) No. SEBI (Listing Obligations and Disclosure Requirements) Regulations require mandatory rotation of engagement partner after completion of 5 years each.

(c) Yes. Since permitted as per Firm policies.

(d) No. Existing engagement partner of a listed company cannot serve as engagement partner beyond 7 years.

7. The reviewer is of the view that the audit opinion on internal controls under section 143(3)(i) of the Companies Act 2013 should have been modified as material weakness existed in the comparative information. Do you agree with the reviewer?

(a) Yes. Restatement of comparative information due to error is a strong indicator of material weakness in internal controls. Also, relevant internal controls were not corrected by the end of the year.

(b) No. All prior-period errors were corrected as per applicable GAAP by restating the comparative information.

(c) No. Judgemental matters, where divergent views are possible, are not indicative of material weakness.

(d) No. Internal controls were corrected by the date of the audit report.

8. Whether CA. Maulik should consider the Board Report or not as the audit report was already issued:

(a) The Board Report should not be considered as auditors don't have any obligation to consider Other Information obtained after such date.

(b) The Board Report should be considered since auditors' responsibility in relation to Other Information is uniform irrespective of the point of their availability.

(c) The Board Report should be considered since subsequent events are required to be assessed.

(d) The Board Report should not be considered to align with the audit report, which specifically excludes Other Information obtained after the date of the audit report.

Case Scenario II [MCQ 9-11]

Meera Films Ltd. is a distributor of movies in the state of West Bengal. The Company has a significant interest in other operating segments and operates through multiple subsidiaries. At the consolidated level, major operating segments comprise of movie distribution, selling tea from self-owned tea gardens at Darjeeling, real estate development for commercial purposes and investment in start-up entities. The Group was founded jointly by Mr. Madan Mohan (the Group Managing Director) and Mr. Kishore Kumar, an old confidant of Mr. Madan Mohan.

Unfortunately, Mr. Madan Paul met with an accident and expired. His untimely death rattled the entire Group and disrupted the business operations of the Group. The Board of the Parent Company decided to induct his son – Mr. Manish Paul – as the Managing Director of the Parent Company and the Group. The appointment of Mr. Manish Paul enraged Mr. Kishore Kumar, and he filed an application of oppression of mismanagement with the National Company Law Tribunal alleging various wrongdoings, including inappropriate related party transactions, siphoning off funds through connected entities and manipulation of financial statements. Considering the gravity of the allegations, the existing auditor of the Parent Company tendered its resignation. The Board appointed Mukesh and Rafi LLP as the new auditors. Mukesh and Rafi LLP informed the previous auditor over the phone and accepted the appointment.

After 5 months, Mukesh and Rafi LLP sent an email to the previous auditor as a professional courtesy stating that the appointment was for the auditor. The previous auditor replied by stating 'Received'.

To deal with these allegations, the Board of the Parent Company initiated a forensic investigation covering all the major operating segments through an independent professional services firm. The conclusion of the investigation significantly delayed the submission of financial statements for the current year of the Parent Company. The outcome of the forensic investigation included the following:

1. SaltLake Ltd.—a subsidiary—is the real estate arm of the Group and has significant receivables from various Partnership Firms/ LLPs. The investigation revealed that these advances, which have been outstanding for more than a decade, were given for the purchase of land. Further, the identity of these entities could not be traced as no PAN/ GST details were available with the subsidiary company. Any attempt to contact these entities proved futile.

   It was also noted that the auditors of SaltLake Ltd. had already completed the audit under the Companies Act 2013. Hemant and Manna LLP - the auditor of SaltLake Ltd. – informed the investigator that, in their view, the allegations do not affect the financial statements of SaltLake Ltd. and accordingly have issued an unmodified audit opinion on the financial statements of the current year. The financial statements and the audit report were adopted by the shareholders in the AGM.

2. Meera Films Ltd. - the parent company historically purchases music rights from Gaana Ltd., which is approximately INR 20 crores per annum. Gaana Ltd. is controlled by Mr. Kishore Kumar. At the beginning of the current year, an advance of INR 50 crores was given to Gaana Ltd. for the purchase of music rights. Any amount remaining unadjusted would be repaid over a period of 5 years. The advance amount is highly disproportionate to the expected purchase amount to be made, and the credit period is not in line with normal credit terms. The investigation revealed that the advance was given to provide financial support to Gaana Ltd. as it was undergoing financial distress. At the end of the

year, INR 30 crores remained unadjusted. No interest was charged on the unadjusted amount.

3. Darjeeling Tea is a cash-generating unit of Chai Ltd., a subsidiary company. The unit generates negative cash flows and is expected to do so in the future. Accordingly, it should have been impaired. However, the cash flow projection was fabricated to avoid recognition of impairment expenses in the previous years.

   There was a disagreement between the subsidiary management and its auditor. The auditor in the audit report under the Companies Act 2013 issued a qualified opinion stating that impairment loss was under-recorded. From the context, the consolidated financial statements understatement of impairment expense would reduce the consolidated:

   - Net Profit by 1%
   - Total assets by 0.5%
   - Net worth by 2%

Based on the abovementioned facts, you are required to answer the following MCQs

9. Is Mukesh and Rafi LLP guilty of professional misconduct for accepting the audit of Meera Films Ltd.?

   (a) Yes, Mukesh and Rafi LLP are guilty of professional misconduct. The email response of the previous auditor does not include reasons for their resignation.

   (b) Yes, Mukesh and Rafi LLP are guilty of professional misconduct. As a matter of professional courtesy, Mukesh and Rafi LLP should have intimated its appointment as auditor to the previous auditor through registered post (instead of sending an email).

   (c) Yes, Mukesh and Rafi LLP are guilty of professional misconduct. As a matter of professional courtesy, Mukesh and Rafi LLP should not have intimated its appointment by telephone.

   (d) Yes, Mukesh and Rafi LLP are guilty of professional misconduct. As a matter of professional courtesy, Mukesh and Rafi LLP should have communicated to the predecessor auditor via email before accepting appointment.

10. Management of Meera Films (Parent Company) reconciled its balances with the customers and vendors at an interim period. Mukesh and Rafi LLP also decided to send independent requests to the customers and vendors to confirm their balances as of the year's end. With the risk of material misstatement assessed to be low, the top 15 parties, comprising 5% of customers and 7% of vendors, were selected to obtain external confirmations. Is the sampling strategy appropriate?

    (a) Inappropriate. Sample size appears to be insufficient. Method of sample selection does not allow each item in the population a chance of selection.

    (b) Inappropriate. Sampling method is judgmental and not statistical based.

    (c) Inappropriate. Considering the underlying audit risk, external confirmation from all customers and vendors should have been obtained.

    (d) Inappropriate. Rely on confirmations obtained by management and perform roll-forward procedures to arrive at the year-end balance.

11. Would the advance for purchasing music rights to the extent remaining unadjusted as at the year-end (i.e. INR 30 crores) require reporting under Clause 3(iii) of CARO 2020 (i.e. grant of loans, etc.)?

    (a) No. Advance for purchase of goods is not a loan/ advance in the nature of loans. Thus, it is not covered under the above clause.

    (b) No. In the absence of interest charges, the advance would neither qualify as a loan nor be an advance in the nature of a loan. Thus, it is not covered under the above clause.

    (c) Yes. The intent was to provide financial support, not purchase goods. The amount of the advance and settlement period are excessive and not as per normal trade practice. It should be reported as an advance in the nature of a loan.

    (d) Yes. Advance for purchase of goods is covered under the above clause.

12. Mukesh and Rafi LLP considered the qualification of the auditor of Chai Ltd. They conclude that the audit opinion on the consolidated financial statements of the Group should be:

(a) Unmodified as the effect of misstatement is not material to the Group.

(b) Unmodified as the effect of misstatement is not material. However, the subsidiary auditor's issued qualified opinion should be highlighted in the audit report through an Emphasis of Matter paragraph.

(c) Qualified as the subsidiary auditor has issued a qualified opinion.

(d) Qualified to the extent it relates to the subsidiary and unmodified to the extent it relates to the remaining part of the Group.

Case Scenario III [MCQ 13-15]

M/s Vrinda & Associates (referred to as 'auditor') have been appointed as one of the statutory central auditors of ICCB Bank, (referred to as 'Bank') for the Financial Year 2023-24.

During the course of the audit, the auditor found that the bank has a balance with a Swiss based bank. The auditor understands that such balance is a matter of important consideration in the audit of the bank.

The engagement partner, Mr. Mitansh, has also advised the audit staff to check in detail the following items appearing in the financial statements of the bank during the year under audit.

Amount of interest accrued and not due on deposits amounting to ₹ 87,75,000/.

The balance of Interest rate swaps amounting to ₹ 81,26,500/-.

Further, the statutory auditors understand that one of the most important areas to be checked in the audit of a bank is the compliance with CRR and SLR requirements.

The audit staff apprised the engagement partners about the few unaudited branches of the Bank and the course of action in this regard was discussed in detail within the engagement team. The details with respect to unaudited branches are as under:

Interest Income: ₹ 27,86,000/-.

Interest Expense: ₹ 13,38,220/-.

Total advances: ₹ 5,10,22,000/-.

Total deposits: ₹ 3,38,00,000/.

The auditors also discussed the following with the audit staff and the bank management during the course of the audit:

Computation of Demand and Time Liabilities.

Computation of Tier I & Tier II capital of the Bank.

Based on the abovementioned facts, you are required to answer the following MCQs

13. What should be the treatment of Interest on deposits accrued but not due amounting to ₹ 87,75,000/- appearing in the financial statements of ICCB Bank.

    (a) The amount should be included in deposits amount.

    (b) The amount should not be included in amount of deposits.

    (c) The amount should be shown under the head other liabilities and provisions.

    (d) Both b & c.

14. The amount of Interest Rate Swaps amounting to ₹ 81,26,500/- should appear as ……… in the financial statements of the bank :-

    (a) Contingent Liabilities.

    (b) Other Liabilities and provisions.

    (c) Current Liabilities.

    (d) Deposits.

15. Which of the following is correct statement related to the requirement laid down by the RBI for Vrinda & Associates while verifying the compliance with the SLR requirements of the bank?

    (a) M/s Vrinda & Associates are required to verify the compliance with SLR requirements at the start and end date of the year under audit.

    (b) M/s Vrinda & Associates are required to verify the compliance with SLR requirements at 12 odd dates in different months of the financial year not being Fridays.

    (c) M/s Vrinda & Associates are required to verify the compliance with SLR requirements at 24 odd dates in different months of the financial year not being Fridays.

(d) M/s Vrinda & Associates are required to verify the compliance with SLR requirements at 10 odd dates in different months of the financial year not being Saturdays.

PART II – Descriptive Question (70 Marks)

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

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

1. (a) Nandini Ltd. a chemical manufacturing company, having its factory located at Kanawali Village, for the year 2023-24 appointed Vasu & Co. as their statutory auditors. During the course of the audit, Vasu & Co. identified that Nandini Ltd. received a show cause notice from National Green Tribunal based on the investigation performed by the regional forest department for violating environmental laws. Upon gathering a further understanding of the said matter, it was identified that Nandini Ltd. was dumping toxic solid waste, without treating it, on the nearby grounds, and because of this, the nearby water bodies were getting polluted. Based on the preliminary investigation performed by the regional forest department under the directions of the National Green Tribunal, it was identified that these practices were carried out since 2009 and a lot of damage has been done to the environment by Nandini Ltd. A show cause notice was already issued to Nandini Ltd. by the National Green Tribunal for levying the penalty of an amount of ₹700 crore. The unaudited profit for the financial year 2023-24 of Nandini Ltd. was ₹ 49 crore and the unaudited turnover was ₹ 120 crore. Upon inquiry it was identified that Nandini Ltd. has disclosed this matter in the financial statements by way of footnote, the extract of which is provided below:

"The company has received a show cause notice from the National Green Tribunal for some potential violation of environmental laws and the company's legal department has assessed and found that the judgment would be in favour of the company. Accordingly, no provision has been created for such notices."

In the light of the above scenario kindly provide what should be the appropriate option for the statutory auditor of the company to report this matter. **(5 Marks)**

(b) Pine & Associates is the statutory auditor of BB Ltd., a listed company and started its operations 6 years ago. The fieldwork during the audit of the financial statements of the company for the year ended 31st March, 2024 was completed on 1st May, 2024. The auditor's report was dated 15th May, 2024. During the documentation review of the engagement, it was observed that the engagement quality control review was completed on 18th May, 2024. The engagement partner had completed his reviews in entirety by 12th May, 2024. Comment **(4 Marks)**

(c) Aditya Ltd. was engaged in the business of owning and managing hotels and resorts, selling tourism packages and performing airline bookings for corporate and individuals. It appointed Sanjay & Co. as its statutory auditor for the financial year 2023-24. While planning the audit, the audit team decided that the risk of improper revenue recognition from hotel business should not be treated as a fraud risk. This conclusion was based on the assessment of earlier years, wherein no fraud was identified in revenue recorded from such business. While testing the internal financial controls over the process of revenue recognition, it was identified that the controls are not properly designed to mitigate the risk of fraud and risk of improper revenue recognition. As a result, the audit team decided to perform additional substantive testing. However, the audit team still were to the conclusion that there is no risk of fraud in revenue recognition. During the course of substantive testing, it was identified that the management did not account for revenue received from corporate hotel bookings amounting to ₹ 43 crore. These amounts were partially received in the company's bank accounts and partially received in the CFO's personal account. The amounts received in the bank account of the company were disclosed as advances received against the future bookings.

In the light of above scenario, kindly guide the statutory auditors with respect to their responsibility relating to fraud in an audit of a financial statement. **(5 Marks)**

2. (a) Suneel was appointed as the auditor of PCM Ltd. for the financial year 2023-24. During the course of planning for the audit, CA. Suneel intends to apply the concept of materiality for the financial statements as a whole. Please guide him with respect to the factors that may affect the identification of an appropriate benchmark for this purpose.

What benchmark should be adopted by CA. Suneel, if PCM Ltd. is engaged in:

(i) the manufacture and sale of air conditioners and is having regular profits.

(ii) the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic.

(5 Marks)

(b) Gravity Ltd. is a medium-sized manufacturing company that is planning to implement a new digital system to streamline its production processes and improve efficiency. The company appointed Mr. Ravi as IT manager. However, he is aware that merging technologies can bring significant benefits but also pose various risks to the organization. In this context, he needs to identify examples of technological risks associated with the implementation of the new digital system and the control considerations necessary to mitigate these risks effectively.

(4 Marks)

(c) Mr. S is a practising Chartered Accountant based out of Chennai. During the weekends, he involved himself in equity research and used to advise his friends, relatives and other known people who are not his clients. Apart from this, he was also involved as a paper-setter for Accountancy subject in the school in which he studied. He also owned agricultural land and was doing agriculture during his free time. During the year 20X1, heavy losses were incurred in agricultural activity due to natural calamities and misfortune, and he lost almost all of his wealth and became undischarged insolvent. After a few court hearings, finally, in the year 20X3, he was declared discharged insolvent and obtained a certificate from the court stating that his insolvency was caused by misfortune without any misconduct on his part. You are required to comment on the above situation with reference to the Chartered Accountants Act, 1949 and Schedules thereto. **(5 Marks)**

3. (a) BPMR and Associates, a renowned audit firm in the field of CA practice for the past three decades, was appointed to conduct the statutory audit of Rexlon Ltd., an unlisted company engaged in the business of paper manufacturing. The firm decided to commence the audit for the recently concluded financial year. After making significant progress in the audit, the auditors made the following observations:

Observation 1: The management had disclosed in the financials that, during the year, one of the warehouses of the Company was affected due to a major flood. As a result of the same, the Company had incurred some losses. But the management was of the view that it was not material.

Observation 2: Due to the flood, few records maintained by the Company with respect to a particular transaction was completely destroyed and there was no duplicate record maintained by the Company. However, those details were not pervasive, but material.

You are required to advise whether BPMR and Associates should report Observation 1 and 2 in its audit report? If so, under which heading should it be reported? **(4 Marks)**

(b) NRF Bank Ltd. is suffering from huge number of NPAs. During the month of April 2023, the management of the bank decided to sell some of its NPAs. Bank is doing this exercise for the first time. The management has selected following NPA accounts for sale:

Name	NPA since F.Y.	Amount (₹ In Lakh)
Fin Pvt. Ltd.	2019-20	36.55
Dairy Works	2021-22	55.24
Book Store	2018-19	29.85
Fancy Corp.	2017-18	61.42
RSM and Associates	2020-21	19.25

Being internal auditor of the bank, you are required to scrutinize the proposal made by the branch and help them by providing specific points to be considered. **(5 Marks)**

(c) A special notice has been issued for a resolution at 4th annual general meeting of TRIM Ltd., providing expressly that CA. Lucky shall not be re-appointed as an auditor of the· company. Consequently, CA. Lucky submitted a representation in writing to the company with a request to circulate to the members. In the detailed representation, CA. Lucky included the contributions made by him in strengthening the control procedures of the company during his association with the company and also indicated his willingness to continue as an auditor if reappointed by the shareholders of the company. Comment with reference to the Chartered Accountants Act, 1949 and schedules thereto.

(5 Marks)

4. (a) Naveen Ltd. is a chair manufacturing company having its corporate office in Maharashtra. The company is in the process of expansion and has acquired five companies during the year. Soni & Co. is the principal auditor of the company while the audit of all the companies acquired during the year is being conducted by Rahul K & Associates. During the course of audit, CA. Soni, the engagement partner asked the management of Naveen Ltd. at the corporate office that in order to conduct the audit of the consolidated financial statements, his audit firm is required to conduct audit of the financial statements of all the components also (Companies acquired during the year). To this, the management asked CA. Soni to consider the audit reports of the component auditor already provided to his audit team and to communicate with the component auditor for any discussion they wish to have. CA. Soni contended that for the purpose of audit of consolidated financial statements either his firm is required to conduct an audit of all the component's financial statements, or he needs the working papers of the component auditors. Is the contention of CA. Soni correct? **(5 Marks)**

(b) You have recently joined a listed company after qualifying CA final exams through campus placement programme conducted by ICAI. The company you have joined is not amongst top 1000 listed companies in the country. However, it wants to include "Sustainability reporting" in accordance with Global Reporting Initiative framework (GRI) in its annual report on voluntary basis. "Sustainability reporting" seems to be new buzzword in corporate circles and you are assigned responsibility for collating all the information required for such reporting.

In above context, dwell upon what is your understanding of "Sustainability reporting"? You are also required to list its expected benefits. **(4 Marks)**

(c) STU & Associates have been the statutory auditors of the listed company "First and Last Ltd.," operating in the petrochemical industry, for the past three years. CA. K, the engagement partner, had designed certain substantive procedures on some selected assertions in response to the assessed risk of material misstatements for the year under audit. These particular assertions were not examined by him in previous years due to materiality or risk considerations.

Mr. X leads the internal audit department of the company and reports to the company's audit committee. During the course of audit, a senior member of the engagement team decides to engage Mr. X for providing direct assistance in performing the above substantive procedures. Comment with respect to the relevant Standards on Auditing.

Also, indicate the activities to be performed by the statutory auditor prior to using internal auditor for providing direct assistance. (**5 Marks)**

5. (a) Jinchandra & Co., Chartered Accountants, has been appointed statutory auditor of Gurudeva Ltd. for the F.Y. 2023-24. The audit team has completed the audit and is in the process of preparing the audit report. Management of the company has also prepared draft annual report.

The audit in-charge was going through the draft annual report and observed that the company has included an item in its annual report indicating a downward trend in market prices of key commodities/raw material as compared to the previous year. However, the actual profit margin of the company as reported in financial statements has gone in the reverse direction. The Audit Manager discussed this issue with a partner of the firm who in reply said that auditors are not covered with such disclosures made by the management in its annual report, it being the responsibility of the management.

Do you think that the partner is correct in his approach on this issue? Discuss with reference to the relevant Standard on Auditing the Auditor's duties with regard to reporting. **(5 Marks)**

(b) During the course of an audit of a state government department, the Office of the Comptroller & Auditor General of India (C&AG) observed that the prescribed law in the state defined a "flat" based on the following two criteria in a premises:

- Dwelling units exceeding a threshold limit
- Buildings with a total area surpassing a threshold limit

However, it was noted during the audit that the relevant database did not include a column for entering the area of the building. Consequently, a certain number of buildings were identified as flats even though they had fewer dwelling units than the threshold limit. In the absence of data regarding the area, the audit team directed physical verification of these flats. The physical verification confirmed that these buildings were incorrectly classified as flats, resulting in the department under collecting water charges.

Identify type and nature of audit being performed by Office of Comptroller & Auditor General of India. To whom report of such audit was likely to have been submitted **(5 Marks)**

(c) CA. Evan has been in practice for two years and runs his proprietorship firm in the name of "Evan & Co." He maintains notes in his mobile where he records the fees received from various clients. Using these records, he prepares and files his income tax return. Comment with respect to the provisions of the Chartered Accountant Act, 1949. **(4 Marks)**

6. (a) You have been appointed to compile the financial statements of the Kings & Company (a partnership firm) for tax purposes. During the course of your work, you discover that the inventory is grossly understated, and the company has failed to apply applicable standards on accounting. On pointing out the same, the partners of the Kings & Co., inform you that it is outside your scope since you are not conducting an audit and the said figures duly certified by the firm should be accepted. Comment. **(5 Marks)**

Or

SAE 3400 explains that prospective financial information can take the form of a forecast, a projection, or a combination of both. In this context, how do you differentiate a forecast from a projection? Also provide an example. Additionally, explain the nature of assurance provided by the practitioner regarding prospective financial information in accordance with SAE 3400. **(5 Marks)**

(b) The manager of Miskin (P) Ltd. approached CA. Rahul in need of a certificate in respect of a consumption statement of raw material. Without having certificate of practice (CoP), CA. Rahul issued the certificate to the manager of the company, acting as a CA in practice and applied for the CoP to the Institute on very next day to avoid any dispute. **(4 Marks)**

(c) Mr. Rajat, while reviewing the anti-fraud controls for a construction company, found that the company has witnessed a few frauds in the past mainly in the nature of material theft from the sites and fake expense vouchers.

Mr. Rajat is evaluating options for verifying the process to reveal fraud and the corrective action to be taken in such cases. As an expert in fraud prevention, you have been asked to brief Mr. Rajat about the inventory fraud and verification procedure with respect to defalcation of inventory? **(5 Marks)**

MODEL TEST PAPER 3

FINAL COURSE: GROUP I

PAPER-3: ADVANCED AUDITING, ASSURANCE AND PROFESSIONAL ETHICS

Time Allowed- 3 hours **Maximum Marks-100**

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I - Case Scenario based MCQs (30 Marks)

Write the most appropriate answer to each of the following multiple-choice questions by choosing one of the four options given. All MCQs are compulsory and carries 2 Marks each.

1. Pack Ltd. is a company engaged in the manufacture of iron and steel bars. TN & Associates are the statutory auditors of Pack Ltd. for the FY 2023-24. During the course of audit, CA. Ashish, the engagement partner, found that the Company's financing arrangements have expired, and the amount outstanding was payable on March 31, 2023. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact. What opinion should CA. Ashish express in the case of Pack Ltd.?

   (a) Unmodified opinion.

   (b) Qualified opinion.

   (c) Adverse opinion.

   (d) Disclaimer of opinion.

2. M/s Jojo & Associates have been appointed as statutory auditors of ZuZu Ltd. for FY 2023-24. During the year, the company has entered into some related party transactions. CA. Sukrit, the engagement

partner has taken a management representation letter regarding the proper accounting, presentation and disclosure of such related party transactions. Is there any further responsibility of CA. Sukrit with respect to the other procedures to be performed for related party transactions?

(a) Yes, the audit firm has the responsibility to perform the audit procedures to identify, assess and respond to the risk of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions and balances.

(b) No, there is no further responsibility of CA. Sukrit as the audit firm is responsible for verifying the balances and disclosure of related party transactions. The identification of related party transactions is the responsibility of the management of ZuZu Ltd.

(c) No, there is no further responsibility of CA. Sukrit as the best audit evidence for the related party transaction is the management representation letter.

(d) Yes, the auditor has the responsibility to detect fraud and error with respect to the related party transactions.

3. Joy, an aspiring student of ICAI, approached Mr. Paul, a practicing Chartered Accountant, for the purpose of articleship. Mr. Paul, the principal, offered him stipend at the rate of ₹ 3,000 per month to be paid every sixth month along with interest at the rate of 10% per annum compounded monthly to compensate such late payment on the plea that cycle of professional receipts from clients is six months. Joe agreed to such late payment in the hope of getting extra stipend in the form of interest. Mr. Paul, however, used to disburse salaries to all his employees on time. As per the Chartered Accountants Act, 1949, under which clause Mr. Paul is liable for misconduct.

(a) Clause (10) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

(b) Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

(c) Mr. Paul is paying interest thus he is not liable for misconduct.

(d) Clause (1) of Part II of the Second Schedule to the Chartered Accountants Act, 1949.

Case Scenario I [MCQ 4-6]

M/s IRIS & Associates, Chartered Accountants were acting as the statutory auditors of M/s DMN Bank Limited. During the statutory audit for the relevant financial year, the following observations were made:

- Interest income included the following:
  - ₹ 8 lakh relating to a short-term crop loan where instalment was overdue for one crop season.
  - ₹ 10 lakh relating to an advance (guaranteed equally by Government of India & Government of Tamil Nadu) where the instalment was due for more than six months.
- A 25 month old NPA account worth ₹ 43 lakh (net book value) was sold to an asset reconstruction company for ₹ 45 lakh. The profit from the above transaction was taken to the P&L account. The above NPA was sold 'without recourse' and on a cash basis. The auditors noticed a discrepancy in this transaction and hence decided to report the same.

After completing the bank audit, IRIS & Associates agreed to take up the following management consultancy and other services for one of the start-up companies based in Noida:

(i) Setting up executive incentive plan and wage incentive plan.

(ii) Price-fixation and other management decision making.

(iii) Conduct a periodical audit and advisor for tax matters.

Mr. Kartik, one of the partners of the firm felt that providing the above services could result in professional misconduct. Hence, he resigned from the partnership and became a sole practitioner. One of the clients of IRIS & associates came to know about the issue and they approached Mr. Kartik to conduct the statutory audit for the financial year. Mr. Kartik took up the assignment without informing the previous firm. Annoyed by this, Mr. Jack filed a complaint to ICAI regarding the act of Mr. Kartik. After inquiry, it was decided that Mr. Kartik was guilty of professional misconduct.

After this incident, Mr. Kartik also decided to file a complaint against Mr. Jack. When he was thinking about a reason for the same, he remembered that Mr. Jack had entered into an agreement with two of his articled clerks to pay stipend on an annual basis, while others were paid on monthly basis. Realising that this act is in violation of Regulation 48 of the Act, he filed a complaint to ICAI. After enquiry, it was found that Mr. Jack was guilty of professional misconduct.

Based on the above facts, answer the following: -

4. From the above facts and details, what is the correct amount of interest which the bank should account for in its financial statements?

   (a) Nil.

   (b) ₹ 8 lakh.

   (c) ₹ 13 lakh.

   (d) ₹ 5 lakh.

5. What could be the possible amount classified as NPA relating to the accounts with respect to observation regarding the inclusion of interest income given below:

   - ₹ 8 lakh relating to a short-term crop loan where instalment was overdue for one crop season.

   - ₹ 10 lakh relating to an advance (guaranteed equally by Government of India & Government of Tamil Nadu) where the instalment was due for more than six months.

   (a) ₹ 5 lakh.

   (b) ₹ 13 lakh.

   (c) ₹ 10 lakh.

   (d) ₹ 18 lakh.

6. In NPA, sale to asset reconstruction company, what discrepancy auditor might have noticed:

   (a) The NPA had not completed 30 months.

   (b) Sale was made 'without recourse'.

   (c) Sale was made for cash basis.

   (d) The profit of ₹ 2 lakh was taken to Profit & Loss account.

7. Being guilty of professional misconduct, which among the following punishment Mr. Jack will be subject to?

   (a) Impose a penalty up-to ₹ 1 lakh.

   (b) Remove his name from members register permanently.

   (c) Impose a penalty up to ₹ 3 lakh.

(d) Impose a penalty of ₹ 6 lakh.

8. After inquiry, it was decided that Mr. Kartik was guilty of professional misconduct. Why Mr. Kartik was guilty of professional misconduct?

(a) He is guilty of professional misconduct as per Clause 7 of Part I of Second Schedule for being grossly negligent in conduct of his professional duty.

(b) He is guilty of professional misconduct as per Clause 8 of Part I of First Schedule due to non-communication to previous auditor.

(c) He is guilty of professional misconduct as per Clause 8 of Part I of Second Schedule due to non-communication to previous auditor.

(d) He is guilty of professional misconduct as per Clause 7 of Part I of First Schedule for being grossly negligent in conduct of his professional duty.

Case Scenario II [MCQ 9-12]

Honey & Co; a reputed Chartered Accountants firm is appointed as a statutory auditor of Copperbox Limited. The Company is into manufacturing of copper products. The company has advanced in all its endeavours by supplying million Copper units. The company has incorporated another company "Coppertile Private Limited" by investing 45% in the share capital of the company and at the same time having 100% control over the Board of Directors as per the agreement with the majority shareholder. The company is listed in the US Stock Exchange but in the process of listing in the Indian Stock Exchanges, having a net worth of ₹ 245 crore. The product is promoted by Ali Baba, as its product Brand Ambassador. You are the audit manager and your 1st year trainee asks you the following questions listed down. He has also noted down some of the questions for you to answer to discuss the impact on the planning stage after understanding the entity and its environment:

- The company is required to appoint the Internal Auditor in accordance with the provisions of the Companies Act, 2013 and the company complied with the same by delegating the duties to an employee, who joined the company as first year Architect. The audit team is planning to use the work performed by the Internal Auditor as the reports given by him are designed in a marvelous fashion. Even the Board of Directors are astonished by the design of the Internal Audit report.

- The company is planning to use the working papers of the previous auditor by demanding the audit working papers from him citing the confidentiality clause. The auditor also plans to use the same for testing the opening balances during the year. The previous year auditor having been appointed as the auditor of subsidiary; the company plans to use his work for verifying the investment balance during the year.

  Based on the above facts, answer the following:-

9. The engagement partner has requested you to comment upon the usage of work of Internal auditor by the engagement team in accordance with relevant Standard on Auditing:

   (a) As the work done by the internal auditor is marvelously designed and presented the same can be considered to the extent the statutory auditor can use it. As the work is highly appreciated even by the Board of Directors, the same should be definitely used by Honey & Co.

   (b) The work done by the Internal Auditor need to be assessed for the sufficiency and should be used to avoid the double work. The audit team of Honey & Co. need to reduce the unnecessary work as the same has been performed by the other auditor.

   (c) The auditor is required to assess the competence and professional care of the work performed by the Internal Auditor. Thus, the auditor Honey & Co. needs to reconsider the audit strategy and cannot use the work of the Internal Auditor.

   (d) The work performed by the internal auditor can be used by the External Auditor in this case if the architect is not an employee of the company but is in private practice.

10. The Trainee asked whether the audit team is required to perform any procedures for the investment in Coppertile Private Limited:

    (a) The company need to prepare the consolidated financial statements and the same need to be audited by the auditor and the auditor needs to consider the financial information and also assess regarding the need to use of the work of the component auditor.

    (b) The auditor needs to perform audit procedures on the investment balances and transactions with related parties.

(c) The auditor need not perform any procedures as the investment in Coppertile Private Limited was already made in the previous year.

(d) Both (a) & (b).

11. The Trainee asked about role of auditor in case the investment in Coppertile Private Limited is increased to 60% in the next year:

(a) The auditor need not do any additional procedures compared to this year except for audit procedures over the increase in Investment value and its disclosures in the Financial Statements.

(b) The auditor should also audit the group consolidated financial statements as the consolidation becomes applicable for the company being the investment is raised from 45% to 60%.

(c) The auditor needs to audit the subsidiary's books of accounts to get comfort over the balances in the material subsidiary. Thus, the audit strategy will change for verifying the investment.

(d) The auditor can either on its own, audit the subsidiary or use the work of another auditor to get comfort over the balances in the subsidiary from the next year.

12. The company has requested its previous auditor to give back its audit documentation ("working papers") and warned the previous auditor with legal notice to submit them back to the company showing the confidentiality clause:

(a) The previous auditor is bound to return the workpapers as the company has raised the confidentiality clause over the audit firm. Thus, SA 230 is not applicable in such a scenario as the original owner itself requests you to return the working papers.

(b) The auditor has a right over its working paper, and he is the owner of the workpapers, but he cannot give the workpapers to any person even at the request of the company.

(c) The auditor has a right over its working paper, and he is the owner of the workpapers and he may give at his discretion make available the workpapers to the company.

(d) The auditor has a right over its working papers but the owner of them is the company. He should make available the workpapers to the company at its request and SQC 1 mandates the auditor to make copies made available to its clients.

Case Scenario III [MCQ 13-15]

FinAp Deposit Limited, a NBFC registered with RBI under section 45-IA of the RBI Act and listed on National Stock Exchange, appointed GRN & Co. Chartered Accountants as their statutory auditor for the financial year ending on 31 March 2023. Mr. Ankush the audit partner of GRN & Co. extracted the monthly net owned fund position from the books of FinAp Deposit Limited.

Month Net Owned Funds (as calculated based on monthly position)

Month	Net Owned Funds (as calculated based on monthly position)
April 2022	₹ 350 Lakh
May 2022	₹ 350 Lakh
June 2022	₹ 320 Lakh
July 2022	₹ 310 Lakh
August 2022	₹ 290 Lakh
September 2022	₹ 250 Lakh
October 2022	₹ 240 Lakh
November 2022	₹ 190 Lakh
December 2022	₹ 180 Lakh
January 2023	₹ 240 Lakh
February 2023	₹ 270 Lakh
March 2023	₹ 310 Lakh

During the year, Mr. Ankush recommended to the Board and Audit Committee the appointment of internal auditors. However, the Board rejected this recommendation due to budget constraints. They assured that they would consider establishing an internal audit department within the Company next year.

Based on the above facts, answer the following:-

13. Mr. Ankush reported, under Clause 3(A)(III) of Master Direction - Non-Banking Financial Companies Auditor's Report (Reserve Bank)

Directions, 2016, that Good Deposit Limited is not eligible to hold its Certificate of Registration under section 45-IA of the RBI Act, as during the year the Net Owned Funds went below the minimum required limit. Management of the NBFC had a different opinion that a certificate pertaining to the Net Owned Funds from the statutory auditor is required with reference to the position of the Company as at the end of the financial year ended 31 March and not based on each month's position. Kindly guide Mr. Ankush with respect to the requirement under Master Direction.

(a) Every NBFC shall submit a certificate from its statutory auditor that it is eligible to hold a Certificate of Registration under Section 45-IA of the RBI Act. Such a certificate should be with reference to the position of the company as of the end of the financial year ended 31 March.

(b) Every NBFC shall submit a Certificate from its statutory auditor that it is eligible to hold a Certificate of Registration under Section 45-IA of the RBI Act. Such a certificate should be with reference to the position of the company as of the end of each month.

(c) Every NBFC shall submit a Certificate from its statutory auditor that it is eligible to hold a Certificate of Registration under Section 45-IA of the RBI Act. Such a certificate should be with reference to the position of the company throughout the financial year.

(d) Only NBFC-MFI shall submit a Certificate from its statutory auditor that it is eligible to hold a Certificate of Registration under Section 45-IA of the RBI Act. Such a certificate should be with reference to the position of the company throughout the financial year.

14. Mr. Ankush wants to highlight the matter with respect to the absence of internal audit function in his audit report under the Emphasis of Matter paragraph. However, management was of the view that the audit partner was not right by disclosing the said matter in his audit report as it was an internal matter, and the audit team had not identified any material evidence which could impact the opinion of the auditor. Kindly guide Mr Ankush whether proposed reporting under Emphasis of Matter (EOM) para in the Audit Report is correct.

(a) EOM paragraph included in auditor's report 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. Hence reporting under EOM is correct.

(b) EOM paragraph included in auditor's report refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, auditor's responsibilities or auditor's report. Hence reporting under EOM is incorrect.

(c) EOM paragraph included in auditor's report 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. Hence reporting under EOM is incorrect.

(d) EOM paragraph included in auditor's report refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, auditor's responsibilities or auditor's report. Hence reporting under EOM is correct.

15. Kindly guide Mr. Ankush regarding areas where he may need to report the absence of internal audit function in the company in Audit Report.

(a) The auditor is required to report the matter in the Basis of Qualification paragraph of his audit report as the Auditor was unable to place reliance on the internal audit function of the Company.

(b) The auditor is required to report the same under Para 3(xiii) of the CARO (Companies Auditor's Report Order), 2020.

(c) The auditor is required to report the same under Para 3(xiv) of the CARO (Companies Auditor's Report Order), 2020.

(d) The auditor is required to report the said matter in Key Audit Matters as per SA 701, which requires significant professional judgement and user attention.

PART II – Descriptive Question (70 Marks)

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

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

1. (a) Whilst the Audit team has identified few matters, they need your advice to conclude on the same. Engagement Partner have asked them to review the Board minutes and other secretarial/ regulatory records based on which the following additional matters were brought to the attention of the Partner: -

(i) An amount of ₹4.75 Lakhs per month is paid to M/s. MNJ Associates, a partnership firm, which is a 'related party' in accordance with the provisions of the Companies Act, 2013 for the marketing services rendered by them. Based on an independent assessment, the consideration paid is higher than the arm's length pricing by ₹ 0.18 Lakh per month. Whilst the transaction was accounted in the financial statements based on the amounts' paid, no separate disclosure of this related party transaction has been made in the notes to accounts forming part of the financial statements highlighting the same as a 'related party' transaction.

(ii) The long-term borrowings from the parent company has no written terms and neither the interest nor the principal has been repaid so far.

(iii) Certain computers were received from the parent company free of cost, the value of which is ₹ 0.75 lakh and no accounting or disclosure of the same has been made in the notes to accounts.

Audit Manager has reported that she had asked certain information relating to another 'related party' transaction (amounting to approx. ₹ 35 lakh) but the CFO refused to provide the same since the same is perceived to be confidential and cannot be shared with the auditors.

You are required to advise about items to be reported to those charged with governance, where applicable, based on your audit findings in the given situation. **(5 Marks)**

(b) It was observed from the modified audit report of the financial statements of Param Limited for the year ended 31st March 2024 that depreciation of ₹ 3.75 crore for the year 2023-24 had been charged off to the Statement of Profit and Loss instead of including it in "carrying value of asset under construction". State in relation to the audit for the year ended 31st March 2024, whether such modification in the previous year's audit report would have any audit implication for the current year and if yes, how would you deal with it in your audit report? **(5 Marks)**

(c) While conducting the audit of Tex Limited, Mr. Dhanush observed that a substantial amount is recognized in respect of obsolescence of inventory and warranty obligation in the financial statements. Mr. Dhanush wants to obtain written representation from the management to determine whether the assumptions and estimates used are reasonable. Guide Mr. Dhanush with reference to the relevant Standard on Auditing. **(4 Marks)**

2. (a) JPG & Associates, Chartered Accountants, are statutory auditors of VS Limited for the last three years. VS Limited is engaged in the manufacturing and marketing of pharmaceutical goods in India. During 2023-24, the Company has diversified and commenced providing software solutions in "e-commerce" in India as well as in certain European countries. JPG & Associates, while carrying out the audit for the current financial year, came to know that the company has expanded its operations into a new segment as well as a new geography. JPG & Associates does not possess necessary expertise and infrastructure to carry out the audit of this diversified business activities and accordingly wishes to withdraw from the engagement and client relationship. Discuss the issues that need to be addressed before deciding to withdraw. **(5 Marks)**

(b) Mr. Sanket has been appointed as an auditor of XYZ Limited, a rapidly growing tech company, has recently adopted a range of new digital technologies to enhance its operations. These include robotics, artificial intelligence and blockchain. He seeks guidance on how to effectively conduct an audit in this technologically advanced environment. Explain what are the key steps for auditors in a changing technology environment? **(4 Marks)**

(c) CA. T, the statutory auditor of Race Limited, a PSU, for the year 2023-24. During the audit, CA. T did not detect any fraud having been committed during that year. However, the C & AG audit staffs, during their routine inspection, found that chief cashier of the company committed fraud in debtor's ledger and absconded with the amount. The investigation made in the fraud revealed that the auditor did not exercise proper skill and care and performed his work improperly.

Comment with reference to the provisions of the Chartered Accountants Act, 1949. **(5 Marks)**

3. (a) Kavyanjali Limited appoints Ridhi & Sidhi as statutory auditors for the financial year 2023-24. Ridhi & Sidhi seems to have different opinions on audit approach to be adopted for audit of Kavyanjali Limited. Sidhi is of the opinion that 100% checking is not required and they can rely on audit sampling techniques in order to provide them a reasonable basis on which they can draw conclusions about the entire population.

Ridhi is concerned whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

You are required to guide Ridhi about his role if audit sampling has not provided a reasonable basis for conclusions about the population that has been tested in accordance with SA 530.

(4 Marks)

(b) CA. Ankit is conducting concurrent audit of branch of a public sector bank. It is a large branch having advances of about ₹ 525 crores including export advances of ₹ 450 crores. Some borrowers also get Letter of Credits issued from branch for importing gold from Dubai. He wants to be sure that there is no revenue leakage in branch. For the time being, he is focusing on advances. Discuss any five areas pertaining to advances of the branch. **(5 Marks)**

(c) NIS Limited, a company registered under the Companies Act, 2013 has created a separate Trust "NIS Employees Gratuity Fund Trust". Both the Company and Trust are under the same management. Mr. Anuj is the auditor of both the entities. Mr. Anuj has observed that some part of the expenditure was not applied towards the objects of the trust. He informed the matter to the Board of Trustees through a separate report but did not qualify the audit report of the Trust. Comment with reference to the Chartered Accountants Act, 1949, and Schedules thereto. **(5 Marks)**

4. (a) Mr. Ashish was appointed as the engagement partner on behalf of Legacy & Co., a Chartered Accountant Firm, to conduct statutory audit assignment of Capital Limited, unlisted public company.

Mr. Sodi, one of the senior engagement team members, was given the responsibility to audit the matters as per the requirements of CARO, 2020 and in that connection, he made the following observations, that may be relevant for reporting as per the said order:-

Sr. No.	Observations
(i)	One of the Plant and Equipment taken on a lease ('right of use' asset) by Capital Limited was revalued based on the valuation by a registered valuer and the net carrying value of Plant and Equipment in aggregate was changed from ₹ 3 crore to ₹ 3.35 crore.
(ii)	During the year under consideration, the cash credit limit of ₹ 5.10 crore was sanctioned to Capital Limited by BDD Bank based on the security of current assets which was reduced to ₹ 4.75 crore after 6 months. In this connection, quarterly returns have been filed by the company with the BDD bank which are in agreement with Books of Accounts.

You are required to examine the contention of Mr. Sodi regarding reporting of the above observations in accordance with CARO 2020. **(5 Marks)**

(b) The nine principles in BRSR are categorized into the ESG components of Environment, Social and Governance with two of the nine in Environment, three in social and four in Governance. One of the principle relates to all the initiatives an entity has to take for the benefit of its employees from the point of view of their dignity, health, well-being. Elucidate the essence of core elements associated with the aforesaid principle. **(4 Marks)**

(c) CA. Suchi is the statutory auditor of RJ Limited for the financial year 2023-24. The company is engaged in the production of electronic products. During the audit, CA. Suchi obtained certain audit evidence of incorrect disclosure of related party transactions and structured finance deals which was not considered with the affirmation leading to misstatement in the financial statements. Discuss how CA. Suchi should deal with the situation in the auditor's report and the different options which can be considered?

(5 Marks)

5. (a) Compute the overall Audit Risk if looking to the nature of business there are chances that 40% bills of services provided would be defalcated, inquiring on the same matter management has assured that internal control can prevent such defalcation to 75%. On his part the auditor assesses that the procedure he could apply in the remaining time to complete audit gives him satisfaction level of detection of frauds & error to an extent of 60%. Analyse the Risk of Material Misstatement and find out the overall Audit Risk.

(5 Marks)

(b) One of the independent directors sought information regarding the appointment of internal auditors for following Group Companies in accordance with the Companies Act, 2013 of which certain Financial Information are given below:

Figures are in ₹ crore and correspond to the previous year.

Name	Nature	Equity Share Capital	Turnover	Loan from Bank and PFI	Public Deposits
IDI Limited	Listed	100	190	50	24
TIJ Limited	Unlisted Public	60	190	50	24
MIN Limited	Unlisted Private	60	190	50	-

You are required to evaluate the requirements of the Companies Act, 2013 regarding the appointment of internal Auditors for the Group Companies. Discuss. **(5 Marks)**

(c) CA. Rishi is a newly qualified Chartered Accountant in practice and in order to increase his professional practice and client base, entered into an agreement with Mr. Krish, a qualified and experienced registered valuer, to share 18% professional fees for all cases of valuation referred to him by CA. Rishi. Based on this, CA. Rishi received ₹ 1,15,000 during the year 2023-24 from Mr. Krish. Is CA. Rishi guilty of misconduct under the Chartered Accountants' Act, 1949? **(4 Marks)**

6. (a) You are engaged by M/s Anchor Limited to examine and report on prospective financial information which the management of the company has prepared for presentation at an Investor meet program organized by a State Government to attract investment in their state.

The company in its vision document described various plans and proposals of the company with projected financial goals and means to achieve the same and various benefits accruing to the economic development of the State. What important matters will be considered by you while determining the nature, timing, and extent of examination procedure to be applied in the review of the same? **(4 Marks)**

Or

CA. Tripti is conducting review of the quarterly financial information of a company of which she is also auditor. She believes that it is necessary to make a material adjustment to the quarterly financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework. She has communicated the matter to the CFO and audit committee. However, no response was received even after waiting for a reasonable time. What are the options available to her? **(4 Marks)**

(b) The Director (Discipline) of the ICAI received information of alleged misconduct against Mr. Nandkishore, the proprietor of NK & Associates, where an event relating to Corporate Social Responsibility was sponsored by NK & Associates, whereby in the sponsorship banner, name of Mr. Nandkishore as ‘CA Nandkishore, Proprietor, NK & Associates’ was mentioned.

On the basis of above information and along with certain evidence against Mr. Nandkishore, he was found guilty and so he was reprimanded and a fine of ₹ 1 lakh was imposed by an order passed against him dated 21st May, 2023.

Against the said order, Mr. Nandkishore preferred an appeal with the Appellate Authority on 04th June, 2023 by submitting a statement of appeal along with the application form of appeal. During such appellate proceedings, it was discovered that the said statement of appeal contained some facts which were false to which Mr. Nandkishore admitted it to be false and apologized for it.

Mr. Nandkishore has violated which of the provisions of the Chartered Accountants Act, 1949? Comment. **(5 Marks)**

(c) KBC nationalized bank received an application from a Limited company seeking sanction of a term loan to expand its existing business. In this connection, the Loan Manager of the Bank approaches you to conduct a thorough investigation of the items of the balance sheet of this Limited company and submit a confidential report based on which he will decide whether to sanction this loan or not. List out the major steps an investigating accountant would keep in mind while verifying assets and liabilities included in the balance sheet of the borrower company which has been furnished to the Bank. **(5 Marks)**

MODEL TEST PAPER 4

FINAL COURSE: GROUP I

PAPER-3: ADVANCED AUDITING, ASSURANCE AND PROFESSIONAL ETHICS

Time Allowed- 3 hours **Maximum Marks-100**

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I - Case Scenario based MCQs (30 Marks)

Write the most appropriate answer to each of the following multiple-choice questions by choosing one of the four options given. All MCQs are compulsory and carry 2 Marks each.

1. Mr. Rajan, the CEO of a mid-sized company, has received an email requesting him to urgently update his account details due to a supposed security breach. The said email, appears to be received from the Company's bank accounts, looks official due to use of bank's logo and branding. Such email also includes a link to a website that resembles the bank's login page. Concerned about the security of the company's finances, Mr. Rajan clicks on the link and enters his login credentials.

   Later, the company's IT department detects unauthorized access to the company's financial accounts and identifies that the CEO's credentials were compromised. Identify the type of cyberattack that Mr. Rajan fell victim to:

   (a) Smishing

   (b) Whaling

   (c) Spear Phishing

   (d) Vishing

2. DFL Ltd. has invited tenders for the appointment of statutory auditors, as M/s Cross Ltd., the previous auditor has retired due to completion of terms of engagement. The tender is exclusively for Chartered

Accountants. M/s SDS & Co. has submitted its tender quoting the fees for audit engagement considering the size and nature of business. The contract was awarded to M/s SDS & Co., and they were appointed as statutory auditors for 3 years from the financial year 2023-24. Whether M/s SDS & Co. will be held guilty of professional misconduct as per the Chartered Accountants Act, 1949.

(a) Yes, SDS & Co. will be held guilty of professional misconduct under clause (6) of Part-I of the First Schedule to the Chartered Accountants Act, 1949.

(b) No, SDS & Co. will not be held guilty of professional misconduct under clause (6) of Part-I of the First Schedule to the Chartered Accountants Act, 1949.

(c) Yes, SDS & Co. will be held guilty of professional misconduct under clause (7) of Part-I of the First Schedule to the Chartered Accountants Act, 1949.

(d) No, SDS & Co. will not be held guilty of professional misconduct under clause (7) of Part-I of the First Schedule to the Chartered Accountants Act, 1949.

3. M/s Pihu & Associates are the statutory auditors of Brick Ltd. for FY 2023-24. During the audit, CA Arpit, the engagement partner noticed the following:

- Notices received from various regulatory authorities.
- Payments of various fines and penalties.
- Unusual cash payments.
- Payments to various government employees not supported by any document.
- Heavy payments to legal counsels.

CA Arpit should consider the above as indicative of:

(a) Doubt on Internal Controls of Brick Ltd.

(b) Doubt of non-compliance with laws by Brick Ltd.

(c) Doubt on the accounting system of Brick Ltd.

(d) Doubt on the going concern assumption of Brick Ltd.

Case Scenario I [MCQ 4-8]

MNO Ltd., incorporated in the financial year 1980-81, is a distinguished company specialising in the manufacturing of nickel-based batteries. As one of the oldest manufacturing companies in this sector, MNO Ltd. operates with two manufacturing plants and a comprehensive distribution network that spans across India. Remarkably, MNO Ltd. was among the first companies to be listed on the stock exchange, underscoring its longstanding presence in the market. The company has consistently adhered to the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015, ensuring compliance with all regulatory standards.

M/s KP & Co. were the statutory auditor in the previous year and resigned from the role of statutory auditor. M/s JKL & Co. has been appointed as a statutory auditor of MNO Ltd. in the FY 2023-24. In conducting initial audit engagement, M/s JKL & Co. has simply placed reliance on the closing balances of preceding period.

During the audit, the auditor observed that the company is unable to pay its creditors on time. The company is also not able to properly comply with the terms of the loan agreement with the banks. Moreover, several key ratios are also adverse. In view of the above, the auditor asked management to provide assessment of going concern, however the management did not provide the same. Despite following up, the management did not provide the requested assessment. As a result, the auditor documented the request and follow-up regarding the going concern assessment in the working papers.

Apart from the above, the company has one accounting software for maintaining its books of accounts, which does not have any feature of edit log (Audit Trail). Accordingly, the auditor reported the said fact of not having the facility of edit log under the heading Other Legal & Regulatory Requirements-Rule 11(g) of the Companies (Audit and Auditors) Rules, 2014 in the main audit report.

Apart from above facts, the several important financial information of MNO Limited during the year ended 31st March 2024 are tabulated as below:

(₹ In Crore)

Sr. No	Particular	Amount (₹)
1.	Paid Up Share Capital	10
2.	Deficit balance in Profit & Loss Account	11.47
3.	Turnover	85
4.	Inventory*	15
5.	Cash Loss	2.95
6.	Operating Loss	1.97

*Out of Total inventory as above, inventory amounting to ₹ 12.35 Crore are lying with third party.

Based on above facts, answer the following MCQs

4. As per the requirement of SA 570, how auditor should deal in the matter of unwillingness of management to provide for the assessment relating to going concern?

   (a) Auditor should report such matters in the section of Key Audit Matter.

   (b) The auditor should properly document evidence relating to asking management and its subsequent follow up with the management for assessment on going concern and accordingly should express unmodified opinion.

   (c) Auditor should report such matters in Emphasis of Matter Paragraph Section.

   (d) Auditor should express modified opinion in his audit report.

5. As per SA 501, what is the correct audit procedure to be followed regarding the existence and condition of inventory wherein an inventory valued ₹ 12.35 crore is lying with the third party?

   (a) The auditor should rely on the management explanation regarding the inventory lying with the third party.

   (b) The auditor should request confirmation from third party as to the quantities and condition of the inventory held with them or perform inspection or other audit procedures as appropriate.

   (c) The auditor should verify the inventory lying with the company.

(d) The auditor should take written representation only from the management regarding the inventory lying with the third party.

6. State the amount required to be reported by the auditor of MNL Ltd., under clause 3(xvii) of Para 3 of CARO, 2020 on account of losses during the year under consideration.

   (a) ₹ 4.92 Crore

   (b) ₹ 1.97 Crore

   (c) ₹ 2.95 Crore

   (d) ₹ 11.47 Crore

7. According to SA 510, which of the following audit procedures can be implemented by M/s JKL & Co. to obtain sufficient and appropriate audit evidence on the opening balances about whether it contain any material misstatement that could affect financial statements of current year?

   (i) Closing balances of the preceding period have been correctly brought forward to the current period.

   (ii) Performing specific audit procedures to obtain evidence regarding its opening balances.

   (iii) Determining whether the opening balances reflects the application of appropriate accounting policies.

   (a) Only (i)

   (b) Only (iii)

   (c) Only (i) and (iii)

   (d) (i), (ii) and (iii)

Case Scenario II [MCQ 8-10]

EFG Ltd., incorporated in 1984-85, has distinguished itself as one of the most rapidly growing non-banking financial companies (NBFCs) having principal business of granting loans. Its head office is situated in Pune, a city renowned for its dynamic financial and industrial sectors. Remarkably, EFG Ltd. holds the notable achievement of being among the first NBFCs to be listed on the stock exchange, which underscores its longstanding and influential presence in the financial market. Over the years, the company has demonstrated an unwavering commitment to regulatory compliance by consistently adhering to the Securities and Exchange Board of India's (SEBI) Listing Obligations and

Disclosure Requirements Regulations of 2015. This steadfast adherence ensures that all its operations align with the rigorous standards set by regulatory authorities, thereby reinforcing its credibility and trustworthiness among investors and stakeholders.

M/s SDS & Co. thoroughly obtained the knowledge and background of the company, including an understanding of the legal and regulatory requirements applicable to the company.

During the audit of the financial statements, auditor observed that, the company has violated one of the prudential guidelines of RBI as applicable to the company relating to the acceptance of public deposit. Since the company was non deposit taking, and in one case during the year under consideration, the company had accepted the public deposit. In this regard, the management has also provided a detailed note in the financial statements and subsequently also repaid the said deposit in the next financial year. Considering the said note, the auditor feels that the matter is important and required attention of the users of the financial statements.

The auditor of EFG Ltd. sent confirmation requests to 14 debtors (to whom loan has been granted) to confirm the year-end balances as per SA 505. The said requests were designed in such a way that debtors will directly respond to the auditor only when they disagree with the same.

Based on above facts, answer the following MCQs

8. Considering the nature of the business, which Reporting clauses of CARO, 2020 would be applicable from below: -

    (i) Whether the company has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934

    (ii) In respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;

    (iii) Whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

(iv) Whether the company has provided any loans, guarantee or provided security to any other entity.

(a) Only (i) and (iii)

(b) Only (i), (ii) and (iii)

(c) Only (i) and (ii)

(d) Only (i), (ii) and (iv)

9. What is the auditor's responsibility when the audit of EFG Ltd. for the previous year has not been conducted by the current auditor i.e. M/s SDS & Co.?

(i) The auditor needs to report such matters in the other matter paragraph in the main audit report.

(ii) The auditor needs to report such matter in the emphasis of matter paragraph.

(iii) The auditor shall be responsible for obtaining sufficient and appropriate audit evidence that the opening balances does not contain any material misstatement.

(a) Both (i) & (iii)

(b) Both (ii) & (iii)

(c) Only (ii)

(d) Only (i)

10. In the given case, what is the reporting requirement in relation to SA 250, on the part of auditor, with reference to violating guidelines by the company relating to the acceptance of public deposit?

(a) The auditor is required to report such matters in the main audit report under the head Other Matter paragraph section only.

(b) The auditor is required to report such matters in the main audit report under the head Emphasis of Matter paragraph section only.

(c) Apart from reporting under the Emphasis of Matter paragraph, the auditor is also required to report to RBI.

(d) Apart from reporting under the Other Matter paragraph, the auditor is also required to report to RBI.

Case Scenario III [MCQ 11-15]

CA Ram and CA Lakshman are close friends and are into practice as sole proprietors. Both decided to expand their focus on taking up more assignments in the field of Goods & Services Tax. On back of the same, they both decided to conduct a joint training session for their clients on GST and decided to share the total fee collected thereof. They invited another CA from their professional circle to join the initiative, however, the person declined the same informing that this act was against professional ethics and will lead to disciplinary action from ICAI.

The partner of M/s AK & Associates is a close friend of CA Ram. The firm was involved in an audit of a listed company which was required to submit Business Responsibility and Sustainability Report (BRSR). The company being audited was into thermal energy production business in India. They had submitted details about the total emissions from its production outlets during the year and a detailed energy consumption plan which it had devised for the upcoming years. Since CA Ram had undergone a course on Sustainability Reporting, he was approached for getting advice on what needs to be reported in the BRSR of the company. As a gesture for helping the firm, the partner of the firm suggested CA Ram's name to the post of becoming a member in the Board of Management of KYC Co-operative Bank, a Primary (Urban) Co-operative Bank and a client of AK & Associates. Upon hearing the same, CA Lakshman requested Ram not to take up the post as it would lead to professional misconduct.

CA Ram was acting as an internal auditor of PL Technologies Private Limited. The company decided to raise more funds for expanding its business across the country by including new age technological services such as AI. Ram was observing the business model and the way in which the company was operating for quite some time, and he was keen on investing in the company. As a result, he decided to invest in the company's shares and ended up acquiring 9.75% of the shares (total face value of the shares acquired was ₹ 4.75 lakhs) of the company during the financial year. CA Lakshman got to know about this information, and he immediately urged Ram to resign from the being the internal auditor of PL Technologies Private Limited, for the reason that an internal auditor cannot hold any shares in the company, and it will lead to professional misconduct and also failure to comply with the provisions of the Companies Act, 2013. However, Ram did not accept the argument of Lakshman, and he said that nothing will happen because of him acquiring 9.75% shares in the company and continuing to act as its internal auditor.

CA Lakshman was the statutory auditor for GH Finance Private Limited, a NBFC head quartered in India. The company's treasury department had undergone changes in the recent past and the current set of team members did not have much experience in handling the treasury functions. Due to this situation, the company reached out to their auditor CA Lakshman who was also into equity research advisory apart from CA practice, to support the company and the members of its treasury department for a brief period by giving Investment Advisory Services, to ensure efficient utilization and management of the funds of the company. Before committing anything on the offer, CA Lakshman wanted to consult with CA Ram as to whether the service requested by the NBFC can be performed by him.

11. Whether the act of conducting joint training session on GST by CA Ram & Lakshman and sharing of the fee collected leads to professional misconduct as per the Chartered Accountants Act 1949?

    (a) Yes, as per clause 2 of Part I of First Schedule, a CA in practice is allowed only to pay / share the commission or brokerage or profits from his professional business only with another practicing CA It does not allow sharing of any fee collected from joint training sessions. Hence both CA Ram & Lakshman are guilty of professional misconduct.

    (b) Yes, CA Ram & Lakshman will be held guilty of professional misconduct for conducting the joint training session on GST as per part IV (other misconduct) of the First Schedule of the Chartered Accountants Act 1949.

    (c) Yes, this is a case of solicitation of client whereby CA Ram can influence clients of CA Lakshman and vice-versa. Hence the conduct of the joint training session will lead to being guilty of professional misconduct as per clause 6 of Part I of First Schedule.

    (d) No, as per the recent decisions of Ethical Standards Board, it is permissible for 2 or more CA in practice collectively to have joint training session for their clients on GST, and share the fee collected from the clients thereof.

12. With regards to the BRSR reporting on the data of total emissions & the future energy consumption plans of the company, how do you treat them?

    (a) The details of the emission forms part of the Essential Indicators and need to be mandatorily disclosed. However, the plan for future energy consumption is only a Leadership Indicator and is considered as optional disclosure.

    (b) Both the details of the emission & future energy consumption plans form part of the Essential Indicators and need to be mandatorily disclosed in the BRSR.

    (c) The details of the emission are a Leadership Indicator and is considered as optional disclosure, whereas the plan for future energy consumption is an Essential Indicator and needs to be mandatorily disclosed in the BRSR.

    (d) Both the details of the emission & future energy consumption plans form part of the Leadership Indicators and are considered as optional disclosure.

13. The futuristic plan which the company has for its energy consumption can be categorized under which principle of National Guidelines on responsible business conduct?

    (a) Principle 1 – Ethics, Transparency and Accountability

    (b) Principle 6 – Protection and Restoration of Environment

    (c) Principle 4 – Respect for Stakeholder's Interests and Responsiveness

    (d) Principle 7 – Influence on Public and Regulatory Policy

14. By accepting the offer to become a member of the Board of Management of KYC Co-operative Bank, do you think that CA Ram would be held guilty of professional misconduct?

    (a) Yes. As per clause 11 of Part I of First Schedule CA Ram would be held guilty of professional misconduct for engaging in another profession/ occupation without the permission of ICAI.

(b) It is permissible for a CA in practice to become a member of the board of management in primary (Rural) co-operative banks. Hence, CA Ram would be held guilty of professional misconduct if he accepts the offer.

(c) It is permissible for a CA in practice to become a member of the Board of management in primary (urban) co-operative banks. Hence, CA Ram would not be held guilty of professional misconduct if he accepts the offer.

(d) Yes. CA Ram would be held guilty of professional misconduct under Part III (other misconduct in relation to members of the Institute generally) of Second Schedule, as Ram is getting this offer as a reciprocation for helping AK & Associates.

15. In the given case, it is mentioned that CA Lakshman is a practicing CA and is also engaged as an Equity Research Advisor. Do you think that CA Lakshman will be held guilty of professional misconduct as per the provisions of the Chartered Accountant Act,1949?

(a) No. A CA in practice may be an equity research advisor, but he cannot publish retail reports as it would amount to other business or occupation. Thus, if CA Lakshman doesn't publish any reports, he will not be held guilty of professional misconduct.

(b) Yes. As per clause 11 of Part I of First Schedule CA Ram would be held guilty of professional misconduct for engaging in another profession/ occupation without the permission of ICAI.

(c) A CA in practice cannot be an Equity Research Advisor, for his existing clients or for any other person. Hence, CA Lakshman will be held guilty of professional misconduct.

(d) Yes. As per clause 11 of Part I of First Schedule read with Part III of Second Schedule, CA Ram would be held guilty of professional misconduct for engaging in another profession/ occupation without the permission of ICAI.

PART II – Descriptive Question (70 Marks)

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

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

1. (a) Spice Ltd., FMCG company, having its tea gardens in northeastern states of the country is exclusively dealing in blending, processing, packing and selling of various brands of tea. During the year under audit, the company entered into joint venture for purchasing Tea Gardens in South Africa and Vietnam. M/s Dharam & Associates are the statutory auditors of the company for the financial year 2023-24. During the audit, the audit team was unable to obtain sufficient appropriate evidence about a single element of the consolidated financial statements being Joint venture investment in Croptop Ltd. representing over 89% of the group's net assets having both material and pervasive possible effect to the consolidated financial statements. The group's investment in Croptop Ltd. is carried at ₹ 120 crore in the group's consolidated balance sheet.

Draft the opinion paragraph and basis of opinion paragraph to be included in the Independent Auditor's report. **(5 Marks)**

(b) As auditor of Growth Limited, you have sent positive confirmation requests to 45 creditors of the company in March 2024. All of the creditors in the informal sector are small concerns. You choose to send positive confirmation requests to all the above parties at their business addresses stated on respective bills after discussing the matter with the CFO of the company. The CFO is cooperative and does not raise any hassles in the matter.

Responses to confirmation requests are received within a week's time. Your articled clerk informs you that out of above 45 creditors, GST registrations of 38 concerns have been cancelled during financial year 2023-24 itself by collating information from GST portal. He further informs you that there are no fresh registrations pertaining to PANs of these parties.

How would you proceed to deal with the situation as auditor of the company? **(5 Marks)**

(c) CA Shobit is conducting an audit of XYZ Ltd. for the year 2023-24. The company is engaged in the export of handicraft items in Europe. The audit is nearing completion in the month of July 2024. However, it becomes known to CA Shobit that one of overseas buyers has made a legal claim against the company on 1st June 2024 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August 2023. The management of the company has decided to agree to an out of court settlement of ₹ 4 crore to protect its reputation. The financial statements of the company are silent on this issue. Discuss how CA Shobit should proceed to deal with the above issue. **(4 Marks)**

2. (a) CA J is the statutory auditor of a branch of a nationalized bank. During the audit, he is also focusing upon verification of Current Accounts & Savings Accounts (CASA) maintained at the branch. Suggest a few audit procedures he should follow. **(5 Marks)**

(b) Mr. Aditya, a Chartered Accountant was the auditor of 'DRAW Limited'. During the financial year 2023-24, the investment appeared in the Balance Sheet of the company of ₹ 23 lakh and was the same amount as in the last year. Later on, it was found that the company's investments were only ₹ 76,000, but the value of investments was inflated for the purpose of obtaining higher amount of Bank loan. Comment with reference to the provisions of the Chartered Accountants Act, 1949 and Schedules thereto.

(5 Marks)

(c) CA Kabir, an auditor assigned to conduct a remote audit of Beetal Limited. The audit will be conducted virtually using online platforms, with the client sharing documents and participating in video conferences. What key considerations should CA Kabir address to ensure the effectiveness and security of the remote audit? **(4 Marks)**

3. (a) Deepti & Co., Chartered Accountants, during the audit of Magma Ltd. found that certain machinery had been imported for production of new product. Although the auditors have applied the

concept of materiality to the financial statements as a whole, they now want to re-evaluate the materiality concept for the said transaction involving foreign exchange. Give your views in this regard? **(4 Marks)**

(b) Singh Ltd. is a company registered under the Companies Act, 2013. The company is engaged in the business of loans and advances, acquisition of shares / stocks / bonds / debentures/securities issued by government or local authorities. For the year ended 31st March 2024 following are some extracts from the financial statements:

(i)	Paid-up share capital	₹ 50 Cr.
(ii)	Non-Current Assets - Loans & Advances	₹ 61.75 Cr.
(iii)	Current Assets - Loans and advances	₹ 312.25 Cr.
(iv)	Total assets of the company	₹ 620 Cr.
(v)	Intangible assets	₹ 12 Cr.
(vi)	Profit for the Year	₹ 7.25 Cr.
(vii)	Income from interest and dividends	₹ 68 Cr.
(viii)	Gross income	₹ 118.75 Cr.

Directors intend to apply for registration as Non-Banking Financial Company (NBFC) under Section 45-IA of the Reserve Bank of India (Amendment) Act, 1997. Advise **(5 Marks)**

(c) CA Shubh, a Chartered Accountant in practice specializing in the field of Information Systems Audit. He is considered to be one of the experts in this field because of his command over the subject. ZX Limited, a company engaged in rendering management consultancy offered him to appoint as its managing director. CA Shubh accepted the position of managing director without obtaining prior permission from the Institute. One of his friends, CA Varun informed him that now he cannot retain full time certificate of practice, thus cannot do attestation function and train articled assistants. Comment with reference to the provisions of the Chartered Accountants Act, 1949 and Schedules thereto.

(5 Marks)

4 (a) Discuss the reporting responsibilities of statutory auditor in the following situations for year 2023-24 under CARO, 2020:

(i) In the financial year 2023-24, Candy Ltd. decided to upgrade its registered office, located at a prime spot in Bangalore. As a part of this upgrade, the company sought to acquire an adjacent plot of land owned by Mr. Sidhant, who is also a director of Candy Ltd. Initially hesitant to sell, Mr. Sidhant was persuaded to transfer his property to the company in exchange for a larger plot owned by Candy Ltd. This plot, located on a nearby street, is double the size of Mr. Sidhant's land.

Satisfied with the exchange, Mr. Sidhant agreed to transfer the property, and the exchange was formalised in a deed executed by the company's authorised representatives and Mr. Sidhant. The registration of the properties was completed by December 31, 2023.

(ii) On 15th May, 2023, a TDS survey was carried out in premises of SSO Industries Limited in accordance with the provisions of the Income-tax Act, 1961.The survey team pointed out certain lapses regarding non-deduction of tax at source and subsequently Deputy Commissioner of Income Tax (TDS) raised a demand of ₹ 25 lacs on the company treating it as "assessee in default". The company has not deposited demand raised and filed appeal against impugned order on 1st March, 2024 under e-appeals scheme with JCIT (Appeals). **(5 Marks)**

(b) One of the independent directors sought information regarding the appointment of internal auditors for the following Group Companies in accordance with the Companies Act, 2013 of which certain financial information is given below:

Figures are in ₹ crore and correspond to the previous year.

Name	Nature	Equity Share Capital	Turnover	Loan from Bank and PFI	Public Deposits
XYX Limited	Listed	100	230	20	48

MNM Limited	Unlisted Public	60	100	50	24
GFG Limited	Unlisted Private	70	180	80	-

You are required to evaluate the requirements regarding the appointment of internal Auditors for the Group Companies. Discuss. **(5 Marks)**

(c) Pitch Private Limited requested CA Angad, a practicing Chartered Accountant, to digitally sign the form related to resignation of Mr. Ravi, one of the Director of Pitch Private Limited, along with the copy of resignation letter to be uploaded on the website of Registrar of Companies. The signature of Mr. Ravi was simply copied and pasted by another Director of Pitch Private Limited. CA Angad, without verifying the genuineness of the resignation letter, digitally signed the form and the said form was uploaded on the website of Registrar of Companies. Comment with reference to the provisions of the Chartered Accountants Act, 1949 and Schedules thereto. **(4 Marks)**

5. (a) SPS & Associates, Chartered Accountants, are statutory auditors of Grec Limited for the last two years. Grec Limited is engaged in the manufacturing and marketing of pharmaceutical goods in India. During the year 2023-24, the company has diversified and commenced providing software solutions in "e-commerce" in India as well as in certain African countries. SPS & Associates, while carrying out the audit, noticed that the company has expanded its operations into a new segment as well as in a new country. SPS & Associates does not possess the necessary expertise and infrastructure to carry out the audit of these diversified business activities and accordingly wishes to withdraw from the engagement and client relationship. Discuss the issues that need to be addressed before deciding to withdraw. **(5 Marks)**

(b) CA H was appointed as a Statutory Auditor of MNL Limited, a listed company, which has three subsidiaries namely M Ltd., N Ltd., L Ltd. and also 15 branches across India. The Auditors are duly appointed for all the subsidiaries and branches. What should be the considerations of CA H regarding determination of materiality during the audit of consolidated financial statements? How he should deal in his report if there are observations (for instance modification and/or emphasis of matter paragraph in accordance with SA 705/706) made by component auditors?

(5 Marks)

(c) During the audit of Indo limited, CA Harish observed that processing of accounting data was given to a third party on account of certain considerations like cost reduction, own computer working to full capacity. Indo Limited used a service organisation to record transactions and process related data. What factors should CA Harish consider regarding the nature and extent of activities undertaken by service organisation so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk.

Discuss with reference to the relevant Standards on Auditing.

(4 Marks)

6. (a) You are engaged by M/s Viva Limited to examine and report on prospective financial information which the management of the company has prepared for presentation at an Investor meet program organized by a State Government to attract investment in their state.

The company in its vision document described various plans and proposals of the company with projected financial goals and means to achieve the same and various benefits accruing to the economic development of the State. What important matters will be considered by you while determining the nature, timing, and extent of examination procedure to be applied in the review of the same? **(5 Marks)**

(b) Shri Limited, a listed Company, having its registered office at Mumbai is engaged in manufacturing of various types of yarns to be supplied to the textile mills. The Company has installed pollution control equipment for processing the pollutants so that before discharge of effluents outside the factory, the level of pollution is kept at a level below the prescribed standard. The company managed to get the pollution clearance certificate by unfair means, while still there continues to be breach of pollution control laws in matters of discharge of polluting effluents. The amount of ₹ 18.75 Lacs had been incurred for arranging clearance certificate and the amount incurred unlawfully had been booked as pollution recycling expenditure. The matter had not reached those in governance, and the Director-Finance, who is a Chartered Accountant, came to know of these matters on review of major expenditure incurred during the period. Comment on the action/responses expected of Director - Finance (CA Gopal) referring to any applicable requirements of Responses for NOCLAR under Code of Ethics. **(5 Marks)**

(c) Vicky is a financial analyst working for a large corporation that is considering the acquisition of a mid-sized manufacturing company. The initial financial statements provided by the target company appear to be in order, showing profits and a solid asset base. However, his team is concerned about potential risks that may not be immediately visible in the financial documents provided.

Guide Vicky on what specific aspects should be focused during due diligence to ensure that there are no hidden liabilities in this deal? **(4 Marks)**

OR

CA Y is the auditor of Stekk Ltd., a company that recently faced material misstatements in its financial records, leading to an adverse opinion on the audited financial statements for the financial year 2023-24. Now, the management of the company has prepared summary financial statements derived from the audited financial statements and requested CA Y to express his opinion on these summaries. What additional points should CA Y consider when expressing an opinion on these summary financial statements? **(4 Marks)**

MODEL TEST PAPER 5

FINAL COURSE: GROUP I

PAPER-3: ADVANCED AUDITING, ASSURANCE AND PROFESSIONAL ETHICS

Time Allowed- 3 hours **Maximum Marks-100**

1. *The question paper comprises two parts, Part I and Part II.*
2. *Part I comprises Case Scenario based Multiple Choice Questions (MCQs)*
3. *Part II comprises questions which require descriptive type answers.*

PART I - Case Scenario based MCQs (30 Marks)

Write the most appropriate answer to each of the following multiple-choice questions by choosing one of the four options given. All MCQs are compulsory and carry 2 Marks each.

1. PIHU Ltd. is a company engaged in the manufacture of Kids toys. The company sells its goods on credit basis. M/s. Mohan Sohan & Associates have been appointed as statutory auditors of PIHU Ltd. for the FY 2023-24. During the course of audit, CA Mohan, the engagement partner asks the management about the e-mail addresses of trade receivables of the company for the purpose of obtaining balance confirmation from the trade receivables. The management of the company asked its sales supervisor to send a confirmation request to the trade receivables and collect all the responses and provide all such responses to the auditor. The management of PIHU Ltd. also informed CA Mohan that confirmation with respect to two of its trade receivables, namely Moon Ltd. and Sun Ltd. won't be available as a dispute between PIHU Ltd. and both the trade receivables is going on. With respect to other trade receivables, the sales supervisor provided CA Mohan with all the balance confirmation. With respect to the balance confirmation request, which of the following is warranted as per the requirement of the relevant SA?

   (a) CA Mohan should not have relied on the explanation provided by the management with respect to the trade receivables, namely Moon Ltd. and Sun Ltd. and he should perform alternative procedures with respect to such trade receivables.

(b) CA Mohan should have obtained direct response from all other trade receivables instead of sales supervisor receiving direct responses from trade receivables and providing them to the auditor.

(c) Both (a) and (b).

(d) CA Mohan should give a qualified opinion as balance confirmation with respect to two trade receivables is not available.

2. CA Rajveer is conducting an audit of a manufacturing company. To streamline the audit process, he uses a sampling tool to select a representative sample of transactions from a large dataset of sales records. He also employs a BOT to cross-check the company's compliance with statutory payments like GST and TDS. While reviewing the financial statements, Rajveer relies on Excel to automate calculations such as variance analysis and trend reports, ensuring the audit is completed on time and meets regulatory requirements. Which type of audit is being described in the above?

   (a) Digital Auditing.

   (b) Auditing Digitally.

   (c) Manual Auditing with technological assistance.

   (d) Traditional Audit.

3. TK Associates a chartered accountant firm has been appointed as an auditor of the company for the financial year 2023-24. It consists of two partners CA T & CA K. CA T is brother of the father of the finance director of the company BAC Ltd. CA K is an old friend of the finance director of the company BAC Ltd.

   What kind of ethical threat is associated with appointment of TK Associates as an auditor of BAC Ltd.?

   (a) Self Interest Threat.

   (b) Advocacy Threat.

   (c) Familiarity Threat.

   (d) Self-Review Threat.

Case Scenario I [MCQ 4-8]

GROSS Ltd., an unlisted company in Jamshedpur, is engaged in the business of spices. Total paid up capital of the company is ₹ 10 Crore. Details of annual turnover and profit of the company for the last 3 years are given below:

Year ended	Turnover (₹ in crore)	Profit (loss)before tax (₹ in crore)
31-03-2022	475.20 (Audited)	65.75
31-03-2023	278.35 (Audited)	01.32
31-03-2024	108.25 (provisional)	(06.25)

The company is using conventional method for preparing spices. This requires more human intervention and hence, cost of production is high as compared to innovative method used by other new companies. Though the company had significant growth in the past years, it has not done well over the last two financial years due to competition.

A new competitor viz, Spice Herbs Ltd, had come in the market during the year 2022 and by the end of March, 2023, they captured around 75% of market share by offering the product at a reduced price. They use new machinery which allows minimizing manual steps and reducing cost of labour.

In order to reduce cost of production and thereby re-capture the market, the management of GROSS Ltd has planned to erect a new plant with an automatic machine. The estimated cost of plant & machinery is ₹ 75 lakh. The company approached IDN Bank Ltd for a term loan of ₹ 70 lakh which would be repaid in 5 years. On 28-12-2023, the bank had sanctioned the loan; and disbursed ₹ 35 lakh till 31st March, 2024.

GROSS Ltd. has appointed M/s Hook & Crook, Chartered Accountants, as auditors of the company at its AGM held on 15-08-2023 for a period of 5 years. As agreed, the audit team commenced their audit work for the year 2023-24 in February, 2024 and completed the work by the end of May, 2024. The audit team submitted following findings to the engagement partner:

- PX Ltd., one of the material suppliers, filed a case against the company on 10-08-2023 for a compensation of ₹ 2.5 crore.
- Company has made an estimate for allowance of debtors @8%.

- 65% of the value of inventory was only covered in physical verification during the year 2023 due to fire.
- Company got a show cause notice from State Pollution Control Board for the contravention of the provisions of Hazardous and waste Management Rule.
- Three incidences of fraud noticed (Total ₹ 1.25 crore)- fraud committed by the Purchase manager ₹ 90 Lakh, by Accounts manager ₹ 15 Lakh and by a cashier ₹ 20 Lakh.

As an auditor of GROSS Ltd for the year 2023-24, answer the following questions based on the facts given in the above paragraph:

Based on above facts, answer the following MCQs

4. Though the company had significant growth in the past years, it has not done well over the last two financial years. As per SA 570, there are certain events or conditions that individually or collectively may cast significant doubt about the going concern assumptions. In order to assess whether GROSS Ltd. is a going concern or not, which of the following audit procedures should not be performed?

   (a) Analyse and discuss with the management of the company to find out whether installation of new plant and machinery would enable the company to reduce cost of production.

   (b) Inquire the company's legal counsel regarding existence of legal litigation and claim against the company, reasonableness of management assessments of their outcome and estimate of their financial implication.

   (c) Evaluating management's future plan and strategy to increase market share of product.

   (d) Analyse and discuss the company's cash flow and profit of the previous years with the projected accounts.

5. Company has made an estimate for allowance of debtors @8%. Some financial statement items cannot be measured precisely but can only be estimated. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimating uncertainty associated with accounting estimates. Please advise which among the

following may have higher estimate uncertainty and higher risk as per SA 540?

(a) Judgments about the outcome of pending litigation with PX Ltd against the company.

(b) Estimates made for inventory obsolescence that are frequently made and updated.

(c) A model used to measure the accounting estimates is well known and the assumptions to the model are observable in marketplace.

(d) Accounting estimate made for allowance for doubtful debts where the result of the auditors' review of similar accounting estimates made in the prior period financial statements do not indicate any substantial difference between the original accounting estimate and the actual outcome.

6. The company in the notes accompanying its financial statements disclosed the existence of suit filed against the company with full details. Based on the audit evidence obtained, it is necessary to draw user's attention to the matter presented in the financial statement by way of clear additional communication as there is an uncertainty relating to the future outcome of the litigation. In this situation, which of the following reporting option would be correct if auditor is satisfied with the conclusions reached by the management and this matter is fundamental to the reader of financial statements?

(a) Include an Emphasis of Matter paragraph in Auditors report having a clear reference to the matter being emphasized and issue a qualified opinion.

(b) Include in the Basis for Adverse opinion paragraph and issue an adverse opinion having a clear reference to the matter referred in the notes on accounts.

(c) Include in the Basis for Disclaimer of opinion paragraph having a clear reference to the matter and issue a disclaimer opinion.

(d) Include an Emphasis of Matter Paragraph in Auditors report having a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statement.

7. Company got a show cause notice from State Pollution Control Board. As per SA 250, the auditor shall perform the audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements. As the audit team of the company became aware of information concerning an instance of non-compliance with law, what would NOT be the audit procedure to be performed?

   (a) Understand the nature of the act and circumstances in which it has occurred and obtain further information to evaluate the possible effect on the financial statement.

   (b) Discuss the matter with management and if they do not provide sufficient information; and if the effect of non-compliance seems to be material, legal advice may be obtained.

   (c) Monitoring legal requirement and compliance with code of conduct and ensuring that operating procedures are designed to assist in the prevention of non-compliance with law and regulation and report accordingly.

   (d) Evaluate the implication of non-compliance in relation to other aspects of audit including risk assessment and reliability of written representation and take appropriate action.

8. The company had availed some amount of loan for new plant and machinery during the year under audit. Out of the total loan sanctioned, an amount of ₹ 35 lakh was earmarked for the purchase of the machinery- Spice Grinder; but the company has acquired an improved model of machinery, viz, Spice grinder and mixer instead. State which of the reporting option would be correct.

   (a) State the fact in CARO report that out of term loan taken for machinery-spice grinder, ₹ 35 Lakh was not utilized for acquiring the machinery for which it was sanctioned.

   (b) Ask the management to change terms and condition of term loan as the company has acquired a different machinery. Report under CARO, if the management does not agree with the demand.

   (c) State the fact in CARO report that the term loan taken has been applied for the purpose for which it was sanctioned.

(d) State the fact in CARO report that the term loan taken has not been applied for the purpose for which it was sanctioned. Also qualify the report as there are misstatements that are material but not pervasive.

Case Scenario II [MCQ 9-11]

The UNCO Bank Ltd. was having 145 branches all over India by the year ending 31st March 2023. Twelve branches of the bank were already covered for concurrent audit and the Bank's Audit Committee decided to include the below mentioned branches for concurrent audit from the year 2023-24.

(i) Udaipur branch which deals in treasury functions like investments and interbank borrowings but not in bill re-discounting.

(ii) Varanasi branch which started foreign exchange business from February 2024.

(iii) Chandigarh branch whose aggregate deposits were more than 35% of the aggregate deposits of the bank.

Globe and Associates, Chartered Accountants were appointed as the stock auditors by the Bank's audit committee for four branches for year 2022-23. The Bank's management appointed and fixed the remuneration of Globe and Associates, Chartered Accountants as the statutory auditors also for the year 2022-23, for the same five branches for which they were given the assignment of stock audit.

At the Kolkata branch of the bank there were high value cash deposits in one of the current accounts during April 2023. Your firm has been appointed as the concurrent auditors for the Kolkata branch for the year 2023-24. The cash collected by the branch was remitted to currency chest on the very same day but, during the concurrent audit for the month of April 2023 itself the auditor noticed that the branch was unable to show intimations sent via e-mail to currency chest for the cash remittance.

Based on above facts, answer the following MCQs

9. Globe and Associates, Chartered Accountants were already appointed for stock audit by the audit committee for the four branches, so whether Globe and Associates, Chartered Accountants are authorised to accept the appointment as statutory auditors for the same branches? Select correct option from the following:

(a) Globe and Associates, Chartered Accountants cannot accept the appointment as it was not offered by the audit committee and Bank's management is not authorised to appoint the auditors.

(b) Globe and Associates, Chartered Accountants can accept the appointment as they were already appointed for the stock audit of those branches by the audit committee.

(c) Globe and Associates, Chartered Accountants can accept the appointment as they have been appointed statutory auditors for the same five branches for which they were conducting stock audit.

(d) Globe and Associates, Chartered Accountants cannot accept the appointment as the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the Bank during the same year.

10. Whether the Bank's Management is authorised to appoint and fix the remuneration of statutory auditors without consulting the Audit Committee of the Board of Directors or members in Annual General Meeting? Select correct option from the following:

(a) Bank's Management cannot appoint or fix the remuneration of the statutory auditor unless the same is passed by a resolution in the Annual General Meeting of the Bank.

(b) Bank's Management can appoint and fix the remuneration of statutory auditors only in consultation with the Audit Committee of the Board of Directors.

(c) Globe and Associates, Chartered Accountants were already appointed for stock audit by the audit committee, therefore only audit committee was authorised to appoint or fix their remuneration as statutory auditors.

(d) Globe and Associates, Chartered Accountants were already appointed for stock audit by the audit committee, so the Bank's Management is authorised to appoint the same firm as the statutory auditors without consulting the audit committee or members in the Annual General Meeting.

11. How the discrepancy of not preserving the intimations of cash remittances to currency chest by Kolkata branch of the bank should be

dealt by the concurrent auditor in his audit report? Select the correct option from the following:

(a) The auditor should report the matter as a major irregularity in his audit report to the management.

(b) The auditor should verify the details from e-mail sent to currency chest and close the matter.

(c) As it is a minor irregularity the auditor can ignore the same.

(d) The auditor should discuss the importance of preserving the hard / soft copy of e-mail sent for cash remittance with the Branch Manager and check for its compliance in the next audit period.

Case Scenario III [MCQ 12-15]

M/s AIM & Co. Chartered Accountants is a newly started firm. Their first assignment was to conduct a statutory audit of M/s DM Crackers Ltd. (a cracker manufacturing company). Since it was their first audit, the partners immediately accepted the work, without paying attention to the relevant procedures. They started their audit work from 25th May 2023 for the financial year (say previous year) ended on 31st March 2023.

During the course of the audit,

(I) The auditors requested for the financials of the preceding previous year, along with the details of transactions till 25th May of the current year. The management, however, argued that both the details are out of the scope of audit and hence told that they can't provide the details. However, after repeated request from the auditors, they finally provided in September 2023.

(II) It was suspected that the senior accountant could have indulged in a fraud amounting to ₹ 115 lakh. However, on further investigation by management it was found that there was a gross mistake on part of the accountant, who had wrongly debited and credited certain accounts by mistake, which amounted to ₹ 17 lakh. The company provided proper and correct evidence for the balance amount; hence the auditors were strongly convinced that no fraud had taken place. Due to the absence of an audit committee, the auditors suggested to the director (finance) to replace the existing accountant as he was poor in basic accounting skills.

Initially, the company thought of handing over the tax audit work to the previous auditor. However, since they had a bad experience last year, in form of an argument regarding the contents to be included in the tax audit report, especially with respect to the disclosure of key ratios, it was decided that the AIM & Co. shall also act as tax auditors.

After the conclusion of the audit, Mr. Shyam, one of the partners of the firm, was confused as to whether the firm could be held guilty of professional miscount for a plausible violation of any of the provisions of the Chartered Accountants Act. He contacted Mr. Ghanshyam, his partner, to get clarified about the doubt.

M/s Hire (P) Ltd., a recruitment agency contacted Mr. Shyam regarding a vacancy in one of the leading manufacturing company. Eventually Mr. Shyam resigned as the partner of AIM & Co. and joined the company. The agency raised an invoice for the service rendered by them, which amounted to 0.2% of the CTC offered. Mr. Shyam agreed to pay the amount. However, since his friend was a manager at the agency, he received full discount on the invoice.

Angered by the act of resignation, Mr. Ghanshyam filed a complaint with the Institute of Chartered Accountants of India (ICAI) stating that Mr. Shyam had violated the provisions of the Chartered Accountants Act and is guilty of professional misconduct. Having come to know that Mr. Ghanshyam was the one who had filed a complaint against him, Mr. Shyam decided to take revenge. While thinking for a suitable reason to file a complaint, he recalled the fact that Mr. Ghanshyam was engaged as a Registration Authority for obtaining digital signatures for his clients. Quoting the same, he filed a complaint against Mr. Ghanshyam stating that he was guilty of misconduct for violating the provisions of the Chartered Accountant Act.

Based on the above facts, answer the following:-

12. What can you infer from the situation given in Point I?

    (a) Management was right. Both the details asked by the auditors were out of the scope of audit.

    (b) The auditors have the right to ask only the details of preceding previous year and not the details of transactions till 15th May of current year.

    (c) Both the auditors and the management have the right to ask both the details and the right to not provide both the details.

(d) The auditors have the right to ask both the details. The management's contention that it is out of the scope of audit is wrong.

13. Is M/s AIM & Co. guilty of professional misconduct for violating any of the provisions of the Chartered Accountants Act? If so, as per which clause?

    (a) Clause 1 of Part I of Second Schedule.

    (b) Clause 8 of Part I of First Schedule.

    (c) Clause 2 of Part II of Second Schedule.

    (d) No. The firm has not violated any of the provisions and hence not guilty of professional misconduct.

14. Is Mr. Shyam guilty of professional misconduct, if so, under what clause?

    (a) Clause 1 of Part I of First Schedule.

    (b) Clause 2 of Part II of Second Schedule.

    (c) No. Mr. Shyam is not guilty of professional misconduct.

    (d) Clause 1 of Part II of First Schedule.

15. Is Mr. Ghanshyam guilty of professional misconduct, if so, under what clause?

    (a) No. Mr. Ghanshyam is not guilty of professional misconduct.

    (b) Clause 11 of Part I of First Schedule.

    (c) Part III of Second Schedule.

    (d) Clause 1 of Part II of Second Schedule.

PART II – Descriptive Question (70 Marks)

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

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

1. (a) Neptune Ltd. is a company that holds significant investments in a portfolio of equity securities. Due to a decline in market values, the company's investments have suffered a notable diminution in value. For the financial year ended 31st March 2023, the audit

report of Neptune Ltd. included a qualification regarding the non-provision of ₹ 70 lakh for the diminution in the value of these investments. As the auditor for the financial year 2023-24, how would you report in the following situations:

(i) If the company does not make a provision for the diminution in the value of investments in the year 2023-24?

(ii) If the company makes an adequate provision for the diminution in the year 2023-24? **(5 Marks)**

(b) Pratibha Ltd. is a company engaged in the manufacturing of iron doors. JLN & Associates are the statutory auditors of Pratibha Ltd. for the Financial Year 2023-24. During the course of audit, CA Shiv, the engagement partner, found that the Company's financing arrangements have expired, and the amount outstanding was payable on March 31, 2024. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact. What opinion should CA Prakash express in case of Pratibha Ltd.? **(5 Marks)**

(c) During the course of audit of PEC Limited, CA Guru has reason to believe that a fraud involving Rs.75 lakhs has been committed in the company by its employees. Is CA Guru under statutory obligation to report the above matter to Central government by filing prescribed form on MCA Portal? How should he proceed to report above said matter? **(4 Marks)**

2. (a) Mr. Arjun was appointed as the engagement partner for conducting the audit of Kurukshetra Tech Ltd. for financial year 2023-24, on behalf of NEMI & Associates. Mr. Krishna was appointed as the engagement quality control reviewer (EQCR) by the firm for the said audit.

During financial year 2023-24, Kurukshetra Tech Ltd. implemented an ERP system in phases, leading to the automation of certain business processes. This implementation had a substantial impact on the auditor's overall audit strategy. Mr. Arjun discussed the implementation of such a system with Mr. Krishna and also told him that such matter may be a key audit matter to be reported in the audit report.

Mr. Krishna considered the significance of said matter, however, he was of the opinion that ERP implementation did not appear to link with the matters disclosed in the financial statements and so there was no need to disclose such matter as a key audit matter.

Whether the contention of Mr. Krishna is appropriate with respect to the matters to be communicated as a key audit matter?

(5 Marks)

(b) CA. Kapila, in practice, is desirous of filling Multi-purpose Empanelment form (MEF) for inclusion of her name in panel for allotment of statutory audit of bank branches web hosted by Professional Development Committee (PDC) of ICAI for financial year 2023-24. The form requires applicants to upload XML files of their personal income tax returns along with computation of income. During relevant year for which information is being sought for by PDC, CA. Kapila has transacted in futures and options derivatives (equity) and has reflected income from such transactions in her return of income as “Business Income”. Analyse the above situation with reference to the provisions of the Chartered Accountants Act, 1949.

Would it make any difference if CA. Kapila had earned income from transacting in currency derivatives and commodity derivatives? **(5 Marks)**

(c) Remote audit is an audit where the auditor uses the online or electronic means to conduct the same. It could be partially or completely virtual, auditor engages using technology to obtain the audit evidence or to perform documentation review with the participation of the auditee. For example, an auditor might use video conferencing and cloud-based file sharing to review financial records remotely. What are the advantages and disadvantages of remote auditing? **(4 Marks)**

3. (a) Studio Ltd. appointed AB & Associates and CD & Co. as joint auditors for conducting the audit for the year ending on 31st March 2024.

During the audit, it was observed that there is a significant understatement in the value of trade receivables. The trade receivable valuation work was looked after by AB & Associates, however, there was no documentation outlining the division of the work between the joint auditors.

Comment on the above situation with respect to the allocation of responsibilities among joint auditors as per relevant Standards on Auditing. **(5 Marks)**

(b) Abhimanyu Finance Ltd. is a Non-Banking Finance Company and was in the business of accepting public deposits and giving loans since 2015. The company was having net owned funds of ₹ 1,75,00,000/-(one crore seventy five lakhs) and was not having registration certificate from RBI and applied for it on 29th March 2024. The company appointed Mr. Kabra as its statutory auditors for the year 2023-24. Advise the auditor with reference to auditor procedures to be taken and reporting requirements on the same in view of CARO 2020? **(5 Marks)**

(c) DIGI & Associates. conducted Stock Audit of PQR Ltd. as per instructions issued by ASG Bank. However instead of visiting the site where the stock was lying, the firm relied on the Management Information Systems report along with inspections reports and photographs of Stock taken by the employees of PQR Ltd. The photographs were also carrying the date and time printed on them.

Comment with reference to the Chartered Accountants Act, 1949 and Schedules thereon. **(4 Marks)**

4 (a) Girdhar Ltd. owns 61% voting power in Meera Ltd. It however, holds and discloses all the shares as "Stock-in-trade" in its accounts. The shares are held exclusively with a view to their subsequent disposal in the near future. Girdhar Ltd. represents that while preparing Consolidated Financial Statements, Meera Ltd. can be excluded from the consolidation. As a Statutory Auditor, how would you deal? **(5 Marks)**

(b) Abhinandan Ltd., a company wholly owned by Delhi government was disinvested during the previous year, resulting in 38% of the shares being held by public. The shares were also listed on the NSE. Since the shares were listed, all the listing requirements were applicable, including publication of quarterly results, submission of information to the NSE etc.

Paras, the Finance Manager of the company is of the opinion that now the company is subject to stringent control by NSE and the markets, therefore the auditing requirements of a limited company in private sector under the Companies Act, 2013 would be applicable to the company and the C&AG will not have any role to play. Comment. **(5 Marks)**

(c) CA Ram, a practicing chartered accountant, is well known for his expertise in handling Goods and Services Tax (GST) cases at the GST Tribunal and he does not provide any assurance services. Given his long-standing reputation in the field, CA Ram is approached by DEF Limited to file an appeal in the Tribunal against a GST demand of ₹ 6 crore, which was imposed by the Commissioner (Appeals), and to represent DEF Limited in the matter. CA Ram offers to accept a fee of ₹ 3,50,000 for filing the appeal and pleading at the GST Tribunal.

Comment on the act of CA Ram in terms of the Chartered Accountant Act, 1949 and Schedules thereon. **(4 Marks)**

5. (a) Quality Ltd. is engaged in the business of manufacturing and distribution of various Ready to cook products like vegetables, Noodles etc. The government made certain changes in rules and regulations relating to this sector, consequently management decided to go for expansion. Management was looking for some financial investor who can fund some part of the proposed expansion. Mr. Aman is interested in the venture and appoints you to act as an advisor to the proposed investment in the business of Quality Ltd. You have to investigate the audited financial statements and ensure that the valuation of shares of the company on the basis of audited financial statements is appropriate. What process will be used for checking and can reliance be placed on the already audited statement of accounts? **(5 Marks)**

(b) While assessing the impact of uncorrected misstatements in the audit of MINI Builders Private Limited, Mr. Gautam encountered a significant issue related to the calculation of materiality on revenue. The initial materiality calculation was based on estimated figures provided by the management. Management, to estimate full-year revenue, extrapolated the sales for 11 months to arrive at a figure for 12 months. However, given the nature of MINI Builders as a company in the construction sector, where monthly sales exhibit substantial variations, a unique challenge emerged.

The actual sales for the last month deviated significantly from the estimated sales due to an unexpected slowdown in project completions. As a result, the last month's actual sales represented only 30% of the estimated sales. Now, Mr. Gautam is confronted with a dilemma regarding the appropriate approach to evaluate uncorrected misstatements using the previously calculated materiality. Kindly Guide Mr. Gautam in the light of relevant Standards on Auditing. **(5 Marks)**

(c) Consistent Enterprises Ltd., a listed company, has been voluntarily preparing and disclosing its sustainability report based on the internationally accepted “Integrated Reporting” framework for some years, even before BRSR reporting became mandatory. Even after BRSR reporting became mandatory, it is cross-referencing disclosures made under such reporting to disclosures sought under BRSR. The key focus of Integrated Reporting is how the company creates value over the short, medium, and long term.

Following further information is provided in respect of the above company:

(i) It has secured a loan to expand its operations and invests the funds in purchasing raw materials and machinery. The loan, along with revenue generated from existing sales, contributes to the pool of resources available for production.

(ii) It has increased the number of beneficiaries under its flagship CSR programmes from previous 10000 to 75000. It has provided value for communities and provided sustainable livelihood to them.

Discussing the above information, identify which of the capitals of “Integrated Reporting” are being referred to at [i] and [ii] respectively? **(4 Marks)**

6. (a) Mr. Atharv, while conducting the audit of Black Mountain Mining Ltd., which is involved in phosphate mining, decided to engage an auditor's expert to assess environmental liabilities and site clean-up costs. Black Mountain Mining Ltd. re-appointed Mr. Aman as an independent expert for this task. For the past five years, the management has consistently re-appointed Mr. Aman. He calculated the environmental liabilities for both completed mining sites and sites scheduled for closure in the near future, including provisions for clean-up costs. Management accepted his assessment.

Mr. Atharv, after performing the inquiries with management, was of the opinion that the objectivity of the independent expert cannot be questioned just because he was appointed by management as their expert. Hence, there is no need to raise a question on the objectivity of Mr. Aman or on his work performed for the company. However, the audit partner was of the opinion that the audit team needs to evaluate the objectivity of an expert engaged by the entity, irrespective of the fact that he was appointed as an independent expert.

Guide the audit partner and Mr. Atharv with respect to requirements pertaining to evaluating the objectivity of the management expert. **(5 Marks)**

(b) Mr. Jay is a practicing Chartered Accountant working as proprietor of M/s Adhya & Co. He went abroad for 4 months. He delegated the authority to Mr. Vijay a Chartered Accountant his employee for taking care of routine matters of his office. During his absence, Mr. Vijay has conducted the under mentioned jobs in the name of M/s Adhya & Co.

(i) Asking for information or issue of questionnaire.

(ii) Initiating and stamping of vouchers and of schedules prepared for the purpose of audit.

(iii) Acknowledging and carrying on routine correspondence with clients.

Comment on eligibility of Mr. Vijay for conducting such jobs in name of M/s Adhya & Co. and liability of Mr. Jay under the Chartered Accountants Act, 1949. **(5 Marks)**

(c) The practitioner shall not accept the compilation engagement unless the practitioner has agreed the terms of engagement with management, and the engaging party if different. In view of the above, mention the responsibilities of the management to be agreed on for the compilation engagement in accordance with SRS 4410. **(4 Marks)**

OR

A review of financial statements includes consideration of the entity's ability to continue as a going concern. If, during the performance of the review, the practitioner becomes aware of events or conditions that may cast significant doubt about the entity's ability to continue as a going concern. Enumerate the steps to be taken by the practitioner for the same. **(4 Marks)**

MODEL TEST PAPER 6

FINAL COURSE: GROUP I

PAPER-3: ADVANCED AUDITING, ASSURANCE AND PROFESSIONAL ETHICS

Time Allowed- 3 hours **Maximum Marks-100**

1. The question paper comprises two parts, Part I and Part II.
2. Part I comprises Case Scenario based Multiple Choice Questions (MCQs)
3. Part II comprises questions which require descriptive answers.

PART I - Case Scenario based MCQs (30 Marks)

Write the most appropriate answer to each of the following multiple-choice questions by choosing one of the four options given. All MCQs are compulsory and carry 2 Marks each.

1. M/s DEF & Associates have been appointed as the statutory auditor of JKL Ltd., a PSU engaged in the generation of electricity from solar power. The Committee on Public undertakings with a view to examining PSU's physical and financial performer is examining the reports and accounts of public undertaking and also audit findings of the C & AG. Following are some of the functions of specialised committees:

    (i) to examine the statement of accounts of autonomous and semi-autonomous bodies, the audit of which is conducted by the Comptroller & Auditor General either under the directions of the President or by a Statute of Parliament;

    (ii) to examine the estimates to report what economies, improvements in organization, efficiency or administrative reform, consistent with the policy underlying the estimates may be effected;

    (iii) to examine the autonomy and efficiency of public undertakings and to see whether they are being managed in accordance with sound business principles and prudent commercial practices;

    (iv) to examine public enterprises through comprehensive appraisal or evaluation of performance of the undertaking. It involves a thorough examination, including evaluation of the policies, programmes and financial working of the undertaking.

From the above functions, which are the functions of Committee on Public Undertakings (COPU)?

(a) (i) & (iv)

(b) (ii) & (iii)

(c) (i) & (ii)

(d) (iii) & (iv)

2. KALI Ltd. is India's one of the largest FMCG Company with 50-year heritage in the country. In terms of compliance of reporting under Business Responsibility and Sustainability Report (BRSR), for the F.Y. 2023-24, CEO & MD of the company reports that "At KALI Ltd. our BRSR adheres to the nine principles of the SEBI framework on sustainability reporting, informing stakeholders of our sustainability endeavours." While giving principle wise performance the following core elements associated with the respective principle need to be covered in the report:

(i) Entities, when in the business of providing essential goods and services (e.g. Utilities), should enable universal access, including to those whose services have been discontinued for any reason, in a non-discriminatory and responsible manner.

(ii) Entities should inform the customers on the safe and responsible ways of usage, reuse, recycling, and disposal of their products, and ways to eliminate over consumption.

(iii) The entities should transparently and accurately disclose all kinds of adverse impacts to the user, planet, society, on the biodiversity from their products.

(iv) The entities are responsible to educate and make aware their consumers and clients about their rights.

From the above information, identify which core elements are related to Principle-9?

(a) (i) & (iv)

(b) (i), (ii) & (iii)

(c) (i), (iii) & (iv)

(d) (ii), (iii) & (iv)

3. For conducting the statutory audit for the financial year 2024-25, CA P has been appointed by SEA Ltd., which is on the verge of becoming sick unit and has accumulated losses but the said losses are not equal to or exceeding its entire net worth as per last audited accounts for the year 2023-24. The audited accounts for the year 2021-22, 2022-23 were showing liability for payment of undisputed audit fees payable to predecessor auditors but were settled completely during last F.Y. 2023-24.

   In terms of Council General guidelines, 2008, Chapter 7, read with relevant proviso of the said guideline, which of the following statement is correct in respect of the aforesaid scenario?

   (a) CA P shall be deemed to be guilty of professional misconduct as he has accepted the appointment as auditor of SEA Ltd. which had not paid undisputed audit fee for the year 2021-22 and 2022-23 of predecessor auditor, though settled in F.Y. 2023-24.

   (b) CA P would not be held guilty of professional misconduct as he has accepted the appointment as auditor of SEA Ltd. which is on the verge of becoming sick unit but whose accumulated losses are not equal to or exceeding its entire net worth as per last audited accounts for the year 2023-2024.

   (c) CA P would not be held guilty of professional misconduct as he has accepted the appointment as auditor of SEA Ltd., which is not a sick unit, whose accumulated losses are not equal to or exceeding its entire net worth as per last audited accounts for the year 2023-24 and there are no unpaid undisputed audit fees of predecessor auditors.

   (d) CA P shall be deemed to be guilty of professional misconduct as he has accepted the appointment as auditor of SEA Ltd. which is on the verge of becoming sick unit and it had not paid undisputed audit fee of predecessor auditor though settled in subsequent year.

Integrated Case scenario I

Tom Ltd. is in to the business of manufacturing and distributing of Toys for the past 25 years. Since inception, the company is having its own in-house dedicated internal audit department, having team of competent & qualified chartered accountants, headed by the Chief Internal Auditor, who with systematic and disciplined approach monitors various Internal Controls laid down at all levels of the functional areas. M/s Deva & Co., Chartered Accountants, have been newly appointed as the statutory auditors of the company for the F.Y. 2024-25.

- M/s Deva & Co. want to use the work of the internal audit function in respect of testing of the operating effectiveness of controls and in respect of substantive procedures involving limited judgement. Due to time constraints and the extensive scope of statutory audit, M/s Deva & Co. want to take direct assistance of internal auditors in the areas of Physical verification of fixed assets, inventory verification and Goodwill impairment assessment. Accordingly, M/s Deva & Co. are in the process of determining in which areas and to what extent internal auditors can be used and in which areas statutory auditors shall not use internal auditors to provide direct assistance to perform procedures.
- M/s Deva & Co. during the course of identifying and assessing the risks of material misstatement through understanding the entity and its environment and during the course of performing the audit procedures finds that the company is holding significant bank accounts and having branch operations in tax-haven jurisdictions for which there appears to be no clear business justification. Also, there were significant related party transactions which do not appear to be in the normal course of business.
- The audit report of Tom Ltd. for the last F.Y. 2023-24, audited by predecessor auditor, contained a qualification regarding non provision of doubtful debts. In F.Y. 2024-25 also, the company does not want to make provision for doubtful debts. The statutory auditors, M/s Deva & Co., in their auditor's report on the current period's financial statements want to report the same.
- Pursuant to the reporting requirements under CARO, 2020 in respect of the company's regularity in depositing undisputed arrears of outstanding statutory dues to the appropriate authorities, M/s Deva & Co. are considering to take a view on the following issue observed during the audit of Tom Ltd.

The company in view of voluminous pay roll data consistently follows the method of making lump sum deposit of estimated amount of ESI collections and adjust the excess or deficit against next following months' deposit and the difference of the said amount always remains insignificant.

Based on the above facts, answer the following Questions (Q.Nos.4 to 7):

4. M/s Deva & Co., in their auditor's report on the current period's financial statements wants to report that Tom Ltd. does not want to make provision for doubtful debts in F.Y. 2024-25. Identify the correct action to be resorted out of the following:

   (a) As per SA 710, can modify their report for previous year's figures of financial statements since the auditor's report on the prior period, as previously issued, included a qualified opinion.

   (b) As per SA 710, can modify their report for current year's figures of financial statements but need not refer to the previous year's modification.

   (c) As per SA 710, will have to modify their report for both current and previous year's figures of financial statements since the auditor's report on the prior period, as previously issued, included a qualified opinion.

   (d) As per SA 710, cannot modify their report but need to refer to the earlier year's modification.

5. M/s Deva & Co. assigned the following procedures to internal auditors to provide direct assistance.

   (i) that relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited.

   (ii) that relate to work with which the internal auditors have been involved and which will not be reported to management or those charged with governance by the internal audit function.

   (iii) that relate to decisions the statutory auditor makes in accordance with SA.

   From the above, identify the appropriate procedure(s) that can be assigned to internal auditors:

   (a) (i), (ii), (iii)

   (b) (ii) only

(c) (ii) & (iii)

(d) (iii) only

6. Issue identified by Deva & Co., with regard to holding significant bank accounts and having branch operations in tax-haven jurisdictions and significant related party transactions is a fraud risk factor. What is the condition created by that fraud risk factor and what fraud does it result in?

(a) The risk factor creates a rationalization for the fraud and results in a misstatement due to fraudulent financial reporting.

(b) The risk factor creates an incentive /pressure for the fraud and results in a misstatement due to misappropriation of assets.

(c) The risk factor creates a perceived opportunity for the fraud and results in a misstatement due to fraudulent financial reporting.

(d) The risk factor creates a perceived opportunity for the fraud and results in a misstatement due to misappropriation of assets.

7. Out of the following which view of M/s Deva & Co. is the correct one for complying the reporting requirement under CARO, 2020 as regards lump-sum deposit of estimated ESI collections and its adjustment against next months' deposit leaving the insignificant difference of ESI amount?

(a) the company consistently follows the method of payment in respect of ESI collections and the difference between the total dues and lump sum deposit is not significant, as per materiality concept, it need not be considered that dues have not been regularly deposited and hence not to be reported.

(b) depositing of ESI collections and the arrears of ESI dues cannot be considered as statutory dues under CARO, 2020 and hence not to be reported.

(c) lumpsum deposit of estimated ESI amount and adjusting excess/deficit against following months' deposit shall be considered as dues payable and hence to be reported under CARO, 2020.

(d) even though the difference between the total dues of ESI and lump sum deposit is not significant, as per materiality concept, it shall be considered that dues have not been regularly deposited and hence to be reported under CARO, 2020.

Integrated Case Scenario II

XYZ & Associates LLP, is a firm of Chartered Accountants, consisting of 12 partners has been allotted Central statutory audit of Maha Bank Limited, a scheduled commercial bank.

(i) During the course of audit, you, as the Engagement partner, have been asked by the GM to calculate CRAR. For this purpose, you have referred to the Master circular on "Prudential Guidelines on Capital Adequacy and Market Discipline - New Capital Adequacy Framework (NCAF)", which provides the guidelines to be followed by banks for capital adequacy.

You are informed that the basic approach of capital adequacy framework is that a bank should have sufficient capital to provide as table resource to absorb any losses arising from the risks in its business. You have observed that Capital is divided into tiers according to the characteristics/qualities of each qualifying instrument. For supervisory purposes capital is split into two categories: Tier I and Tier II, representing different instruments quality as capital.

You have calculated Eligible total capital funds comprising -

1. Tier I capital of Share capital ₹ 200 Crore, and disclosed Reserves ₹ 20 Crore.

2. Tier II capital of Other Reserves ₹ 30 Crore, and subordinated debt ₹ 20 Crore.

The Risk weighted assets constitute ₹ 25 Crore, while Off-balance sheet items are ₹ 5 Crore.

(ii) As a part of the scope, the audit firm has been asked to find out the correct position of Demand and Time liabilities of Maha Bank.

DTL balance as on 30th September 2024 was ₹ 50,000 Crore which included the following-

		₹ Cr.
(i)	Paid up capital	27,000
(ii)	Reserves	1,650

(iii)	Credit balance in Profit & Loss account	1,210
(iv)	Loan taken from RBI	575
(v)	Refinance taken from EXIM bank and NHB	480
(vi)	Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery	125
(vii)	Net credit balance in branch adjustment accounts	105
(viii)	Interest accrued but not accounted for in books	90
(ix)	Margins held and kept in sundry deposits for funded facilities	80

(iii) During the FY 2024-25, XYZ & Associates LLP is appointed as Statutory auditors of APP Ltd., an NBFC, which was set up under the Companies Act, 2013 and got itself registered as non-banking financial company (NBFC) with the Reserve Bank of India, fulfilling the required criteria. During the financial year ending 31st March 2025, the company commenced operations on a massive scale. You are informed that RBI has revised different facets of existing NBFC Classification and regulation like Capital requirements, Government standards, Prudential regulations, etc. based on four layers that are defined based on their size, activity and perceived riskiness.

During the FY 2024-25 APP Ltd. has accepted deposits of ₹ 900 Crore, while its asset size is ₹ 990 Crore. It has also undertaken following activities -

(i) Standalone Primary Dealers (SPDs)

(ii) Infrastructure Debt Fund

(iii) Housing Finance

(iv) Infrastructure Finance

The auditors are about to begin audit of APP Ltd. for which your audit team has been asked to prepare audit checklist.

(iv) XYZ & Associates LLP has been appointed as auditors of Heavy Electricals Corporation, a Public Sector Undertaking (PSU) during the FY 2024-25 by C & AG. It has been intimated about the intention of taking up planned performance audit with the scope and extent of audit including the constitution of audit team and the tentative time schedule, well before the commencement of Audit. The Engagement partner has asked the audit team to prepare an Audit Design Matrix (ADM) as it is a structured and highly focused approach for designing a performance audit study. The audit team has been informed that ADM should be prepared on the basis of information and knowledge obtained during the planning stage. Further, it is desirable to prepare ADM for each of the audit objectives.

On the basis of above details, you are required to answer the following questions.

8. Keeping in view of the information in para (iii), Identify under which layer APP Ltd. will be categorised -

   (a) Top Layer

   (b) Upper Layer

   (c) Middle Layer

   (d) Base Layer

9. Based on facts given in para (i), you are required to arrive at the correct percentage of Capital Risk Adequacy Ratio for the Maha Bank Limited

   (a) 10%

   (b) 10.80%

   (c) 8.33%

   (d) None of the above

10. Based on facts given in para (ii), you are required to Compute Demand and Time Liabilities (DTL) balance as on 30th September 2024.

   (a) ₹ 18,000 crore

   (b) ₹ 19,360 crore

   (c) ₹ 18,790 crore

   (d) ₹ 18,880 crore

11. Keeping in view of the information in para (iv), in the case of Performance audit of PSU, which one of the following is not part of Audit Design Matrix (ADM)

   (a) Audit programme

(b) Evidence

(c) Audit Questions

(d) Data collection and Analysis Method

Integrated Case Scenario - III

M/s HVM & Co. is a firm of Chartered Accountants based in Chennai. CA M, CA V and CA H are the partners of the firm. The firm is engaged in various assignments including Audits and its engagement partners who were handling their respective assignments for the financial year 2023-24 dealt with the following issues raised during and after the course of their respective audits.

M/s HVM & Co. are appointed as statutory auditors of AST Ltd. for the financial year 2023-24. CA V, the engagement partner while conducting audit of AST Ltd. was encountered with significant difficulties. He observed that there are not only inordinate delays by the management but lack of willingness by the authorised personnel of the company in providing the required information necessary to perform audit procedures in making the assessment of AST Ltd.'s ability to continue as a going concern in view of material uncertainty related to it. CA V wants to communicate this and other circumstances as additional information in his report with those charged with the governance.

Financial statements of VED Ltd. for the year ended on 31st March 2024 were signed by CA H, the engagement partner on 15th May 2024. The AGM was decided to be held during the month of August 2024. On 17th May 2024 the company had received a communication from the Central Government that an amount of ₹ 8500 crore on account of incentives in respect of F.Y. 2021-22 which was kept in abeyance would be released to the company by 15th June 2024. Accordingly, the Board of Directors of the company agreed to amend the accounts and gave approval to include this amount in the financial statements of the company for the Financial Year ended on 31st March, 2024 and requested CA H to consider this matter.

During the course of audit of SIM Limited there arose doubts as to the reliability of written representation regarding the existence and value of certain Machineries. The management gave a certificate to prove the existence and value of Machinery as appearing in the books of account. The certificate from the Registered valuer shows a value which is inconsistent with the written representation of management.

HT institute of professional studies is a reputed educational institution providing various courses in the field of commerce and arts. The management of the institution is inclined towards imparting quality education to the students, therefore most of the faculties engaged by them are qualified professionals. CA M of M/s HVM & Co. is an alumnus of the institution, and he has joined as a visiting faculty for teaching financial management and accounting subject. The management of the HT institute of professional studios is highly satisfied with his teaching skills and level of knowledge he possesses. Due to his capabilities, the management offers CA M to take up the assignment of statutory audit of their institute for the financial year 2023-24.

Based on the above facts, answer the following Questions (Q. Nos. 12 to 15):

12. Since there arose a doubt on the management representation and considering the responsibilities of M/s HVM & Co. to obtain written representations from management as per relevant Standard on Auditing, select the incorrect option from the following:

    (a) Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

    (b) The fact that management has provided reliable written representations affect the nature or extent of other audit evidence that the auditor obtains about the fulfilment of management's responsibilities, or about specific assertions.

    (c) In the case of identified inconsistencies between one or more written representations and audit evidence obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, revise the risk assessment and determine the nature, timing and extent of further audit procedures to respond to the assessed risks.

    (d) The auditor may have identified significant issues relating to the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, but concluded that the written representations are nevertheless reliable. In such a case, this significant matter is documented in accordance with SA 230.

13. CA V, engagement partner, in the course of audit of AST Ltd. wants to communicate as he considers necessary to include additional information in the auditor's report in accordance with SA 260. Following are the circumstances for which communication with those charged with governance is required.

    Help CA V in getting identified incorrect circumstance from the below mentioned circumstances.

    (a) when the auditor has concluded that there is an uncorrected material misstatement of the other information in accordance with SA 720.

    (b) when the auditor considers it necessary to include an Emphasis of Matter paragraph or Other Matter paragraph in accordance with SA 706 or is required to do so by other SAs.

    (c) when a material uncertainty related to going concern is reported in accordance with SA 570.

    (d) when there are no key audit matters to be communicated in accordance with SA 701.

14. In view of the Board of Directors of the VED Ltd. agreeing to include an amount of ₹ 8500 crore on account of incentives in respect of F.Y. 2021-22 in the financial statements of the company for the Financial Year ended on 31 March, 2024 by amending the accounts, CA H shall consider the following procedures. Identify the incorrect procedure from the following:

    (a) Carry out the audit procedures necessary in the circumstances on the amendment.

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

    (c) Provide a new auditor's report on the amended financial statements. The new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

(d) Modify the opinion as required by SA 705 and then provide the auditor's report.

15. In response to the management offer, guide CA M, whether to take up the assignment of statutory audit of HT institute of professional studies for the financial year 2023-24.

Select the correct option in terms of professional code of conduct.

(a) CA M can accept the assignment as his role as a visiting faculty will not interfere with the statutory audit functions.

(b) CA M cannot accept the assignment as it violates clause (4) of Part I of the Second schedule to the Chartered Accountants Act, 1949.

(c) CA M can accept the statutory assignment as he does not have any substantial interest in the HT Institute of professional studies.

(d) CA M cannot accept the assignment as it violates clause (11) of Part I of the First schedule to the Chartered Accountants Act, 1949.

PART II – Descriptive Question (70 Marks)

Question No.**1** is compulsory.

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

1. (a) PQR Associates are the statutory auditors of a large un-listed company, which is engaged in manufacturing of auto components. Subsequent to re-appointment of auditors in the Annual General Meeting, the Company shared the appointment letter with PQR Associates, seeking acknowledgement and acceptance letter. CA. R is the engagement partner and is planning to issue the acceptance letter. During the current financial year, there was a search by the Income-tax Authorities on the company, and certain accounting records were seized for verification. Based on the information available on social media, CA. R noted that the promoters' brother, is contemplating to contest in the ensuing elections, under the banner of a political party. One of the current senior engagement team manager, who has been doing the audit engagement till last year, has left PQR Associates and is planning to provide some accounting services to one of the associate

companies. PQR Associates are yet to recruit another senior manager having adequate experience in the audits of clients engaged in automotive sector.

Elaborate the matters to be considered by PQR Associates with respect to acceptance & continuance of client relationships considering the above issues. **(5 Marks)**

(b) Fancy Limited is a foreign company providing software support services having its Branch Office at Delhi. During the year 2023-24, Fancy Limited incorporated a subsidiary Nancy Private Limited in Gurgaon. For furtherance of objectives, Fancy Limited entered into a Business Transfer Agreement dated 5thOctober 2023 with Nancy Private Limited for transfer of all assets and liabilities along with the business of Delhi Branch to Nancy Private Limited on a going concern basis effective from 01st April, 2023. Further necessary approval from regulatory authorities is also received on 20th December, 2023 for such transfer. Fancy Limited promised that it shall provide continuing financial and operational support to Delhi Branch and further confirmed that any losses incurred post the date of transfer shall be borne by Fancy Limited.

During the year 2023-24, Delhi Branch of Fancy Limited have prepared its financial statements on the basis that the Branch Office does not continue to be a going concern and all its assets are carried in the books of accounts at the values likely to be recovered at the time of closure of operations, to the extent ascertainable at the time of preparation of the financial statements. Delhi Branch has incorporated above matter in detailed form in Note XX to the financial statements.

You are the statutory auditor of Delhi Branch of Fancy Limited for the financial year 2023-24. According to you, Delhi Branch has correctly disclosed about the matter in Note XX to the Financial Statements regarding management's intention to close the operations of the branch office. Further you have obtained sufficient appropriate audit evidence concerning audit and on the verge of finalization of audit report.

Draft a suitable opinion paragraph and basis thereof in the given case along with disclosure of Note XX with suitable place in audit report in terms of relevant auditing standard. **(5 Marks)**

(c) Mr. BK has been engaged by XYZ Ltd. to report on summary financial statements derived from the financial statements audited by him in accordance with SAs. Mr. BK wants to determine whether the applied criteria are acceptable before accepting such assignment. Guide him the factors affecting auditor's determination of the acceptability of applied criteria as per relevant Standard on Auditing. **(4 Marks)**

2. (a) Happy Hospital is a very renowned hospital for Orthopedic Surgeries in Mumbai having sophisticated infrastructure. Happy Hospital has started using a novice system which includes complete record of Indoor Patient i.e. their diagnosis, their treatment, their medications, their billings, and receipts thereon which is developed and managed by CT Contractors. CA Z is a statutory auditor of Happy Hospital. CA Z came to know about this system while auditing. CA Z is concerned whether the controls at CT Contractors Associates are operating effectively or not. For this purpose, CA Z demanded from CT Contractors, an assurance report from a practicing chartered accountant about their opinion on the description of CT Contractor's system, and the effectiveness of the control. Which type of report should be obtained by CA Z in terms of relevant Standard on Auditing? What aspects are to be considered by CA Z in using such assurance report as audit evidence that controls at CT Contractors are operating effectively? **(5 Marks)**

(b) PN and Associates are appointed as the Statutory Auditors of The Iron Company Ltd. The Central Government holds 65% of the paid-up share capital in this company. The appointment letter of the company gave a very limited time to PN and Associates for accepting the audit. CA N, the engagement partner communicated with the previous auditor but due to lack of time he had to give acceptance for the audit assignment before receiving reply from the previous auditor. Hence CA N gave a conditional acceptance of the appointment and commenced the audit. Discuss with reference to the Chartered Accountants Act, 1949 and the schedules thereunder, whether CA N has complied with same.

(5 Marks)

(c) The management of High Limited is concerned with the reporting requirement cast through Rule 11 of the Companies (Audit and Auditors) Rules, 2014 for the financial year 2023-24 with regard to the Audit Trail (edit log). Audit trails may be enabled at the accounting software level depending on the features available in such software or same may be captured directly in the database underlying such accounting software. Consequently, the management of the company approached CA J and asked him to suggest them list of internal controls which may be required to be implemented and operated to demonstrate that the Audit trail (or Edit Log) feature was functional, operated and was not disabled. Help CA J. **(4 Marks)**

3. (a) Core Limited submitted a credit proposal XYZ Bank Limited for the sanction of a Term Loan of ₹ 150.00 crore required for procuring and installing a latest Plant and machinery for their upcoming project. Based on the application, XYZ Bank Limited approached CA P to investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by Core Limited, as well as the value of the security in the form of assets of the business already possessed and those which will be created out of the loan. Elucidate the steps that should be undertaken by CA P?

(5 Marks)

(b) CA N is carrying out an audit of restated financial statements of BQR Limited for past 3 financial years i.e. 2023-24, 2022-23 and 2021-22 for onward submission to SEBI pursuant to their upcoming IPO (Initial Public Offer). CA N is planning to issue an Audit Report on 5th August, 2024 covering these restated financial statements. Before issuing the audit report, CA N requested Management Representation Letter from the management of the Company for this assignment. The Management of the Company provided Management Representation Letter dated 1st April, 2024 covering the period of financial year 2023-24 only as they were not in position to provide for the financial year 2022-23 and 2021-22 because they were not in place during that period.

How would CA N deal with the above situation as per relevant Standard on Auditing? **(5 Marks)**

(c) CA Raj, a practicing chartered accountant, is offered to take up an appointment as a "Secretary" in his professional capacity by the Central Government for a Metro Project for a term of 2 years not on a salary-cum-full-time basis. After giving deep thought to the offer, CA Raj accepted the appointment. Comment in terms of the Chartered Accountant Act, 1949 and Schedules thereto. **(4 Marks)**

4. (a) CA Giri is a senior partner of M/s TSV Associates. M/s TSV Associates is a reputed firm of Chartered Accountants which has been in practice for more than five decades. The firm undertakes statutory audits of large listed companies across various industry sectors and has more than fifty qualified experienced professionals. CA Giri has been assigned as an Engagement Quality Control Reviewer for an audit engagement of a listed company. What are the aspects, which would be looked into by CA Giri as an EQCR in relation to the engagement?

Upon completion of the review, CA Giri has identified certain issues, with respect to revenue recognition and adequacy of provisions relating to onerous contracts. The views of CA Giri are not accepted by the Engagement Partner. Suggest the ways of resolving the differences of opinion between CA Giri and the engagement partner. **(5 Marks)**

(b) MNC Limited has engaged CA Lalit to help the company in compilation of the financial information. CA Lalit explained his team members, the scope of work and the responsibilities under this engagement. The team members have done mostly audit engagements and do not have exposure to compilation engagements. Discuss the key issues that CA Lalit should deliberate and guide his team members with respect to this engagement and the manner it differ from assurance engagements. Give your views on the applicability of SQC 1 to this engagement. **(5 Marks)**

(c) SU Limited is amongst the top 1000 listed entities. With the introduction of new reporting requirements by SEBI on ESG parameters called the Business Responsibility and Sustainability Report (BRSR), it requires SU Limited to make disclosures on their performance against the various principles of the "National

Guidelines on Responsible Business Conduct". One of the principles emphasizes that the business decisions in an organization should be open to disclosure and accessible to the relevant interested parties. Elucidate the essence of core elements associated with the aforesaid principle. **(4 Marks)**

5. (a) PQ Pharma Limited, a company dealing in research and development and manufacture of pharmaceuticals is coming up with an Initial Public Offer (IPO). PQ Pharma Ltd has prepared the prospective financial statements for the next 3 years and included the same in the prospectus as part of its IPO. The prospective financial information includes projected balance sheets, statement of profit and loss and cash flow statements, which are prepared on the basis of several key assumptions like favourable government regulations, planned research and development of more effective medicines at reasonable prices, etc.

The company approaches CA Z to provide assurance on the prospective financial information and to assess the presentation and disclosure of the prospective financial information included in the IPO. List out the aspects that must be considered for making such assessment. **(5 Marks)**

(b) R Limited is a listed company engaged in manufacture of round bars. The company is having investment in the following components:

(i) 2 Subsidiary Companies

(ii) 1 Joint Venture Company

(iii) 2 Associate Companies

(iv) 3 Business entities under common control

(v) Interest in assets, liabilities, revenues, and expenses in a joint operation with 1 Company

R Limited and all its components are required to present their accounts as per Ind AS. While preparing consolidated financial statements, R Limited consolidated its components on a line-by-line basis by adding together like items of assets, liabilities, income, expenses, and cash flows.

R Limited seeks your advice on the accounting treatment in respect of the above components for consolidation in accordance with the Companies (Indian Accounting Standards) Rules, 2015.

(5 Marks)

(c) TP Limited is a listed company engaged in the business of manufacturing of kids garments under the brand name of MM. M/s R & Associates, firm of chartered accountants, are appointed as a Statutory Auditor of the Company for the year 2023-24. CA R is looking after the audit of the Company. During audit, CA R observed that there are number of notices received from GST Department and Income-tax Department for various issues. Further during plant visit, CA R observed that few child labourers are engaged in some of the activity. In response to the observation made, CA R followed the procedure as envisaged in SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". According to CA R, the provisions of SA 250 and the provisions of NOCLAR (Non-Compliance with Laws and Regulations) under Revised Code of Ethics are one and the same. Do you agree? If not, give your comments. **(4 Marks)**

6. (a) You are appointed as a Statutory Auditor of SDA Limited for the year
2023-24 in the place of CA T. During audit you found an order dated 01.05.2023 under section 148 of the Income-tax Act, 1961 wherein tax of ₹ 50 lakhs were demanded owing to undisclosed cash sales of ₹ 150 lakhs for the financial year 2020-21 which was accepted by the company and the applicable tax was paid by the Company during the year 2023-24. The company has not recorded such undisclosed income in their books of account during the year 2023-24. On further inquiring the matter with CA T, you came to know that CA T resigned due to non-recording of such transaction by the company. Is there any reporting responsibility casted on you regarding the above matters under CARO, 2020 for the year 2023-24? **(5 Marks)**

(b) MNC Limited, is engaged in manufacture & sale of FMCG products. It has manufacturing locations across various states in India and engages dealer channels to sell it products. One dealer is appointed for each district within the state and products are despatched from the nearest manufacturing location to the dealer. Considering the voluminous transactions, MNC Limited has a robust ERP network, for recording the transactions. As statutory auditors of MNC Ltd., your firm is about to commence the current year audit. The audit team includes certain IT experts and discussions are underway amongst the team members. As an IT manager of the engagement team, explain the key areas for an auditor to understand IT environment. **(5 Marks)**

(c) CA Kumar, a practicing-chartered accountant, is well known in the field of pleading of Income-tax cases at Income-tax Tribunal and does not provide any assurance services. Considering the long standing in the field, CA Kumar is approached by XYZ Limited to file an appeal in the Tribunal against the Income-tax Demand of ₹ 10 crore which was added by the CIT(A) and to plead on behalf of XYZ Limited in the matter. CA Kumar offers to accept the case with the following fee structure:

The fees for filing an appeal and to plead at Income-tax Tribunal will be higher of the following (a) or (b):

(i) ₹ 5,00,000/-

(ii) 10% of Tax Demand Reduced.

Comment on the act of CA Kumar in terms of the Chartered Accountant Act, 1949 and Schedules thereon. **(4 Marks)**

OR

Kushal Pvt Ltd is a company engaged in trading activities, it also has made investments in shares of other Companies and advanced loans to group companies amounting to more than 50% of its total assets. However, trading income constitutes majority of its total income. Whether the Company is an NBFC? **(4 Marks)**

ANSWERS

ANSWERS OF MODEL TEST PAPER 1

FINAL COURSE GROUP I

PAPER 1: FINANCIAL REPORTING

PART – I CASE SCENARIO BASED MCQS

1. **Option (b) :** 38%
2. **Option (c) :** ₹ 2,48,000; ₹ 2,28,000
3. **Option (d) :** ₹ 1,30,000
4. **Option (a) :** ₹ 2,05,00,000
5. **Option (c) :** ₹ 1,70,83,333
6. **Option (d) :** ₹ 34,16,667
7. **Option (c) :** 1.4 million EURO
8. **Option (a) :** ₹ 117.6 million
9. **Option (b) :** ₹ 4,32,573
10. **Option (b) :** ₹ 68,091
11. **Option (d) :** Since A Ltd. is not a listed entity and if X Ltd. does not object to A Ltd. for not preparing consolidated financial statements, A Ltd. will not be required to prepare CFS.
12. **Option (b) :** Since X Ltd. is not preparing CFS under Ind AS, A Ltd. is mandatorily required to prepare CFS under Ind AS
13. **Option (d) :** Even if A Ltd. is an unlisted entity, it is mandatorily required to prepare CFS
14. **Option (a) :** S Pvt. Ltd. has to mandatorily prepare its financial statements as per Ind AS
15. **Option (d) :** Automation requires ongoing training and education to keep up with the latest technology

PART – II DESCRIPTIVE QUESTIONS

1. Statement showing Cost of production line:

Particulars	Amount ₹'000
Purchase cost	10,000
Goods and services tax – recoverable goods and services tax not included	-
Employment costs during the period of getting the production line ready for use (1,200 x 2 months / 3 months)	800
Other overheads – abnormal costs	
Payment to external advisors – directly attributable cost	600
	500
Dismantling costs – recognized at present value where an obligation exists (2,000 x 0.68)	1,360
Total	13,260

Carrying value of production line as on 31st March, 20X2:

Particulars	Amount ₹ '000
Cost of Production line	13,260
Less: Depreciation (W.N.1)	(1,694)
Net carrying value carried to Balance Sheet	11,566

Provision for dismantling cost:

Particulars	Amount ₹ '000
Non-current liabilities	1,360
Add: Finance cost (WN3)	57
Net book value carried to Balance Sheet	1,417

Extract of Statement of Profit & Loss

Particulars	Amount ₹ '000
Depreciation (W.N.1)	1,694
Finance cost (W.N.2)	57
Amounts carried to Statement of Profit & Loss	1,751

Extract of Balance Sheet

Particulars	Amount ₹ '000
Assets	
Non-current assets	
Property, plant and equipment	11,566
Equity and liabilities	
Non-current liabilities	
Other liabilities	
Provision for dismantling cost	1417

Working Notes:

1. Calculation of depreciation charge

Particulars	Amount ₹ '000
In accordance with Ind AS 16 the asset is split into two depreciable components: Out of the total capitalization amount of 13,260, Depreciation for 3,000 with a useful economic life (UEL) of four years (3,000 x ¼ x 10/12). This is related to a major overhaul to ensure that it generates economic benefits for the second half of its useful life	625
For balance amount, depreciation for 10,260 with an useful economic life (UEL) of eight years will be: 10,260 x 1/8 x 10/12	1,069
Total (To Statement of Profit & Loss for the year ended 31st March 20X2)	1,694

2. Finance costs

Particulars	Amount ₹ '000
Unwinding of discount (Statement of	57

Profit and Loss – finance cost) 1,360 x 5% x 10/12	
To Statement of Profit & Loss for the year ended 31st March 20X2	57

2. Consolidated Balance Sheet of PN Ltd. and its subsidiary SR Ltd.

as at 31 March 20X2

Particulars	**Note No.**	**₹**
I. Assets		
1. Non-current assets		
(i) Property, Plant & Equipment	1	26,83,200
(ii) Goodwill	2	89,402
2. Current Assets		
(i) Inventories	3	5,34,800
(ii) Financial Assets		
(a) Trade Receivables	4	3,11,300
(b) Cash & Cash equivalents	5	70,100
Total Assets		36,88,802
II. Equity and Liabilities		
1. Equity		
(i) Equity Share Capital	6	15,60,000
(ii) Other Equity	7	11,39,502
2. Non-controlling Interest (W.N.3)		5,07,300
3. Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	8	2,12,400
(b) Short term borrowings	9	2,69,600
Total Equity & Liabilities		36,88,802

Notes to accounts

			₹
1.	**Property, Plant & Equipment**		
	Land & Building	13,41,600	
	(4,68,000+5,61,600+3,12,000)	13,41,600	26,83,200
2.	Plant & Machinery (W.N.5)		89,402
3.	**Goodwill (W.N.4)**		
	Inventories	3,74,400	
	PN Ltd.	1,60,400	5,34,800
4.	SR Ltd. (1,13,600 +46,800)		
	Trade Receivables	1,86,500	
	PN Ltd.	1,24,800	3,11,300
5.	SR Ltd.		
	Cash & Cash equivalents	45,200	
	PN Ltd.	24,900	70,100
8.	SR Ltd.		
	Trade Payables	1,46,900	
	PN Ltd.	65,500	2,12,400
9.	SR Ltd. (34,300 + 31,200)		
	Short-term borrowings	2,49,600	
	PN Ltd.	20,000	2,69,600
	SR Ltd.		

Statement of Changes in Equity:

6. Equity share Capital

Balance at the beginning of the reporting period ₹	**Changes in Equity share capital during the year** ₹	**Balance at the end of the reporting period** ₹
15,60,000	0	15,60,000

7. Other Equity

	Reserves & Surplus			Total
	Capital reserve ₹	Retained Earnings ₹	Other Reserves ₹	₹
Balance at the beginning of the reporting period	0	0	9,36,000	9,36,000
Total comprehensive income for the year	0	1,78,400	0	1,78,400
Dividends	0	(52,416)	0	(52,416)
Total comprehensive income attributable to parent (W.N.2)	0	77,518	0	77,518
Gain on Bargain purchase	0	0	0	0
Balance at the end of reporting period	0	2,03,502	9,36,000	11,39,502

Working Notes:

1. Adjustments of Fair Value

The Plant & Machinery of SR Ltd. would stand in the books at ₹ 4,44,600 on 1 October 20X1, considering only six months' depreciation on ₹ $\left(\frac{4,21,200}{90\%}\right)$ = 4,68,000;

total depreciation being ₹ $4,68,000 \times 10\% \times \frac{6}{12} = 23,400$.

Being the fair value of the asset ₹ 6,24,000, there is an appreciation to the extent of ₹ 1,79,400 (₹ 6,24,000 – ₹ 4,44,600).

Acquisition date profits of SR Ltd. ₹

Reserves on 1.4.20X1	3,12,000
Profit& Loss Account Balance on 1.4.20X1	93,600
Profit for 20X1-20X2: Total [₹2,55,800 - (93,600 - 74,880)] x 6/12 i.e. ₹ 1,18,540 upto 1.10.20X1	1,18,540
Total Appreciation	5,07,000*
Total	10,31,140
Holding Co. Share (70%)	7,21,798
NCI	3,09,342

*Appreciation = Land & Building ₹ 3,12,000 + Inventories ₹ 46,800+ Plant & Machinery ₹ 1,79,400 –Trade Payables (₹ 31,200) = ₹ 5,07,000

2. Post-acquisition profits of SR Ltd. ₹

Profit after 1.10.20X1 [2,55,800 - (93,600-74,880)] x 6/12	1,18,540
*Less:*10% depreciation on ₹6,24,000 for 6 months less depreciation already charged for 2nd half of 20X1-20X2 on ₹4,68,800 (ie 31,200-23,400)	(7,800)
Total	1,10,740
Share of holding Co. (70%)	77,518
Share of NCI (30%)	33,222

3. Non-controlling Interest ₹

Par value of 1872 shares	1,87,200
*Add:*30% Acquisition date profits [(10,31,140–74,880)x30%]	2,86,878
30% Post-acquisition profits [W.N.2]	33,222
	5,07,300

4. Goodwill ₹

Amount paid for 4,368 shares		12,48,000
Less : Par value of shares	4,36,800	
Acquisition date profits-share of PN Ltd. (W.N.1)	7,21,798	(11,58,598)
Goodwill		89,402

5. Value of Plant & Machinery: ₹

PN Ltd.		7,48,800
SR Ltd.	4,21,200	
Add: Appreciation on 1.10.20X1	1,79,400	
	6,00,600	
Add: Depreciation for 2nd half charged on pre-revalued value	23,400	
Less: Depreciation on ₹ 6,24,000 for 6 months	(31,200)	5,92,800
		13,41,600

6. Consolidated Profit & Loss account ₹

PN Ltd. (as given)	1,78,400	
Less: Dividend	(52,416)	1,25,984
Share of PN Ltd. in post-acquisition profits (W.N.2)		77,518
		2,03,502

3. (a) Balance Sheet as at 31st March, 20X2 (Extracts)

Financial Assets:	₹
Interest rate option (W.N.1)	15,250
6% Debentures in Fox Ltd. (W.N.2)	1,53,000
Shares in Cox Ltd. (W.N.3)	1,87,500

Statement of Profit and Loss (Extracts)

Finance Income:

Gain on interest rate option (W.N.1)	5,250
Effective interest on 6% Debentures (W.N.2)	12,000

Working Notes:

1. **Interest rate option**

This is a derivative and so it must be treated as at fair value through profit or loss

Particulars	₹	₹
Initial measurement (at cost) Financial Asset Dr. To Cash A/c	10,000	10,000

At 31st March, 20X2

Particulars	₹	₹
(Re-measured to fair value) Financial Asset (₹ 15,250 - ₹10,000) Dr. To Profit and loss A/c	5,250	5,250

Financial Assets (₹10,000 + ₹5,250) = ₹ 15,250 (Balance Sheet)

Gain on interest option = ₹ 5,250 (Statement of Profit and Loss)

2. **Debentures**

On the basis of information provided, this can be treated as a held-to-maturity investment

Particulars	₹	₹
Initial measurement (at cost) Financial Asset Dr. To Cash A/c	1,50,000	1,50,000

At 31st March, 20X2 (Amortized cost)

Particulars	₹	₹
Financial Asset (₹1,50,000 x 8%) Dr.	12,000	
To Finance Income		12,000
Cash (₹ 1,50,000 x 6%) Dr.	9,000	
To Financial asset		9,000

Amortized cost at 31st March, 20X2

(₹ 150,000 + ₹ 12,000 – ₹ 9,000) = ₹ 153,000 (Balance Sheet)

Effective interest on 6% debenture = ₹ 12,000 (Statement of Profit and Loss)

3. Shares in Cox Ltd.

These are treated as an available for sale financial asset (shares cannot normally be held to maturity and they are clearly not loans or receivables)

Particulars	₹	₹
Initial measurement (at cost)		
Financial Asset (₹ 50,000 x ₹3.50) Dr.	1,75,000	
To Cash A/c		1,75,000

At 31stMarch, 20X2 (Re-measured at fair value)

Particulars	₹	₹
Financial Asset Dr.	12,500	
[(₹ 50,000 x 3.75) – 1,75,000]		
To Equity A/c		12,500

Shares in Cox Ltd (₹ 1,75,000 + ₹ 12,500) = ₹ 1,87,500 (Balance Sheet)

(b) As per Ind AS 36, the revised carrying amount of asset ASSOTA would be ₹ 6,50,000.

The tax base of asset ASSOTA is given as ₹ 8,00,000.

Carrying base of asset = ₹ 6,50,000

Tax base of asset = ₹ 8,00,000

Since tax base is greater than carrying base of asset, so deferred tax asset would be created on the temporary difference of ₹1,50,000 (₹8,00,000 – ₹6,50,000) at the given tax rate of 30%.

Hence, Deferred tax asset for the asset ASSOTA would be ₹1,50,000 x 30% = ₹45,000.

4. (a) (i) Points earned on ₹ 10,00,000 @ 10 points on every ₹ 500 = [(10,00,000 / 500) x 10] = 20,000 points.

Value of points = 20,000 points x ₹ 0.5 each point = ₹ 10,000

Revenue recognized for sale of goods	₹ 9,90,099	[10,00,000 x (10,00,000/10,10,000)]
Revenue for points deferred	₹ 9,901	[10,00,000x (10,000/10,10,000)]

Journal Entry

		₹	₹
Bank A/c	Dr.	10,00,000	
To Sales A/c			9,90,099
To Liability under Customer Loyalty programme			9,901

(ii) Points earned on ₹ 50,00,00,000 @ 10 points on every ₹ 500 = [(50,00,00,000/500) x 10] = 1,00,00,000 points.

Value of points

= 1,00,00,000 points x ₹ 0.5 each point = ₹ 50,00,000

Revenue recognized for sale of goods

= ₹ 49,50,49,505 [50,00,00,000 x (50,00,00,000/ 50,50,00,000)]

Revenue for points

= ₹ 49,50,495 [50,00,00,000 x (50,00,000/ 50,50,00,000)]

Journal Entry in the year 20X1

		₹	₹
Bank A/c	Dr.	50,00,00,000	
To Sales A/c			49,50,49,505
To Liability under Customer Loyalty programme			49,50,495
(On sale of Goods)			
Liability under Customer Loyalty programme	Dr.	42,11,002	
To Sales A/c			42,11,002
(On redemption of (100 lakhs -18 lakhs) points)			

Revenue for points to be recognized

Undiscounted points estimated to be recognized next year =18,00,000 x 80% = 14,40,000 points

Total points to be redeemed within 2 years

= [(1,00,00,000-18,00,000) + 14,40,000] = 96,40,000

Revenue to be recognised with respect to discounted point = 49,50,495 x (82,00,000/96,40,000) = 42,11,002

(iii) Revenue to be deferred with respect to undiscounted point in 20X1-20X2 = 49,50,495 – 42,11,002 = 7,39,493

(iv) In 20X2-20X3, KK Ltd. would recognize revenue for discounting of 60% of outstanding points as follows:

Outstanding points = 18,00,000 x 60% = 10,80,000 points

Total points discounted till date

= 82,00,000 + 10,80,000 = 92,80,000 points

Revenue to be recognized in the year 20X2-20X3 = [{49,50,495 x (92,80,000 / 96,40,000)} - 42,11,002] = ₹ 5,54,620.

Liability under Customer Loyalty Programme Dr.	₹ 5,54,620	
To Sales A/c		₹ 5,54,620
(On redemption of further 10,80,000 points)		

The Liability under Customer Loyalty programme at the end of the year 20X2-20X3 will be ₹ 7,39,493 – ₹ 5,54,620 = ₹ 1,84,873.

(v) In the year 20X3-20X4, the merchant will recognize the balance revenue of ₹ 1,84,873 irrespective of the points redeemed as this is the last year for redeeming the points. Journal entry will be as follows:

Liability under Customer Loyalty programme	Dr.	₹ 1,84,873	
To Sales A/c			₹ 1,84,873
(On redemption of balance points)			

(b) **Either**

As per paragraph 9 of Ind AS 24, Related Party Disclosures, "Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity."

Accordingly, key management personnel (KMP) includes any director of the entity who are having authority and responsibility for planning, directing and controlling the activities of the entity. Hence, independent director Mr. Atul and non-executive director Mr. Naveen are covered under the definition of KMP in accordance with Ind AS.

Also as per paragraph 7 and 9 of Ind AS 19, 'Employee Benefits', an employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of the Standard, Employees include directors and other management personnel.

Therefore, contention of the Accountant is wrong that they are not employees of X Ltd.

Paragraph 17 of Ind AS requires disclosure about employee benefits for key management personnel. Therefore, an entity shall disclose key management personnel compensation in total i.e. disclosure of directors' fee of (₹ 10,00,000 + ₹ 7,50,000) ₹ 17,50,000 is to be made as employees benefits (under various categories).

Since short-term employee benefits are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services, the sitting fee paid to directors will fall under it (as per Ind AS 19) and is required to be disclosed in accordance with the paragraph 17 of Ind AS 24.

Or

(i) The land and government grant should be recognized by A Ltd. at fair value of ₹ 12,00,000 and this government grant should be presented in the books as deferred income. Alternatively, if the company is following the policy of recognising non-monetary grants at nominal value, the company will not recognise any government grant. Land will be shown in the financial statements at ₹ 1)

(ii) As per para 10A of Ind AS 20 ‘Accounting for Government Grants and Disclosure of Government Assistance’, loan at concessional rates of interest is to be measured at fair value and recognised as per Ind AS 109. Value of concession is the difference between the initial carrying value of the loan determined in accordance with Ind AS 109, and the proceeds received. The benefit is accounted for as Government grant.

(iii) ₹ 25 lakh has been received by D Ltd. for immediate start-up of business. Since this grant is given to provide immediate financial support to an entity, it should be recognised in the Statement of Profit and Loss immediately with disclosure to ensure that its effect is clearly understood, as per para 21 of Ind AS 20.

(iv) ₹ 10 lakh should be recognized by S Ltd. as deferred income and will be transferred to profit and loss over the useful life of the asset. In this case, ₹ 1,00,000 [₹ 10 lakh/10 years] should be credited to profit and loss each year over period of 10 years. Alternatively, if the company is following the policy of recognising non-monetary grants at nominal value, the company will not recognise any government grant. The machinery will be recognised at ₹ 70 lakh (₹ 80 lakh - ₹ 10 lakh). Reduced depreciation will be charged to the Statement of Profit or Loss.

(v) As per para 12 of Ind AS 20, the entire grant of ₹ 25 lakh should be recognized immediately as deferred income and charged to profit and loss over a period of two years based on the related costs for which the grants are intended to compensate provided that there is reasonable assurance that U Ltd. will comply with the conditions attached to the grant.

5. (a) **Allocation of proceeds of the bond issue:**

Liability component (W.N.1)	₹ 18,47,720
Equity component	₹ 1,52,280
	₹ 20,00,000

The liability and equity components would be determined in accordance with Ind AS 32. These amounts are recognised as the initial carrying amounts of the liability and equity components. The amount assigned to the issuer conversion option equity element is an addition to equity and is not adjusted.

Basic earnings per share Year 1:

$$\frac{₹\ 10,00,000}{12,00,000} = ₹\ 0.83 \text{ per ordinary share}$$

Diluted earnings per share Year 1:

It is presumed that the issuer will settle the contract by the issue of ordinary shares. The dilutive effect is therefore calculated in accordance with the Standard.

$$\frac{₹\ 10,00,000 + ₹\ 1,66,295\ (W.N.2)}{12,00,000 + 5,00,000\ (W.N.3)} = ₹\ 0.69 \text{ per ordinary share}$$

Working Notes:

1. This represents the present value of the principal and interest discounted at 9%

1,20,000 x 2.531	=	₹ 3,03,720
20,00,000 x 0.772	=	₹ 15,44,000
		₹ 18,47,720

2. Profit is adjusted for the accretion of ₹ 1,66,295 (₹ 18,47,720 × 9%) of the liability because of the passage of time. However, it is assumed that interest @ 6% for the year has already been adjusted.

3. 5,00,000 ordinary shares = 250 ordinary shares x 2,000 convertible bonds

(b) This information will be incorporated into the consolidated statement of cash flows as follows:

Statement of cash flows for 20X2 (extract)	**Amount (₹)**	**Amount (₹)**
Cash flows from opening activities		
Profit before taxation	70,000	
Adjustments for non-cash items:		
Depreciation	30,000	
Decrease in inventories (Note 1)	9,000	
Decrease in trade receivables (Note 2)	4,000	
Decrease in trade payables (Note 3)	(24,000)	
Interest paid to be included in financing activities	4,000	
Taxation (11,000 + 15,000 – 12,000)	(14,000)	
Net cash inflow from operating activities		79,000
Cash flows from investing activities		
Cash paid to acquire subsidiary (74,000 – 2,000)	(72,000)	
Net cash outflow from investing activities		(72,000)
Cash flows from financing activities		
Interest paid	(4,000)	

Net cash outflow from financing activities		(4,000)
Increase in cash and cash equivalents		**3,000**
Cash and cash equivalents at the beginning of the year		**5,000**
Cash and cash equivalents at the end of the year		**8,000**

Working Notes:

1. Inventories

Total inventories of the Group at the end of the year	₹ 30,000
Inventories acquired during the year from subsidiary	(₹ 4,000)
	₹ 26,000
Opening inventory	(₹ 35,000)
Decrease in inventory	₹ 9,000

2. Trade Receivables

Total trade receivables of the Group at the end of the year	₹54,000
Trade receivables acquired during the year from subsidiary	(₹8,000)
	₹46,000
Opening trade receivables	(₹50,000)
Decrease in trade receivables	₹ 4,000

3. Trade Payables

Trade payables at the end of the year	₹ 68,000
Trade payables of the subsidiary assumed during the year	(₹32,000)
	₹ 36,000
Opening Trade payable	(₹ 60,000)
Decrease in Trade payables	₹ 24,000

6. (a) Presentation of Revenue numbers:

Ind AS 115 requires revenue to be recognized only on satisfaction of the performance obligations under the contract. It is crucial that the performance obligations be identified at the commencement of the contract, so that the trigger points for revenue recognition become identifiable.

Management would always have an incentive to present higher revenue numbers. In the given case, the fact that the COO is given an incentive for revenues and EBITDA indicates that revenue is a potential area for material misstatement, given the personal interest of the COO in the same.

The sale of fibre optic cable cannot be recognized on 31st March 20X2 as the goods are not yet transferred to the customer Ethernet Bullet Ltd.'s factory premises, which is one of the critical obligations of Astra Ltd. The contention of the COO that it takes merely a few minutes to shift the goods, and hence the sale can be recognized does not hold true. One can always cross-question as to why the movement of goods did not happen if it was merely a few minutes job. It could be a possibility that the goods may not be packed, or there may still be some pending inspection of the goods before transferring the same etc. In view of this, the performance obligation under this contract has not been completed, and hence booking the revenue has resulted in an overstatement of revenue by ₹ 2 crores, and a consequent inflation of profits, assuming that Astra Ltd. is making profit on this sale transaction. Additionally, booking this sale has resulted in an understatement of inventory as at the reporting date of 31st March 20X2.

In view of the above, multiple conflicts of interest arise for Ms. Suparna Dasgupta:

- Pressure to present favourable revenue figures and chartered accountant's personal circumstances.

- The chartered accountant is under pressure to present favourable numbers, notably in favour of the COO, thereby increasing the incentives to the COO, and in turn benefiting with the continued job prospects. Thus, the ethical and professional standards required of the accountant are at odds with the pressures of her personal circumstances.

Duty to stakeholders

The directors have a duty to act in the best interests of the company's stakeholders. While higher revenue numbers do indicate a good growth trajectory of the company, recognizing the revenue before fulfilling the performance obligations, or incorrectly booking grant income as revenue, results in misleading the stakeholders about the actual performance of the entity, thereby actually becoming detrimental to the stakeholders.

Ethical principles guiding the chartered accountant's response

By exhibiting bias in reporting higher revenue figures due to the risk of losing the job, objectivity stands compromised. Knowingly disclosing incorrect information compromises integrity, and erring in complying with Ind AS requirements, though continuing to report so in the financial statements, results in displaying absence of professional competence.

Appropriate action

In the given case, the chartered accountant faces an ethical dilemma, and must apply her moral and ethical judgment. As a professional, she is responsible for presenting the truth, and to avoid indulging in 'creative accounting practices' due to pressure.

The chartered accountant accordingly must put the interests of the company and professional ethics first and insist that the financial statements represent correct revenue numbers, in compliance with the relevant Ind AS. Being an advisor to the directors, she must prevent deliberate misrepresentation / fraudulent financial reporting, regardless of the personal consequences. The accountant should not allow any undue influence from the directors to override her professional judgment or integrity. This is in the long-term interests of the company,

Further, knowingly providing incorrect information is regarded as professional misconduct. To prevent such misconduct, the chartered accountant should not sign off on the financial statements containing incorrect financial information. By adhering to the ethical principles, the chartered accountant will maintain her professional integrity and contribute to the trust and reliability placed in the work expected from her.

However, if she signs the financial statements containing the inflated revenue numbers, Ms. Suparna Dasgupta would be guilty of professional misconduct under Clause I of Part II of Second Schedule to the Chartered Accountants Act, 1949. The Clause states that a member of the Institute, whether in practice or not, shall be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder, or any guidelines issued by the Council. As per the Council guidelines, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

(b) For 80,000 share-based options vested before transition date:

Ind AS 101 provides that a first-time adopter is encouraged, but not required, to apply Ind AS 102 on 'Share-based Payment' to equity instruments **that vested before the date of transition to Ind AS**. Hence, Nuogen Ltd. may opt for the exemption given in Ind AS 101 for 80,000 share options vested before the transition date. However, since no earlier accounting was done for these share-based options under previous GAAP too, therefore this led to an error on the transition date, as detected on the reporting date i.e. 31st March, 20X4. Hence, being an error, no exemption could be availed by Nuogen Ltd. on transition date with respect to Ind AS 102.

While preparing the financial statements for the financial year 20X3-20X4, an error has been discovered which occurred in the year 20X1-20X2, i.e., for the period which was earlier than earliest prior period presented. The error should be corrected by restating the opening balances of relevant assets and/or liabilities and relevant component of equity for the year 20X2-20X3. This will result in consequential restatement of balances as at 1st April, 20X2 (i.e, opening balance sheet as at 1st April, 20X2).

Accordingly, on retrospective calculation of Share based options with respect to 80,000 options, Nuogen Ltd. will create 'Share based payment reserve (equity)' by ₹ 16,00,000 and correspondingly adjust the same though Retained earnings.

For 40,000 share-based options to be vested on 31st March, 20X5:

Since share-based options have not been vested before transition date, no option as per Ind AS 101 is available to Nuogen Ltd. The entity will apply Ind AS 102 retrospectively. However, Nuogen Ltd. did not account for the same at the grant date. This will result in consequential restatement of balances as at 1st April, 20X2 (i.e, opening balance sheet as at 1st April, 20X2). Adjustment is to be made by recognising the 'Share based payment reserve (equity)' and adjusting the retained earnings by ₹ 2,00,000.

Further, expenses for the year ended 31st March, 20X3 and share based payment reserve (equity) as at 31st March, 20X3 were understated because of non-recognition of 'employee benefits expense' and related reserve. To correct the above errors in the annual financial statements for the year ended 31st March, 20X4, the entity should restate the comparative amounts (i.e., those for the year ended 31st March, 20X3) in the statement of profit and loss. In the given case, 'Share based payment reserve (equity)' would be credited by ₹ 2,00,000 and 'employee benefits expense' would be debited by ₹ 2,00,000

For the year ending 31st March, 20X4, 'Share based payment reserve (equity)' would be credited by ₹ 2,00,000 and 'employee benefits expense' would be debited by ₹ 2,00,000.

Working Note:

Period	Lot	Proportion	Fair value	Cumulative expenses	Expenses
		a	b	d= b x a	e = d- previous period d
20X1-20X2	1 (1-year vesting period)	1/1	16,00,000	16,00,000	16,00,000
20X1-20X2	2 (4-year vesting period)	1/4	8,00,000	2,00,000	2,00,000
20X2-20X3	2 (4-year vesting period)	2/4	8,00,000	4,00,000	2,00,000
20X3-20X4	2 (4-year vesting period)	3/4	8,00,000	6,00,000	2,00,000

ANSWERS OF MODEL TEST PAPER 2

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

ANSWER TO PART – I CASE SCENARIO BASED MCQS

1 **Option (d) :** Provision for ₹ 50 crores

2. **Option (a) :** ₹ 48,753

3 **Option (b) :** ₹ 1.75 crores

4. **Option (c) :** ₹ 0.03 crores

5. **Option (c) :** ₹ 20,00,000 goodwill

6. **Option (d) :** The first Ind AS financial statements shall distinguish the correction of errors from changes in accounting policies and reported as part of the reconciliations as at 1st April, 20X2.

7. **Option (a) :** 4 performance obligations

8. **Option (d) :** ₹ 40 lakhs

9. **Option (d) :** Issuance of equity shares ₹ 40 lakhs; dividends paid ₹ 10 lakhs

10. **Option (d) :** Advertising costs ₹ 40 lakhs; staff bonuses ₹ 60 lakhs

11. **Option (c) :** Annual depreciation charge will be ₹ 13,000 and an annual transfer of ₹ 3,000 may be made from revaluation surplus to retained earnings.

12. **Option (d) :** ₹ Nil

13. **Option (b) :** Interest expense ₹ 12,000

14. **Option (d) :** ₹ 36 lakhs

15. **Option (d) :** All of the above

ANSWERS OF PART – II DESCRIPTIVE QUESTIONS

1. **Calculation of purchase consideration:**

Particulars	**₹ in million**
Market value of shares issued (150 million x 4/3 x ₹ 10)	2,000

Initial estimate of market value of shares to be issued (150 million x 1/5 x ₹ 10)	300
Incremental acquisition costs other than the issue cost of shares	1
Total consideration	2,331

Contingent consideration is recognized in full if payment is probable. Incremental costs associated with the acquisition, other than the issue costs of financial instruments, can be included in the cost of the investment. Where material, future consideration is measured at the present value of the amount payable. In the case of shares to be issued, this is represented by the share price.

Statement of fair value of identifiable net assets at the date of acquisition

Particulars	₹ in million
As per B Ltd.'s Balance Sheet	1,200
Fair value of customer relationships	100
Fair value of research and development project	50
Total net assets acquired	1,350

As per *Ind AS 38 'Intangible assets',* intangible assets can be recognized separately from goodwill provided they are identifiable, are under the control of the acquiring entity, and their fair value can be measured reliably.

Customer relationships that are similar in nature to those previously traded, pass these tests but employee expertise fails the 'control' test. Both the research and development phases in process project can be capitalised provided their fair value can be measured reliably.

Statement of computation of goodwill

Particulars	₹ in million
Fair value of consideration given	2,331
Fair value of net assets acquired	(1,350)
Goodwill on acquisition	981

As per para 58 of Ind AS 103, changes in the fair value of contingent consideration that the acquirer recognises after the acquisition date are measurement period adjustments to be dealt with in accordance with paragraphs 45–49.

As per para 48 of Ind AS 103, the acquirer recognises an increase (decrease) in the amount by means of a decrease (increase) in goodwill.

Accordingly, the changes in the fair value of contingent consideration is recorded as an adjustment to goodwill as follows:

Goodwill	Dr.	₹ 30 million	
To Contingent consideration			₹ 30 million

2. **(a)** The USD contract for purchase of machinery entered into by company A includes an embedded foreign currency derivative due to the following reasons:

- The host contract is a purchase contract (non-financial in nature) that is not classified as or measured at FVTPL.
- The embedded foreign currency feature (requirement to settle the contract by payment of USD at a future date) meets the definition of a stand-alone derivative – it is akin to a USD-₹ forward contract maturing on 31 December 20X1.
- USD is not the functional currency of either of the substantial parties to the contract (i.e., neither company A nor company B).
- Machinery is not routinely denominated in USD in commercial transactions around the world. In this context, an item or a commodity may be considered 'routinely denominated' in a particular currency only if such currency was used in a large majority of similar commercial transactions around the world. For example, transactions in crude oil are generally considered routinely denominated in USD. A transaction for acquiring machinery in this illustration would generally not qualify for this exemption.
- USD is not a commonly used currency for domestic commercial transactions in the economic environment in which either company A or B operate. This exemption generally applies when the business practice in a particular economic environment is to use a more stable or liquid foreign currency (such as the USD), rather than the local currency, for a majority of internal or cross-border transactions, or both. In the illustration above, companies

A and B are companies operating in India and the purchase contract is an internal/domestic transaction. USD is not a commonly used currency for internal trade within this economic environment and therefore the contract would not qualify for this exemption.

Accordingly, company A is required to separate the embedded foreign currency derivative from the host purchase contract and recognise it separately as a derivative.

The separated embedded derivative is a forward contract entered into on 9th September 20X1, to exchange USD 10,00,000 for ₹ at the USD/₹ forward rate of 67.8 on 31st December 20X1. Since the forward exchange rate has been deemed to be the market rate on the date of the contract, the embedded forward contract has a fair value of zero on initial recognition.

Subsequently, company A is required to measure this forward contract at its fair value, with changes in fair value recognised in the statement of profit and loss. The following is the accounting treatment at quarter-end and on settlement:

Accounting treatment:

Date	Particulars	Amount (₹)	Amount (₹)
09-Sep-X1	***On initial recognition of the forward contract*** (No accounting entry recognised since initial fair value of the forward contract is considered to be nil)	Nil	Nil
30-Sep-X1	***Fair value change in forward contract*** Derivative asset (company B) Dr. [(67.8-67.5) x10,00,000]	3,00,000	
	To Profit or loss		3,00,000
31-Dec-X1	***Fair value change in forward contract*** Forward contract asset (company B) Dr.	5,00,000	

	[{(67.8-67) x 10,00,000} - 3,00,000] To Profit or loss		5,00,000
31-Dec-X1	***Recognition of machinery acquired and on settlement***		
	Property, plant and equipment Dr. (at forward rate)	6,78,00,000	
	To Forward contract asset (company B)		8,00,000
	To Creditor (company B) / Bank		6,70,00,000

(b) (i) Ind AS 1, inter alia, provides, "An entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment." In the present case, following the default, grace period within which an entity can rectify the breach is less than twelve months after the reporting period. Hence as on 31st March, 20X2, the loan will be classified as current.

(ii) Ind AS 1 deals with classification of liability as current or non-current in case of breach of a loan covenant and does not deal with the classification in case of expectation of breach. In this case, whether actual breach has taken place or not is to be assessed on 30th June, 20X2, i.e., after the reporting date. Consequently, in the absence of actual breach of the loan covenant as on 31st March, 20X2, the loan will retain its classification as non-current.

3. **(a)** Applying paragraph 17 of Ind AS 23 to the fact pattern, the entity would not begin capitalising borrowing costs until it incurs borrowing costs (i.e. from 1st July, 20X1)

In determining the expenditures on a qualifying asset to which an entity applies the capitalisation rate (paragraph 14 of Ind AS 23), the entity does not disregard expenditures on the qualifying asset incurred before the entity obtains the general borrowings. Once the entity incurs borrowing costs and therefore satisfies all three conditions in para 17 of Ind AS 23, it then applies paragraph 14 of Ind AS 23 to determine the expenditures on the qualifying asset to which it applies the capitalisation rate.

Calculation of borrowing cost for financial year 20X0-20X1

Expenditure		Capitalization Period (current year)	Weighted average Accumulated Expenditure
Date	Amount		
1st January 20X1	₹ 5 crore	0/3	Nil

Borrowing Costs eligible for capitalisation = NIL. LT Ltd. cannot capitalise borrowing costs before 1st July, 20X1 (the day it starts to incur borrowing costs).

Calculation of borrowing cost for financial year 20X1-20X2

Expenditure		Capitalization Period (current year)	Weighted average Accumulated Expenditure
Date	Amount		
1st January, 20X1	₹ 5 crore	9/12*	₹ 3.75 crore
30th June, 20X1	₹ 20 crore	9/12	₹ 15 crore
31st March, 20X2	₹ 20 crore	0/12	Nil
Total			₹ 18.75 crore

Borrowing Costs eligible for capitalisation

= 18.75 cr. x 10% = ₹ 1.875 cr.

*LT Ltd. cannot capitalise borrowing costs before 1st July, 20X1 (the day it starts to incur borrowing costs). Accordingly, this calculation uses a capitalization period from 1st July, 20X1 to 31st March, 20X2 for this expenditure.

Calculation of borrowing cost for financial year 20X2-20X3

Expenditure		Capitalization Period (current year)	Weighted average Accumulated Expenditure
Date	Amount		
1st January, 20X1	₹ 5 crore	3/12	₹ 1.25 crore
30th June, 20X1	₹ 20 crore	3/12	₹ 5 crore
31st March, 20X2	₹ 20 crore	3/12	₹ 5 crore
31st March, 20X2	₹ 1.875 crore	3/12	₹ 0.47 crore
30th June, 20X2	₹ 5 crore	0/12	Nil
Total			₹ 11.72 crore

Borrowing Costs eligible for capitalisation= ₹ 11.72 cr. x 10% = ₹ 1.172 cr.

(b) Computation of amounts to be recognized in the P&L and OCI:

Particulars	*USD*	*Exchange rate*	*₹*
Cost of the bond	1,000	40	40,000
Interest accrued @ 10% p.a.	100	42	4,200
Interest received (USD 1,250 x 4.7%)	(59)	45	(2,655)
Amortized cost at year-end	1,041	45	46,845
Fair value at year end	1,060	45	47,700
Interest income to be recognized in P & L			4,200
Exchange gain on the principal amount [1,000 x (45-40)]			5,000
Exchange gain on interest accrual [100 x (45 - 42)]			300
Total exchange gain/loss to be recognized in P&L			5,300
Fair value gain to be recognized in OCI [45 x (1,060 - 1,041)]			855

Journal entry to recognize gain/loss

Bond (₹ 47,700 – ₹ 40,000) Dr.	7,700	
Bank (Interest received) Dr.	2,655	
To Interest Income (P & L)		4,200
To Exchange gain (P & L)		5,300
To OCI (fair value gain)		855

4. (a) (i) **Computation of benefit attributed to prior years and current year:** **Amount in ₹**

Year	1	2	3	4	5
Benefit attributed to:					
- Prior years	-	131	262	393	524
- Current year (Refer W.N.1)	131	131	131	131	131
Total (i.e. current and prior years)	**131**	**262**	**393**	**524**	**655**

(ii) **Computation of the obligation for an employee who is expected to leave at the end of year 5 (taking discount rate of 10% p.a.)** **Amount in ₹**

Year	1	2	3	4	5
Opening obligation (A)	-	89	196	324	475
Interest at 10% (B = A X 10%)	-	9	20	32	47
Current service cost (C) (Refer WN 2)	89	98	108	119	131
Closing obligation D = (A+B+C)	**89**	**196**	**324**	**475**	**653**

Figures have been rounded off in the above table.

Working Notes:

1. A lump sum benefit is payable on termination of service and equal to 1 per cent of final salary for each year of service. The salary in year 1 is ₹ 10,000 and is assumed to increase at 7% (compound) each year.

The year on year salary would be as follows: Amount in ₹

Year	1	2	3	4	5
Salary	10,000	10,700 (10,000 x 107%)	11,449 (10,700 x 107%)	12,250 (11,449 x 107%)	13,108 (12,250 x 107%)

Accordingly, for the purpose of above-mentioned employee benefit, 1% of final salary to be considered for each year of service would be ₹ 131.

2. **Computation of current service cost: Amount in ₹**

Year	**1**	**2**	**3**	**4**	**5**
1% salary at the end of year 5	-	-	-	-	131
PV factor at the end of each year to be considered at 10% p.a. **(E)**	0.683	0.751	0.826	0.909	1.000
PV at the end of each year	89 (131 x E)	98 (131 x E)	108 (131 x E)	119 (131 x E)	131 (131 x E)

Accordingly, for the purpose of above-mentioned employee benefit, 1% of final salary to be considered for each year of service would be ₹ 131.

(b) **Journal entries in the books of P Ltd (without modification of service period of stock appreciation rights) (₹ in lakhs)**

Date	Particulars	Debit	Credit
31.03.20X2	Profit and Loss account Dr.	15.75	
	To Liability against SARs		15.75
	(Being expenses liability for stock appreciation rights recognised)		

31.03.20X3	Profit and Loss account Dr.	17.25	
	To Liability for SARs		17.25
	(Being expenses liability for stock appreciation rights recognised)		
31.03.20X4	Profit and Loss account Dr.	15.38	
	To Liability for SARs		15.38
	(Being expenses liability for stock appreciation rights recognised)		
31.03.20X5	Profit and Loss account Dr.	17.02	
	To Liability for SARs		17.02
	(Being expenses liability for stock appreciation rights recognised)		

Journal entries in the books of P Ltd (with modification of service period of stock appreciation rights) (₹ in lakhs)

Date	Particulars	Debit	Credit
31.03.20X2	Profit and Loss account Dr.	15.75	
	To Liability for SARs		15.75
	(Being expenses liability for stock appreciation rights recognised)		
31.03.20X3	Profit and Loss account Dr.	28.25	
	To Liability for SARs		28.25
	(Being expenses liability for stock appreciation rights recognised)		
31.03.20X4	Profit and Loss account Dr.	20.50	
	To Liability for SARs		20.50
	(Being expenses liability for stock appreciation rights recognised)		

Working Notes:

Calculation of expenses for issue of stock appreciation rights without modification of service period

For the year ended 31st March 20X2

= ₹ 210 x 400 awards x 75 employees x 1 year /4 years of service

= ₹ 15,75,000

For the year ended 31st March 20X3

= ₹ 220 x 400 awards x 75 employees x 2 years /4 years of service - ₹ 15,75,000 previous recognised

= ₹ 33,00,000 - ₹ 15,75,000 = ₹ 17,25,000

For the year ended 31st March 20X4

= ₹ 215 x 400 awards x 75 employees x 3 years/4 years of service- ₹ 33,00,000 previously recognised

= ₹ 48,37,500 - ₹ 33,00,000 = ₹ 15,37,500

For the year ended 31st March, 20X5

= ₹ 218 x 400 awards x 75 employees x 4 years / 4 years of service – ₹ 48,37,500 previously recognised

= ₹ 65,40,000 – ₹ 48,37,500 = ₹ 17,02,500

Calculation of expenses for issue of stock appreciation rights with modification of service period

For the year ended 31st March 20X2

= ₹ 210 x 400 awards x 75 employees x 1 year / 4 years of service

= ₹ 15,75,000

For the year ended 31st March 20X3

= ₹ 220 x 400 awards x 75 employees x 2 years / 3 years of service - ₹ 15,75,000 previous recognised

= ₹ 44,00,000 - ₹ 15,75,000 = ₹ 28,25,000

For the year ended 31st March 20X4

= ₹ 215 x 400 awards x 75 employees x 3 years/ 3 years of service - ₹ 44,00,000 previous recognised

= ₹ 64,50,000 - ₹ 44,00,000 = ₹ 20,50,000.

5. (a) (i) Determination of how revenue is to be recognised in the books of ABC Ltd. as per expected value method

Calculation of probability weighted sales volume

Sales volume (units)	Probability	Probability-weighted sales volume (units)
9,000	15%	1,350
28,000	75%	21,000
36,000	10%	3,600
		25,950

Calculation of probability weighted sales value

Sales volume (units)	Sales price per unit (₹)	Probability	Probability-weighted sales value (₹)
9,000	90	15%	1,21,500
28,000	80	75%	16,80,000
36,000	70	10%	2,52,000
			20,53,500

Average unit price = Probability weighted sales value/ Probability weighted sales volume

= 20,53,500 / 25,950 = ₹ 79.13 per unit

Revenue is recognised at ₹ 79.13 for each unit sold. First 10,000 units sold will be booked at ₹ 90 per unit and liability is accrued for the difference price of ₹ 10.87 per unit (₹ 90 – ₹ 79.13), which will be reversed upon subsequent sales of 15,950 units (as the question states that ABC Ltd. achieved the same number of units of sales to the customer during the year as initially estimated under the expected value method for the financial year 20X1-20X2). For, subsequent sale of 15,950 units, contract liability is accrued at ₹ 0.87 (80 – 79.13) per unit and revenue will be deferred.

(ii) Journal Entries in the books of ABC Ltd.

			₹	₹
1.	Bank A/c (25,950 x ₹ 80)	Dr.	20,76,000	
	To Revenue A/c (25,950 x ₹ 79.13)			20,53,424
	To Liability (25,950 x ₹ 0.87)			22,576
	(Revenue recognised on sale of 25,950 units)			
2.	Liability (1,08,700 – 86,124)	Dr.	22,576	
	To Revenue A/c [25,950x(80-79.13)]			22,576
	(On reversal of liability at the end of the financial year 20X1-20X2 i.e. after completion of stipulated time)			

(b) The revenue from sale of goods shall be recognised at the fair value of the consideration received or receivable. The fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest where the receipt is deferred beyond normal credit terms. The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue.

The fair value of consideration (cash price equivalent) of the sale of goods is calculated as follows: ₹

Year	Consideration (Installment)	Present value factor	Present value of consideration
Time of sale	3,33,333	-	3,33,333

End of 1st year	3,33,333	0.949	3,16,333
End of 2nd year	<u>3,33,334</u>	0.901	<u>3,00,334</u>
	<u>10,00,000</u>		**<u>9,50,000</u>**

The Company that agrees for deferring the cash inflow from sale of goods will recognise the revenue from sale of goods and finance income as follows:

Initial recognition of sale of goods		₹	₹
Cash	Dr.	3,33,333	
Trade Receivable	Dr.	6,16,667	
To Sale			9,50,000
Recognition of interest expense and receipt of second installment			
Cash	Dr.	3,33,333	
To Interest Income			33,053
To Trade Receivable			3,00,280
Recognition of interest expense and payment of final installment			
Cash	Dr.	3,33,334	
To Interest Income (Balancing figure)			16,947
To Trade Receivable			3,16,387

Statement of Profit and Loss (extracts)

for the year ended 31st March, 20X2 and 31st March, 20X3

₹

	As at 31st March, 20X2	**As at 31st March, 20X3**
Income		
Sale of Goods	9,50,000	-
Other Income (Finance income)	33,053	16,947

Balance Sheet (extracts) as at 31st March, 20X2 and 31st March, 20X3 ₹

	As at 31st March, 20X2	As at 31st March, 20X3
Assets		
Current Assets		
Financial Assets		
Trade Receivables	3,16,387	XXX

(c) **Either**

The usefulness of financial information can be enhanced by applying four enhancing qualitative characteristics as follows:

- *Comparability:* Users' decisions involve choosing between alternatives. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. Comparability refers to the use of the same methods for the same items, and uniformity implies that like things must look alike and different things must look different.

- *Verifiability:* Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Verification can be direct or indirect.

- *Timeliness:* Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.

- *Understandability:* Classifying, characterising and presenting information clearly and concisely makes it understandable. Some phenomena are inherently complex and cannot be made easy to understand. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

(c) **Or**

Following entities are mandatorily required to prepare their financial statements based on Indian Accounting Standards

- All Listed Corporate Entities
- Unlisted Corporate Entities having net worth of rupees two hundred and fifty crore or more
- All holding, subsidiary, joint venture or associate companies of the above mentioned listed and unlisted corporate entities
- All NBFCs
- MF schemes

6. (a) **Lease agreement substance presentation**

Stakeholders make informed and accurate decisions based on the information presented in the financial statements and as such, ensuring the financial statements are reliable and of utmost importance. The directors of Sunshine Ltd. are ethically responsible to produce financial statements that comply with Ind AS and are transparent and free from material error. Lenders often attach covenants to the terms of the agreement in order to protect their interests in an entity. They would also be of crucial importance to potential debt and equity investors when assessing the risks and returns from any future investment in the entity.

The proposed action by Sunshine Ltd. appears to be a deliberate attempt to circumvent the terms of the covenants. The legal form would require treatment as a series of short-term leases which would be recorded in the profit or loss, without any right-of-use asset and lease liability being recognized as required by Ind AS 116, *Leases*. This would be a form of 'off-balance sheet finance' and would not report the true assets and obligations of Sunshine Ltd. As a result of this proposed action, the liquidity ratios would be adversely misrepresented. Further, the operating profit margins would also be adversely affected, as the expenses associated with the lease are likely to be higher than the deprecation charge if a leased asset was recognized, hence the proposal may actually be detrimental to the operating profit covenant.

Sunshine Ltd. is aware that the proposed treatment may be contrary to Ind AS. Such manipulation would be a clear breach of the fundamental principles of objectivity and integrity as outlined in the Code of Ethics. It is important for a chartered accountants to exercise professional behaviour and due care all the time. The proposals by Sunshine Ltd. are likely to mislead the stakeholders in the entity. This could discredit the profession by creating a lack of confidence within the profession. The directors of Sunshine Ltd. must be reminded of their ethical responsibilities and persuaded that the accounting treatment must fully comply with the Ind AS and principles outlined within the framework should they proceed with the financing agreement.

However, if the CFO fails to comply with his professional duties, he will be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

(b) X Pharmaceutical Ltd. is advised as under:

1. It should recognize the drug license as an intangible asset because it is a separate external purchase, separately identifiable asset and considered successful in respect of feasibility and probable future cash inflows.

   The drug license should be recorded at ₹ 1,00,00,000.

2. It should recognize the brand as an intangible asset because it is purchased as part of acquisition and it is separately identifiable. The brand should be amortised over a period of 15 years.

The brand will be recorded at ₹ 3,00,00,000.

3. The advertisement expenses of ₹ 1,00,00,000 should be expensed off.

4. The development cost incurred during the financial year 20X1-20X2 should be capitalised.

Cost of intangible asset (Drug A) as on 31st March, 20X2

Opening cost	₹ 5,00,00,000
Development cost	₹ 5,00,00,000
Total cost	₹ 10,00,00,000

5. Research expenses of ₹ 50,00,000 incurred for developing 'Drug B' should be expensed off since technological feasibility has not yet established.

(c) Equity Valuation of KK Ltd.

Particulars	**Weights**	**(₹ in crore)**
As per Market Approach	50	5268.2
As per Income Approach	50	3235.2
Enterprise Valuation based on weights (5268.2 x 50%) + (3235.2 x 50%)		4,251.7
Less: Debt obligation as on measurement date		(1465.9)
Add: Surplus cash & cash equivalent		106.14
Add: Fair value of surplus assets and liabilities		312.40
Enterprise value of KK Ltd.		3204.33
No. of shares		85,284,223
Value per share		375.72

ANSWERS OF MODEL TEST PAPER 3

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

PART – I CASE SCENARIO BASED MCQS

1. **Option (b) :** Current financial Liability
2. **Option (c) :** Non-Current financial Liability
3. **Option (c) :** ₹ 1,000 thousand
4. **Option (d) :** ₹ 810 thousand is to be recognised in the year of sale and ₹ 90 thousand to be spread over next three years.
5. **Option (c) :** ₹ Nil
6. **Option (d) :** ₹ 15 million
7. **Option (d) :** ₹ 0.125 million
8. **Option (a) :** Grant relating to an inducement to begin developing the factory can be recognized immediately in the Statement of Profit or Loss
9. **Option (d) :** ₹ 36 million
10. **Option (c) :** ₹ 37.782 million
11. **Option (b) :** Agreement is in the nature of Joint Operations
12. **Option (c) :** ₹ 20,25,00,000
13. **Option (a) :** ₹ 50,62,500
14. **Option (a) :** F Ltd. can continue following the existing accounting policy of amortising the exchange differences in respect of loan over the balance period of such long-term liability routed through statement of profit and loss for the period
15. **Option (c) :** Scanned documents of several years will acquire unnecessary office space.

PART – II DESCRIPTIVE QUESTIONS

1. A Ltd. and B Ltd. will account for the transaction as a sale and leaseback.

Step 1

Since the consideration for the sale of the building is not at fair value, A Ltd. and B Ltd. make adjustments to measure the sale proceeds at fair value. Thus, the amount of the excess sale price of ₹ 6,00,000 (as calculated below) is recognised as additional financing provided by B Ltd. to A Ltd.

Sale Price:	60,00,000
Less: Fair Value (at the date of sale):	(54,00,000)
Additional financing provided by B Ltd. to A Ltd.	**6,00,000**

Step 2

Calculation of the present value of the annual payments which amounts to
₹ 29,88,000 (calculated considering 20 payments of ₹ 4,00,000 each, discounted at 12% p.a.) of which ₹ 6,00,000 relates to the additional financing (as calculated above) and balance ₹ 23,88,000 relates to the lease — corresponding to 20 annual payments of ₹ 80,320 and ₹ 3,19,680, respectively (refer calculations below).

Proportion of annual lease payments:

Present value of lease payments (as calculated above) (A)	29,88,000
Additional financing provided (as calculated above) (B)	6,00,000
Relating to the Additional financing provided (C) = (E x B / A)	80,320
Relating to the Lease (D) = (E – C)	3,19,680
Annual payments (at the end of each year) (E)	4,00,000

A Ltd.:

At the commencement date, A Ltd. measures the ROU asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right-of-use retained by A Ltd., calculated as follows:

Carrying Amount	(A)	30,00,000
Fair Value (at the date of sale)	(B)	54,00,000
Discounted lease payments for the 20-year ROU asset	(C)	23,88,000
ROU Asset	**[(A / B) x C]**	**13,26,667**

A Ltd. recognises only the amount of the gain that relates to the rights transferred to B Ltd., calculated as follows:

Fair Value (at the date of sale)	(A)	54,00,000
Carrying Amount	(B)	30,00,000
Discounted lease payments for the 20-year ROU asset	(C)	23,88,000
Gain on sale of building	**(D) = (A - B)**	**24,00,000**
Relating to the right to use the building retained by A Ltd.	(E) = [(D/A) x C]	10,61,333
Relating to the rights transferred to B Ltd.	(D - E)	13,38,667

At the commencement date, A Ltd. accounts for the transaction, as follows:

Cash	Dr.	60,00,000	
ROU Asset	Dr.	13,26,667	
To Building			30,00,000
To Financial Liability			29,88,000
To Gain on rights transferred			13,38,667

B Ltd.:

At the commencement date, B Ltd. accounts for the transaction, as follows:

Building	Dr.	54,00,000	
Financial Asset (20 payments of ₹ 80,320 discounted @ 12% p.a.) (approx.)	Dr.	6,00,000	
To Cash			60,00,000

After the commencement date, B Ltd. accounts for the lease by treating ₹ 3,19,680 of the annual payments of ₹ 4,00,000 as lease payments. The remaining ₹ 80,320 of annual payments received from A Ltd. are accounted for as:

(a) payments received to settle the financial asset of ₹ 6,00,000 and

(b) interest revenue.

2. (a) Journal Entry

Date	Particulars	Dr.	Cr.
		₹	₹
1/4/20X1	Loan to Mr. Y A/c Dr. Pre-paid employee cost A/c Dr. To Bank A/c (Being loan to employee recorded at fair value)	10,43,638 1,56,362	 12,00,000
31/3/20X2	Loan to Mr. Y A/c Dr. To Finance Income A/c (Being finance income @ 9% recorded in the books)	93,927	 93,927
31/3/20X2	Bank A/c Dr. To Loan to Mr. Y A/c (Being installment received at the end of the year)	3,00,000	 3,00,000

Working Notes:

1. Calculation of initial recognition amount of loan to employee

Year	Estimated Cash Flows	PV Factor @ 9%	Present Value
	₹		₹
31/3/20X2	3,00,000	0.9174	2,75,220
31/3/20X3	3,00,000	0.8417	2,52,510
31/3/20X4	3,00,000	0.7722	2,31,660
31/3/20X5	3,00,000	0.7084	2,12,520
31/3/20X6	40,000 (W.N.2)	0.6499	25,996

31/3/20X7	40,000 (W.N.2)	0.5963	23,852
31/3/20X8	40,000 (W.N.2)	0.5470	21,880
Fair Value of Loan			10,43,638

2. Computation of Interest to be paid

Year	Opening outstanding balance a	Cash Flows b	Principal outstanding at year end c	Interest @ 4% on a d	Cumulative Interest e
		₹	₹	₹	₹
31/3/20X2	12,00,000	3,00,000	9,00,000	48,000	48,000
31/3/20X3	9,00,000	3,00,000	6,00,000	36,000	84,000
31/3/20X4	6,00,000	3,00,000	3,00,000	24,000	1,08,000
31/3/20X5	3,00,000	3,00,000	Nil	12,000	1,20,000
31/3/20X6	1,20,000	40,000 (1,20,000/3)			
31/3/20X7		40,000 (1,20,000/3)			
31/3/20X8		40,000 (1,20,000/3)			

3. Computation of finance cost as per amortization table

Year	Opening Balance (1)	Interest @ 9% (2)	Repayment (3)	Closing Balance (1+2-3)
	₹	₹	₹	₹
1/4/20X1				10,43,638
31/3/20X2	10,43,638	93,927	3,00,000	8,37,565
31/3/20X3	8,37,565	75,381	3,00,000	6,12,946
31/3/20X4	6,12,946	55,165	3,00,000	3,68,111
31/3/20X5	3,68,111	33,130	3,00,000	1,01,241
31/3/20X6	1,01,241	9,112	40,000	70,353
31/3/20X7	70,353	6,332	40,000	36,685
31/3/20X8	36,685	3,315*	40,000	Nil

*Difference of ₹ 13 (₹ 3,315 – ₹ 3,302) is due to approximation.

(b) Table showing computation of tax charge:

	Quarter ending 31st March, 20X1	Quarter ending 30th June, 20X1	Quarter ending30th September, 20X1	Quarter ending 31st December, 20X1	Year ending 31st December, 20X1
	₹	₹	₹	₹	₹
Profit before tax	50,000	50,000	50,000	50,000	2,00,000
Tax charge	(12,500)	(15,000)	(15,000)	(15,000)	(57,500)
	37,500	35,000	35,000	35,000	1,42,500

Since an entity's accounting year is not same as the tax year, more than one tax rate might apply during the accounting year. Accordingly, the entity should apply the effective tax rate for each interim period to the pre-tax result for that period.

3. (a) Computation of goodwill impairment

	NCI at fair value	NCI at of net assets
	₹ in '000	**₹ in '000**
Cost of investment		
Share exchange (6,000 x 75% x 2/3 x ₹ 6.50)	19,500	19,500
Deferred consideration (3,575 / 1.10)	3,250	3,250
Contingent consideration	12,500	12,500
Non-controlling interest at date of acquisition:		
Fair value – 1,500 x ₹ 6	9,000	
% of net assets – 34,000 (Refer W.N.) x 25%		8,500
Net assets on the acquisition date (Refer W.N.)	(34,000)	(34,000)

Goodwill on acquisition	10,250	9,750
Impairment @ 10%	1,025	975

Working Note:

Net assets on the acquisition date	**₹ '000**
Fair value at acquisition date	35,000
Deferred tax on fair value adjustments [20%x(35,000–30,000)]	(1,000)
	34,000

(b) **(i)** The gas will be used to generate electricity, which will be sold at a profit. The economic benefits from the contract include the benefits to the entity of using the gas in its business and, because the electricity will be sold at a profit, the contract is not onerous.

(ii) The electricity is sold to a wide range of customers. The entity first considers whether the assets used to generate electricity are impaired. To the extent that there is still a loss after the assets have been written down, a provision for an onerous contract should be recorded.

(iii) The only economic benefit from the purchase contract costing ₹ 2,30,000 are the proceeds from the sales contract, which are ₹ 1,80,000. Therefore, a provision should be made for the onerous element of ₹ 50,000, being the lower of the cost of fulfilling the contract and the penalty cost of cancellation (₹ 55,000).

4. **(a)** **Calculation of Investor Ltd.'s investment in XYZ Ltd. under equity method:**

	₹	₹
Acquisition of investment in XYZ Ltd.		
Share in book value of XYZ Ltd.'s net assets (35% of ₹ 90,00,000)	31,50,000	
Share in fair valuation of XYZ Ltd.'s net assets [35% of (₹ 1,10,00,000 – ₹ 90,00,000)]	7,00,000	
Goodwill on investment in XYZ Ltd. (balancing figure)	9,00,000	

Cost of investment		**47,50,000**
Profit during the year		
Share in the profit reported by XYZ Ltd. (35% of ₹ 9,00,000)	3,15,000	
Adjustment to reflect effect of fair valuation [35% of (₹ 20,00,000/10 years)]	(70,000)	
Share of profit in XYZ Ltd. recognised in income by Investor Ltd.		**2,45,000**
Long term equity investment		
FVTOCI gain recognised in OCI (35% of ₹ 2,00,000)		70,000
Dividend received by Investor Ltd. during the year [35% of ₹ 10,00,000]		(3,50,000)
Closing balance of Investor Ltd.'s investment in XYZ Ltd.		**47,15,000**

(b) (i) Calculation of Basic EPS:

Basic EPS = Profit for the year / Weighted average Number of shares outstanding

Basic EPS (Continued Operations) = Profit from continued operations / Weighted average Number of shares outstanding

= ₹ 90,00,000/ 10,00,000

= ₹ 9.00

Basic Loss per share

(Discontinued operations) = Loss from discontinued operations/Weighted Number of shares outstanding

= ₹ (1,08,00,000)/10,00,000

= (₹ 10.80)

Overall Basic Loss per share = (₹ 18,00,000) / 10,00,000

= ₹ (1.80) (i)

Calculation of Diluted EPS

Diluted EPS = Profit for the year / Adjusted Weighted average Number of shares outstanding

EPS (Continued Operations) = Profit from continued operations / Adjusted Weighted average Number of shares outstanding

= ₹ 90,00,000 / 12,00,000 = ₹ 7.50

Loss per share (Discontinued operations) = Loss from discontinued operations/ Adjusted weighted average number of shares outstanding

= ₹ (1,08,00,000)/12,00,000

= (₹ 9.00)

Overall Diluted Loss per share = ₹ 18,00,000 / 12,00,000

= ₹ (1.50) (ii)

The income from continuing operations is the control number, there is a dilution in basic EPS for income from continuing operations (reduction of EPS from ₹ 9.00 to ₹ 7.50). Therefore, even though there is an anti-dilution [Loss per share reduced from ₹ 1.80 (i) to ₹ 1.50 (ii) above], diluted loss per share of ₹ 1.50 is reported.

(ii) In case of loss from continuing operations, the potential shares are excluded since including those shares would result into anti-dilution effect on the **control number** (loss from continuing operations). Therefore, the diluted EPS will be calculated as under:

Diluted EPS = Profit for the year / Adjusted weighted average number of shares outstanding

Overall Profit = Loss from continuing operations + Gain from discontinued operations

= ₹ (30,00,000) + ₹ 1,08,00,000

= ₹ 78,00,000

Weighted average number of shares outstanding = 10,00,000

Diluted EPS = ₹ 7.80

The dilutive effect of the potential common shares on EPS for income from discontinued operations and net income would not be reported because of the loss from continuing operations.

5. (a) (i) On 1st April, 20X1, entity A entered into a single transaction with three identifiable separate components:

1. Sale of a good (i.e. engineering machine);
2. Rendering of services (i.e. engineering machine maintenance services on 30th September, 20X1 and 1st April, 20X2); and
3. Providing finance (i.e. sale of engineering machine and rendering of services on extended period credit).

(ii) Calculation and allocation of revenue to each component of the transaction

Date	***Opening balance***	***Finance income***	***Goods***	***Services***	***Payment received***	***Closing balance***
1st April, 20X1	–	–	2,51,927	–	–	2,51,927
30th September, 20X1	2,51,927	12,596 (Note 1)	–	45,000	–	3,09,523
31st March 20X2	3,09,523	15,477 (Note 2)	–	–	–	3,25,000
1st April, 20X2	3,25,000	–	–	75,000	(4,00,000)	

Notes:

1. Calculation of finance income as on 30th September, 20X1

= 5% x 2,51,927

= ₹ 12,596

2. Calculation of finance income as on 31st March, 20X2

= 5% x 3,09,523

= ₹ 15,477

(iii) **Journal Entries**

Date	Particulars	Dr. (₹)	Cr. (₹)
1st April, 20X1	Mr. Anik Dr.	2,51,927	
	To Revenue - sale of goods (Profit or loss A/c)		2,51,927
	(Being revenue recognised from the sale of the machine on credit)		
	Cost of goods sold (Profit or loss) Dr.	1,60,000	
	To Inventories		1,60,000
	(Being cost of goods sold recognised)		
30th September 20X1	Mr. Anik Dr.	12,596	
	To Finance Income (Profit or loss)		12,596
	(Being finance income recognised)		
	Mr. Anik Dr.	45,000	
	To Revenue- rendering of services (Profit or loss)		45,000
	(Being revenue from the rendering of maintenance services recognised)		
	Cost of services (Profit or loss) Dr.	30,000	
	To Cash/Bank or payables		30,000
	(Being the cost of performing maintenance services recognised)		
31st March 20X2	Mr. Anik Dr.	15,477	
	To Finance Income (Profit or loss)		15,477
	(Being finance income recognised)		

1st April, 20X2	Mr. Anik Dr. To Revenue - rendering of services (Profit or loss) (Being revenue from the rendering of maintenance services recognised)	75,000	 75,000
	Cost of services (Profit or loss) Dr. To Cash/Bank or payables (Being the cost of performing maintenance services recognised)	50,000	 50,000
	Cash/Bank Dr. To Mr. Anik (Being the receipt of cash from the customer recognised)	4,00,000	 4,00,000

(b) Ind AS 101 provides that a first-time adopter is encouraged, but not required, to apply Ind AS 102 on 'Share-based Payment' to equity instruments that vested before the date of transition to Ind AS. However, if a first-time adopter elects to apply Ind AS 102 to such equity instruments, it may do so only if the entity has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in Ind AS 102.

Having regard to the above, X Ltd. has the following options:

- For 100 options that vested before the date of transition:

  (a) To apply Ind AS 102 and account for the same accordingly, provided it has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in Ind AS 102.

  (b) Not to apply Ind AS 102.

  However, for all grants of equity instruments to which Ind AS 102 has not been applied, i.e., equity instruments vested but not settled before date of transition to Ind AS, X Ltd. would still need to disclose the information.

- For 200 options that will vest after the date of transition: X Ltd. will need to account for the same as per Ind AS 102.

6. **(a)** **(i)** In terms of Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, an entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be *highly probable*.

For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the **sale should be expected to qualify for recognition as a completed sale within one year from the date of classification**, except in specific cases as permitted by the Standard, and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. The probability of required approvals (as per the jurisdiction) should be considered as part of the assessment of whether the sale is highly probable.

An entity that is committed to a sale plan involving loss of control of a subsidiary shall classify all the assets and liabilities of that subsidiary as held for sale when the criteria set out above are met, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the sale.

Based on the provisions highlighted above, the disposal of D Ltd. appears to meet the criteria of **held for sale**. J Ltd. is the probable acquirer, and the sale is highly probable, expected to be completed seven months after the year end, well within the 12-months criteria highlighted above. Accordingly, D Ltd. should be treated as a disposal group, since a single equity transaction is the most likely form of disposal. In case D Ltd. is deemed to be a separate major component of business or geographical area of the group, the losses of the group should be presented separately as a discontinued operation within the Financial Statements of M Ltd.

In terms of Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, an entity shall measure a non-current asset (or disposal group) classified as held for sale at the **lower of its carrying amount and fair value less costs to sell**. The carrying amount of D Ltd. (i.e., the subsidiary of M Ltd.) comprises of the net assets and goodwill less the non-controlling interest. The impairment loss recognised to reduce D Ltd. to fair value less costs to sell should be allocated first to goodwill and then on a pro-rata basis across the other non-current assets of the Company.

The Chief Operating Officer (COO) is incorrect to exclude any form of restructuring provision in the Financial Statements. Since the disposal is communicated to the media as well as the Stock Exchange, a constructive obligation exists. However, ongoing costs of business should not be provided for, only **directly attributable costs of restructuring** should be provided. Future operating losses should be excluded as no obligating event has arisen, and no provision is required for impairment losses of Property, Plant and Equipment as it is already considered in the remeasurement to fair value less costs to sell. Thus, a provision is required for ₹ 13.75 crores (₹ 3.75 crores + ₹ 10 crores).

(ii) Ethics

Accountants have a duty to ensure that the financial statements are **fair**, **transparent** and **comply with the accounting standards**. Mr. X have committed several mistakes. In particular, he was unaware of which costs should be included within a restructuring provision and has failed to recognise that there is no obligating event in relation to future operating losses. A chartered accountant is expected to carry his work with **due care and attention** for lending credibility to the financial statements. Accordingly, he must update his knowledge and ensure that work is carried out in accordance with relevant ethical and professional standards. Failure to do so would be a breach of **professional competence**. Accordingly, Mr. X must ensure that this issue is addressed, for example by attending regular training and professional development courses.

It appears that the chief operating officer is looking for means to **manipulate** the financial statements for meeting the bonus targets. Neither is he willing to reduce the profits of the group by applying held for sale criteria in respect of D Ltd. nor is he willing to create appropriate restructuring provisions. Both the adjustment which comply with the requirements of Ind AS will result in reduction of profits. His argument that the management has a duty to maximize the returns for the shareholders is true, but such maximization must not be achieved at the cost of **objective** and **faithful representation** of the performance of the Company. In the given case, it appears that the chief operating officer is motivated by bonus targets under the garb of maximizing returns for the shareholders, thereby resulting in misrepresentation of the results of the group.

Further, by threatening to dismiss Mr. X, the COO has acted unethically. **Threatening and intimidating behaviour** is unacceptable and against all ethical principles. This has given rise to an **ethical dilemma** for Mr. X. He has a duty to produce financial statements but doing so in a fair manner could result in a loss of job for him. The chartered accountant should approach the chief operating officer and remind him the basic ethical principles and communicate him to do the necessary adjustments in the accounts so that they are fair and objective.

In case Mr. X, falls under undue influence of COO and applies the incorrect accounting treatment, he will be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, for contravening the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

(b) Impact on consolidated balance sheet of P Ltd. group at 31st March, 20X2

- The tax loss creates a potential deferred tax asset for the P Ltd. group since its carrying value is nil and its tax base is ₹ 10,00,000. However, no deferred tax asset can be recognised because there is no prospect of being able to reduce tax liabilities in the foreseeable future as no taxable profits are anticipated.
- The development costs have a carrying value of ₹ 19,00,000 (₹ 20,00,000 – (₹ 20,00,000 x 1/5 x 3/12)). The tax base of the development costs is nil since the relevant tax deduction has already been claimed. The deferred tax liability will be ₹ 5,70,000 (₹ 19,00,000 x 30%). All deferred tax liabilities are shown as non-current.
- The carrying value of the loan at 31st March, 20X2 is ₹ 1,07,80,000 (₹ 1,00,00,000 – ₹ 200,000 + (₹ 98,00,000 x 10%)). The tax base of the loan is 1,00,00,000. This creates a deductible temporary difference of ₹ 7,80,000 and a potential deferred tax asset of ₹ 2,34,000 (₹ 7,80,000 x 30%).

(c) Either

Paragraph 16(a) of Ind AS 8 provides that the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring are not changes in accounting policies.

As per Ind AS 16, 'property, plant and equipment' are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period."

As per Ind AS 40, 'investment property' is property (land or a building—or part of a building—or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business."

As per the above definitions, whether a building is an item of property, plant and equipment (PPE) or an investment property for an entity depends on the purpose for which it is held by the entity. It is thus possible that due to a change in the purpose for which it is held, a building that was previously classified as an item of property, plant and equipment may warrant reclassification as an investment property, or vice versa. Whether a building is in the nature of PPE or investment property is determined by applying the definitions of these terms from the perspective of that entity. Thus, the classification of a building as an item of property, plant and equipment or as an investment property is not a matter of an accounting policy choice. Accordingly, a change in classification of a building from property, plant and equipment to investment property due to change in the purpose for which it is held by the entity is **not** a change in an accounting policy.

Or

As per Ind AS 10, even if partial information has already been published, the reporting period will be considered as the period between the end of the reporting period and the date of approval of financial statements. In the above case, the financial statements for the year 20X1-20X2 were approved on 15th May, 20X2. Therefore, for the purposes of Ind AS 10, ‘after the reporting period’ would be the period between 31st March, 20X2 and 15th May, 20X2.

ANSWERS OF MODEL TEST PAPER 4

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

ANSWER TO PART – I CASE SCENARIO BASED MCQS

1. **Option (a) :** ₹ 8,40,000
2. **Option (b) :** ₹ 42,000
3. **Option (d) :** ₹ 50,000
4. **Option (c) :** 11.4375%
5. **Option (c) :** ₹ 15,000
6. **Option (a) :** ₹ 22,875
7. **Option (d) :** Loss on initial recognition of biological asset ₹ 6,000
8. **Option (a) :** Gain on remeasurement of biological asset ₹ 9,800
9. **Option (c) :** Equity
10. **Option (b) :** Financial Liability
11. **Option (b) :** Z Ltd. is an associate of H Ltd.
12. **Option (b) :** G Ltd. is an associate of H Ltd.
13. **Option (b) :** Y Ltd. is an associate of H Ltd.
14. **Option (d) :** Do not disclose assumptions and bases, so that users are not misled.
15. **Option (a) :** Ensure that all passwords are simple and are not changed regularly.

PART – II DESCRIPTIVE QUESTIONS

1. **Identifying the acquirer**

   As a result of Entity A issuing 150 ordinary shares, Entity B's shareholders own 60 per cent of the issued shares of the combined entity (i.e., 150 of the 250 total issued shares). The remaining 40 per cent are owned by Entity A's shareholders. Thus, the transaction is determined to be a reverse acquisition in which Entity B is identified as the accounting acquirer while Entity A is the legal acquirer.

Calculating the fair value of the consideration transferred

If the business combination had taken the form of Entity B issuing additional ordinary shares to Entity A's shareholders in exchange for their ordinary shares in Entity A, Entity B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. Entity B's shareholders would then own 60 of the 100 issued shares of Entity B — 60 per cent of the combined entity. As a result, the fair value of the consideration effectively transferred by Entity B and the group's interest in Entity A is ₹ 1,600 (40 shares with a fair value per share of ₹ 40).

The fair value of the consideration effectively transferred should be based on the most reliable measure. Here, the quoted market price of Entity A's shares provides a more reliable basis for measuring the consideration effectively transferred than the estimated fair value of the shares in Entity B, and the consideration is measured using the market price of Entity A's 100 shares with a fair value per share of ₹ 16.

Measuring goodwill

Goodwill is measured as the excess of the fair value of the consideration effectively transferred (the group's interest in Entity A) over the net amount of Entity A's recognised identifiable assets and liabilities, as follows:

	₹	₹
Consideration effectively transferred		1,600
Net recognised values of Entity A's identifiable assets and liabilities		
Current assets	500	
Non-current assets	1,500	
Current liabilities	(300)	
Non-current liabilities	(400)	(1,300)
Goodwill		300

Consolidated balance sheet at 31st December, 20X1

The consolidated balance sheet immediately after the business combination is:

	₹
Non-current assets [3,000 + 1,500]	4,500
Goodwill	300
Current assets [700 + 500]	1,200
Total assets	6,000
Shareholders' equity	
Issued equity 250 ordinary shares [600 + 1,600]	2,200
Retained earnings	1,400
Total shareholders' equity	3,600
Non-current liabilities [1,100 + 400]	1,500
Current liabilities [600 + 300]	900
Total liabilities	2,400
Total liabilities and shareholders' equity	6,000

The amount recognised as issued equity interests in the consolidated financial statements (₹ 2,200) is determined by adding the issued equity of the legal subsidiary immediately before the business combination (600) and the fair value of the consideration effectively transferred (₹ 1,600). However, the equity structure appearing in the consolidated financial statements (i.e., the number and type of equity interests issued) must reflect the equity structure of the legal parent, including the equity interests issued by the legal parent to affect the combination.

2. **(a)** Ind AS 109 requires that financial assets and liabilities are recognized on initial recognition at its fair value, as adjusted for the transaction cost. In accordance with Ind AS 113 Fair Value Measurement, the fair value of a financial liability with a demand feature (e.g., a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

Both parent and subsidiary recognize financial asset and liability, respectively, at fair value on initial recognition. The difference between the loan amount and its fair value is treated as an equity contribution to the subsidiary. This represents a further investment by the parent in the subsidiary.

Accounting in the books of XYZ Ltd (Parent)

Particulars	Amount	Amount
On the date of loan		
Loan to ABC Ltd (Subsidiary) Dr.	7,51,315	
Deemed Investment (Capital Contribution) in ABC Ltd. Dr.	2,48,685	
To Bank		10,00,000
(Being the loan is given to ABC Ltd and recognised at fair value)		
Accrual of Interest income		
Loan to ABC Ltd Dr.	75,131	
To Interest income		75,131
(Being interest income accrued) – Year 1		
Loan to ABC Ltd Dr.	82,645	
To Interest income		82,645
(Being interest income accrued) – Year 2		
Loan to ABC Ltd Dr.	90,909	
To Interest income		90,909
(Being interest income accrued) – Year 3		
On repayment of loan		
Bank Dr.	10,00,000	
To Loan to ABC Ltd (Subsidiary)		10,00,000

Accounting in the books of ABC Ltd (Subsidiary)

Particulars	Amount	Amount
On the date of loan		
Bank Dr.	10,00,000	
To Loan from XYZ Ltd (Payable)		751,315
To Equity (Deemed Capital Contribution from XYZ Ltd)		2,48,685
(Being the loan taken from XYZ Ltd. and recognised at Fair value)		

Accrual of Interest		
Interest expense Dr.	75,131	
To Loan from XYZ Ltd (Payable)		75,131
(Being interest expense recognised) – Year 1		
Interest expense Dr.	82,645	
To Loan from XYZ Ltd (Payable)		82,645
(Being interest expense recognised) – Year 2		
Interest expense Dr.	90,909	
To Loan from XYZ Ltd (Payable)		90,909
(Being interest expense recognised) – Year 3		
On repayment of loan		
Loan from XYZ Ltd (Payable) Dr.	10,00,000	
To Bank		10,00,000

Working Notes:

1	**Computation of Present value of loan**	
	Rate	10%
	Amount of Loan	10,00,000
	Year	3
	Present Value	7,51,315
2	**Computation of interest for Year I**	
	Present Value	7,51,315
	Rate	10%
	Period of interest - for 1 year	1
	Closing value at the end of year 1	8,26,446
	Interest for 1^{st} year	75,131
3	**Computation of interest for Year 2**	
	Value of loan as at the beginning of Year 2	8,26,446
	Rate	10%
	Period of interest - for 2^{nd} year	1
	Closing value at the end of year 2	9,09,091
	Interest for 2^{nd} year	82,645

4	Computation of interest for Year 3	
	Value of loan as at the beginning of Year 3	9,09,091
	Rate	10%
	Period of interest - for 3rd year	1
	Closing value at the end of year 3	10,00,000
	Interest for 3rd year	90,909

(b) **Either**

In accordance with Ind AS 24 'Related Party Disclosures', effective 1st January 20X3, Candour Ltd. would be regarded as a related party of Buildwell Ltd. This is because Candour Ltd. is controlled by the close family member of one of Buildwell Ltd.'s key management personnel. This means that from 1st January 20X3, the purchases from Candour Ltd. would be regarded as related party transactions.

As per the provisions of para 18 of Ind AS 24, transactions with related parties need to be disclosed in the notes to the financial statements, together with the nature of the relationship. It is irrelevant whether or not these transactions are at normal market rates. As per para 23 of the standard, disclosures that related party transactions were made on terms equivalent to those that prevail in arm's length transactions are made only if such terms can be substantiated.

The disclosure is required to state that Candour Ltd., controlled by the spouse of a director, supplied goods to the value of ₹ 4·5 million (3 x ₹ 1·5 million) in the current accounting period.

Or

The entity should use First-in-first-out (FIFO) method for its Ind AS 108 disclosures, even though it uses the weighted average cost formula for measuring inventories for inclusion in its financial statements. Where chief operating decision maker uses only one measure of segment asset, same measure should be used to report segment information. Accordingly, in the given case, the method used in preparing the financial information for the chief operating decision maker should be used for reporting under Ind AS 108.

However, reconciliation between the segment results and results as per financial statements needs to be given by the entity in its segment report.

3. (a) Statement of Cash Flows for the year ended 31st March 20X3

(Indirect method)

Particulars	₹	₹
Cash flow from operating activities: Net Profit before taxes and extraordinary items (7,20,000+8,80,000) *Add*: Depreciation	 16,00,000 6,00,000	
Operating profit before working capital changes	22,00,000	
Increase in inventories Decrease in trade receivables Advances Decrease in trade payables Increase in outstanding expenses	(1,80,000) 16,80,000 (12,000) (60,000) 2,40,000	
Cash generated from operations *Less*: Income tax paid (Refer W.N.4)	38,68,000 (8,68,000)	
Net cash from operations		30,00,000
Cash from investing activities: Purchase of land Purchase of building & equipment (Refer W.N.2) Sale of equipment (Refer W.N.3)	 (4,80,000) (28,80,000) 3,60,000	
Net cash used for investment activities		(30,00,000)
Cash flows from financing activities: Issue of share capital Dividends paid	 8,40,000 (7,20,000)	
Net cash from financing activities:		1,20,000

Net increase in cash and cash equivalents		1,20,000
Cash and cash equivalents at the beginning		6,00,000
Cash and cash equivalents at the end		7,20,000

Working Notes:

1. Building & Equipment Account

Particulars	₹	Particulars	₹
To Balance b/d	36,00,000	By Sale of assets	7,20,000
To Cash/bank (purchases)(bal.fig)	28,80,000	By Balance c/d	57,60,000
	64,80,000		64,80,000

2. Building & Equipment Accumulated Depreciation Account

Particulars	₹	Particulars	₹
To Sale of asset (acc. depreciation)	4,80,000	By Balance b/d	12,00,000
To Balance c/d	13,20,000	By Profit & Loss A/c (provisional)	6,00,000
	18,00,000		18,00,000

3. Computation of sale price of Equipment

Particulars	₹
Original cost	7,20,000
Less Accumulated Depreciation	(4,80,000)
Net cost	2,40,000
Profit on sale of assets	1,20,000
Sale proceeds from sale of assets	3,60,000

4. Provision for tax Account

Particulars	₹	Particulars	₹
To Bank A/c	8,68,000	By Balance b/d	1,20,000
To Balance c/d	1,32,000	By Profit & Loss A/c (provisional)	8,80,000
	10,00,000		10,00,000

(b) As per Ind AS 19, net remeasurement of ₹ 900 would be recognized in other comprehensive income.

Computation of Net remeasurement

= Remeasurement – Actuarial loss

= ₹ 1000 (Refer WN - 1) – ₹ 100 (Given in the question) = ₹ 900.

Computation of net interest expense

Particulars	₹
Defined benefit liability as at 1st April 20X1 **(A)** **(Given in the question)**	12,000
Fair value of plan asset as at 1st April 20X1 **(B)** **(Given in the question)**	(10,000)
Net defined benefit liability **(A - B)**	2,000
Net interest expense (as it is net liability) (Refer note given below)	200

Note: Net interest expense would be computed on net defined benefit liability using discount rate of 10% given in the question-

= Net defined benefit liability x Discount rate

= 2,000 x 10%

= ₹ 200.

Working Note:

Computation of amount of remeasurement

Particulars	₹
Actual return on plan asset for the year ended 31st March 20X2 **(Given in the question) (C)**	2,000

Less: Interest income on ₹ 10,000 held for 12 months at 10% **(D)**	(1,000)
Remeasurement **(E = C - D)**	1,000

4. (a) Impact on consolidated balance sheet of PQR Ltd. group at 31st March, 20X2

i. The tax loss creates a potential deferred tax asset for the PQR Ltd. group since its carrying value is nil and its tax base is ₹ 30,00,000. However, no deferred tax asset can be recognised because there is no prospect of being able to reduce tax liabilities in the foreseeable future as no taxable profits are anticipated.

ii. The development costs have a carrying value of ₹ 15,20,000 (₹ 16,00,000 – (₹ 16,00,000 x 1/5 x 3/12)). The tax base of the development costs is nil since the relevant tax deduction has already been claimed. The deferred tax liability will be ₹ 4,56,000 (₹ 15,20,000 x 30%). All deferred tax liabilities are shown as non-current.

iii. The carrying value of the loan at 31st March, 20X2 is ₹ 1,07,80,000 (₹ 1,00,00,000 – ₹ 200,000 + (₹ 98,00,000 x 10%)). The tax base of the loan is 1,00,00,000. This creates a deductible temporary difference of ₹ 7,80,000 and a potential deferred tax asset of ₹ 2,34,000 (₹ 7,80,000 x 30%).

(b) In the facts provided above, the entity has made sale of two goods – machine and space parts, whose control is transferred at a point in time. Additionally, company agrees to hold the spare parts for the customer for a period of 2-4 years, which is a separate performance obligation. Therefore, total transaction price shall be divided amongst 3 performance obligations –

(i) Sale of machinery

(ii) Sale of spare parts

(iii) Custodial services for storing spare parts.

Recognition of revenue for each of the three performance obligations shall occur as follows:

- **Sale of machinery:** Machine has been sold to the customer and physical possession as well as legal title passed to the customer on 31st March, 20X3. Accordingly, revenue for sale of machinery shall be recognized on 31st March, 20X3.

- **Sale of spare parts:** The customer has made payment for the spare parts and legal title has been passed to specifically identified goods, but such spares continue to be physically held by the entity. In this regard, the company shall evaluate if revenue can be recognized on bill-and-hold basis if all below criteria are met:

(a)	the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);	The customer has specifically requested for entity to store goods in their warehouse, owing to close proximity to customer's factory.
(b)	the product must be identified separately as belonging to the customer;	The spare parts have been specifically identified and inspected by the customer.
(c)	the product currently must be ready for physical transfer to the customer; and	The spares are identified and segregated, therefore, ready for delivery.
(d)	the entity cannot have the ability to use the product or to direct it to another customer	Spares have been segregated and cannot be redirected to any other customer.

Therefore, all conditions of bill-and-hold are met and hence, company can recognize revenue for sale of spare parts on 31st March, 20X3.

- **Custodial services:** Such services shall be given for a period of 2 to 4 years from 31st March, 20X3. Where services are given uniformly and customer receives & consumes benefits simultaneously, revenue for such service shall be recognized on a straight-line basis over a period of time.

5. **(a)** Paragraph 2 of Ind AS 20, "Accounting for Government Grants and Disclosure of Government Assistance" inter alia states that the Standard does not deal with government participation in the ownership of the entity.

Since ABC Ltd. is a Government company, it implies that government has 100% shareholding in the entity. Accordingly, the entity needs to determine whether the payment is provided as a shareholder contribution or as a government. Equity contributions will be recorded in equity while grants will be shown in the Statement of Profit and Loss.

Where it is concluded that the contributions are in the nature of government grant, the entity shall apply the principles of Ind AS 20 retrospectively as specified in Ind AS 101 'First Time Adoption of Ind AS'. Ind AS 20 requires all grants to be recognised as income on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate. Unlike AS 12, Ind AS 20 requires the grant to be classified as either a capital or an income grant and does not permit recognition of government grants in the nature of promoter's contribution directly to shareholders' funds.

Where it is concluded that the contributions are in the nature of shareholder contributions and are recognised in capital reserve under previous GAAP, the provisions of paragraph 10 of Ind AS 101 would be applied which states that except in certain cases, an entity shall in its opening Ind AS Balance Sheet:

(a) recognise all assets and liabilities whose recognition is required by Ind AS;

(b) not recognise items as assets or liabilities if Ind AS do not permit such recognition;

(c) reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with Ind AS; and

(d) apply Ind AS in measuring all recognised assets and liabilities.

Accordingly, as per the above requirements of paragraph 10(c) in the given case, contributions recognised in the Capital Reserve should be transferred to appropriate category under 'Other Equity' at the date of transition to Ind AS.

(b) Identification of the contract (by applying para 9 of Ind AS 116)

(a) Identified asset

Feel Fresh Ltd. (a customer company) enters into a long-term purchase contract with M/s Radhey (a manufacturer) to purchase a particular type and quality of soaps for 10 year period.

Since for the purpose of the contract M/s Radhey has to buy a customized machine as per the directions of Feel Fresh Ltd. and also the machine cannot be used for any other type of soap, the machine is an identified asset.

(b) Right to obtain substantially all of the economic benefits from use of the asset throughout the period of use

Since the machine cannot be used for manufacture of soap for any other buyer, Feel Fresh Ltd. will obtain substantially all the economic benefits from the use of the asset throughout the period of use.

(c) Right to direct the use

Feel Fresh Ltd. controls the use of machine and directs the terms and conditions of the contract with respect to recovery of fixed expenses related to machine.

Hence the contract contains a lease.

Lease term

The lease term shall be 10 years assuming reasonable certainty. Though the lessee is not contractually bound till 10th year, i.e., the lessee can refuse to make payment anytime without lessor's permission but, it is assumed that the lessee is reasonably certain that it will not exercise this option to terminate.

Identification of lease payment

Lease payments are defined as payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

(a) fixed payments (including in-substance fixed payments), **less** any lease incentives

(b) variable lease payments that depend on an index or a rate

(c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option

(d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

Here in-substance fixed payments in the given lease contract are ₹ 1,74,015 p.a. The present value of lease payment which would be recovered in 8 years @ 8% would be ₹ 10,00,000 (approx.)

Variable lease payments that do not depend on an index or rate and are not, in substance, fixed are not included as lease payments. Instead, they are recognised in profit or loss in the period in which the event that triggers the payment occurs (unless they are included in the carrying amount of another asset in accordance with other Ind AS).

Hence, lease liability will be recognized by ₹ 10,00,000 in the books of Feel Fresh Ltd. Since there are no payments made to lessor before commencement date less lease incentives received from lessor or initial direct costs incurred by lessee or estimate of costs for restoration / dismantling of underlying asset, the right of use asset is equal to lease liability.

Journal Entries

On initial recognition

ROU Asset Dr.	10,00,000	
To Lease Liability		10,00,000
To initially recognise the Lease Liability and the corresponding ROU Asset		

At the end of the first year

Interest Expense Dr.	80,000	
To Lease Liability		80,000
To record interest expense and accrete the lease liability using the effective interest method (₹ 10,00,000 x 8%)		
Depreciation Expense (10,00,000 / 10 years) Dr.	1,00,000	
To ROU Asset		1,00,000
To record depreciation on ROU using the straight-line method (₹ 10,00,000 / 10 years)		
Lease Liability Dr.	1,74,015	
To Bank / M/s. Radhey		1,74,015
To record lease payment		
Cost of soap Dr.	24,75,000	
To Bank / M/s. Radhey {5,50,000 x (4 + 0.5)}		24,75,000
To record variable expenses paid as cost of the goods purchased		

6. (a) The above issue needs to be examined in the umbrella of the provisions given in Ind AS 1 ‘*Presentation of Financial Statements*’, Ind AS 16 ‘*Property, Plant and Equipment*’ in relation to property ‘1’ and ‘2’ and *Ind AS 40 ‘Investment Property’* in relation to property ‘3’.

Venus Ltd. shall apply the same accounting policy (i.e. either revaluation or cost model) to entire class of property being property ‘1’ and ‘2”. It also required to depreciate these properties irrespective of that, their fair value exceeds the carrying amount. The revaluation gain shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus.

There is no alternative of revaluation model in respect to property '3' being classified as Investment Property and only cost model is permitted for subsequent measurement. However, Venus ltd. is required to disclose the fair value of the property in the Notes to Accounts. Also the property '3' shall be presented as separate line item as Investment Property.

Therefore, as per the provisions of Ind AS 1, Ind AS 16 and Ind AS 40, the presentation of these three properties in the balance sheet is as follows:

Case 1: Venus Ltd. has applied the Cost Model to an entire class of property, plant and equipment.

Balance Sheet (extracts) as at 31st March, 20X2 ₹

Assets		
Non-Current Assets		
Property, Plant and Equipment		
Property '1'	13,500	
Property '2'	9,000	22,500
Investment Properties		
Property '3'		10,800

Case 2: Venus Ltd. has applied the Revaluation Model to an entire class of property, plant and equipment.

Balance Sheet (extracts) as at 31st March, 20X2 ₹

Assets		
Non-Current Assets		
Property, Plant and Equipment		
Property '1'	16,000	
Property '2'	11,000	27,000
Investment Properties		
Property '3'		10,800

Equity and Liabilities		
Other Equity		
Revaluation Reserve		
Property '1' [16,000 – (15,000 – 1,500)]	2,500	
Property '2' [11,000 – (10,000 – 1,000)]	2,000	4,500

The revaluation reserve should be routed through Other Comprehensive Income (subsequently not reclassified to Profit and Loss) in Statement of Profit and Loss and shown in a separate column under Statement of Changes in Equity.

(b) Ethical Considerations

Long-term success of any organization strongly depends on the fair treatment of employees, which in turn is based on the ethical behaviour of the management as well as how the same is perceived by the stakeholders. In the given case, the CFO has suggested not paying the discretionary bonus, which the directors are considering as it will enable the company to record profits of ₹ 2 crores, thereby ensuring a bonus pay out to the directors. This suggestion is not illegal at all as the bonus is discretionary rather than statutory/contractual. In other words, the company has no legal obligation to pay the bonus to the employees. However, the reason behind non-payment of the bonus is what gives rise to ethical considerations. The suggestion by the CFO will have the aforesaid impact of reducing expenses and improving profits.

On a moral ground, the suggestion is likely to have negative consequences for the company. The employees would be dissatisfied that the bonus has been withdrawn, and further, when they would see the directors withdrawing bonuses out of the profits arising on a saving in bonus costs, it would have a negative impact on employee morale, which would result in low employee satisfaction scores and poor retention rates, which are reported as non-financial information in the financial statements. Companies are also under increasing pressure to reduce the wage gap between the management and its employees. By not paying a bonus, this metric will be adversely affected.

The CFO's statement that the above action will not negatively impact the company as the non-financial reporting indicators are not widely read by the users is misleading. The non-financial information is becoming increasingly important to the users of financial statements as they care about companies' treatment of their employees and view it as being important in the long-term success of the company.

A chartered accountant has a responsibility to exercise due diligence and clearly consider both financial and non-financial information while discharging his professional duty. It would be unethical for a chartered accountant to guide the management on matters which may result into any kind of disadvantage (it includes even non-financial matters) to the stakeholders.

Further, a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. A chartered accountant's responsibility is not exclusively to satisfy the needs of an individual client or employing organization. Therefore, the Code contains requirements and application material to enable chartered accountants to meet their responsibility to act in the public interest. Hence, it is essential for a chartered accountant to uphold the professional standards and act in accordance with the ethical principles by ensuring transparency and accuracy in financial reporting.

ANSWERS OF MODEL TEST PAPER 5

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

PART – I CASE SCENARIO BASED MCQS

1. **Option (a)** : Bad debts expenses incurred during third quarter should be recognised in the same quarter. Accordingly, ₹ 50,000 should be deducted from ₹ 20,00,000.
2. **Option (d) :** ₹ 14,50,000
3. **Option (c) :** A single performance obligation
4. **Option (b) :** ₹ 2,05,00,000
5. **Option (a) :** ₹ 1,70,83,333
6. **Option (c) :** ₹ 34,16,667
7. **Option (b) :** 2.40
8. **Option (a) :** 2.29
9. **Option (d) :** Executory contract and non-derivative contract
10. **Option (c) :** Equity
11. **Option (a) :** ₹ 34,000 crores
12. **Option (b) :** ₹ 4,000 crores
13. **Option (c) :** ₹ 250 crores
14. **Option (a) :** 1^{st} April, 20X0
15. **Option (d) :** 20X0-20X1

PART – II DESCRIPTIVE QUESTIONS

1. **Consolidated Balance Sheet of DEF Ltd. and its subsidiary, XYZ Ltd.**

as at 31^{st} March, 20X2

Particulars	Note No.	₹
I. Assets		
(1) Non-current assets		
(i) Property Plant & Equipment	1	86,00,000
(2) Current Assets		
(i) Inventories	2	17,14,000

(ii) Financial Assets		
(a) Trade Receivables	3	9,98,000
(b) Cash & Cash equivalents	4	2,25,000
Total Assets		**1,15,37,000**
II. Equity and Liabilities		
(1) Equity		
(i) Equity Share Capital	5	50,00,000
(ii)Other Equity	6	49,92,000
(2) Current Liabilities		
(i) Financial Liabilities		
(a) Trade Payables	7	7,45,000
(b) Short term borrowings	8	8,00,000
Total Equity & Liabilities		**1,15,37,000**

Notes to Accounts

			₹
1.	**Property Plant & Equipment**		
	Land & Building	43,00,000	
	Plant & Machinery	43,00,000	86,00,000
2.	**Inventories**		
	DEF Ltd.	12,00,000	
	XYZ Ltd.	5,14,000	17,14,000
3.	**Trade Receivables**		
	DEF Ltd.	5,98,000	
	XYZ Ltd.	4,00,000	9,98,000
4.	**Cash & Cash equivalents**		
	DEF Ltd.	1,45,000	
	XYZ Ltd.	80,000	2,25,000
7.	**Trade payable**		
	DEF Ltd.	4,71,000	
	XYZ Ltd.	2,74,000	7,45,000
8.	**Short-term borrowings**		
	Bank overdraft		8,00,000

Statement of Changes in Equity:

1. **Equity share Capital**

Balance at the beginning of the reporting period	Changes in Equity share capital during the year	Balance at the end of the reporting period
50,00,000	0	50,00,000

2. **Other Equity**

	Reserves & Surplus			Total
	Capital reserve	Retained Earnings	Other Reserves	
Balance at the beginning		0	24,00,000	24,00,000
Total comprehensive income for the year	0	5,72,000		5,72,000
Dividends	0	(2,00,000)		(2,00,000)
Total comprehensive income attributable to parent	0	3,35,000		3,35,000
Gain on Bargain purchase	18,85,000	____	____	18,85,000
Balance at the end of reporting period	18,85,000	7,07,000	24,00,000	49,92,000

It is assumed that there exists no clear evidence for classifying the acquisition of the subsidiary as a bargain purchase and, hence, the bargain purchase gain has been recognized directly in capital reserve. If, however, there exists such a clear evidence, the bargain purchase gain would be recognized in other comprehensive income and then accumulated in capital reserve. In both the cases, closing balance of capital reserve will be ₹ 18,85,000.

Working Notes:

1. Adjustments of Fair Value

The Plant & Machinery of XYZ Ltd. would stand in the books at ₹ 14,25,000 on 1st October, 20X1, considering only six months' depreciation on ₹ 15,00,000 total depreciation being ₹ 1,50,000. The value put on the assets being ₹ 20,00,000 there is an appreciation to the extent of ₹ 5,75,000.

2. Acquisition date profits of XYZ Ltd. ₹

Reserves on 1.4.20X1	10,00,000
Profit & Loss Account Balance on 1.4. 20X1	3,00,000
Profit for 20X2:	
Total ₹ 8,20,000 less ₹ 1,00,000 (3,00,000 – 2,00,000) i.e. ₹ 7,20,000; for 6 months i.e. up to 1.10.20X1	3,60,000
Total Appreciation including machinery appreciation (10,00,000 1,50,000 + 5,75,000 – 1,00,000)	16,25,000
Share of DEF Ltd.	32,85,000

3. Post-acquisition profits of XYZ Ltd. ₹

Profit after 1.10. 20X1 [8,20,000-1,00,000]x 6/12	3,60,000
Less: 10% depreciation on ₹ 20,00,000 for 6 months less depreciation already charged for 2nd half of 20X1-20X2 on ₹ 15,00,000 (1,00,000-75,000)	(25,000)
Share of DEF Ltd.	3,35,000

4. Consolidated total comprehensive income ₹

DEF Ltd.	
Retained earnings on 31.3.20X2	5,72,000
Less: Retained earnings as on 1.4.20X1	(0)
Profits for the year 20X1-20X2	5,72,000
Less: Elimination of intra-group dividend	(2,00,000)
Adjusted profit for the year	3,72,000
XYZ Ltd.	

Adjusted profit attributable to DEF Ltd. (W.N.3)	3,35,000
Consolidated profit or loss for the year	7,07,000

No Non-controlling Interest as 100% shares of XYZ Ltd. are held by DEF Ltd.

5. Gain on Bargain Purchase ₹

Amount paid for 20,000 shares		34,00,000
Par value of shares	20,00,000	
DEF Ltd.'s share in acquisition date profits of XYZ Ltd.	32,85,000	(52,85,000)
Gain on Bargain Purchase		18,85,000

6. Value of Plant & Machinery ₹

DEF Ltd.		24,00,000
XYZ Ltd.	13,50,000	
Add: Appreciation on 1.10. 20X1	5,75,000	
	19,25,000	
Add: Depreciation for 2nd half charged on pre-revalued value	75,000	
Less: Depreciation on ₹ 20,00,000 for 6 months	(1,00,000)	19,00,000
		43,00,000

7. Consolidated retained earnings ₹

	DEF Ltd.	XYZ Ltd.	Total
As given	5,72,000	8,20,000	13,92,000
Consolidation Adjustments:			
(i) Elimination of pre-acquisition element [3,00,000 + 3,60,000]	0	(6,60,000)	(6,60,000)
(ii) Elimination of intra-group dividend	(2,00,000)	2,00,000	0
(iii) Impact of fair value adjustments	0	(25,000)	(25,000)
Adjusted retained earnings consolidated	3,72,000	3,35,000	7,07,000

Assumptions:

1. Investment in XYZ Ltd is carried at cost in the separate financial statements of DEF Ltd.
2. Appreciation of ₹10 lakhs in land & buildings is entirely attributable to land element only.
3. Depreciation on plant and machinery is on WDV method.
4. Acquisition-date fair value adjustment to inventories of XYZ Ltd. existing at the balance sheet date does not result in need for any write-down.

2. **(a)** On the date of initial recognition, the effective interest rate of the loan shall be computed keeping in view the contractual cash flows and upfront processing fee paid. The following table shows the amortisation of loan based on effective interest rate:

Date	Cash flows (principal)	Cash flows (interest and fee)	Amortised cost (opening + interest – cash flows)	Interest @ EIR (11.50%)
1-Jan-20X1	(500,000,000)	5,870,096	494,129,904	
31-Dec-20X1	100,000,000	55,000,000	395,954,843	56,824,939
31-Dec-20X2	100,000,000	44,000,000	297,489,650	45,534,807
31-Dec-20X3	100,000,000	33,000,000	198,700,959	34,211,310
31-Dec-20X4	100,000,000	22,000,000	99,551,570	22,850,610
31-Dec-20X5	100,000,000	11,000,000	(0)	11,448,430

a. **1 January 20X1 –**

Particulars	(₹)	(₹)
Bank A/c Dr. To Loan from bank A/c (Being loan recorded at its fair value less transaction costs on the initial recognition date)	494,129,904	 494,129,904

b. 31 December 20X1 –

Particulars	(₹)	(₹)
Loan from bank A/c Dr.	98,175,061	
Interest expense (profit and loss) Dr.	56,824,939	
To Bank A/c		155,000,000
(Being first instalment of loan and payment of interest accounted for as an adjustment to the amortised cost of loan)		

c. 31 December 20X2 – Before Wheel Co. Limited approached the bank –

Particulars	(₹)	(₹)
Interest expense (profit and loss Dr.	45,534,807	
To Loan from bank A/c		1,534,807
To Bank A/c		44,000,000
(Being loan payment of interest recorded by the Company before it approached the Bank for deferment of principal)		

Upon receiving the new terms of the loan, Wheel Co. Limited, re-computed the carrying value of the loan by discounting the new cash flows with the original effective interest rate and comparing the same with the current carrying value of the loan. As per requirements of Ind AS 109, any change of more than 10% shall be considered a substantial modification, resulting in fresh accounting for the new loan:

Date	Cash flows (principal)	Interest outflow @ 15%	Discount factor	PV of cash flows
31-Dec-20X2	(400,000,000)			
31-Dec-20X3	40,000,000	60,000,000	0.8969	89,686,099
31-Dec-20X4	40,000,000	54,000,000	0.8044	75,609,805
31-Dec-20X5	40,000,000	48,000,000	0.7214	63,483,092
31-Dec-20X6	40,000,000	42,000,000	0.6470	53,053,542
31-Dec-20X7	40,000,000	36,000,000	0.5803	44,100,068
31-Dec-20X8	40,000,000	30,000,000	0.5204	36,429,133
31-Dec-20X9	40,000,000	24,000,000	0.4667	29,871,422
31-Dec-20Y0	40,000,000	18,000,000	0.4186	24,278,903
31-Dec-20Y1	40,000,000	12,000,000	0.3754	19,522,235

31-Dec-20Y3	40,000,000	6,000,000	0.3367	15,488,493
PV of new contractual cash flows discounted at 11.50%				451,522,791
Carrying amount of loan				397,489,650
Difference				54,033,141
Percentage of carrying amount				13.59%

Note: Calculation done above is on full decimal, though in the table discount factor is limited to 4 decimals.

Considering a more than 10% change in PV of cash flows compared to the carrying value of the loan, the existing loan shall be considered to have been extinguished and the new loan shall be accounted for as a separate financial liability. The accounting entries for the same are included below:

d. 31 December 20X2 – accounting for extinguishment

Particulars	(₹)	(₹)
Loan from bank (old) A/c Dr.	397,489,650	
Loss on modification of loan (profit and loss) Dr.	2,510,350	
To Loan from bank (new) A/c		400,000,000
(Being new loan accounted for at its principal amount in absence of any transaction costs directly related to such loan and correspondingly a de-recognition of existing loan)		

e. 31 December 20X3

Particulars	(₹)	(₹)
Loan from bank A/c Dr.	40,000,000	
Interest expense (profit and loss) Dr.	60,000,000	
To Bank A/c		100,000,000
(Being first instalment of the new loan and payment of interest accounted for as an adjustment to the amortised cost of loan)		

(b) Inventory and debtors need to be classified in accordance with the requirement of Ind AS 1, which provides that an asset shall be classified as current if an entity expects to realise the same or intends to sell or consume it in its normal operating cycle.

(a) In this case, time lag between the purchase of inventory and its realisation into cash is 19 months [11 months + 8 months]. Both inventory and the debtors would be classified as current if the entity expects to realise these assets in its normal operating cycle.

(b) No, the answer will be the same as the classification of debtors and inventory depends on the expectation of the entity to realise the same in the normal operating cycle. In this case, time lag between the purchase of inventory and its realisation into cash is 28 months [15 months + 13 months]. Both inventory and debtors would be classified as current if the entity expects to realise these assets in the normal operating cycle.

3. (a) Assessing whether the manufacturing unit can be classified as held for sale

1. The manufacturing unit can be classified as held for sale due to the following reasons:

(i) The disposal group is available for immediate sale and in its present condition. The regulatory approval is customary and it is expected to be received in one year. The date at which the disposal group must be classified as held for sale is 31st October, 20X1, i.e., the date at which management becomes committed to the plan.

(ii) The sale is highly probable as the appropriate level of management i.e., board of directors in this case have approved the plan.

(iii) A firm purchase agreement has been entered with the buyer.

(iv) The sale is expected to be complete by 30th June, 20X2, i.e., within one year from the date of classification.

2. **Measurement of the manufacturing unit as on the date of classification as held for sale**

Step 1: Immediately before the initial classification of the asset (or disposal group) as held for sale, the carrying amounts of the asset (or all the assets and liabilities in the group) shall be measured in accordance with applicable Ind AS.

The carrying value of the disposal group as on 31st October, 20X1 is determined at ₹ 2,600. The difference between the carrying value as on 31st March, 20X1 and 31st October, 20X1 is accounted for as per the relevant Ind AS.

Step 2: An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

The fair value less cost to sell of the disposal group as on 31st October, 20X1 is ₹ 1,750 (i.e. 1,850 - 100). This is lower than the carrying value of ₹ 2,600. Thus, an impairment loss needs to be recognised and allocated first towards goodwill and thereafter pro-rata between non-current assets of the disposal group which are within the scope of Ind AS 105 based on their carrying value.

Thus, the assets will be measured as under:

Particulars	Carrying value – 31st October, 20X1	Impairment	Carrying value as per Ind AS 105 – 31st October, 20X1
Goodwill	500	(500)	-
Plant and Machinery	900	(115)	785
Building	1,850	(235)	1,615
Debtors	1,050	-	1,050

Inventory	400	-	400
Creditors	(250)	-	(250)
Loans	(1,850)	-	(1,850)
	2,600	(850)	1,750

3. **Measurement of the manufacturing unit as at the year end**

   The measurement as at the end of the financial year shall be on similar lines as done above.

   The assets and liabilities in the disposal group not within the scope of this Standard are measured as per the respective Standards.

   The fair value less cost to sell of the disposal group as a whole is calculated. This fair value less cost to sell as at the year-end shall be compared with the carrying value as at the date of classification as held for sale. It is provided that the fair value as on the year end is less than the carrying amount as on that date – thus the impairment loss shall be allocated in the same way between the assets of the disposal group falling within the scope of this standard as shown above.

(b) **Journal Entries**

Purchase of Machinery on credit basis on 30th January 20X1:

	₹	₹
Machinery A/c ($ 5,000 x ₹ 60) Dr.	3,00,000	
To Creditors-Machinery A/c		3,00,000
(Initial transaction will be recorded at exchange rate on the date of transaction)		

Exchange difference arising on translating monetary item on 31st March 20X1:

	₹	₹
Profit & Loss A/c [($ 5,000 x ₹ 65) – ($ 5,000 x ₹ 60)] Dr.	25,000	
To Creditors-Machinery A/c		25,000

Machinery A/c Dr. To Revaluation Surplus (OCI) [Being Machinery revalued to USD 5,500; (₹ 60 x ($ 5,500 - $ 5,000)]	30,000	30,000
Machinery A/c Dr. To Revaluation Surplus (OCI) (Being Machinery measured at the exchange rate on 31.3.20X1 [$ 5,500 x (₹ 65 - ₹ 60)]	27,500	27,500
Revaluation Surplus (OCI) Dr. To Deferred Tax Liability (DTL created @ of 30% of the total OCI amount)	17,250	17,250

Exchange difference arising on translating monetary item and settlement of creditors on 31st March 20X2:

	₹	₹
Creditors-Machinery A/c ($ 5,000 x ₹ 65) Dr. Profit & loss A/c [(5,000 x (₹ 67 -₹ 65)] Dr. To Bank A/c	3,25,000 10,000	 3,35,000
Machinery A/c [{$ 5,500 x (₹ 67 - ₹ 65)}] Dr. To Revaluation Surplus (OCI)	11,000	 11,000
Revaluation Surplus (OCI) Dr. To Deferred Tax Liability (DTL created @ of 30% of the total OCI amount)	3,300	 3,300

4. (a) The annual depreciation charges prior to the change in useful life were

Buildings	₹ 1,50,00,000/15 =	₹ 10,00,000
Plant and machinery	₹ 1,00,00,000/10 =	₹ 10,00,000
Furniture and fixtures	₹ 35,00,000/7 =	₹ 5,00,000
Total =		₹ 25,00,000 (A)

The revised annual depreciation for the year ending 31st March, 20X5, would be

Buildings	[₹1,50,00,000 – (₹ 10,00,000 × 3)] / 10	₹ 12,00,000
Plant and machinery	[₹ 1,00,00,000 – (₹ 10,00,000 × 3)] / 7	₹ 10,00,000
Furniture and fixtures	[₹ 35,00,000 – (₹ 5,00,000 × 3)] / 5	₹ 4,00,000
Total		₹ 26,00,000 (B)

The impact on Statement of Profit and Loss for the year ending 31st March, 20X5 = ₹ 26,00,000 – ₹ 25,00,000 = ₹ 1,00,000

This is a change in accounting estimate which is adjusted prospectively in the period in which the estimate is amended and, if relevant, to future periods if they are also affected. Accordingly, from 20X4-20X5 onward, excess of ₹ 1,00,000 will be charged in the Statement of Profit and Loss every year till the time there is any further revision.

(b) Journal entries in the books of P Ltd (without modification of service period of stock appreciation rights) (₹ in lakhs)

Date	Particulars	Debit	Credit
31.03.20X2	Profit and Loss account Dr.	15.75	
	To Liability against SARs		15.75
	(Being expenses liability for stock appreciation rights recognised)		
31.03.20X3	Profit and Loss account Dr.	17.25	
	To Liability for SARs		17.25
	(Being expenses liability for stock appreciation rights recognised)		
31.03.20X4	Profit and Loss account Dr.	15.38	
	To Liability for SARs		15.38
	(Being expenses liability for stock appreciation rights recognised)		
31.03.20X5	Profit and Loss account Dr.	17.02	
	To Liability for SARs		17.02
	(Being expenses liability for stock appreciation rights recognised)		

Journal entries in the books of P Ltd
(with modification of service period of stock appreciation rights)

(₹ in lakhs)

Date	Particulars	Debit	Credit
31.03.20X2	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	15.75	15.75
31.03.20X3	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	28.25	28.25
31.03.20X4	Profit and Loss account Dr. To Liability for SARs (Being expenses liability for stock appreciation rights recognised)	20.50	20.50

Working Notes:

Calculation of expenses for issue of stock appreciation rights without modification of service period

For the year ended 31st March 20X2

= ₹ 210 x 400 awards x 75 employees x 1 year /4 years of service = ₹ 15,75,000

For the year ended 31st March 20X3

= ₹ 220 x 400 awards x 75 employees x 2 years /4 years of service - ₹ 15,75,000 previous recognised

= ₹ 33,00,000 - ₹ 15,75,000 = ₹ 17,25,000

For the year ended 31st March 20X4

= ₹ 215 x 400 awards x 75 employees x 3 years/4 years of service - ₹ 33,00,000 previously recognised

= ₹ 48,37,500 - ₹ 33,00,000 = ₹ 15,37,500

For the year ended 31st March, 20X5

= ₹ 218 x 400 awards x 75 employees x 4 years / 4 years of service – ₹ 48,37,500 previously recognised

= ₹ 65,40,000 – ₹ 48,37,500 = ₹ 17,02,500

Calculation of expenses for issue of stock appreciation rights with modification of service period

For the year ended 31st March 20X2

= ₹ 210 x 400 awards x 75 employees x 1 year / 4 years of service

= ₹ 15,75,000

For the year ended 31st March 20X3

= ₹ 220 x 400 awards x 75 employees x 2 years / 3 years of service - ₹ 15,75,000 previous recognised

= ₹ 44,00,000 - ₹ 15,75,000 = ₹ 28,25,000

For the year ended 31st March 20X4

= ₹ 215 x 400 awards x 75 employees x 3 years/ 3 years of service - ₹ 44,00,000 previous recognised

= ₹ 64,50,000 - ₹ 44,00,000 = ₹ 20,50,000.

5. **(a)** In determining the transaction price, AST Limited separately estimates variable consideration for each element of variability i.e. the early completion bonus and the quality bonus.

AST Limited decides to use the expected value method to estimate the variable consideration associated with the early completion bonus because there is a range of possible outcomes, and the entity has experience with a large number of similar contracts that provide a reasonable basis to predict future outcomes. Therefore, the entity expects this method to best predict the amount of variable consideration associated with the early completion bonus. AST's best estimate of the early completion bonus is ₹ 2.13 crore, calculated as shown in the following table:

Bonus %	Amount of bonus (₹ in crore)	Probability	Probability-weighted amount (₹ in crore)
15%	3.75	25%	0.9375

10%	2.50	40%	1.00
5%	1.25	15%	0.1875
0%	-	20%	-
			2.125

AST Limited decides to use the most likely amount to estimate the variable consideration associated with the potential quality bonus because there are only two possible outcomes (₹ 2 crore or Nil) and this method would best predict the amount of consideration associated with the quality bonus. AST Limited believes the most likely amount of the quality bonus is ₹ 2 crore.

Total transaction price would be 25 cr + 2.125 cr + 2 cr = 29.125 cr.

(b) Players' Registrations

Acquisition

As per Ind AS 38 Intangible Assets, the costs associated with the acquisition of players' registrations would need to be capitalized which would be the amount of cash or cash equivalent paid or the fair value of other consideration given to acquire such registrations. In line with Ind AS 38 Intangible Assets, costs would include transfer fees, league levy fees, and player agents' fees incurred by the club, along with other directly attributable costs, if any. Amounts capitalized would be fully amortized over the period covered by the player's contract.

Sale of registrations

Player registrations would be classified as assets held for sale under Ind AS 105 Non-Current Assets Held for Sale and Discontinued Operations when their carrying amount is expected to be recovered principally through a sale transaction and a sale is considered to be highly probable. To consider a sale to be 'highly probable', the assets (in this case, player registrations) should be actively marketed for sale at a price that is reasonable in relation to its current fair value. In the given case, it would appear that the management is committed to a plan to sell the registration, that the asset is available for immediate sale and that an active plan to locate a buyer is already in place by circulating clubs. Ind AS 105 stipulates that it should be unlikely that the plan to sell the registrations would be significantly changed or withdrawn. To fulfil this requirement, it would be prudent if only those registrations are classified as held for sale where unconditional offers have been received prior to the reporting date.

Once the conditions for classifying assets as held for sale in accordance with Ind AS 105 have been fulfilled, the player registrations would be stated at lower of carrying amount and fair value less costs to sell, with the carrying amount stated in accordance with Ind AS 38 prior to application of Ind AS 105, subjected to impairment, if any.

Profits and losses on sale of players' registrations would be computed by deducting the carrying amount of the players' registrations from the fair value of the consideration receivable, net of transactions costs. In case a portion of the consideration is receivable on the occurrence of a future performance condition (i.e. contingent consideration), this amount would be recognized in the Statement of Profit and Loss only when the conditions are met.

The players registrations disposed of, subsequent to the year end, for ₹ 175 crores, having a corresponding book value of ₹ 49 crores would be disclosed as a non-adjusting event in accordance with Ind AS 10 Events after the Reporting Period.

Impairment review

Ind AS 36 Impairment of Assets requires companies to annually test their assets for impairment. An asset is said to be impaired if the carrying amount of the asset exceeds its recoverable amount. The recoverable amount is higher of the asset's fair value less costs to sell and its value in use (which is the present value of future cash flows expected to arise from the use of the asset). In the given scenario, it is not easy to determine the value in use of any player in isolation as that player cannot generate cash flows on his/her own unless via a sale transaction or an insurance recovery. Whilst any individual player cannot really be separated from the single cash-generating unit (CGU), being a cricket team or a hockey team in the instant case, there may be certain instances where a player is taken out of the CGU when it becomes clear that he/she will not play for the club again. If such circumstances arise, the carrying amount of the player should be assessed against the best estimate of the player's fair value less any costs to sell and an impairment charge should be recognized in the profit or loss, which reflects any loss arising.

(c) Five fundamental principles of ethics for Chartered Accountants:

(1) Integrity – to be straightforward and honest in all professional and business relationships.

(2) Objectivity – not to compromise professional or business judgments because of bias, conflict of interest or undue influence of others.

(3) Professional Competence and Due Care – to:

(i) attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and

(ii) act diligently and in accordance with applicable technical and professional standards.

(4) Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships.

(5) Professional Behaviour – to comply with relevant laws and regulations and avoid any conduct that the Chartered Accountant knows or should know might discredit the profession.

6. (a) (i) An earnings-based valuation of Entity A's holding of shares in company XYZ could be calculated as follows:

Particulars	**Unit**
Entity XYZ's after-tax maintainable profits (A)	₹ 70,000
Price/Earnings ratio (B)	15
Adjusted discount factor (C) (1- 0.20)	0.80
Value of Company XYZ (A) x (B) x (C)	₹ 8,40,000

Value of a share of XYZ = ₹ 8,40,000 ÷ 5,000 shares = ₹ 168

The fair value of Entity A's investment in XYZ's shares is estimated at ₹ 42,000 (that is, 250 shares x ₹ 168 per share).

(ii) Share price = ₹ 8,50,000 ÷ 5,000 shares = ₹ 170 per share.

The fair value of Entity A's investment in XYZ shares is estimated to be ₹ 42,500 (250 shares x ₹ 170 per share).

(b) **Either**

Calculation of Net Worth:

Particulars	**₹ in crores**
Equity Share Capital	160
Securities Premium	200
General Reserve	150
Profit and Loss A/c	75
Miscellaneous Expenditure not written off	(80)
Net Worth as per Section 2(57) of The Companies Act, 2013	**505**

Note – Revaluation Reserve would not be included in the calculation of net worth as per definition mentioned in section 2(57) of The Companies Act, 2013

The company is a listed company and it does meet the net worth threshold of ₹ 500 Crores. Hence it would be covered under phase I. Hence Ind AS would be applicable to the company for accounting periods beginning on or after 1st April 2016.

Even if Company A is an unlisted company as company A's net worth is more than 500 Crores, it would be covered under Phase I of the road map and hence Ind AS would be applicable for the accounting periods beginning on or after 1st April 2016.

Or

Accounting Treatment:

Trade Receivables fall within the ambit of financial assets under Ind AS 109, Financial Instruments. Thus, the issue in question is whether the factoring arrangement entered into with Samantha Ltd. requires Natasha Ltd. to derecognize the trade receivables from its financial statements.

As per Para 3.2.3, 3.2.4, 3.2.5 and 3.2.6 of Ind AS 109, Financial Instruments, an entity shall derecognise a financial asset when, and only when:

(a) the contractual rights to the cash flows from the financial asset expire, or

(b) it transfers the financial asset or substantially all the risks and rewards of ownership of the financial asset to another party.

In the given case, since the trade receivables are appearing in the Balance Sheet of Natasha Ltd. as at 31st March 20X2 and are expected to be collected, the contractual rights to the cash flows have not expired.

As far as the transfer of the risks and rewards of ownership is concerned, the factoring arrangement needs to be viewed in its substance, rather than its legal form. Natasha Ltd. has transferred the receivables to Samantha Ltd. for cash of ₹ 250 crores, and yet, it remains liable for making good any shortfall between ₹ 250 crores and the amount collected by Samantha Ltd. Thus, in substance, Natasha Ltd. is effectively liable for the entire ₹ 250 crores, although the shortfall would not be such an amount. Accordingly, Natasha Ltd. retains the credit risk despite the factoring arrangement entered.

It is also explicitly stated in the agreement that Samantha Ltd. would be liable to pay to Natasha Ltd. any amount collected more than ₹ 250 crores, after retaining an amount towards interest. Thus, Natasha Ltd. retains the potential rewards of full settlement.

A perusal of the above clearly shows that substantially all the risks and rewards continue to remain with Natasha Ltd., and hence, the trade receivables should continue to appear in the Balance Sheet of Natasha Ltd. The immediate payment (i.e. consideration as per the factoring agreement) of ₹ 250 crores by Samantha Ltd. to Natasha Ltd. should be regarded as a financial liability and be shown as such by Natasha Ltd. in its Balance Sheet.

(c) (a) At 31st March, 20X1, the end of the reporting period

<u>*Present obligation as a result of a past obligating event –*</u> There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion – No provision is recognised for the cost of fitting the smoke filters.

(b) At 31st March, 20X2, the end of the reporting period

<u>Present obligation as a result of a past obligating event –</u> There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

<u>An outflow of resources embodying economic benefits in settlement –</u> Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

<u>Conclusion –</u> No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

ANSWERS OF MODEL TEST PAPER 6

FINAL COURSE GROUP - I

PAPER – 1: FINANCIAL REPORTING

1. **Option (d):** Provision for ₹ 100 crores
2. **Option (c):** Financial asset measured at FVTPL
3. **Option (b):** A, B and E
4. **Option (a):** ₹ 48,753
5. **Option (c):** ₹ 15,00,000
6. **Option (c):** When there is reasonable assurance that the entity will comply with the conditions and receive the grants.
7. **Option (a):** Conflicts of interest should not compromise professional or business judgement
8. **Option (c):** Only (ii), (iii) and (iv) are true
9. **Option (c):** Current financial liability
10. **Option (d):** ₹ 1,512.80 lakhs
11. **Option (c):** ₹ 2,426 lakhs
12. **Option (a):** Expenses incurred for food court and gaming zone should be capitalised
13. **Option (b):** ₹ 16 crores
14. **Option (d):** ₹ 25 crores
15. **Option (c):** Nikhil Pvt. Ltd. should recognise the fair value of the consideration as part of the business combination, thus increasing goodwill and remeasure it at the end of each reporting period. The impact of change in fair value is recognised in the Statement of Profit and Loss.

PART-II Descriptive Questions

1. Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31st March, 20X4

	Notes No.	₹ in lakhs
Assets		
Non-current assets		
Property, plant and equipment	1	21,070
Goodwill	2	150
Current assets		
Inventory	3	4,275
Financial assets		
Cash and cash equivalents	4	2,540
Trade receivables	5	6,840
Dividend receivable	6	Nil
Total		**34,875**
Equity and Liabilities		
Equity		
Share capital - Equity shares of ₹ 10 each		10,000
Other equity	7	16,292
Non-controlling interest (W.N.4)		1,824
Non-current liabilities		
Financial liabilities		
Borrowings- 13% Debentures	8	2,999
Current Liabilities		
Financial liabilities		
Trade payables	9	2,180
Dividend payable	10	80
Other liabilities		1,500
Total		**34,875**

Notes to Accounts

1. Property, Plant and Equipment **₹ in lakhs**

Particulars		₹	₹
H Ltd.		14,800	
S Ltd.	6,000		
Add: Fair value gain	300		
Less: Additional depreciation due to fair value gain	(30)	6,270	21,070

2. Goodwill **₹ in lakhs**

Particulars	₹	₹
Goodwill on acquisition of S Ltd. (Refer W.N.3)	250	
Less: Impairment	(100)	150

3. Inventory **₹ in lakhs**

Particulars		₹	₹
H Ltd.		2,600	
S Ltd.	2,000		
Less: Fair value loss	(300)		
Less: Unrealised gain (200/80% x 20% x 50%)	(25)	1,675	4,275

4. Cash and cash equivalent **₹ in lakhs**

Particulars	₹	₹	₹
H Ltd.	500		
Add: Cheque in Transit	40	540	
S Ltd.		2,000	2,540

5. Trade Receivable **₹ in lakhs**

Particulars		₹	₹
H Ltd.	4,000		
Less: Mutual transaction	(160)	3,840	
S Ltd.		3,000	6,840

6. Dividend Receivable **₹ in lakhs**

Particulars	₹	₹
H Ltd.	320	
Less: Mutual transaction	(320)	Nil

7. Other Equity (Retained Earnings) **₹ in lakhs**

Particulars	₹	₹
H Ltd.	16,320	
Less: Share of pre-acquisition dividend (400 x 80%)	(320)	16,000
Post acquisition RE of S Ltd. (W.N.1)	2,370	
Less: Share of NCI in post-acquisition RE of S Ltd. (2,370 x 20%)	(474)	1,896
Less: Impairment of goodwill (100 x 80%)		(80)
Less: Loss on cancellation of debentures (mutual holding) (W.N.5)		(1,499)
Less: Unrealised gain (W.N.6)		(25)
		16,292

8. Borrowings (13% Debentures) **₹ in lakhs**

Particulars	₹	₹
S Ltd.	3,000	
Less: Mutual holding by H Ltd. (1,000 Debentures x ₹ 100)	(1)	2,999

9. Trade Payables **₹ in lakhs**

Particulars		₹	₹
H Ltd.		1,700	
S Ltd.	600		
Less: Mutual transaction	(120)	480	2,180

10. Dividend Payables **₹ in lakhs**

Particulars	₹	₹
S Ltd.	400	
Less: Mutual transaction	(320)	80

Working Notes:

1. Analysis of Retained Earnings of S Ltd. **₹ in lakhs**

Closing balance as on 31st March, 20X4	5,000
Less: Pre-acquisition Retained Earnings as on 1st April, 20X3 (3,000 – 400)	(2,600)
	2,400
Less: Additional depreciation	(30)
Post-acquisition Retained Earnings	2,370

2. Computation of net worth (net identifiable assets) as on 1st April, 20X3 **₹ in lakhs**

Share Capital of S Ltd.	4,000
Pre-acquisition Retained Earnings	3,000
Fair value gain on PPE (2,800 – 2,500)	300
Fair value loss on inventory (500 - 200)	(300)
Net Worth or Net Identifiable Assets	7,000

3. Computation of Goodwill on acquisition date of S Ltd.

₹ in lakhs

Purchase consideration	5,800
NCI (by fair value method) as on 1st April, 20X3 [(5,800/80%) x 20%]	1,450
	7,250
Less: Net worth or Net Identifiable Assets (W.N.2)	(7,000)
Goodwill as on 1st April, 20X3	250

4. Non-Controlling Interest as on 31st March, 20X4 **₹ in lakhs**

NCI (by fair value method) as on 1st April, 20X3	1,450
Less: Share of pre-acquisition dividend (400 x 20%)	(80)
Post-acquisition Retained Earnings (2,370 x 20%)	474

Less: Share of impairment of Goodwill (100 x 20%)	(20)
NCI as on 31st March, 20X4	1,824

5. **Loss on settlement of Debentures held by H Ltd.** **₹ in lakhs**

Investment in Debentures by H Ltd.	1,500
Less: Nominal value of debentures held by H Ltd. (1,000 x ₹ 100)	(1)
Loss on settlement of investment in Debentures	1,499

6. **Computation of unrealised gain by H Ltd. on sale of goods to S Ltd.** **₹ in lakhs**

Cost price of the goods sold	200
Sales price of the goods sold (200/80%)	250
Profit on sale of such goods	50
Unrealized gain on 50% unsold goods (50 x 50%)	25

2. (a) **Assessment of the arrangement using the definition of derivative included under Ind AS 109**

Derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

(c) it is settled at a future date.

The contract meets the definition of a derivative as follows:

(a) the value of the contract to purchase USD at a fixed price changes in response to changes in foreign exchange rate.

(b) the initial amount received to enter into the contract is zero. A contract which would give the holder a similar response to foreign exchange rate changes would have required an investment of USD 40,000 on inception.

(c) the contract is settled in future

The derivative liability is a written put option contract.

As per Ind AS 109, derivatives are measured at fair value upon initial recognition and are subsequently measured at fair value through profit and loss.

- **Accounting on 1st January, 20X3**

  As there was no consideration paid and without evidence to the contrary the fair value of the contract on the date of inception is considered to be zero. Accordingly, no accounting entries shall be recorded on the date of entering into the contract.

- **Accounting on 31st March, 20X3**

  The value of the derivative put option contract shall be recorded as a derivative financial liability in the books of Joe & Co. Ltd. by recording the following journal entry:

Particulars	**Dr. (₹)**	**Cr. (₹)**
Profit and loss A/c Dr.	50,000	
To Derivative financial liability		50,000
(Being mark to market loss on the put option contract recorded)		

- **Accounting on 30th June, 20X3**

  The change in value of the derivative put option contract shall be recorded as a derivative financial liability in the books of Joe & Co. Ltd. by recording the following journal entry:

Particulars	**Dr. (₹)**	**Cr. (₹)**
Derivative financial liability A/c Dr.	20,000	
To Profit and loss A/c		20,000
(Being partial reversal of mark to market loss on the put option contract recorded)		

- **Accounting on 30th September, 20X3**

  The change in value of the derivative option contract shall be recorded at zero in the books of Joe & Co. Ltd. by recording the following journal entry:

Particulars	Dr. (₹)	Cr. (₹)
Derivative financial liability A/c Dr. To Profit and loss A/c (Being gain on mark to market of put option contract booked to make the value of the derivative liability as zero)	30,000	 30,000

- **Accounting on 31st December, 20X3**

  The settlement of the derivative put option contract by actual purchase of USD 40,000 shall be recorded in the books of Joe & Co. Ltd. upon exercise by Box Ltd. by recording the following journal entry:

Particulars	Dr. (₹)	Cr. (₹)
Bank (USD Account) (@40,000 x ₹ 76) Dr. Profit and loss A/c Dr. To Bank (@ 40,000 x ₹ 78) (Being loss on settlement of put option contract booked on actual purchase of USD)	30,40,000 80,000	 31,20,000

(b) It is assumed that net profit for all the quarters of the year 20X3-20X4 excludes the brought forward losses of ₹ 620 lakh.

Computation of estimated total earnings for the year 20X3-20X4

Quarter	Earnings before tax (in lakhs)
1	650 (actual)
2	360 (actual)
3	(160) (estimated)
4	720+160 = 880 (estimated)
	,730 (estimated)

Tax rate for the company = 25 x 110% = 27.5%

Computation of Average Annual Effective Tax Rate

The estimated payment of the annual tax on earnings for the current year:

= (1,730-620) x 27.5% = ₹ 305.25 lakhs.

As per Ind AS 34, income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income-tax rate expected for the full financial year.

Thus, average annual effective tax rate = (305.25 / 1,730) × 100

= 17.645% (approx.)

Tax expense to be shown in each quarter

Quarter	Earnings before tax (in lakhs)	Tax expense @ 17.645%
1	650 (actual)	114.69
2	360 (actual)	63.52
3	(160) (estimated)	(28.23)
4	720+160 = 880 (estimated)	155.27
	1,730 (estimated)	305.25

3. **(a)** Investment property is held to earn rentals or for capital appreciation or both. Ind AS 40 shall be applied in the recognition, measurement and disclosure of investment property. An investment property shall be measured initially at its cost. After initial recognition, an entity shall measure all of its investment properties in accordance with the requirements of Ind AS 16 for cost model.

The measurement and disclosure of Investment property as per Ind AS 40 in the balance sheet would be as follows:

	Investment Properties: (₹ in crores)			
Particulars	**Property X**	**Property Y**		**Period ended 31st March, 20X4**
Gross Amount:				
Opening balance	120.00		120.00	

Additions during the year		20.00	20.00	
Closing balance A	120.00	20.00		140.00
Depreciation:				
Opening balance	60.00		60.00	
Depreciation during the year (12 + 1)	12.00	1.00	13.00	
Closing balance B	72.00	1.00		(73.00)
Net balance (A-B)	48.00	19.00		67.00

The changes in the carrying value of investment properties for the year ended 31st March, 20X4 are as follows:

Amount recognized in Profit and Loss with respect to Investment Properties **(₹ in crores)**

Particulars	**Period ending 31st March, 20X4**
Rental income from investment properties (15.00 + 5.00)	20.00
Less: Direct operating expenses generating rental income (0.50 + 0.10 + 0.25 + 0.15 + 0.20 + 0.10)	(1.30)
Profit from investment properties before depreciation and indirect expenses	18.70
Less: Depreciation	(13.00)
Profit from earnings from investment properties before indirect expenses	5.70

Disclosure Note on Investment Properties acquired by the entity

The investment properties consist of Building X and Building Y. As at 31st March, 20X4, the fair value of the properties is ₹ 105 crores. The valuation is performed by independent valuers, who are specialists in valuing investment properties. A valuation model as recommended by International Valuation Standards Committee has been applied. The Company considers factors like management intention, terms of rental agreements, area leased out, life of the assets etc. to determine classification of assets as investment properties.

The Company has no restrictions on the realisability of its investment properties and no contractual obligations to purchase, construct or develop investment properties or for repairs, maintenance and enhancements.

Description of valuation techniques used and key inputs to valuation on investment properties:

Valuation technique	Significant unobservable inputs	Range (Weighted average)
Discounted cash flow (DCF) method	- Estimated rental value per sq. ft. per month - Rent growth per annum - Discount rate	- ₹ 50 to ₹ 60 - 10% every 3 years - 12% to 13%

(b) Computation of tax base

Particulars	Carrying amount (₹)	Taxbase (₹)
Carrying balance on 1st April, 20X2	5,00,000	5,00,000
Less: Depreciation	(1,00,000)	(1,00,000)
Balance as on 31st March, 20X3	4,00,000	4,00,000
No Temporary difference as on 31st March, 20X3	--	--
Less: Carrying amount on the date of disposal to be reversed (accounting record) (Refer W.N.)	(32,000)	
Less: Sale proceeds of the asset to be deducted as per tax records		(1,00,000)
Less: Depreciation Accounting depreciation (4,00,000 x 20%) Tax depreciation {(4,00,000 - 1,00,000) x 20%)}	(80,000)	(60,000)
Balance of the asset as on 31st March, 20X4	2,88,000	2,40,000

Working Note:

Accounting book value on 31st March, 20X4

= ₹ 50,000 - ₹ 10,000 - ₹ 8,000

= ₹ 32,000

Carrying amount is greater than Tax base which leads to Deferred Tax Liability i.e. Temporary difference = ₹ 2,88,000 - ₹ 2,40,000 = ₹ 48,000

Deferred Tax Liability = ₹ 48,000 x 35% = ₹ 16,800

4. (a) (i) Accounting Treatment

The present value of such decommissioning and site restoration obligation at the end of 4th year is ₹ 4,41,000 [being 6,00,000 / $(1.08)^4$]. Peacock Ltd. will recognize the present value of decommissioning liability of ₹ 4,41,000 as an addition to cost of PPE and will also recognize a corresponding decommissioning liability.

Further, the entity will recognize the unwinding of discount as finance charge every year till the estimated life of the machine.

(ii) Journal Entries

Date	**Particular**	**Dr. (₹)**	**Cr. (₹)**
1st April, 20X0	Machine A/c (PPE) Dr.	4,41,000	
	To Provision for decommissioning liability		4,41,000
	(Being the present value of decommissioning liability of ₹ 4,41,000 recognized as an addition to cost of PPE with corresponding recognition to decommissioning liability)		
31st March, 20X1	Finance charge Dr.	35,280	
	To Provision for decommissioning liability		35,280
	(Being the unwinding of discount as finance charge recognized at the end of Year 1)		

	Profit and Loss A/ Dr. To Finance charge (Being Finance charge transferred to Profit & Loss A/c)	35,280	35,280
31st March, 20X2	Finance charge Dr. To Provision for decommissioning liability (Being the unwinding of discount as finance charge recognized at the end of Year 2)	38,102	38,102
	Profit and Loss A/ Dr. To Finance charge (Being Finance charge transferred to Profit & Loss A/c)	38,102	38,102
31st March, 20X3	Finance charge Dr. To Provision for decommissioning liability (Being the unwinding of discount as finance charge recognized at the end of Year 3)	41,151	41,151
	Profit and Loss A/c Dr. To Finance charge (Being Finance charge transferred to Profit & Loss A/c)	41,151	41,151
31st March, 20X4	Finance charge Dr. To Provision for decommissioning liability (Being the unwinding of discount as finance charge recognized at the end of Year 4)	44,467	44,467
	Profit and Loss A/c Dr. To Finance charge (Being Finance charge transferred to Profit & Loss A/c)	44,467	44,467
	Provision for decommissioning liability Dr. To Bank A/c (Being decommissioning liability incurred at the end of the life of the machine i.e. 4th year)	6,00,000	6,00,000

Working Note:

The following table shows the unwinding of discount (₹)

Year	Opening Decommissioning Liability	Unwinding of Interest @ 8%	Closing Decommissioning Liability
1	4,41,000	35,280	4,76,280
2	4,76,280	38,102	5,14,382
3	5,14,382	41,151	5,55,533
4	5,55,533	44,467*	6,00,000

*Difference of ₹ 24 (44,467- 44,443) is due to rounding off.

(b) Journal Entries

31st March, 20X2		₹	₹
Employee benefits expenses (W.N.1)	Dr.	43,12,500	
To Share-based payment reserve (equity)			43,12,500
(Being 1/3rd expenses on share-based payment recognised)			
Profit and Loss A/c	Dr.	43,12,500	
To Employee benefits expenses			43,12,500
(Being employee benefits expenses transferred to P/L)			
31st March, 20X3			
Share-based payment reserve (equity) (W.N.1)	Dr.	3,75,000	
To Employee benefits expenses (transferred to P/L)			3,75,000
(Being reversal of excess expenses booked on computation of 2/3rd expenses on share-based payment)			
Employee benefits expenses	Dr.	3,75,000	
To Profit and Loss A/c			3,75,000
(Being employee benefits expenses transferred to P/L)			

31st March, 20X4			
Employee benefits expenses (W.N.3)	Dr.	35,62,500	
To Share-based payment reserve (equity)			35,62,500
(Being final recognition of expenses on vesting of share-based options)			
Profit and Loss A/c	Dr.	35,62,500	
To Employee benefits expenses			35,62,500
(Being employee benefits expenses transferred to P/L)			
31st March, 20X5			
Share-based payment reserve (equity) (W.N.4)	Dr.	75,00,000	
Bank A/c (W.N.4)	Dr.	42,18,750	
To Share Capital (W.N.4)			9,37,500
To Securities Premium (W.N.4)			1,03,12,500
To Retained Earnings (W.N.4)			4,68,750
(Being accounting on exercise of 375 options and lapse of 25 options)			

Working Notes:

1. Calculation of Employee Benefit Expenses

	31.3.20X2	**31.3.20X3**	**31.3.20X4**
No of Employees	750	750	750
Less: Employees left	(25)	(300)	(350)
Less: Employees expected	(35)	(135)	____
No of employees eligible	690	315	400
No of options per employee	250	250	250
Total options expected to vest	172,500	78,750	100,000
Fair value per option	75	75	75
Total FV	12,937,500	5,906,250	7,500,000
	1/3	2/3	3/3
Cumulative expenses	4,312,500	3,937,500	7,500,000
Expense already recognised	-	4,312,500	3,937,500
Expense to be recognised	4,312,500	-375,000	3,562,500

2. **For the year ended 31st March, 20X5**

Bank = 375 employees x 250 options x ₹ 45 = ₹ 42,18,750

Share capital = 375 employees x 250 options x ₹ 10 = ₹ 9,37,500

Securities Premium	=	375 employees x 250 options x ₹ (75 + 35)
	=	₹ 1,03,12,500
Retained Earnings	=	(400-375) employeesx250 options x ₹ 75
	=	₹ 4,68,750

5. **(a)** Points earned on ₹ 1,50,00,000 @ 6 points on every ₹ 400

= [(1,50,00,000/400) x 6] = 2,25,000 points.

Out of 2,25,000 points, it is estimated that 54,000 points will remain unredeemed in the current year. Further, it is expected that 75% of the unredeemed points will be redeemed in the future.

Accordingly, value of points will be computed as follows:

Value of points redeemed in the current year

= (2,25,000-54,000) points x ₹ 0.6 each point = ₹ 1,02,600

Value of points estimated to be redeemed in future

= 54,000 points x 75% x ₹ 0.6 each point = ₹ 24,300

Total value of loyalty points = ₹ 1,02,600 + ₹ 24,300 = ₹ 1,26,900

Revenue recognized for sale of goods

= ₹ 1,48,74,165 [1,50,00,000 x (1,50,00,000 / 1,51,26,900)]

Revenue for points = ₹ 1,25,835 [1,26,900 x (1,50,00,000 / 1,51,26,900)]

Journal Entry for the year 20X3-20X4

		₹	₹
Bank A/c	Dr.	1,50,00,000	
To Sales A/c			1,48,74,165
To Liability under Customer Loyalty programme			1,25,835
(On sale of Goods)			
Liability under Customer Loyalty programme	Dr.	1,01,739	
To Sales A/c			1,01,739
(On redemption of (2,25,000 – 54,000) points)			

Revenue for points to be recognized

Undiscounted points estimated to be recognized next year

= 54,000 x 75% = 40,500 points

Total points to be redeemed within 3 years

= [(2,25,000 – 54,000) + 40,500] = 2,11,500 points

Revenue to be recognised with respect to discounted points

= ₹ 1,25,835 x (1,71,000/2,11,500) = ₹ 1,01,739

Note: The above answer is based on the consideration that 75% likelihood of redemption of award points in future. **Alternatively,** the 75% likelihood of redemption of award points in future might not be considered. In such a case, the answer would be as follows:

Points earned on ₹ 1,50,00,000 @ 6 points on every ₹ 400

= [(1,50,00,000/400) x 6] = 2,25,000 points.

Out of 2,25,000 points, it is estimated that 54,000 points will remain unredeemed in the current year.

Accordingly, value of points redeemed in the current year

= 2,25,000 points x ₹ 0.6 each point = ₹ 1,35,000

Revenue recognized for sale of goods

= ₹ 1,48,66,204 [1,50,00,000 x (1,50,00,000 / 1,51,35,000)]

Revenue for points = ₹ 1,33,796 [1,35,000 x (1,50,00,000 / 1,51,35,000)]

Journal Entry for the year 20X3-20X4

		₹	₹
Bank A/c To Sales A/c To Liability under Customer Loyalty programme (On sale of Goods)	Dr.	1,50,00,000	 1,48,66,204 1,33,796
Liability under Customer Loyalty programme To Sales A/c (On redemption of (2,25,000 – 54,000) points)	Dr.	1,08,175	 1,08,175

Revenue for points to be recognized

Undiscounted points estimated to be recognized next year

= 54,000 x 75% = 40,500 points

Total points to be redeemed within 3 years

= [(2,25,000 – 54,000) + 40,500] = 2,11,500 points

Revenue to be recognised with respect to discounted points

= ₹ 1,33,796x (1,71,000 / 2,11,500) = ₹ 1,08,175

(b) Assessment of Preliminary Impact Assessment on transition to Ind AS of Z Ltd.'s Financial Statements

(i) Fair value as deemed cost for property plant and equipment:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per AS 10, Property, Plant and Equipment is recognised at cost less depreciation.	Ind AS 101 allows entity to elect to measure Property, Plant and Equipment on the transition date at its fair value or	The company has decided to adopt fair value as deemed cost in this case. Since fair value exceeds book value, the book value

	previous GAAP carrying value (book value) as deemed cost.	should be brought up to fair value. The resulting impact of fair valuation of land ₹ 1,00,000 should be adjusted in other equity.

Journal Entry on the date of transition

Particulars	Debit (₹)	Credit (₹)
Property, Plant and Equipment Dr.	1,00,000	
To Revaluation Surplus (OCI- Other Equity)		1,00,000
(Being PPE recorded at fair value on the date of transition to Ind AS)		

(ii) Borrowings - Processing fees/transaction cost:

Accounting Standards (Erstwhile IGAAP)	Ind AS	Impact on Company's financial statements
As per AS, such expenditure is charged to Profit and loss account or capitalised as the case may be	As per Ind AS, such expenditure is amortised over the period of the loan. Ind AS 101 states that if it is impracticable for an entity to apply retrospectively the effective interest method in Ind AS 109, the fair value of the financial asset or the financial liability at the date of transition to Ind AS shall be the new gross carrying amount of that financial asset or the new amortised cost of that financial liability.	Fair value as on the date of transition is ₹ 2,80,000 as against its book value of ₹ 3,00,000. Accordingly, the difference of ₹ 20,000 is adjusted through retained earnings.

Journal Entry on the date of transition

Particulars	**Debit (₹)**	**Credit (₹)**
Borrowings / Loan payable Dr.	20,000	
To Retained earnings		20,000
(Being Borrowings recorded at fair value on date of transition to Ind AS)		

(c) **Either**

Concept of Offsetting: Offsetting refers to presenting an asset and a liability net or income and expenses net as a single amount, in the financial statements. As per Ind AS, an entity is required to report separately both assets and liabilities, and income and expenses. Offsetting in the statement of profit and loss or balance sheet is not permitted unless when offsetting reflects the substance of the transaction or other event.

Scenarios for determining applicability of the concept of offsetting:

(a) Paragraph 35 of Ind AS 1 requires an entity to present on a net basis gains and losses arising from a group of similar transactions. Accordingly, gains or losses arising from disposal of various items of property, plant and equipment shall be presented on a net basis. However, gains or losses should be presented separately if they are material.

(b) As per paragraph 33 of Ind AS 1, offsetting is permitted only when offsetting reflects the substance of the transaction. In this case, the agreement/arrangement, if any, between the holding and subsidiary company needs to be considered. If the arrangement is to reimburse the cost incurred by the holding company on behalf of the subsidiary company, the same may be presented net. It should be ensured that the substance of the arrangement is that the payments are actually in the nature of reimbursement.

(c) Ind AS 1 prescribes that assets and liabilities, and income and expenses should be reported separately, unless offsetting reflects the substance of the transaction. In addition to this, as per paragraph 42 of Ind AS 32, a financial asset and a financial liability should be offset if the entity has legally enforceable right to set off and the entity intends either to settle on net basis or to realise the asset and settle the liability simultaneously. Accordingly, the receivable and payable should be offset against each other and net amount is presented in the balance sheet if the entity has a legal right to set off and the entity intends to do so. Otherwise, the receivable and payable should be reported separately.

Or

The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

1. **Comparability:** Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. Comparability refers to the use of the same methods for the same items, and uniformity implies that like things must look alike and different things must look different.

2. **Verifiability:** Verifiability means that different knowledgeable and independent observers could reach a consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

3. **Timeliness:** Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it is. However, some information may continue to be timely long after the end of a reporting period because some users may need to identify and assess trends.

4. **Understandability:** Classifying, characterising and presenting information clearly and concisely makes it understandable.

   Enhancing qualitative characteristics should be maximised to the extent possible. However, the enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or does not provide a faithful representation of what it purports to represent.

Sometimes, one enhancing qualitative characteristic may have to be diminished to maximise another qualitative characteristic. For example, a temporary reduction in comparability as a result of prospectively applying a new Ind AS may be worthwhile to improve relevance or faithful representation in the longer term. Appropriate disclosures may partially compensate for non-comparability.

6. **(a)** To identify the performance obligations under the contract and determine if they are distinct, an automated process can be implemented using technology. The following steps can be taken:

a. Analyze the clauses in the contract related to the services provided (broadband services, voice call services, modem sales).

b. Each clause should be codified using appropriate parameters or tags to capture the relevant information.

c. Assign Boolean values (0 or 1) to each parameter or tag in the codified clauses.

d. Use "0" to represent "No" and "1" to represent "Yes" for each parameter.

e. Define the criteria for evaluating the performance obligations based on the parameters and their Boolean values.

f. Consider factors such as the type of service involved, benefits derived by the customer, and promises made in the contract regarding the transfer of goods or services.

g. Develop an automated algorithm or script that evaluates the Boolean values of the parameters according to the defined criteria.

h. Calculate scores or weights for each parameter based on their significance in determining performance obligations.

i. Utilize the scores or weights assigned to the parameters to determine if the performance obligations are distinct.

j. If the total score exceeds a certain threshold, consider it a separate performance obligation.

The automated process should flag and identify these distinct performance obligations based on the evaluation results.

Considering the above facts, the following conclusion arises:

There are three separate obligations

- Broadband Service
- Voice Call Services
- Modem

(b) According to paragraph 35 of Ind AS 16, when an item of property, plant and equipment is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:

(i) The gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset.

The accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses.

In such a situation, the revised carrying amount of the machinery will be as follows:

Gross carrying amount ₹ 5,00,000 [(4,00,000/2,40,000) x 3,00,000]

Less: Net carrying amount (₹ 3,00,000)

Accumulated depreciation ₹ 2,00,000 (1,60,000 + 40,000)

Journal Entry **(₹)**

Plant and Machinery (Gross Block) Dr.	1,00,000	
To Accumulated Depreciation		40,000
To Revaluation Reserve		60,000
(Being the value of gross block of the asset restated to make it consistent with revalued amount)		

Depreciation subsequent to revaluation

Since the Gross Block has been restated, the depreciation charge will be revised to ₹ 50,000 per annum (₹ 5,00,000 /10 years).

Journal Entry **(₹)**

Depreciation Dr	50,000	
To Accumulated Depreciation		50,000
(Being the revised depreciation after revalued charged)		

(ii) The accumulated depreciation is eliminated against the gross carrying amount of the asset.

The amount of the adjustment of accumulated depreciation forms part of the increase or decrease in carrying amount that is accounted for in accordance with paragraphs 39 and 40 of Ind AS 16.

In this case, the gross carrying amount is restated to ₹ 3,00,000 to reflect the fair value and accumulated depreciation is set at zero.

Journal Entry

Accumulated Depreciation Dr.	₹ 1,60,000	
To Plant and Machinery (Gross Block)		₹1,60,000
(Being the asset brought down to the carrying value)		
Plant and Machinery (Gross Block) Dr.	₹ 60,000	
To Revaluation Reserve		₹ 60,000
(Being revaluation of the asset recognised)		

Depreciation subsequent to revaluation

Since the revalued amount is the revised gross block, the useful life to be considered is the remaining useful life of the asset which results in the same depreciation charge of ₹ 50,000 per annum as per Option A (₹ 3,00,000 / 6 years).

Journal entry

Depreciation Dr. To Accumulated Depreciation (Being the revised depreciation charged to the Gross Block)	50,000	 50,000

(c) (a) In case, it is assumed that the judgement of court has been received after the approval of previous year's financial statements of the reporting entity and the probability for payment of arrears of salaries and wages was remote in the previous year because of which the entity had neither made any provision or disclosure, then the liability for arrears of salary and wages would be considered as a change in accounting estimate in the current year.

Alternatively, if it is assumed that in case the judgement of court has been received before the approval of financial statements of the previous year, then the entity should have adjusted the liability in that year itself. In the absence of said accounting treatment in the previous year, it will be considered a mistake and would be accounted for as a prior period error.

(b) In the given case, since the information regarding expenses of ₹ 1,50,000 in the previous year was available with the entity, and was omitted due to an oversight, it will be considered as a prior period error.

(c) As per para 32 of Ind AS 8, a loss allowance for expected credit losses (i.e. provision for doubtful debts) applying Ind AS 109, *Financial Instruments,* is an example of accounting estimate. Hence, any change in the previous year's estimate on account of recovery of such loss allowance in the current year would be a change in the accounting estimate in the current year because of the uncertainties inherent in business activities and it is not possible to measure the provision for doubtful debts with precise accuracy.

(d) This is neither a case of prior period error nor a change in accounting estimates. In the given case, the company did not have any information as on the balance sheet date and it is the mistake committed by the Group Insurance company and not the reporting entity. Hence, the demand for an additional premium amount by the Group Insurance Company will not be considered as a prior period error for the reporting entity. Further, the entity had paid the premium amount in the previous year, so no accounting estimate was involved thereupon. Therefore, the additional demand cannot be considered as a change in accounting estimate for the reporting entity.

MODEL TEST PAPER 1

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

ANSWER TO PART – I CASE SCENARIO BASED MCQS

1. **Option (a)**

2. **Option (b)**

3 **Option (c)**

4. **Option (d)**

5. **Option (b)**

6. **Option (a)**

7. **Option (c)**

8. **Option (b)**

9. **Option (d)**

10. **Option (c)**

11. **Option (d)**

12. **Option (c)**

13. **Option (d)**

14. **Option (b)**

15. **Option (b)**

ANSWERS OF PART – II DESCRIPTIVE QUESTIONS

1. **(a)** Here the given cash flows have to be adjusted for inflation. Alternatively, the discount rate can be converted into nominal rate, as follows: -

Year 1 = $\frac{0.909}{1.05}$ = 0.866; Year 2 = $\frac{0.826}{(1.05)^2}$ or $\frac{0.826}{1.1025}$ = 0.749

Year 3 = $\frac{0.751}{(1.05)^3} = \frac{0.751}{1.1576}$ = 0.649

Year	Nominal Cash Flows (₹ in lakhs)	Adjusted PVF as above	PV of Cash Flows (₹ in lakhs)
1	30	0.866	25.98
2	40	0.749	29.96
3	30	0.649	19.47
	Cash Inflow		75.41
	Less: Cash Outflow		72.00
	Net Present Value		3.41

With positive NPV, the project is financially viable.

Alternative Solution

Assumption: The cost of capital given in the question is "Real'.

Nominal cost of capital = (1.10) (1.05) -1 = 0.155 =15.50%

DCF Analysis of the project

(₹ Lakhs)

	Period	PVF @15.50%	CF	PV
Investment	0	1	-72	-72.00
Operation	1	0.866	30	+25.98
---do---	2	0.750	40	+30.00
---do---	3	0.649	30	+19.47
NPV				+3.45

The proposal may be accepted as the NPV is positive.

(b) The bank (Dealer) covers itself by buying from the market at market selling rate.

Rupee – Dollar selling rate = ₹ 42.85

Dollar – Hong Kong Dollar = HK $ 7.5880

Rupee – Hong Kong cross rate = ₹ 42.85 / 7.5880

= ₹ 5.6471

Profit / Loss to the Bank

Amount received from customer (1 crore × 5.70) ₹ 5,70,00,000

Amount paid on cover deal (1 crore × 5.6471)	₹ 5,64,71,000
Profit to Bank	₹ 5,29,000

(c) Financial projections include three basic documents that make up a business's financial statements.

- **Income statement:** This estimate how much money the business will generate by projecting income and expenses. It will show:
    - ❖ How much revenue did the business generate?
    - ❖ How much did it cost to generate and support that revenue?
    - ❖ How much did the business pay its employees?
    - ❖ How much did it pay towards rent?

    For your first year in business, you'll want to create a monthly income statement. For the second year, quarterly statements will suffice. For the following years, you'll just need an annual income statement.
- **Cash flow statement:** A projected cash flow statement will depict how much cash will be coming into the business and how much cash will be utilized. At the end of each period (e.g. monthly, quarterly, annually), one can tally it all up to show either the cash burn or the cash generated during the period and the cash balance remaining at the end of the period.
- **Balance sheet:** The balance sheet shows the business's overall finances including assets, liabilities and equity. Typically, one will create an annual balance sheet for one's financial projections. It shows:
    - ❖ How much cash is in the bank?
    - ❖ How much money does the company owe to suppliers?
    - ❖ How much money has been invested in the company?

2. (a) In the given case, the exchange rates are indirect. These can be converted into direct rates as follows:

Spot rate

GBP = $\frac{1}{USD1.5617}$ to $\frac{1}{USD1.5673}$

USD = GBP 0.64033 - GBP 0.63804

6 months' forward rate

GBP = $\frac{1}{USD1.5455}$ to $\frac{1}{USD1.5609}$

USD = GBP 0.64704 - GBP 0.64066

Payoff in 3 alternatives

i. Forward Cover

Amount payable	USD 3,64,897
Forward rate	GBP 0.64704
Payable in GBP	GBP 2,36,103

ii. Money market Cover

Amount payable	USD 3,64,897
PV @ 4.5% for 6 months i.e. $\frac{1}{1.0225} = 0.9779951$	USD 3,56,867
Spot rate purchase	GBP 0.64033
Borrow GBP 3,56,867 x 0.64033	GBP 2,28,512
Interest for 6 months @ 7 %	7,998
	-
Payable after 6 months	GBP 2,36,510

iii. Currency options

Amount payable	USD 3,64,897
Unit in Options contract	GBP 12,500
Value in USD at strike rate of 1.70 (GBP 12,500 x 1.70)	USD 21,250
Number of contracts USD 3,64,897/ USD 21,250	17.17

Exposure covered USD 21,250 x 17	USD 3,61,250
Exposure to be covered by Forward (USD 3,64,897 – USD 3,61,250)	USD 3,647
Options premium 17 x GBP 12,500 x 0.096	USD 20,400
Premium in GBP (USD 20,400 x 0.64033)	GBP 13,063
Total payment in currency option	
Payment under option (17 x 12,500)	GBP 2,12,500
Premium payable	GBP 13,063
Payment for forward cover (USD 3,647 x 0.64704)	GBP 2,360
	GBP 2,27,923

Thus, total payment in:

(i)	Forward Cover	2,36,103 GBP
(ii)	Money Market	2,36,510 GBP
(iii)	Currency Option	2,27,923 GBP

The company should take currency option for hedging the risk.

Note: Even interest on Option Premium can also be considered in the above solution.

(b) Following are main features of VAR

i. **Components of Calculations:** VAR calculation is based on following three components :

(a) Time Period

(b) Confidence Level – Generally 95% and 99%

(c) Loss in percentage or in amount

ii. **Statistical Method:** It is a type of statistical tool based on Standard Deviation.

iii. **Time Horizon:** VAR can be applied for different time horizons say one day, one week, one month and so on.

iv. **Probability:** Assuming the values are normally attributed, probability of maximum loss can be predicted.

v. **Risk Control:** Risk can be controlled by setting limits for maximum loss.

vi. **Z Score:** Z Score indicates how many standard Deviations is away from Mean value of a population. When it is multiplied with Standard Deviation it provides VAR.

3. (a) (i) Computation of Expected Return from Portfolio

Security	Beta (β)	Expected Return (r) as per CAPM	Amount (₹ Lakhs)	Weights (w)	wr
Moderate	0.50	8%+0.50 (10% - 8%) = 9%	60	0.115	1.035
Better	1.00	8%+1.00 (10% - 8%) = 10%	80	0.154	1.540
Good	0.80	8%+0.80 (10% - 8%) = 9.60%	100	0.192	1.843
Very Good	1.20	8%+1.20 (10% - 8%) = 10.40%	120	0.231	2.402
Best	1.50	8%+1.50 (10% - 8%) = 11%	160	0.308	3.388
Total			**520**	**1**	**10.208**

Thus, Expected Return from Portfolio 10.208% say 10.21%.

Alternatively, it can be computed as follows:

$$\text{Average } \beta = 0.50 \times \frac{60}{520} + 1.00 \times \frac{80}{520} + 0.80 \times \frac{100}{520} + 1.20 \times \frac{120}{520}$$

$$+ 1.50 \times \frac{160}{520} = 1.104$$

As per CAPM

$= 0.08 + 1.104(0.10 – 0.08) = 0.10208$ i.e. 10.208%

(ii) As computed above the expected return from Better is 10% same as return from Nifty, hence there will be no difference even if the replacement of security is made. The main logic behind this neutrality is that the beta of security 'Better' is 1 which clearly indicates that this security shall yield same return as market return.

(b) Initial Margin $= \mu + 3\sigma$

Where μ = Daily Absolute Change

σ = Standard Deviation

Accordingly

Initial Margin = ₹ 10,000 + ₹ 6,000 = ₹ 16,000

Maintenance margin = ₹ 16,000 x 0.75 = ₹ 12,000

Day	Changes in future Values (₹)	Margin A/c (₹)	Call Money (₹)
4/2/09	-	16000	-
5/2/09	50 x (3294.40 - 3296.50) = -105	15895	-
6/2/09	50 x (3230.40 - 3294.40) = -3200	12695	-
7/2/09	50 x (3212.30 - 3230.40) = -905	16000	4210
10/2/09	50 x (3267.50 - 3212.30) = 2760	18760	-
11/2/09	50 x (3263.80 - 3267.50) = -185	18575	-
12/2/09	50 x (3292 - 3263.80) =1410	19985	-
14/2/09	50 x (3309.30 - 3292) = 865	20850	-
17/2/09	50 x (3257.80 - 3309.30) = -2575	18275	-
18/2/09	50 x (3102.60 - 3257.80) = -7760	16000	5485

4. (a) Cost of capital by applying Free Cash Flow to Firm (FCFF) Model is as follows:-

$$\text{Value of Firm} = V_0 = \frac{FCFF_1}{K_c - g_n}$$

Where –

$FCFF_1$ = Expected FCFF in the year 1

K_c= Cost of capital

g_n = Growth rate forever

Thus, ₹ 1800 lakhs = ₹ 54 lakhs /(K_c-g)

Since g = 9%, then K_c = 12%

Now, let X be the weight of debt and given cost of equity = 20% and cost of debt = 10%, then 20% (1 – X) + 10% X = 12%

Hence, X = 0.80, so book value weight for debt was 80%

∴ Correct weight should be 60 of equity and 72 of debt.

∴ Cost of capital = K_c = 20% (60/132) + 10% (72/132) = 14.5455% and correct firm's value

= ₹ 54 lakhs/ (0.1454 – 0.09) = ₹ 974.73 lakhs.

(b) **(i)** Current future price of the index = 5000 + 5000 (0.09-0.06) $\frac{4}{12}$

= 5000+ 50= 5,050

∴ Price of the future contract = ₹ 50 x 5,050 = ₹ 2,52,500

(ii) Hedge ratio = $\frac{1010000}{252500} \times 1.5$ = 6 contracts

Index after three months turns out to be 4500

Future price will be = 4500 + 4500 (0.09-0.06) $\times \frac{1}{12}$ = 4,511.25

Therefore, Gain from the short futures position is = 6 x (5050 – 4511.25) x 50

= ₹ 1,61,625

Note: Alternatively, we can also use daily compounding (exponential) formula.

(c)

Corporate level strategy should be able to answer three basic questions:	
Suitability	Whether the strategy would work for the accomplishment of common objective of the company.

Feasibility	Determines the kind and number of resources required to formulate and implement the strategy.
Acceptability	It is concerned with the stakeholders' satisfaction and can be financial and non-financial.

OR

Trading in futures is for two purposes namely:

(a) Speculation and

(b) Hedging

(a) **Speculation –** For simplicity we will assume that one contract = 100 units and the margin requirement is 20% of the value of contract entered. Brokerage and transaction costs are not taken into account.

(b) **Hedging –** Hedging is the practice of taking a position in one market to offset and balance against the risk adopted by assuming a position in a contrary or opposing market or investment. In simple language, hedging is used to reduce any substantial losses/gains suffered by an individual or an organization. To hedge, the investor takes a stock future position exactly opposite to the stock position. That way, any losses on the stock position will be offset by gains on the future position.

5. (a) SWAP RATIO

	Abhiman Ltd. (₹)	**Swabhiman Ltd. (₹)**
Share capital	200 lacs	100 lacs
Free reserves & surplus	900 lacs	600 lacs
Total	1100 lacs	700 lacs
No. of shares	2 lacs	10 lacs
Book value for share	₹ 550	₹ 70
Promoters Holding	50%	60%
Non promoters holding	50%	40%

Free float market capitalization (Public)	500 lacs	₹ 156 lacs
Total Market Cap	1000 lacs	390 lacs
No. of shares	2 lacs	10 lacs
Market Price	₹ 500	₹ 39
P/E ratio	10	4
EPS	₹ 50.00	₹ 9.75

Calculation of SWAP Ratio

Book Value	1:0.1273	0.1273 × 25%	0.031825
EPS	1:0.195	0.195 × 50%	0.097500
Market Price	1:0.078	0.078 × 25%	0.019500
Total			**0.148825**

(i) SWAP Ratio is 0.148825 shares of Abhiman Ltd. for every share of Swabhiman Ltd.

Total No. of shares to be issued = 10 lakh × 0.148825 = 148825 shares

(ii) Book value, EPS & Market Price.

Total No. shares = 200000 +148825=348825

Total capital = ₹200 lakh + ₹148.825 lac = ₹ 348.825 lac

Reserves = ₹ 900 lac + ₹ 551.175 lac = ₹ 1451.175 lac

Book value Per Share = $\frac{₹\ 348.825\text{lac} + ₹\ 1451.175\text{ lac}}{3.48825\text{ lac}}$ = ₹ 516.02

or ₹ 516.02 x 0.148825 = ₹ 76.80

or = $\frac{\text{Total Capital}}{\text{No. of Shares}} = \frac{1100\text{lac} + 700\text{ lac}}{348825}$ = ₹ 516.02

EPS = $\frac{\text{Total Profit}}{\text{No. of shares}} = \frac{₹100\text{ lac} + ₹\ 97.50\text{ lac}}{3.48825\text{lac}}$ = ₹ 56.62

or ₹ 56.62 x 0.148825 = ₹ 8.43

Expected market price = ₹ 56.62 × PE Ratio= ₹ 56.62 × 10 = ₹ 566.20

or ₹ 566.20 x 0.148825 = ₹ 84.26

(b) Expected Value of Option

(300 – 180) X 0.1	12
(300 – 260) X 0.2	8
(300 – 280) X 0.5	10
(300 – 320) X 0.1	Not Exercised*
(300 – 400) X 0.1	Not Exercised*
	30

* If the strike price goes beyond ₹ 300, option is not exercised at all.

In case of Put option, since Share price is greater than strike price Option Value would be zero.

6. (a) (i) Calculation of initial outlay:

		₹ (million)
a.	Face value	300
	Add: Call premium	12
	Cost of calling old bonds	312
b.	Gross proceed of new issue	300
	Less: Issue costs	6
	Net proceeds of new issue	294
c.	Tax savings on call premium	
	and unamortized cost 0.30 (12 + 9)	6.3

∴ Initial outlay = ₹ 312 million – ₹ 294 million – ₹ 6.3 million = ₹ 11.7 million

(ii) Calculation of net present value of refunding the bond:

	₹ (million)
Saving in annual interest expenses	
[300 x (0.12 – 0.10)]	6.00
Less: Tax saving on interest and amortization	
0.30 x [6 + (9-6)/6]	1.95

Annual net cash saving	<u>4.05</u>
PVIFA (7%, 6 years)	4.766
∴ Present value of net annual cash saving	₹ 19.30 million
Less: Initial outlay	<u>₹ 11.70 million</u>
Net present value of refunding the bond	<u>₹ 7.60 million</u>

Decision: The bonds should be refunded

(b) Final settlement amount shall be computed by using formula:

$$= \frac{(N)(RR - FR)(dtm/DY)}{[1 + RR(dtm/DY)]}$$

Where,

N = the notional principal amount of the agreement;

RR = Reference Rate for the maturity specified by the contract prevailing on the contract settlement date;

FR = Agreed-upon Forward Rate; and

dtm = maturity of the forward rate, specified in days (FRA Days)

DY = Day count basis applicable to money market transactions which could be 360 or 365 days.

Accordingly,

If actual rate of interest after 6 months happens to be 9.60%

$$= \frac{(₹\,60\,\text{crore})(0.096 - 0.093)(3/12)}{[1 + 0.096(3/12)]}$$

$$= \frac{(₹\,60\,\text{crore})(0.00075)}{1.024} = ₹\ 4{,}39{,}453.13$$

Thus, banker will pay Parker & Co. a sum of ₹ 4,39,453.13 or ₹ 4,39,453.

If actual rate of interest after 6 months happens to be 8.80%

$$= \frac{(₹\,60\,\text{crore})(0.088 - 0.093)(3/12)}{[1 + 0.088(3/12)]}$$

$$= \frac{(₹\,60\,\text{crore})(-0.00125)}{1.022} = -\ ₹\ 7{,}33{,}855.19$$

Thus Parker & Co. will pay banker a sum of ₹ 7,33,855.19 or ₹ 7,33,855.

Note: Alternatively, students may solve the question on basis of different days count conventions instead of months (as considered in above calculations) i.e. 90 days/360 days, 90 days/ 365 days, 91 days/360 days or 91 days/365 days.

MODEL TEST PAPER - 2

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

ANSWER TO PART – I CASE SCENARIO BASED MCQS

1. Option (b)

2. Option (a)

3 Option (c)

4. Option (b)

5. Option (a)

6. Option (a)

7. Option (b)

8. Option (d)

9. Option (b)

10. Option (d)

11. Option (d)

12. Option (a)

13. Option (a)

14. Option (d)

15. Option (b)

ANSWERS OF PART – II DESCRIPTIVE QUESTIONS

1. (a) Calculation of Variance and Standard Deviation

Project K

Expected Net Cash Flow

= (0.10 x 11) + (0.20 x13) + (0.40 x 15) + (0.20 x 17) + (0.10 x 19)

= 1.1 + 2.6 + 6 + 3.4 + 1.9 = 15

$$\sigma^2 = 0.10(11-15)^2 + 0.20(13-15)^2 + 0.40(15-15)^2 + 0.20\ (17-15)^2 + 0.10(19-15)^2$$

= 1.6 + 0.8 + 0 + 0.8 + 1.6 = 4.8

$\sigma = \sqrt{4.8} = 2.19$

Project S

Expected Net Cash Flow

= (0.10 X 9) + (0.25 X 13) + (0.30 X 17) + (0.25 X 21) + (0.10 X 25)

= 0.9 + 3.25 + 5.1 + 5.25 + 2.5 = 17

$\sigma^2 = 0.1\ (9-17)^2 + 0.25(13-17)^2 + 0.30\ (17-17)^2 + 0.25(21-17)^2 + 0.10(25-17)^2$

= 6.4 + 4 + 0 + 4 + 6.4 = 20.8

$\sigma = \sqrt{20.8} = 4.56$

Calculation of Coefficient of Variation

Coefficient of Variation = $\frac{\text{Standard Deviation}}{\text{Mean}}$

Project K = $\frac{2.19}{15} = 0.146$

Project S = $\frac{4.56}{17} = 0.268$

Project S is riskier as it has higher Coefficient of Variation.

(6 marks)

(b) Buy £ 62500 × 1.2806 = $ 80037.50

Sell £ 62500 × 1.2816 = <u>$ 80100.00</u>

Profit = <u>$ 62.50</u>

Alternatively, if the market comes back together before December 15, the dealer could unwind his position (by simultaneously buying £ 62,500 forward and selling a futures contract. Both for delivery on December 15) and earn the same profit of $ 62.50.

(4 marks)

(c) **Peer-to-peer lending:** In this process a group of people come together and lend money to each other. Peer to peer lending has been there for many years. Many small and ethnic business groups having similar faith or interest generally support each other in their start up endeavors.

Crowdfunding: Crowdfunding is the use of small amounts of capital from a large number of individuals to finance a new business initiative. Crowdfunding makes use of the easy accessibility of vast networks of people through social media and crowdfunding websites to bring investors and entrepreneurs together.

(4 marks)

2. **(a)** **(i)** Receipts using a forward contract

= \$10,000,000/0.016129 = ₹ 620,001,240

(ii) Receipts using currency Futures

The number of contracts needed is (\$10,000,000/0.016118)/24,816,975 = 25

Initial margin payable is 25 contracts x ₹ 22,500 = ₹ 5,62,500

On April 1,2015 Close at 0.016134

Receipts = US\$10,000,000/0.016136 = ₹ 619,732,276

Variation Margin =

[(0.016134 – 0.016118) x 25 x 24,816,975/-]/0.016136

OR (0.000016x 25 x 24,816,975)/.016136

= 9926.79/0.016136 = ₹ 615,195

Less: Interest Cost – ₹ 5,62,500x 0.07 x 3/12 = ₹ 9,844

Net Receipts ₹ 620,337,627

(iii) **Receipts under different methods of hedging**

Forward contract	₹ 620,001,240
Futures	₹ 620,337,627
No hedge (US\$ 10,000,000/0.016136)	₹ 619,732,276

The most advantageous option would have been to hedge with futures. **(10 marks)**

(b) The financial risk can be evaluated from different point of views as follows:

(i) From stakeholder's point of view: Major stakeholders of a business are equity shareholders and they view financial gearing i.e. ratio of debt in capital structure of company as risk since in event of winding up of a company they will be least prioritized.

Even for a lender, existing gearing is also a risk since company having high gearing faces more risk in default of payment of interest and principal repayment.

(ii) From Company's point of view: From company's point of view if a company borrows excessively or lend to someone who defaults, then it can be forced to go into liquidation.

(iii) From Government's point of view: From Government's point of view, the financial risk can be viewed as failure of any bank or (like Lehman Brothers) down grading of any financial institution leading to spread of distrust among society at large. Even this risk also includes willful defaulters. This can also be extended to sovereign debt crisis. **(4 marks)**

3. (a) Workings:

Asset turnover ratio	= 1.1
Total Assets	= ₹ 600
Turnover ₹ 600 lakhs × 1.1	= ₹ 660 lakhs
Effective interest rate	$= \frac{\text{Interest}}{\text{Libilities}} = 8\%$
Liabilities	= ₹ 125 lakhs + 50 lakhs = 175 lakh
Interest	= ₹ 175 lakhs × 0.08 = ₹ 14 lakh
Operating Margin	= 10%
Hence operating cost	= (1 - 0.10) ₹ 660 lakhs = ₹ 594 lakh
Dividend Payout	= 16.67%
Tax rate	= 40%

(i) Income statement

	(₹ Lakhs)
Sale	660
Operating Exp	594
EBIT	66
Interest	14
EBT	52
Tax @ 40%	20.80
EAT	31.20
Dividend @ 16.67%	5.20
Retained Earnings	26.00

(ii) SGR = ROE (1-b)

ROE = $\frac{PAT}{NW}$ and NW = ₹ 100 lakh + ₹ 300 lakh = 400 lakh

ROE = $\frac{₹\ 31.2\ \text{lakhs}}{₹\ 400\ \text{lakhs}}$ x 100 = 7.8%

SGR = 0.078(1 - 0.1667) = 6.5% or $\frac{0.078 \times 0.8333}{1\text{-}0.078 \times 0.8333}$ = 6.95%

(iii) Calculation of fair price of share using dividend discount model

$P_o = \frac{D_0(1+g)}{k_e - g}$

Dividends = $\frac{₹\ 5.2\ \text{lakhs}}{₹\ 10\ \text{lakhs}}$ = ₹ 0.52

Growth Rate = 6.5% or 6.95%

Hence P_o = $\frac{₹\ 0.52(1+0.065)}{0.15\text{-}0.065}$ = $\frac{₹\ 0.5538}{0.085}$ = ₹ 6.51 or $\frac{0.52(1+0.0695)}{0.15-0.0695}$

$$= \frac{0.5561}{0.0805} = ₹\ 6.91$$

(iv) Since the current market price of share is ₹ 14, the share is overvalued. Hence the investor should not invest in the company. **(10 marks)**

(b) In a securitization transaction, investors are exposed to several risks at each stage of the transaction. The various types of risks in any securitization transaction are as follows:

Credit risk or Counterparty risk

It is the prime risk wherein investors are prone to the risk of bankruptcy and non-performance of the servicer.

Legal risks

Since in the Indian context it is a recently developed concept there is an absence of conclusive judicial precedent or explicit statutory provisions on securitization transactions. As a result, any dispute over the legal ownership of the assets is likely to result in uncertainty regarding investor pay-outs from the pool cash flow.

Market risks

Market risks represent risks external to the transaction and include market-related factors that impact the performance of the transaction. Some of these risks are as follows:

(a) **Macroeconomic risks:** The performance of the underlying loan contracts depends on macroeconomic factors, such as industry downturns or adverse price movements of the underlying assets. For example, in the transportation industry a continuous decline in industrial production may lead to a downtrend in the use of services of the Commercial Vehicles (CVs) adversely impacting the cash flow of CVs operators. This in turn, may impact repayments on CV loans. Similarly, a fall in the prices of the CVs may increase chances of default as the borrower may wilfully default the loan and let the finance company repossess and sell the underlying vehicle instead of retaining it and continuing to pay instalments on time.

(b) **Prepayment risks:** A change in the market interest rate represents a difficult situation for investors because it is a combination of prepayment risk and volatile interest rates. With a reduction in interest rates generally prepayment of retail loans increases, resulting in reinvestment risk for investors because investors may receive their monies ahead of schedule and may not be able to reinvest the amount at the same yield.

(c) **Interest rate risks:** This risk is prominent where the loans in the pool are based on a floating rate and investor pay-outs are based on a fixed rate or vice versa. It results in an interest rate mismatch and can lead to a situation where the pool cash inflow, even at 100% collection efficiency, is not sufficient to meet investor pay-outs. Interest rate swaps can be used to hedge this type of risk to some extent.

(4 Marks)

4. (a) Computation of Business Value

			(₹ Lakhs)
Profit before tax $\frac{77}{1-0.30}$			110
Less: Extraordinary income			(8)
Add: Extraordinary losses			10
			112
Profit from new product		(₹ Lakhs)	
Sales		70	
Less: Material costs	20		
Labour costs	12		
Fixed costs	10	(42)	28
			140.00
Less: Taxes @30%			42.00
Future Maintainable Profit after taxes			98.00
Relevant Capitalisation Factor			0.14
Value of Business (₹98/0.14)			700

(6 marks)

(b) The Challenges to the Efficient Market Theory are as follows:-

(i) **Information inadequacy** – Information is neither freely available nor rapidly transmitted to all participants in the stock market. There is a calculated attempt by many companies to circulate misinformation.

(ii) **Limited information processing capabilities** – Human information processing capabilities are sharply limited. According to Herbert Simon every human organism lives in an environment which generates millions of new bits of information every second but the bottlenecks of the perceptual apparatus does not admit more than thousand bits per seconds and possibly much less.

David Dreman maintained that under conditions of anxiety and uncertainty, with a vast interacting information grid, the market can become a giant.

(iii) **Irrational Behaviour** – It is generally believed that investors' rationality will ensure a close correspondence between market prices and intrinsic values. But in practice this is not true. J. M. Keynes argued that all sorts of consideration enter into the market valuation which is in no way relevant to the prospective yield. This was confirmed by L. C. Gupta who found that the market evaluation processes work haphazardly almost like a blind man firing a gun. The market seems to function largely on hit or miss tactics rather than on the basis of informed beliefs about the long term prospects of individual enterprises.

(iv) **Monopolistic Influence** – A market is regarded as highly competitive. No single buyer or seller is supposed to have undue influence over prices. In practice, powerful institutions and big operators wield great influence over the market. The monopolistic power enjoyed by them diminishes the competitiveness of the market. **(4 marks)**

(c) The key decisions falling within the scope of financial strategy are as follows:

1. **Financing decisions:** These decisions deal with the mode of financing or mix of equity capital and debt capital.

2. **Investment decisions:** These decisions involve the profitable utilization of firm's funds especially in long-term projects (capital projects). Since the future benefits associated with such projects are not known with certainty, investment decisions necessarily involve risk. The projects are therefore evaluated in relation to their expected return and risk.

3. **Dividend decisions:** These decisions determine the division of earnings between payments to shareholders and reinvestment in the company.

4. **Portfolio decisions:** These decisions involve evaluation of investments based on their contribution to the aggregate performance of the entire corporation rather than on the isolated characteristics of the investments themselves.

OR

CDS can be defined as an insurance (not in stricter sense) against the risk of default on a debt which may be debentures, bonds etc.

Under this arrangement, one party (called buyer) needing protection against the default pays a periodic premium to another party (called seller), who in turn assumes the default risk. Hence, in case default takes place then there will be settlement and in case no default takes place no cash flow will accrue to the buyer alike option contract and agreement is terminated. Although it resembles the options but since element of choice is not there it more resembles the swap arrangements.

Amount of premium mainly depends on the price of underlying and especially when the credit risk is more.

Following are the main purposes for which CDS can be used:

(i) **Hedging -** Main purpose of using CDS is to neutralize or reduce a risk to which CDS is exposed to. Thus, by buying CDS, risk can be passed on to CDS seller or writer.

(ii) **Arbitrage -** It involves buying a CDS and entering into an asset swap. For example, a fixed coupon payment of a bond is swapped against a floating interest stream.

(iii) **Speculation -** CDS can also be used to make profit by exploiting price changes. For example, a CDS writer assumed risk of default, will gain from contract if credit risk does not materialize during the tenure of contract or if compensation received exceeds potential pay-out. **(4 marks)**

5. (a) Financial Analysis whether to set up the manufacturing units in India or not may be carried using NPV technique as follows:

I. Incremental Cash Outflows

	$ Million
Cost of Plant and Machinery	500.00
Working Capital	50.00
Release of existing Working Capital	(15.00)
	535.00

II. Incremental Cash Inflow after Tax (CFAT)

(a) Generated by investment in India for 5 years

	$ Million
Sales Revenue (5 Million x $80)	400.00
Less: Costs	
Variable Cost (5 Million x $20)	100.00
Fixed Cost	30.00
Depreciation ($500Million/5)	100.00
EBIT	170.00
Taxes@35%	59.50
EAT	110.50
Add: Depreciation	100.00
CFAT (1-5 years)	210.50

(b) Cash flow at the end of the 5 years (Release of Working Capital) 35.00

(c) Cash generation by exports (Opportunity Cost)

	$ Million
Sales Revenue (1.5 Million x $80)	120.00
Less: Variable Cost (1.5 Million x $40)	60.00

Contribution before tax	60.00
Tax@35%	21.00
CFAT (1-5 years)	39.00

(d) Additional CFAT attributable to Foreign Investment

	$ Million
Through setting up subsidiary in India	210.50
Through Exports in India	39.00
CFAT (1-5 years)	171.50

III. Determination of NPV

Year	**CFAT ($ Million)**	**PVF@12%**	**PV ($ Million)**
1-5	171.50	3.6048	618.2232
5	35	0.5674	19.8590
			638.0822
Less: Initial Outflow			535.0000
			103.0822

Since NPV is positive the proposal should be accepted.

(10 Marks)

(b)

Sl. No. (1)	**Company Name (2)**	**Trend (3)**	**Amount (₹) (4)**	**Beta (5)**	**(₹) (6) [(4) x (5)]**	**Position (7)**
(i)	Right Ltd.	Rise	50 lakh	1.25	62,50,000	Short
(ii)	Wrong Ltd.	Depreciate	25 lakh	0.90	22,50,000	Long
					40,00,000	Short

(4 Marks)

6. (a) **Duration of Bond X**

Year	Cash flow	P.V. @ 10%		Proportion of bond value	Proportion of bond value x time (years)
1	1070	0.909	972.63	1.000	1.000

Duration of the Bond is 1 year.

Duration of Bond Y

Year	Cash flow	P.V. @ 10%		Proportion of bond value	Proportion of bond value x time (years)
1	80	0.909	72.72	0.077	0.077
2	80	0.826	66.08	0.071	0.142
3	80	0.751	60.08	0.064	0.192
4	1080	0.683	737.64	0.788	3.152
			936.52	1.000	3.563

Duration of the Bond is 3.563 years.

Let x_1 be the investment in Bond X and therefore investment in Bond Y shall be $(1 - x_1)$. Since the required duration is 2 years the proportion of investment in each of these two securities shall be computed as follows:

$2 = x_1 + (1 - x_1)\ 3.563$

$x_1 = 0.61$

Accordingly, the proportion of investment shall be 61% in Bond X and 39% in Bond Y respectively.

Amount of investment

Bond X	Bond Y
PV of ₹ 1,00,000 for 2 years @ 10% x 61% = ₹ 1,00,000 (0.826) x 61% = ₹ 50,386 No. of Bonds to be purchased	PV of ₹ 1,00,000 for 2 years @ 10% x 39% = ₹ 1,00,000 (0.826) x 39% = ₹ 32,214 No. of Bonds to be purchased

= ₹ 50,386/₹ 972.63 = 51.80 i.e. approx. 52 bonds	= ₹ 32,214/₹ 936.52 = 34.40 i.e. approx. 34 bonds

Note: The investor has to keep the money invested for two years. Therefore, the investor can invest in both the bonds with the assumption that Bond X will be reinvested for another one year on same returns.

Further, in the above computation, Modified Duration can also be used instead of Duration. **(8 Marks)**

(b) **(i)** Semi-annual fixed payment

= (N) (AIC) (Period)

Where N = Notional Principal amount = ₹ 5,00,000

AIC = All- in- cost = 8% = 0.08

$= 5,00,000 \times 0.08 \left(\frac{180}{360}\right)$

$= 5,00,000 \times 0.08\ (0.5)$

$= 5,00,000 \times 0.04 =$ ₹ 20,000/-

(ii) **Floating Rate Payment**

$= N\ (LIBOR) \left(\frac{dt}{360}\right)$

$= 5,00,000 \times 0.06 \times \frac{181}{360}$

$= 5,00,000 \times 0.06\ (0.503)$ or $5,00,000 \times 0.06\ (0.502777)$

$= 5,00,000 \times 0.03018$ or $5,00,000 \times 0.030166 =$ ₹ 15,090 or ₹ 15,083

(iii) **Net Amount**

= (i) – (ii)

= ₹ 20,000 – ₹ 15,090 = ₹ 4,910

or = ₹ 20,000 – ₹ 15,083 = ₹ 4,917 **(6 Marks)**

MODEL TEST PAPER 3

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

ANSWER TO PART – I CASE SCENARIO BASED MCQS

1. **Option (a)**
2. **Option (b)**
3 **Option (c)**
4. **Option (c)**
5. **Option (b)**
6. **Option (a)**
7. **Option (d)**
8. **Option (b)**
9. **Option (b)**
10. **Option (a)**
11. **Option (a)**
12. **Option (d)**
13. **Option (b)**
14. **Option (c)**
15. **Option (b)**

ANSWERS OF PART – II DESCRIPTIVE QUESTIONS

1. (a) P.V. of Cash Flows

Year 1	Running Cost	₹ 4,000 x 0.917	= (₹ 3,668)
	Savings	₹ 12,000 x 0.917	= ₹ 11,004
Year 2	Running Cost	₹ 5,000 x 0.842	= (₹ 4,210)
	Savings	₹ 14,000 x 0.842	= ₹ 11,788
			₹ 14,914

Year 0	Less: P.V. of Cash Outflow	₹ 10,000 x 1 **NPV**	₹ 10,000 ₹ 4,914

Sensitivity Analysis

(i) If the initial project cost is varied adversely by say 10%.

NPV (Revised) (₹ 4,914 – ₹ 1,000) = ₹ 3,914

Change in NPV $\frac{₹\ 4,914 - ₹\ 3,914}{₹\ 4,914}$ = 20.35%

(ii) If Annual Running Cost is varied by say 10%.

NPV (Revised) (₹ 4,914 – ₹ 400 X 0.917 – ₹ 500 X 0.843)

= ₹ 4,914 – ₹ 367 – ₹ 421= ₹ 4,126

Change in NPV $\frac{₹\ 4,914 - ₹\ 4,126}{₹\ 4,914}$ = 16.04%

(iii) If Saving is varied by say 10%.

NPV (Revised) (₹ 4,914 – ₹ 1,200 X 0.917 – ₹ 1,400 X 0.843)

= ₹ 4,914 – ₹ 1,100 – ₹ 1,180 = ₹ 2,634

Change in NPV $\frac{₹\ 4,914 - ₹\ 2,634}{₹\ 4,914}$ = 46.40%

Hence, savings factor is the most sensitive to affect the acceptability of the project. **(6 Marks)**

(b) Net exposure of each foreign currency in Rupees

	Inflow **(Millions)**	Outflow **(Millions)**	Net Inflow **(Millions)**	Spread	Net Exposure **(Millions)**
US$	40	20	20	0.81	16.20
FFr	20	8	12	0.67	8.04
UK£	30	20	10	0.41	4.10
Japan Yen	15	25	-10	-0.80	8.00

(4 Marks)

(c) **Stages of funding for VC**

- *Seed Money:* Low level financing needed to prove a new idea.
- *Start-up:* Early-stage firms that need funding for expenses associated with marketing and product development.
- *First-Round:* Early sales and manufacturing funds.
- *Second-Round:* Working capital for early stage companies that are selling product, but not yet turning in a profit.
- *Third Round:* Also called Mezzanine financing, this is expansion money for a newly profitable company.
- *Fourth-Round:* Also called bridge financing, it is intended to finance the "going public" process. **(4 Marks)**

2. (a) (i) **Profit at current exchange rates**

2400 [€ 500 × ₹ 51.50 – (S$ 800 × ₹ 27.25 + ₹ 1,000 + ₹ 1,500)]

2400 [₹ 25,750 - ₹ 24,300] = ₹ 34,80,000

Profit after change in exchange rates

2400[€500× ₹ 52 – (S$ 800 × ₹ 27.75 + ₹ 1000 + ₹ 1500)]

2400[₹ 26,000 - ₹ 24,700] = ₹ 31,20,000

Loss due to Transaction Exposure

₹ 34,80,000 – ₹ 31,20,000 = ₹ 3,60,000

(ii) Profit based on new exchange rates

2400[₹ 25,000 - (800 × ₹ 27.15 + ₹ 1,000 + ₹ 1,500)]

2400[₹ 25,000 - ₹ 24,220] = ₹ 18,72,000

Profit after change in exchange rates at the end of six months

2400 [₹ 25,000 - (800 × ₹ 27.75 + ₹ 1,000 + ₹ 1,500)]

2400 [₹ 25,000 - ₹ 24,700] = ₹ 7,20,000

Decline in profit due to transaction exposure

₹ 18,72,000 - ₹ 7,20,000 = ₹ 11,52,000

Current price of each unit in € = $\frac{₹\ 25,000}{₹\ 51.50}$ = € 485.44

Price after change in Exch. Rate = $\frac{₹\ 25,000}{₹\ 51.75}$ = € 483.09

Change in Price due to change in Exch. Rate

€ 485.44 - € 483.09 = € 2.35 or (-) 0.48%

Price elasticity of demand = 1.5

Increase in demand due to fall in price 0.48 × 1.5 = 0.72%

Size of increased order = 2400 ×1.0072 = 2417 units

Profit = 2417 [₹ 25,000 – (800 × ₹ 27.75 + ₹ 1,000 + ₹ 1,500)]

= 2417 [₹ 25,000 - ₹ 24,700] = ₹ 7,25,100

Therefore, decrease in profit due to operating exposure

₹ 18,72,000 – ₹ 7,25,100 = ₹ 11,46,900

Alternatively, if it is assumed that Fixed Cost shall not be changed with change in units then answer will be as follows:

Fixed Cost = 2400[₹ 1,000] = ₹ 24,00,000

Profit = 2417 [₹ 25,000–(800× ₹ 27.75+₹ 1,500)] – ₹ 24,00,000

= 2417 (₹ 1,300) – ₹ 24,00,000 = ₹ 7,42,100

Therefore, decrease in profit due to operating exposure ₹ 18,72,000 – ₹ 7,42,100 = ₹ 11,29,900 **(10 Marks)**

(b) VAR can be applied:

(i) to measure the maximum possible loss on any portfolio or a trading position.

(ii) as a benchmark for performance measurement of any operation or trading.

(iii) to fix limits for individuals dealing in front office of a treasury department.

(iv) to enable the management to decide the trading strategies.

(v) as a tool for Asset and Liability Management especially in banks. **(4 Marks)**

3. (a) (i) **Expected return of the portfolio A and B**

E (A) = (10 + 16) / 2 = 13%

E (B) = (12 + 18) / 2 = 15%

$$Rp = \sum_{i-l}^{N} X_i R_i = 0.4(13) + 0.6(15) = 14.2\%$$

(ii) Stock A:

Variance = 0.5 (10 – 13)² + 0.5 (16 – 13) ² = 9

Standard deviation = $\sqrt{9}$ = 3%

Stock B:

Variance = 0.5 (12 – 15) ² + 0.5 (18 – 15) ² = 9

Standard deviation = 3%

(iii) Covariance of stocks A and B

Cov_{AB} = 0.5 (10 – 13) (12 – 15) + 0.5 (16 – 13) (18 – 15) = 9

(iv) Correlation of coefficient

$$r_{AB} = \frac{Cov_{AB}}{\sigma_A \sigma_B} = \frac{9}{3 \times 3} = 1$$

(v) Portfolio Risk

$$\sigma_P = \sqrt{X^2{}_A \sigma^2{}_A + X^2{}_B \sigma^2{}_B + 2X_A X_B (\sigma_A \sigma_B \sigma_{AB})}$$

$$= \sqrt{(0.4)^2 (3)^2 + (0.6)^2 (3)^2 + 2(0.4)(0.6)(3)(3)(1)}$$

$$= \sqrt{1.44 + 3.24 + 4.32} = 3\%$$

(10 Marks)

(b) Secondary participants involved into the securitization process are as follows:

(i) *Obligors:* They are the main root of the whole securitization process. They are the parties who owe money to the firm and are assets in the Balance Sheet of Originator. The amount due from the obligor is transferred to SPV and hence they form the basis of securitization process and their credit standing is of paramount importance in the whole process.

(ii) *Rating Agency:* Since the securitization is based on the pools of assets rather than the originators, the assets have to be assessed in terms of its credit quality and credit support available.

(iii) *Receiving and Paying agent (RPA):* Also, called Servicer or Administrator, it collects the payment due from obligor(s) and passes it to SPV. It also follows up with defaulting obligor and if required initiate appropriate legal action against them. Generally, an originator or its affiliates acts as servicer.

(iv) *Agent or Trustee:* Trustees are appointed to oversee that all parties to the deal perform in the true spirit of terms of agreement. Normally, it takes care of interest of investors who acquire the securities.

(v) *Credit Enhancer:* Since investors in securitized instruments are directly exposed to performance of the underlying securities and sometime may have limited or no recourse to the originator, they seek additional comfort in the form of credit enhancement. In other words, they require credit rating of issued securities which also empowers marketability of the securities.

Originator itself or a third party say a bank may provide this additional context called Credit Enhancer. While originator provides comfort in the form of over collateralization or cash collateral, the third party provides it in form of letter of credit or surety bonds.

(vi) *Structurer:* It brings together the originator, investors, credit enhancers and other parties to the deal of securitization. Normally, these are investment bankers also called arranger of the deal. It ensures that deal meets all legal, regulatory, accounting and tax laws requirements. **(4 Marks)**

4. (a) Cost of capital by applying Free Cash Flow to Firm (FCFF) Model is as follows:-

$$\text{Value of Firm} = V_0 = \frac{FCFF_1}{K_c - g_n}$$

Where –

$FCFF_1$ = Expected FCFF in the year 1

K_c= Cost of capital

g_n = Growth rate forever

Thus, ₹ 1800 lakhs = ₹ 54 lakhs /(K_c-g)

Since g = 9%, then K_c = 12%

Now, let X be the weight of debt and given cost of equity = 20% and cost of debt = 10%, then 20% (1 – X) + 10% X = 12%

Hence, X = 0.80, so book value weight for debt was 80%

∴ Correct weight should be 60 of equity and 72 of debt.

∴ Cost of capital = K_c = 20% (60/132) + 10% (72/132) = 14.5455% and correct firm's value

= ₹ 54 lakhs/ (0.1454 – 0.09) = ₹ 974.73 lakhs. **(6 Marks)**

(b) That price reflects all available information, the highest order of market efficiency. According to Eugene Fama, there exist three levels of market efficiency:-

(i) *Weak form efficiency* – Price reflects all information found in the record of past prices and volumes.

(ii) *Semi – Strong efficiency* – Price reflects not only all information found in the record of past prices and volumes but also all other publicly available information.

(iii) *Strong form efficiency* – Price reflects all available information public as well as private.

(c) In post-pandemic time their role has been advanced in the following areas in addition to traditional role:

(i) *Risk Management:* Now a days the CFOs are expected to look after the overall functioning of the framework of Risk Management system of an organisation.

(ii) *Supply Chain:* Post pandemic supply chain management system has been posing the challenge for the company to maintain the sustainable growth. Since CFOs are care takers of finance of the company, considering the financial viability

of the Supply Chain Management their role has now become more critical.

(iii) *Mergers, acquisitions, and Corporate Restructuring:* Since in recent period to maintain the growth and capture the market share there has been a spate of Mergers and Acquisitions and hence the role of CFOs has become more crucial because these are strategic decision and any error in them can lead to collapse of the whole business.

(iv) *Environmental, Social and Governance (ESG) Financing:* With the evolving of the concept of ESG their role has been shifted from traditional financing to sustainability financing.

Thus, from above discussion it can be concluded that in today's time CFOs are taking a leadership role in Value Creation for the organisation and that too on sustainable basis for a longer period.

(4 Marks)

OR

Stock index futures is most popular financial derivatives over stock futures due to following reasons:

1. It adds flexibility to one's investment portfolio. Institutional investors and other large equity holders prefer this instrument the most in terms of portfolio hedging purpose. The stock systems do not provide this flexibility and hedging.

2. It creates the possibility of speculative gains using leverage. Because a relatively small amount of margin money controls a large amount of capital represented in a stock index contract, a small change in the index level might produce a profitable return on one's investment if one is right about the direction of the market. Speculative gains in stock futures are limited but liabilities are greater.

3. Stock index futures are the most cost-efficient hedging device whereas hedging through individual stock futures is costlier.

4. Stock index futures cannot be easily manipulated whereas individual stock price can be exploited more easily.

5. Since, stock index futures consists of many securities, so being

an average stock, is much less volatile than individual stock price. Further, it implies much lower capital adequacy and margin requirements in comparison of individual stock futures. Risk diversification is possible under stock index future than in stock futures.

6. One can sell contracts as readily as one buys them and the amount of margin required is the same.

7. In case of individual stocks the outstanding positions are settled normally against physical delivery of shares. In case of stock index futures they are settled in cash all over the world on the premise that index value is safely accepted as the settlement price.

8. It is also seen that regulatory complexity is much less in the case of stock index futures in comparison to stock futures.

9. It provides hedging or insurance protection for a stock portfolio in a falling market. **(4 Marks)**

5. (a) Working Notes:

(i) Computation of Forward Rates

End of Year	NC	NC/₹
1	NC1.60 x $\left(\frac{(1+0.09)}{(1+0.08)}\right)$	1.615
2	NC1.615 x $\left(\frac{(1+0.09)}{(1+0.08)}\right)$	1.630
3	NC1.630 x $\left(\frac{(1+0.09)}{(1+0.08)}\right)$	1.645

(ii) NC Cash Flows converted in Indian Rupees

Year	NC (Million)	Conversion Rate	₹ (Million)
0	-25.00	1.600	-15.625

1	2.60	1.615	1.61
2	3.80	1.630	2.33
3	4.10	1.645	2.49

Net Present Value

(₹ Million)

Year	Cash Flow in India	Cash Flow in Nepal	Total	PVF @ 9%	PV
0	---	-15.625	-15.625	1.000	-15.625
1	2.869	1.61	4.479	0.917	4.107
2	4.200	2.33	6.53	0.842	5.498
3	4.600	2.49	7.09	0.772	5.473
					-0.547

Modified Internal Rate of Return

	Year			
	0	1	2	3
Cash Flow (₹ Million)	-15.625	4.479	6.53	7.09
Year 1 Cash Inflow reinvested for 2 years (1.188 x 4.479)				5.32
Year 2 Cash Inflow reinvested for 1 years (1.090 x 6.53)				7.12
				19.53

$$\text{MIRR} = \sqrt[n]{\frac{\text{Terminal Cash Flow}}{\text{Initial Outlay}}} - 1 = \sqrt[3]{\frac{19.53}{15.625}} - 1 = 0.0772 \text{ say } 7.72\%$$

(10 Marks)

(b) (i) Current Portfolio Beta

Current Beta for share portfolio = 1.6

Beta for cash = 0

Current portfolio beta = 0.85 x 1.6 + 0 x 0.15 = 1.36

(ii) Portfolio beta after 3 months:

Beta for portfolio of shares

$$= \frac{\text{Change in value of portfolio of share}}{\text{Change in value of market portfolio (Index)}}$$

$$1.6 = \frac{0.032}{\text{Change in value of market portfolio (Index)}}$$

Change in value of market portfolio (Index) = (0.032 / 1.6) x 100 = 2%

Position taken on 100 lakh Nifty futures : Long

Value of index after 3 months = ₹ 100 lakh x (1.00 - 0.02)

= ₹ 98 lakh

Mark-to-market paid = ₹ 2 lakh

Cash balance after payment of mark-to-market = ₹ 13 lakh

Value of portfolio after 3 months = ₹85 lakh x (1 - 0.032) + ₹13 lakh

= ₹95.28 lakh

Change in value of portfolio $= \frac{₹100 \text{ lakh} - ₹95.28 \text{ lakh}}{₹100 \text{ lakh}}$

= 4.72%

Portfolio beta = 0.0472/0.02 = 2.36

(4 Marks)

6. (a) Initial Margin = $\mu + 3\sigma$

Where μ = Daily Absolute Change

σ = Standard Deviation

Accordingly

Initial Margin = ₹ 10,000 + ₹ 6,000 = ₹ 16,000

Maintenance margin = ₹ 16,000 x 0.75 = ₹ 12,000

Day	Changes in future Values (₹)	Margin A/c (₹)	Call Money (₹)
4/2/09	-	16000	-
5/2/09	50 x (3294.40 - 3296.50) = -105	15895	-
6/2/09	50 x (3230.40 - 3294.40) = -3200	12695	-
7/2/09	50 x (3212.30 - 3230.40) = -905	16000	4210
10/2/09	50 x (3267.50 - 3212.30) = 2760	18760	-
11/2/09	50 x (3263.80 - 3267.50) = -185	18575	-
12/2/09	50 x (3292 - 3263.80) =1410	19985	-
14/2/09	50 x (3309.30 - 3292) = 865	20850	-
17/2/09	50 x (3257.80 - 3309.30) = -2575	18275	-
18/2/09	50 x (3102.60 - 3257.80) = -7760	16000	5485

(8 Marks)

(b) First of all we shall calculate premium payable to bank as follows:

$$P = \frac{rp}{\left[(1 \div i) - \frac{1}{i \times (1+i)^t}\right]} \text{ X A or } \frac{rp}{PVAF(3.5\%,4)} \times A$$

Where

P = Premium

A = Principal Amount

rp = Rate of Premium

i = Fixed Rate of Interest

t = Time

$$= \frac{0.01}{\left[(1/0.035) - \frac{1}{0.035 \times 1.035^4}\right]} \times £15,000,000 \text{ or}$$

$$\frac{0.01}{(0.966 + 0.933 + 0.901 + 0.871)}$$

× £15,000,000

$$= \frac{0.01}{\left[(28.571) - \frac{1}{0.0402}\right]} \times £15,000,000 = £\ 40,595 \text{ or } \frac{£150,000}{3.671} = £\ 40,861$$

Now we see the net payment received from bank.

Reset Period	Additional interest due to rise in interest rate	Amount received from bank	Premium paid to bank*	Net Amt. received from bank
1	£ 75,000	£ 75,000	£ 40,861	£34,139
2	£ 112,500	£ 112,500	£ 40,861	£71,639
3	£ 150,000	£ 150,000	£ 40,861	£109,139
TOTAL	**£ 337,500**	**£ 337,500**	**£122,583**	**£ 214,917**

Thus, from above it can be seen that interest rate risk amount of £ 337,500 reduced by £ 214,917 by using of Cap option.

* Alternatively, if premium paid is considered as £ 40,595, then above figure of £ 214,917 shall be changed to £ 215,715. **(6 Marks)**

MODEL TEST PAPER - 4

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

ANSWER TO PART – I CASE SCENARIO BASED MCQS

1. **Option (b)**
2. **Option (c)**
3 **Option (c)**
4. **Option (d)**
5. **Option (c)**
6. **Option (b)**
7. **Option (a)**
8. **Option (c)**
9. **Option (b)**
10. **Option (c)**
11. **Option (b)**
12. **Option (a)**
13. **Option (c)**
14. **Option (c)**
15. **Option (c)**

ANSWERS OF PART – II DESCRIPTIVE QUESTIONS

1. (a) (i) **Cancellation Rate**

The forward sale contract shall be cancelled at Spot TT Purchase for $ prevailing on the date of cancellation as follows:

$/ ₹ Market Buying Rate	₹ 63.6800
Less: Exchange Margin @ 0.10%	₹ 0.0636
	₹ 63.6163

Rounded off to ₹ 63.6175

(ii) Amount payable on $ 2,00,000

Bank sells $2,00,000 @ ₹ 64.4000	₹ 1,28,80,000
Bank buys $2,00,000 @ ₹ 63.6175	₹ 1,27,23,500
Amount payable by customer	₹ 1,56,500

(iii) Swap Loss

On 10th June the bank does a swap sale of $ at market buying rate of ₹ 63.8000 and forward purchase for June at market selling rate of ₹ 63.9500.

Bank buys at	₹ 63.9500
Bank sells at	₹ 63.8000
Amount payable by customer	₹ 0.1500

Swap Loss for $ 2,00,000 is ₹ = ₹ 30,000

(iv) Interest on Outlay of Funds

On 10th June, the bank receives delivery under cover contract at ₹ 64.2800 and sell spot at ₹ 63.8000.

Bank buys at	₹ 64.2800
Bank sells at	₹ 63.8000
Amount payable by customer	₹ 0.4800

Outlay for $ 2,00,000 is ₹ 96,000

Interest on ₹ 96,000 @ 12% for 3 days = ₹ 96

(v) New Contract Rate

The contract will be extended at current rate

$/ ₹ Market forward selling Rate for August	₹ 64.2500
Add: Exchange Margin @ 0.10%	₹ 0.0643
	₹ 64.3143

Rounded off to ₹ 64.3150

(vi) Total Cost

Cancellation Charges	₹ 1,56,500.00
Swap Loss	₹ 30,000.00

Interest	₹ 96.00
	₹ 1,86,596.00

(b) Broadly, Financial Risk can be divided into following categories.

Counter Party Risk

This risk occurs due to non-honoring of obligations by the counter party which can be failure to deliver the goods for the payment already made or vice-versa or repayment of borrowings and interest etc. Thus, this risk also covers the credit risk i.e. default by the counter party.

Political Risk

Generally, this type of risk is faced by and overseas investors, as the adverse action by the government of host country may lead to huge loses. This can be on any of the following form.

- Confiscation or destruction of overseas properties.
- Rationing of remittance to home country.
- Restriction on conversion of local currency of host country into foreign currency.
- Restriction as to borrowings.
- Invalidation of Patents
- Price control of products

Interest Rate Risk

This risk occurs due to change in interest rate resulting in change in asset and liabilities. This risk is more important for banking companies as their balance sheet's items are more interest sensitive and their base of earning is spread between borrowing and lending rates.

As we know that the interest rates are of two types i.e. fixed and floating. The risk in both of these types is inherent. If any company has borrowed money at floating rate then with increase in floating the liability under fixed rate shall remain the same. This fixed rate, with falling floating rate the liability of company to pay interest under fixed rate shall comparatively be higher.

Currency Risk

This risk mainly affects the organization dealing with foreign exchange as their cash flows changes with the movement in the currency exchange rates. This risk can affect cash flow both adversely or favorably. For example, if rupee depreciates vis-à-vis US$ receivables will stand to gain vis-à-vis to the importer who has the liability to pay bill in US$. The best case we can quote Infosys (Exporter) and Indian Oil Corporation Ltd. (Importer).

Liquidity Risk

Broadly liquidity risk can be defined as inability of organization to meet it liabilities whenever they become due.

This risk mainly arises when organization is unable to generate adequate cash or there may be some mismatch in period of cash flow generation.

This type of risk is more prevalent in banking business where there may be mismatch in maturities and receiving fresh deposits pattern.

2. **(a)** **(i)** On the basis of standard deviation project X be chosen because it is less risky than Project Y having higher standard deviation.

(ii) $CV_x = \frac{SD}{ENPV} = \frac{90,000}{1,22,000} = 0.738$

$CV_y = \frac{1,20,000}{2,25,000} = 0.533$

On the basis of Co-efficient of Variation (C.V.) Project X appears to be riskier and hence Y should be accepted.

(iii) However, the NPV method in such conflicting situation is best because the NPV method is in compatibility of the objective of wealth maximization in terms of time value.

(b) Forward Rate = $\frac{2.50\,(1+0.075)}{(1+0.060)}$ = Can\$ 2.535/£

(i) If spot rate decline by 2%

Spot Rate = Can\$ 2.50 x 1.02 = Can\$ 2.55/£

	£
£ receipt as per Forward Rate (Can $ 5,00,000/ Can$ 2.535)	1,97,239
£ receipt as per Spot Rate (Can $ 5,00,000/ Can$ 2.55)	1,96,078
Gain due to forward contract	1,161

(ii) If spot rate gains by 4%

Spot Rate = Can$ 2.50 x 0.96 = Can$ 2.40/£

	£
£ receipt as per Forward Rate (Can $ 5,00,000/ Can$ 2.535)	1,97,239
£ receipt as per Spot Rate (Can $ 5,00,000/ Can$ 2.40)	2,08,333
Loss due to forward contract	11,094

(iii) If spot rate remains unchanged

	£
£ receipt as per Forward Rate (Can $ 5,00,000/ Can$ 2.535)	1,97,239
£ receipt as per Spot Rate (Can $ 5,00,000/ Can$ 2.50)	2,00,000
Loss due to forward contract	2,761

(c) Structure of Venture Capital Fund in India

Three main types of fund structure exist: one for domestic funds and two for offshore ones:

(i) Domestic Funds: Domestic Funds (i.e. one which raises funds domestically) are usually structured as:

i) a domestic vehicle for the pooling of funds from the investor, and

ii) a separate investment adviser that carries those duties of asset manager.

The choice of entity for the pooling vehicle falls between a trust and a company, (India, unlike most developed countries does not recognize a limited partnership), with the trust form prevailing due to its operational flexibility.

(ii) **Offshore Funds:** Two common alternatives available to offshore investors are: the "offshore structure" and the "unified structure".

Offshore structure

Under this structure, an investment vehicle (an LLC or an LP organized in a jurisdiction outside India) makes investments directly into Indian portfolio companies. Typically, the assets are managed by an offshore manager, while the investment advisor in India carries out the due diligence and identifies deals.

Unified Structure

When domestic investors are expected to participate in the fund, a unified structure is used. Overseas investors pool their assets in an offshore vehicle that invests in a locally managed trust, whereas domestic investors directly contribute to the trust. This is later used to make the local portfolio investments.

3. (a) High growth phase :

$k_e = 0.10 + 1.15 \times 0.06 = 0.169$ or 16.9%.

$k_d = 0.13 \times (1-0.3) = 0.091$ or 9.1%.

Cost of capital = $0.5 \times 0.169 + 0.5 \times 0.091 = 0.13$ or 13%.

Stable growth phase :

$k_e = 0.09 + 1.0 \times 0.05 = 0.14$ or 14%.

$k_d = 0.1286 \times (1 - 0.3) = 0.09$ or 9%.

Cost of capital = $0.6 \times 0.14 + 0.4 \times 0.09 = 0.12$ or 12%.

Determination of forecasted Free Cash Flow of the Firm (FCFF)

(₹ in crores)

	Yr. 1	Yr. 2	Yr. 3	Yr. 4	Terminal Year
Revenue	2,400	2,880	3,456	4,147.20	4,561.92
EBIT	360	432	518.40	622.08	684.29
EAT	252	302.40	362.88	435.46	479.00
Capital Expenditure	96	115.20	138.24	165.89	-
Less: Depreciation					
∆ Working Capital	100.00	120.00	144.00	172.80	103.68
Free Cash Flow (FCF)	**56.00**	**67.20**	**80.64**	**96.77**	**375.32**

Alternatively, it can also be computed as follows:

(₹ in crores)

	Yr. 1	Yr. 2	Yr. 3	Yr. 4	Terminal Year
Revenue	2,400	2,880	3,456	4,147.20	4,561.92
EBIT	360	432	518.40	622.08	684.29
EAT	252	302.40	362.88	435.46	479.00
Add: Depreciation	240	288	345.60	414.72	456.19
	492	590.40	708.48	850.18	935.19
Less: Capital Exp	336	403.20	483.84	580.61	456.19
∆ WC	100.00	120.00	144.00	172.80	103.68
	56.00	**67.20**	**80.64**	**96.77**	**375.32**

Present Value (PV) of FCFF during the explicit forecast period is:

FCFF (₹ in crores)	PVF@13%	PV (₹ in crores)
56.00	0.885	49.56
67.20	0.783	52.62
80.64	0.693	55.88
96.77	0.613	59.32
		₹ 217.38

Terminal Value of Cash Flow

$$\frac{375.32}{0.12 - 0.10} = ₹\,18{,}766.00 \text{ Crores}$$

PV of the terminal, value is:

$$₹\,18{,}766.00 \text{ Crores} \times \frac{1}{(1.13)^4} = ₹\,18{,}766.00 \text{ Crores} \times 0.613 = ₹\,11{,}503.56 \text{ Crores}$$

The value of the firm is :

₹ 217.38 Crores + ₹ 11,503.56 Crores = ₹ 11,720.94 Crores

(b) In post-pandemic time their role has been advanced in the following areas in addition to traditional role:

(i) **Risk Management:** Now a days the CFOs are expected to look after the overall functioning of the framework of Risk Management system of an organisation.

(ii) **Supply Chain**: Post pandemic supply chain management system has been posing the challenge for the company to maintain the sustainable growth. Since CFOs are care takers of finance of the company, considering the financial viability of the Supply Chain Management their role has now become more critical.

(iii). **Mergers, acquisitions, and Corporate Restructuring:** Since in recent period to maintain the growth and capture the market share there has been a spate of Mergers and Acquisitions and hence the role of CFOs has become more crucial because these are strategic decision and any error in them can lead to collapse of the whole business.

(iv) **Environmental, Social and Governance (ESG) Financing**: With the evolving of the concept of ESG their role has been shifted from traditional financing to sustainability financing.

Thus, from above discussion it can be concluded that in today's time CFOs are taking a leadership role in Value Creation for the organisation and that too on sustainable basis for a longer period.

Or

It is a combination of following 3 words:

Credit: Loan given

Default: Non payment

Swap: Exchange of Liability or Risk

Accordingly, CDS can be defined as an insurance (not in stricter sense) against the risk of default on a debt which may be debentures, bonds etc.

Under this arrangement, one party (called buyer) needing protection against the default pays a periodic premium to another party (called seller), who in turn assumes the default risk. Hence, in case default takes place then there will be settlement and in case no default takes place no cash flow will accrue to the buyer alike option contract and agreement is terminated. Although it resembles the options but since element of choice is not there it more resembles the swap arrangements.

Amount of premium mainly depends on the price of underlying and especially

when the credit risk is more.

Parties to CDS

In a CDS at least three parties are involved which are as follows:

The initial borrowers- It is also called a 'reference entity', which are owing a loan or bond obligation.

Buyer- It is also called 'investor' i.e. the buyer of protection. The buyer will make regular payment to the seller for the protection from default or credit event of reference entity.

Seller- It is also called 'writer' of the CDS and makes payment to buyer in the event of credit event of reference entity. It receives a regular pay off from the buyer of CDS.

4. (a)

(i)

	E Ltd.	**H Ltd.**
Market capitalization	1000 lakhs	1500 lakhs
No. of shares	20 lakhs	15 lakhs
Market Price per share	₹ 50	₹ 100

P/E ratio	10	5
Earnings per share	₹ 5	₹ 20
Profit	₹ 100 lakh	₹ 300 lakh
Share capital	₹ 200 lakh	₹ 150 lakh
Reserves and surplus	₹ 600 lakh	₹ 330 lakh
Total	₹ 800 lakh	₹ 480 lakh
Book Value per share	₹ 40	₹ 32

(ii) Calculation of Swap Ratio

EPS	1 : 4 i.e.	4.0 × 40%	1.6
Book value	1 : 0.8i.e.	0.8 × 25%	0.2
Market price	1 : 2 i.e.	2.0 × 35%	0.7
		Total	2.5

Swap ratio is for every one share of H Ltd., to issue 2.5 shares of E Ltd. Hence, total no. of shares to be issued 15 lakh × 2.5 = 37.50 lakh shares.

(iii) Promoter's holding = 9.50 lakh shares + (10× 2.5 = 25 lakh shares)

= 34.50 lakh i.e. Promoter's holding % is (34.50 lakh/57.50 lakh) × 100 = 60%.

(iv) Calculation of EPS after merger

Total No. of shares 20 lakh + 37.50 lakh = 57.50 lakh

EPS $\frac{\text{Total profit}}{\text{No. of shares}} = \frac{100 \text{ lakh} + 300 \text{ lakh}}{57.50 \text{ lakh}} = \frac{400}{57.50} =$ ₹ 6.956

(v) Calculation of Market price and Market capitalization after merger

Expected market price	= EPS 6.956 × P/E 10 = ₹ 69.56
Market capitalization	= ₹ 69.56 per share × 57.50 lakh shares
	= ₹ 3,999.70 lakh or ₹ 4,000 lakh

(vi) Free float of market capitalization = ₹ 69.56 per share × (57.50 lakh × 40%) = ₹ 1599.88 lakh

(b) Following are some similarities between Tokenization and Securitization:

(i) **Liquidity: -** First and foremost both Securitization and Tokenization inject liquidity in the market for the assets which are otherwise illiquid assets.

(ii) **Diversification: -** Both help investors to diversify their portfolio thus managing risk and optimizing returns.

(iii) **Trading: -** Both are tradable hence helps to generate wealth.

(iv) **New Opportunities: -** Both provide opportunities for financial institutions and related agencies to earn income through collection of fees.

5. **(a)** Here we shall evaluate NPV in two possible situations:

(1) **As on Today**

At cost of Capital of 10%, the value of saving forever = $\frac{₹\ 21 \text{ lakhs}}{0.10}$

= ₹ 2.1 crore

NPV = ₹ 2.1 crore - ₹ 2.5 crore = - ₹ 0.4 crore

Since NPV is negative, it does not worth to accept the project.

(2) **After one Year**

After one year these are two possible situations, either rate of electricity decreases or increase.

(i) If price of electricity increases

At cost of Capital of 10%, the value of saving forever = $\frac{₹35 \text{ lakh}}{0.10}$

= ₹ 3.50 crore

The position of the NPV will be as follows:

= ₹ 3.50 crore - ₹ 2.50 crore = ₹ 1 crore

And Rate of Return will be (3.5/2.5) - 1 = 0.40 is 40%

(ii) If the price of electricity decreases, then value of saving forever will be

At cost of Capital of 10%, the value of saving forever = $\frac{12 \text{ lakh}}{0.10}$

= ₹ 1.20 crore

The position of the NPV will be as follows:

= ₹ 1.20 crore - ₹ 2.5 crore = - ₹ 1.3 crore

and Rate of Return will be (1.2/2.5) - 1 = -0.52 i.e. – 52.00%

Diagrammatically it can be shown below

₹ 3.50 crore

₹ 2.5 crore

- ₹ 1.20 crore

Let prob. of price increase be p. Then using Risk Neutral Method, the risk-free rate of return will be equal to expected saving as follows:

p x 0.40 + (1-p) (-0.52) = 0.08

0.40p - 0.52 + 0.52p = 0.08

0.92p = 0.60

p = 0.652

Hence, expected pay off = 0.652 x ₹ 1 crore + 0.348 x (- ₹ 1.30 crore) = ₹ 19.9 lakh.

PV of Pay off after one year = ₹ 19.96 lakh/ 1.08 = ₹ 18.48 lakh.

Thus, it shall be advisable to wait and see as NPV may turn out to be positive after one year.

(b) (i) Semi-annual fixed payment

= (N) (AIC) (Period)

Where N = Notional Principal amount = ₹ 5,00,000

AIC = All-in-cost = 8% = 0.08

$$= 5,00,000 \times 0.08 \left(\frac{180}{360}\right)$$

= 5,00,000 × 0.08 (0.5)

= 5,00,000 × 0.04 = ₹ 20,000/-

(ii) Floating Rate Payment

$$= N\ (LIBOR) \left(\frac{dt}{360}\right)$$

$$= 5,00,000 \times 0.06 \times \frac{181}{360}$$

= 5,00,000 × 0.06 (0.503) or 5,00,000 × 0.06 (0.502777)

= 5,00,000 × 0.03018 or 5,00,000 × 0.030166 = ₹15,090 or 15,083

(iii) Net Amount

= (i) – (ii)

= ₹20,000 – ₹15,090 = ₹4,910

or = ₹ 20,000 – ₹ 15,083 = ₹ 4,917

6. (a) Calculation of NPV

Year	**0**	**1**	**2**	**3**
Inflation factor in India	1.00	1.10	1.21	1.331
Inflation factor in Africa	1.00	1.40	1.96	2.744
Exchange Rate (as per IRP)	6.00	7.6364	9.7190	12.3696
Cash Flows in ₹ '000				
Real	-50000	-1500	-2000	-2500
Nominal (1)	-50000	-1650	-2420	-3327.50

Cash Flows in African Rand '000				
Real	-200000	50000	70000	90000
Nominal	-200000	70000	137200	246960
In Indian ₹'000 (2)	-33333	9167	14117	19965
Net Cash Flow in ₹ '000 (1) + (2)	-83333	7517	11697	16637
PVF@20%	1	0.833	0.694	0.579
PV	-83333	6262	8118	9633

NPV of 3 years = - 59320 (₹ '000)

NPV of Terminal Value = $\frac{16637}{0.20} \times 0.579 =$ 48164 (₹ '000)

Total NPV of the Project = -59320 (₹ '000) + 48164 (₹ '000) = -11156 (₹ '000)

(b) (i) Expected Share Price

= ₹ 120 X 0.05 + ₹ 140 X 0.20 + ₹ 160 X 0.50 + ₹ 180 X 0.10 + ₹ 190 X 0.15

= ₹ 6 + ₹28 + ₹ 80 + ₹ 18 + ₹ 28.50 = ₹ 160.50

(ii) Value of Call Option

= ₹ 150 - ₹ 150 = Nil

(iii) If the option is held till maturity the expected Value of Call Option

Expected price (X)	Value of call(C)	Probability (P)	CP
₹ 120	0	0.05	0
₹ 140	0	0.20	0
₹ 160	₹ 10	0.50	₹ 5
₹ 180	₹ 30	0.10	₹ 3
₹ 190	₹ 40	0.15	₹ 6
Total			₹ 14

Alternatively, it can also be calculated as follows:

Expected Value of Option

(120 – 150) X 0.1	Not Exercised*
(140 – 150) X 0.2	Not Exercised*
(160 – 150) X 0.5	5
(180 – 150) X 0.1	3
(190 – 150) X 0.15	6
	14

* If the stock price goes below ₹ 150, option is not exercised at all.

MODEL TEST PAPER - 5

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

ANSWER TO PART – I CASE SCENARIO BASED MCQS

1. Option (c)

2. Option (a)

3 Option (c)

4. Option (c)

5. Option (c)

6. Option (a)

7. Option (b)

8. Option (d)

9. Option (c)

10. Option (a)

11. Option (b)

12. Option (b)

13. Option (d)

14. Option (a)

15. Option (b)

ANSWERS OF PART – II DESCRIPTIVE QUESTIONS

1. (a) (i) Calculation of NPV of XY Co.:

Project X		**Cash Flow**	**PVF**	**PV**
Year				
1	(30 × 0.3) + (50 × 0.4) + (65 × 0.3)	48.5	0.909	44.09
2	(30 × 0.3) + (40 × 0.4) + (55 × 0.3)	41.5	0.826	34.28

3	(30 × 0.3) + (40 × 0.4) + (45 × 0.3)	38.5	0.751	28.91
				107.28
	NPV: (107.28 – 70.00) =			(+)37.28

Project Y (For 1-3 Years)

1-3	(40 × 0.2) + (45 × 0.5) + (50 × 0.3)	45.5	2.487	113.16
	NPV (113.16 – 80.00)			(+) 33.16

(ii) Calculation of Standard deviation σ

As per Hiller's model

$$M = \sum_{i=0}^{n} (1+r)^{-1} Mi$$

$$\sigma^2 = \sum_{i=0}^{n} (1+r)^{-2i} \sigma_i^2$$

Hence,

Project X

Year

1 $\sqrt{(30-48.5)^2 0.30 + (50-48.5)^2 0.40 + (65-48.5)^2 0.30}$

2 $\sqrt{(30-41.5)^2 0.30 + (40-41.5)^2 0.40 + (55-41.5)^2 0.30}$

3 $\sqrt{(30-38.5)^2 0.30 + (40-38.5)^2 0.40 + (45-38.5)^2 0.30}$

Standard Deviation about the expected value

$$= \sqrt{\frac{185.25}{(1+0.10)^2} + \frac{95.25}{(1+0.10)^4} + \frac{35.25}{(1+0.10)^6}}$$

$$= \sqrt{\frac{185.25}{1.21} + \frac{95.25}{1.4641} + \frac{35.25}{1.7716}} = \sqrt{153.10+65.06+19.90}$$

$$= \sqrt{238.06} = 15.43$$

Project Y (For 1-3 Years)

$$\sqrt{(40-45.5)^2 0.20 + (45-45.5)^2 0.50 + (50-45.5)^2 0.30}$$

Standard Deviation about the expected value

$$= \sqrt{\frac{12.25}{(1+0.10)^2} + \frac{12.25}{(1+0.10)^4} + \frac{12.25}{(1+0.10)^6}}$$

$$= \sqrt{\frac{12.25}{1.21} + \frac{12.25}{1.4641} + \frac{12.25}{1.7716}} = \sqrt{10.12+8.37+6.91}$$

$$= \sqrt{25.4} = 5.03$$

Analysis: Project Y is less risky as its Standard Deviation is less than Project X.

(b) **(i)** **Cancellation Rate:**

The forward sale contract shall be cancelled at Spot TT Purchase for $ prevailing on the date of cancellation as follows:

$/ ₹ Market Buying Rate	₹ 63.6800
Less: Exchange Margin @ 0.10%	₹ 0.0636
	₹ 63.6163

Rounded off to ₹ 63.6175

(ii) **Amount payable on $ 2,00,000**

Bank sells $2,00,000 @ ₹ 64.4000	₹ 1,28,80,000
Bank buys $2,00,000 @ ₹ 63.6175	₹ 1,27,23,500
Amount payable by customer	₹ 1,56,500

(c) Pitch presentation is a short and brief presentation (not more than 20 minutes) to investors explaining about the prospects of the company and why they should invest into the startup business. So, pitch deck presentation is a brief presentation using PowerPoint to provide a quick overview of business plan and convincing the investors to put some money into the business.

Following are some points to be kept in mind while preparing a pitch presentation:

(i) *Introduction:* To start with, first step is to give a brief account of yourself i.e. who are you? What are you doing?

(ii) *Team:* The next step is to introduce the audience to the people behind the scenes. The reason is that the investors will want to know the people who are going to make the product or service successful.

(iii) *Problem:* Further, the promoter should be able to explain the problem that the startup is going to solve and solutions emerging from it.

(iv) *Solution:* It is very important to describe in the pitch presentation as to how the company is planning to solve the problem.

(v) *Marketing/Sales:* This is a very important part where investors will be deeply interested. The market size of the product must be communicated to the investors.

(vi) *Projections or Milestones:* It is true that it is difficult to make financial projections for a startup concern.

2. (a) The only thing lefts Rohit and Bros to cover the risk in the money market. The following steps are required to be taken:

(i) Borrow pound sterling for 3- months. The borrowing has to be such that at the end of three months, the amount becomes £ 500,000. Say, the amount borrowed is £ x. Therefore

$$x \left[1+0.05\times\frac{3}{12}\right] = 500,000 \text{ or } x = £493,827$$

(ii) Convert the borrowed sum into rupees at the spot rate. This gives: £493,827 × ₹ 56 = ₹ 27,654,312

(iii) The sum thus obtained is placed in the money market at 12 per cent to obtain at the end of 3- months:

$$S = ₹\ 27,654,312 \times \left[1+0.12\times\frac{3}{12}\right] = ₹\ 28,483,941$$

(iv) The sum of £500,000 received from the client at the end of 3- months is used to refund the loan taken earlier.

From the calculations. It is clear that the money market operation has resulted into a net gain of ₹ 483,941 (₹ 28,483,941 – ₹ 500,000 × 56).

If pound sterling has depreciated in the meantime. The gain would be even bigger.

(b) The bank (Dealer) covers itself by buying from the market at market selling rate.

Rupee – Dollar selling rate	= ₹ 42.85
Dollar – Hong Kong Dollar	= HK $ 7.5880
Rupee – Hong Kong cross rate	= ₹ 42.85 / 7.5880
	= ₹ 5.6471

Profit / Loss to the Bank

Amount received from customer (1 crore × 5.70)	₹ 5,70,00,000
Amount paid on cover deal (1 crore × 5.6471)	₹ 5,64,71,000
Profit to Bank	₹ 5,29,000

(c) Financial planning is the backbone of the business planning and corporate planning. It helps in defining the feasible area of operation for all types of activities and thereby defines the overall planning framework.

Financial planning is a systematic approach whereby the financial planner helps the customer to maximize his existing financial resources by utilizing financial tools to achieve his financial goals.

There are 3 major components of Financial planning:

- Financial Resources (FR)
- Financial Tools (FT)
- Financial Goals (FG)

Financial Planning = FR + FT + FG

3. **(a)** **(i)** Mr. X's position in the two securities are +1.50 in security A and -0.5 in security B. Hence the portfolio sensitivities to the two factors:-

b prop. 1 =1.50 x 0.80 + (-0.50 x 1.50) = 0.45

b prop. 2 = 1.50 x 0.60 + (-0.50 x 1.20) = 0.30

(ii) Mr. X's current position:-

Security A ₹ 3,00,000 / ₹ 1,00,000 = 3

Security B -₹ 1,00,000 / ₹ 1,00,000 = -1

Risk free asset -₹ 100000 / ₹ 100000 = -1

b prop. 1 = 3.0 x 0.80 + (-1 x 1.50) + (- 1 x 0) = 0.90

b prop. 2 = 3.0 x 0.60 + (-1 x 1.20) + (-1 x 0) = 0.60

(iii) Expected Return = Risk Free Rate of Return + Risk Premium

Let λ_1 and λ_2 are the Value Factor 1 and Factor 2 respectively.

Accordingly

$15 = 10 + 0.80\ \lambda_1 + 0.60\ \lambda_2$

$20 = 10 + 1.50\ \lambda_1 + 1.20\ \lambda_2$

On solving equation, the value of $\lambda_1 = 0$, and risk premium of factor 2 for Securities A & B shall be as follows:

<u>Using Security A's Return</u>

Total Return = 15% = 10% + 0.60 λ_2

Risk Premium (λ_2) = 5%/ 0.60 = 8.33%

<u>Alternatively using Security B's Return</u>

Total Return = 20% = 10 + 1.20 λ_2

Risk Premium = 10%/ 1.20 = 8.33%

(b) The areas where Application of Blockchain can be noticed are given below: -

i. **Financial Services:** Blockchain can be used to provide an automated trade lifecycle in terms of the transaction log of any transaction of asset or property - whether physical or digital such as laptops, smartphones, automobiles, real estate, etc. from one person to another.

ii. **Healthcare:** Blockchain provides secure sharing of data in healthcare industry by increasing the privacy, security, and interoperability of the data by eliminating the interference of third party and avoiding the overhead costs.

iii. **Government:** At the government front, there are instances where the technical decentralization is necessary but politically should be governed by governments like land registration, vehicle registration and management, e-voting etc. Blockchain improves the transparency and provides a better way to monitor and audit the transactions in these systems.

iv. **Travel Industry:** Blockchain can be applied in money transactions and in storing important documents like passports/other identification cards, reservations and managing travel insurance, loyalty, and rewards thus, changing the working of travel and hospitality industry.

v. **Economic Forecasts:** Blockchain makes possible the financial and economic forecasts based on decentralized prediction markets, decentralized voting, and stock trading, thus enabling the organizations to plan and shape their businesses.

4. (a) (i) Taxable Income = ₹ 15 lac/(1-0.30)

= ₹ 21.43 lacs or ₹ 21,42,857

Operating Income = Taxable Income + Interest

= ₹ 21,42,857 + ₹ 10,00,000

= ₹ 31,42,857 or ₹ 31.43 lacs

(ii) EVA = EBIT (1-Tax Rate) – WACC x Invested Capital

= ₹ 31,42,857(1 – 0.30) – 13% x ₹ 95,00,000

= ₹ 22,00,000 – ₹ 12,35,000 = ₹ 9,65,000

(iii) EVA Dividend $= \dfrac{₹\ 9,65,000}{₹\ 6,00,000} =$ ₹ 1.6083

(b) The factors affecting economic analysis are mentioned below: -

i. **Growth Rates of National Income and Related Measures*:*** For most purposes, what is important is the difference between the nominal growth rate quoted by GDP and the 'real' growth after taking inflation into account. The estimated growth rate of the economy would be a pointer to the prospects for the industrial sector, and therefore to the returns investors can expect from investment in shares.

ii. **Growth Rates of Industrial Sector*:*** This can be further broken down into growth rates of various industries or groups of industries if required. The growth rates in various industries are estimated based on the estimated demand for its products.

iii. **Inflation*:*** Inflation is measured in terms of either wholesale prices (the Wholesale Price Index or WPI) or retail prices (Consumer Price Index or CPI). The demand in some industries, particularly the consumer products industries, is significantly influenced by the inflation rate. Therefore, firms in these industries make continuous assessment about inflation rates likely to prevail in the near future so as to fine-tune their pricing, distribution and promotion policies to the anticipated impact of inflation on demand for their products.

iv. **Monsoon*:*** Because of the strong forward and backward linkages, monsoon is of great concern to investors in the stock market too.

(c) The various techniques to manage this type of risk are as follows:

i. Carrying out Due Diligence before dealing with any third party.

ii. Do not over commit to a single entity or group or connected entities.

iii. Know your exposure limits.

iv. Review the limits and procedure for credit approval regularly.

v. Rapid action in the event of any likelihood of defaults.

vi. Use of performance guarantee, insurance or other instruments.

OR

The main types of risks associated with investment in collateralized debt Obligation (CDOs): -

a) **Default Risk: -** Also called 'credit risk', it emanates from the default of underlying party to the instruments. The prime sufferers of these types of risks are equity or junior tranche in the waterfall.

(b) **Interest Rate Risk: -** Also called Basis risk and mainly arises due to different basis of interest rates. For example, asset may be based on floating interest rate but the liability may be based on fixed interest rates. Though this type of risk is quite difficult to manage fully but commonly used techniques such as swaps, caps, floors, collars etc. can be used to mitigate the interest rate risk.

(c) **Liquidity Risk: -** Another major type of risk by which CDOs are affected is liquidity risks as there may be mismatch in coupon receipts and payments.

(d) **Prepayment Risk: -** This risk results from unscheduled or unexpected repayment of principal amount underlying the security. Generally, this risk arises in case assets are subject to fixed rate of interest and the debtors have a call option. Since, in case of falling interest rates they may pay back the money.

(e) **Reinvestment Risk: -** This risk is generic in nature as the CDO manager may not find adequate opportunity to reinvest the proceeds when allowed for substitutions.

(f) **Foreign Exchange Risk: -** Sometimes CDOs are comprised of debts and loans from countries other than the country of issue. In such a case, in addition to above mentioned risks, CDOs are also subject to the foreign exchange rate risk.

5. (a) Working Notes:

1. Estimated Exchange Rates (Using PPP Theory)

Year	0	1	2	3	4	5	6
Exchange Rate	57	57.54	57.82	57.82	57.54	56.99	56.18

2. Share in sales

Year	**1**	**2**	**3**	**4**	**5**
Annual Units in crores	24	24	24	24	24
Price per bottle (₹)	7.50	8.50	9.50	10.50	11.50
Price fluctuating Inflation Rate	6.00%	5.50%	5.00%	4.50%	4.00%

Inflated Price (₹)	7.95	8.97	9.98	10.97	11.96
Inflated Sales Revenue (₹ Crore)	190.80	215.28	239.52	263.28	287.04
Sales share @55%	104.94	118.40	131.74	144.80	157.87

3. Royalty Payment

Year	1	2	3	4	5
Annual Units in crores	24	24	24	24	24
Royalty in $	0.01	0.01	0.01	0.01	0.01
Total Royalty ($ Crore)	0.24	0.24	0.24	0.24	0.24
Exchange Rate	57.54	57.82	57.82	57.54	56.99
Total Royalty (₹ Crore)	13.81	13.88	13.88	13.81	13.68

4. Tax Liability (₹ Crore)

Year	1	2	3	4	5
Sales Share	104.94	118.40	131.74	144.80	157.87
Total Royalty	13.81	13.88	13.88	13.81	13.68
Total Income	118.75	132.28	145.61	158.61	171.55
Less: Expenses					
Production Cost (Sales share x 40%)	41.98	47.36	52.69	57.92	63.15
Depreciation (195 x 20%)	39.00	39.00	39.00	39.00	39.00
PBT	37.77	45.92	53.92	61.69	69.40
Tax on Profit @30%	11.33	13.78	16.18	18.51	20.82
Net Profit	26.44	32.14	37.74	43.18	48.58

5. Free Cash Flow (₹ Crore)

Year	0	1	2	3	4	5	6
Sales Share	0.00	104.94	118.40	131.74	144.80	157.87	0.00
Total Royalty	0.00	13.81	13.88	13.88	13.81	13.68	0.00
Production Cost	0.00	-41.98	-47.36	-52.69	-57.92	-63.15	0.00

Initial Outlay	-200.00	0.00	0.00	0.00	0.00	0.00	0.00
Working Capital	-50.00	-5.00	-5.00	-5.00	-5.00	70.00	0.00
Scrap Value	0.00	0.00	0.00	0.00	0.00	5.00	0.00
Tax on Profit	0.00	0.00	-11.33	-13.78	-16.18	-18.51	-20.82
Free Cash Flow	**-250.00**	**71.77**	**68.59**	**74.15**	**79.51**	**164.89**	**-20.82**

6. Remittance of Cash Flows (₹ Crore)

Year	0	1	2	3	4	5	6
Free Cash Flow	-250.00	71.77	68.59	74.15	79.51	164.89	-20.82
50% of Current Year Cash Flow	0.00	35.89	34.29	37.07	39.76	82.45	0.00
Previous year remaining cash flow	0.00	0.00	35.88	34.30	37.08	39.75	82.44
Total Remittance	**-250.00**	**35.88**	**70.17**	**71.37**	**76.84**	**122.20**	**61.62**

NPV of Project under Appraisal

Year	0	1	2	3	4	5	6	7
Total Remittance (₹ Crore)	-250.00	35.88	70.17	71.37	76.84	122.20	61.62	-
Exchange Rate	57.00	57.54	57.82	57.82	57.54	56.99	56.18	-
Remittance ($ mn)	-43.86	6.24	12.14	12.34	13.35	21.44	10.97	-
US Tax @35% ($ mn)	0.00	0.00	2.18	4.25	4.32	4.67	7.50	3.84
Indian Tax ($ mn)	0.00	0.00	1.96	2.38	2.82	3.25	3.71	-
Net Tax ($ mn)	0.00	0.00	0.22	1.87	1.51	1.42	3.79	3.84
Net Cash Flow ($ mn)	-43.86	6.24	11.92	10.47	11.84	20.02	7.18	-3.84
PVF @ 15%	1.000	0.870	0.756	0.658	0.572	0.497	0.432	0.376

Present Value ($ mn)	-43.86	5.43	9.01	6.89	6.77	9.95	3.10	-1.44
Net Present Value ($ mn)							= -4.15	

Decision: Since NPV of the project is negative, Perfect inc. should not invest in the project.

(b) Number of index future to be sold by the Fund Manager is:

$$\frac{1.1 \times 90,00,00,000}{4,300 \times 50} = 4,605$$

Justification of the answer:

Loss in the value of the portfolio if the index falls by 10% is ₹ $\frac{11}{100}$x90 Crore = ₹ 9.90 Crore.

Gain by short covering of index future is: $\frac{0.1 \times 4,300 \times 50 \times 4,605}{1,00,00,000}$ = 9.90 Crore

This justifies the answer. Further, cash is not a part of the portfolio.

6. (a)

Shares	**No. of shares (lakhs) (1)**	**Market Price of Per Share (2)**	**× (2) (₹ lakhs)**	**% to total (w)**	**ß (x)**	**wx**
A Ltd.	3.00	500.00	1500.00	0.30	1.40	0.42
B Ltd.	4.00	750.00	3000.00	0.60	1.20	0.72
C Ltd.	2.00	250.00	500.00	0.10	1.60	0.16
			5000.00	**1.00**		**1.30**

(1) Portfolio beta 1.30

(2) Required Beta 0.91

Let the proportion of risk free securities for target beta 0.91 = p

0.91 = 0 × p + 1.30 (1 – p)

p = 0.30 i.e. 30%

Shares to be disposed off to reduce beta (5000 × 30%) ₹ 1,500 lakh and Risk Free securities to be acquired.

(3) Number of shares of each company to be disposed off

Shares	**% to total (w)**	**Proportionate Amount (₹ lakhs)**	**Market Price Per Share**	**No. of Shares (Lakh)**
A Ltd.	0.30	450.00	500.00	0.90
B Ltd.	0.60	900.00	750.00	1.20
C Ltd.	0.10	150.00	250.00	0.60

(4) Number of Nifty Contract to be sold

$$\frac{(1.30\text{-}0.91) \times 5000 \text{ lakh}}{8{,}125 \times 200} = 120 \text{ contracts}$$

(b) As borrower does not want to pay more than 8.5% p.a., on this loan where the rate of interest is likely to rise beyond this, hence, he has hedge the risk by entering into an agreement to buy interest rate caps with the following parameters:

- Notional Principal: ₹ 40,00,000/-
- Strike rate: 8.5% p.a.
- Reference rate: the rate of interest applicable to this loan
- Calculation and settlement date: 31st March every year
- Duration of the caps: till 31st March 2016
- Premium for caps: negotiable between both the parties

To purchase the caps this borrower is required to pay the premium upfront at the time of buying caps. The payment of such premium will entitle him with right to receive the compensation from the seller of the caps as soon as the rate of interest on this loan rises above 8.5%. The compensation will be at the rate of the difference between the rate of none of the cases the cost of this loan will rise above 8.5% calculated on ₹ 40,00,000/-. This implies that in none of the cases the cost of this loan will rise above 8.5%. This hedging benefit is received at the respective interest due dates at the cost of premium to be paid only once.

The premium to be paid on 1st October 2012 is **30,000/-** (₹ 40,00,000 x 0.75/100). The payment of this premium will entitle the buyer of the caps to receive the compensation from the seller of the caps whereas the buyer will not have obligation. The compensation received by the buyer of caps will be as follows:

On 31st March 2013

The buyer of the caps will receive the compensation at the rate of 1.70% (10.20 - 8.50) to be calculated on ₹ 40,00,000, the amount of compensation will be ₹ 68000/- (40,00,000 x 1.70/100).

On 31st March 2014

The buyer of the caps will receive the compensation at the rate of 3.00% (11.50 – 8.50) to be calculated on ₹ 40,00,000/-, the amount of compensation will be ₹ 120000/- (40,00,000 x 3.00/100).

On 31st March 2015

The buyer of the caps will receive the compensation at the rate of 0.75% (9.25 – 8.50) to be calculated on ₹ 40,00,000/-, the amount of compensation will be ₹ 30,000 (40,00,000 x 0.75/100).

On 31st March 2016

The buyer of the caps will not receive the compensation as the actual rate of interest is 8.25% whereas strike rate of caps is 8.5%. Hence, his interest liability shall not exceed 8.50%.

Thus, by paying once the premium upfront buyer of the caps gets the compensation on the respective interest due dates without any obligations.

MODEL TEST PAPER 6

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

ANSWER TO PART – I CASE SCENARIO BASED MCQS

1 **Option (c)**

2. **Option (a)**

3. **Option (c)**

4. **Option (a)**

5. **Option (a)**

6. **Option (b)**

7. **Option (a)**

8. **Option (c)**

9. **Option (b)**

10. **Option (a)**

11. **Option (b)**

12. **Option (b)**

13. **Option (c)**

14. **Option (c)**

15. **Option (c)**

ANSWERS OF PART – II DESCRIPTIVE QUESTIONS

1. (a) (i) **Forward Cover**

3-month Forward Rate = $\frac{1}{1.8726}$ = ₹ 0.5340/JY

Accordingly, INR required for JY 1,00,00,000 (1,00,00,000 X ₹ 0.5340) = ₹ 53,40,000

(ii) **Option Cover**

To purchase JY 1,00,00,000, XYZ LTD shall enter into a Put Option @ JY 1.8855/INR

	₹
Accordingly, outflow in INR $\left(\dfrac{\text{JY}\,1{,}00{,}00{,}000}{1.8855}\right)$	53,03,633
Premium $\left(\dfrac{\text{INR}\,5303633 \times 0.098}{1.7825}\right)$	2,91,588
	55,95,221

Since outflow of cash is least in case of Forward Cover, same should be opted for.

(b) Required Rate of Return is given by

$$R_j = R_f + \beta\ (R_m\text{-}R_f)$$

For Stock A, $R_j = 9\% + 1.9\ (14\% - 9\%) = 18.50\%$

Stock B, $R_j = 9\% + 0.8\ (14\% - 9\%) = 13.00\%$

Stock C, $R_j = 9\% + 1.4\ (14\% - 9\%) = 16.00\%$

Required Return %	Expected Return %	Valuation	Decision
18.50%	20.00%	Under Valued	Buy
13.00%	13.00%	Correctly Valued	Hold
16.00%	17.00%	Under Valued	Buy

(c) A Unicorn is a privately held start-up company which has achieved a valuation US$ 1 billion. This term was coined by venture capitalist Aileen Lee, first time in 2013. Unicorn, a mythical animal represents the statistical rarity of successful ventures.

A start-up is referred as a Unicorn if it has following features:

(i) A privately held start-up.

(ii) Valuation of start-up reaches US$ 1 Billion.

(iii) Emphasis is on the rarity of success of such start-up.

(iv) Other common features are new ideas, disruptive innovation, consumer focus, high on technology etc.

However, it is important to note that in case the valuation of any start-up slips below US$ 1 billion it can lose its status of 'Unicorn'. Hence a start-up may be Unicorn at one point of time and may not be at another point of time.

2. (a) Working Notes:

Calculation of Forward Exchange Rates

End of Year	₹	₹/LKR
1	$0.37 \times \frac{1.06}{1.052}$	0.373
2	$0.373 \times \frac{1.06}{1.052}$	0.376
3	$0.376 \times \frac{1.06}{1.052}$	0.379
4	$0.379 \times \frac{1.06}{1.052}$	0.382
5.	$0.382 \times \frac{1.06}{1.052}$	0.385

1. Home Currency Approach

Year	Cash Flow Billion LKR	₹ / LKR	Cash flow Billion ₹	PVF @ 8%	PV Billion ₹
1	5	0.373	1.865	0.92593	1.7269
2	6	0.376	2.256	0.85734	1.9342
3	7	0.379	2.653	0.79383	2.1060
4	8	0.382	3.056	0.73503	2.2463
5	9	0.385	3.465	0.68058	2.3582
					10.3716
Less: Investment	25	0.37			9.2500
				NPV	1.1216

2. Foreign Currency Approach

(1 + 0.06) (1+ Risk Premium) = 1.08

1 + Risk Premium = 1.08/1.06 = 1.01887

Therefore, Risk adjusted LKR Rate = 1.01887 × 1.0502 – 1 = 0.07 i.e. 7%

Calculation of NPV

Year	Cash Flow (Billion LKR)	PVF @ 7%	PV (Billion LKR)
1	5	0.93457	4.6729
2	6	0.87344	5.2406
3	7	0.81630	5.7141
4	8	0.76290	6.1032
5	9	0.71299	6.4169
			28.1477
Less: Investment			25.0000
		NPV	3.1477

Thus, Rupee NPV of the Project = ₹ 0.37 × 3.1477 = ₹ 1.1646 billion

Decision: NPV is positive in the approach so, project will worth investment.

(b) **(i)** Present Value of the stock of ABC Ltd. is:-

Vo = $\frac{5(1.04)}{0.105-0.04}$ = ₹ 80/-.

(ii) **(A)** Value of stock under the PE Multiple Approach

Particulars	
Actual Stock Price	₹ 70.00
Return on equity	18%
EPS	₹ 4.50
PE Multiple (1/Return on Equity) = 1/18%	5.56
Market Price per Share	₹ 25.02

Since, Actual Stock Price is higher, hence it is overvalued.

(B) Value of the Stock under the Earnings Growth Model

Particulars	
Actual Stock Price	₹ 70.00
Return on equity	18%
EPS	₹ 4.50
Growth Rate	4%
Market Price per Share [EPS ×(1+g)]/(K_e – g)	₹ 72
= ₹ 4.50x 1.04 / (0.105-0.04)	

Since, Actual Stock Price is lower, hence it is slightly undervalued.

(c) The sustainable growth rate (SGR), concept by Robert C. Higgins, of a firm is the maximum rate of growth in sales that can be achieved, given the firm's profitability, asset utilization, and desired dividend payout and debt (financial leverage) ratios. The sustainable growth rate is a measure of how much a firm can grow without borrowing more money. After the firm has passed this rate, it must borrow funds from another source to facilitate growth. Variables typically include the net profit margin on new and existing revenues; the asset turnover ratio, which is the ratio of sales revenues to total assets; the assets to equity ratio; and the retention rate, which is defined as the fraction of earnings retained in the business.

SGR = ROE x (1- Dividend payment ratio)

Sustainable growth model assume that the business wants to:

1) maintain a target capital structure without issuing new equity;

2) maintain a target dividend payment ratio; and

3) increase sales as rapidly as market conditions allow.

3. (a) Working Notes:

(1) Beta of each Security

$$\beta = \frac{\text{Cov(Security,Market)}}{\text{Varianceof Market}}$$

$$\beta_A = \frac{3.370}{3.100} = 1.087$$

$$\beta_B = \frac{2.800}{3.100} = 0.903$$

(2) Weight of Security A in portfolio = $\frac{2,40,000}{4,00,000}$ = 0.60

Weight of Security B in portfolio = $\frac{1,60,000}{4,00,000}$ = 0.40

(3) Portfolio Beta

0.60 x 1.087 + 0.40 x 0.903 = 1.013

(i) Expected Return

Security A Return = 10% + 1.087(12% - 10%) = 12.17%.

Security B Return = 10% + 0.903(12% - 10%) = 11.81%.

Portfolio Return = 10% + 1.013(12% - 10%) = 12.03%.

(ii) Variance of Returns

$$Cor_{i,j} = \frac{Cov\,(i,j)}{\sigma_i \sigma_j}$$

Accordingly, for Security A

$$1 = \frac{Cov\,(A,A)}{\sigma_A \sigma_A}$$

σ_A^2= 4.800

Accordingly, for Security B

$$1 = \frac{Cov\,(B,B)}{\sigma_B \sigma_B}$$

σ_B^2= 4.250

Accordingly, for Market Return

$$1 = \frac{Cov\,(M,M)}{\sigma_M \sigma_M}$$

σ_M^2 = 3.100

Alternatively, by referring diagonally the given Table these values can identified as follows:

Variance_A = 4.800

Variance_B = 4.250

Variance_M = 3.100

(iii) Variance and Standard Deviation of Portfolio Variance

$\sigma^2_{AB} = w_A^2\sigma_A^2 + w_B^2\sigma_B^2 + 2w_A w_B \text{Cov}_{A,B}$

$= (0.60)^2 (4.800) + (0.40)^2 (4.250) + 2(0.60)(0.40)(4.300)$

Variance = 4.472

Standard Deviation

$\sigma_{AB} = \sqrt{4.472} = 2.115$

(iv) Systematic and Unsystematic Risks of Security A, Security B and Portfolio

Systematic Risk = $\beta^2\sigma_m^2$

Accordingly,

Systematic Risk of Security A = $(1.087)^2$ x 3.10 = 3.663

Systematic Risk of Security B = $(0.903)^2$ x 3.10 = 2.528

Systematic Risk of Portfolio = $(1.013)^2$ x 3.10 = 3.181

Unsystematic Risk = Total Risk – Systematic Risk

Accordingly,

Unsystematic Risk of Security A = 4.80 – 3.663 = 1.137

Unsystematic Risk of Security B = 4.250 – 2.528 = 1.722

Unsystematic Risk of Portfolio = 4.472 – 3.181 = 1.291

(b) Tokenization is a process of converting tangible and intangible assets into blockchain tokens. Digitally representing anything has recently acquired a lot of traction. It can be effective in conventional industries like real estate, artwork etc.

Tokenization and Securitization

Since tokenization of illiquid assets attempts to convert illiquid assets into a product that is liquid and tradable and hence to some extent it resembles the process of Securitization. Hence, following are some similarities between Tokenization and Securitization:

(i) **Liquidity: -** First and foremost both Securitization and Tokenization inject liquidity in the market for the assets which are otherwise illiquid assets.

(ii) **Diversification: -** Both help investors to diversify their portfolio thus managing risk and optimizing returns.

(iii) **Trading: -** Both are tradable hence helps to generate wealth.

(iv) **New Opportunities: -** Both provide opportunities for financial institutions and related agencies to earn income through collection of fees.

OR

The main types of risk associated with investment in CDOs are as follows:

(i) **Default Risk: -** Also called 'credit risk', it emanates from the default of underlying party to the instruments. The prime sufferers of these types of risks are equity or junior tranche in the waterfall.

(ii) **Interest Rate Risk: -** Also called Basis risk and mainly arises due to different basis of interest rates. For example, asset may be based on floating interest rate but the liability may be based on fixed interest rates. Though this type of risk is quite difficult to manage fully but commonly used techniques such as swaps, caps, floors, collars etc. can be used to mitigate the interest rate risk.

(iii) **Liquidity Risk: -** Another major type of risk by which CDOs are affected is liquidity risks as there may be mismatch in coupon receipts and payments.

(iv) **Prepayment Risk: -** This risk results from unscheduled or unexpected repayment of principal amount underlying the security. Generally, this risk arises in case assets are subject to fixed rate of interest and the debtors have a call option. Since, in case of falling interest rates they may pay back the money.

(v) **Reinvestment Risk: -** This risk is generic in nature as the CDO manager may not find adequate opportunity to reinvest the proceeds when allowed for substitutions.

(vi) **Foreign Exchange Risk: -** Sometimes CDOs are comprised of debts and loans from countries other than the country of issue. In such a case, in addition to above mentioned risks, CDOs are also subject to the foreign exchange rate risk.

4. (a) (i) Calculation of initial outlay:-

		₹ (million)
a.	Face value	600
	Add:-Call premium	24
	Cost of calling old bonds	624
b.	Gross proceed of new issue	600
	Less: Issue costs	12
	Net proceeds of new issue	588
c.	Tax savings on call premium	
	and unamortized cost 0.30 (24+18)	12.60

∴ Initial outlay = ₹ 624 million – ₹ 588 million – ₹ 12.60 million = ₹ 23.40 million

(ii) Calculation of net present value of refunding the bond:-

Saving in annual interest expenses	₹ (million)
[600 x (0.12 – 0.10)]	12.00
Less: Tax saving on interest and amortization	
0.30 x [12 + (18-12)/6]	3.90
Annual net cash saving	8.10
PVIFA (7%, 6 years)	4.766
∴ Present value of net annual cash saving	₹ 38.6046 million
Less: Initial outlay	₹ 23.40 million
Net present value of refunding the bond	₹ 15.2046 million

Decision: The bonds should be refunded

(b) Total premium paid on purchasing a Call and Put option

= (₹ 60 per share × 100) + (₹ 10 per share × 100).

= ₹ 6,000 + ₹ 1000 = ₹ 7,000

(i) In this case, Mr. A exercises neither the Call option nor the Put option as both will result in a loss for him.

Accordingly, the Ending value = - ₹ 7,000 + zero gain = - ₹ 7,000

i.e Net loss = ₹ 7000

(ii) Since the price of the stock is below the exercise price of the Call, the Call will not be exercised. Only Put is valuable and hence is exercised. Accordingly,

Total Premium paid = ₹ 7,000

Ending value = – ₹ 7000 + ₹ [(900 – 700) × 100] = – ₹ 7000 + ₹ 20,000 = ₹ 13,000

∴ Net gain = ₹ 13,000

(iii) Since the price of stock rises above the exercise price of Put, the Put will not be exercised. Only Call is valuable and hence is exercised. Accordingly,

Total Premium paid = ₹ 7,000

Ending value = - ₹ 7000 + ₹ [(1300-1100) × 100]

= - ₹ 7000 + ₹ 20000

Net gain = ₹ 13,000

(c) VAR can be applied in the following areas:

(a) to measure the maximum possible loss on any portfolio or a trading position.

(b) as a benchmark for performance measurement of any operation or trading.

(c) to fix limits for individuals dealing in front office of a treasury department.

(d) to enable the management to decide the trading strategies.

(e) as a tool for Asset and Liability Management especially in banks.

5. (a) Determination of forecasted Free Cash Flow to the Firm (FCFF)

(₹ in crores)

	Yr. 1	**Yr. 2**	**Yr. 3**	**Terminal Year**
Revenue	18000.00	21600.00	25920.00	27993.60
COGS	7200.00	8640.00	10368.00	11197.44
Operating Expenses	3960.00*	4752.00	5702.40	6158.59
Depreciation	1440	1728	2073.60	2239.49
EBIT	5400	6480	7776	8398.08
Tax @30%	1620	1944	2332.80	2519.42
EAT	3780	4536	5443.20	5878.66
Capital Exp. – Dep.	345	396.76	456.26	-
∆ Working Capital	750	900	1080	518.40
Free Cash Flow (FCF)	2685	3239.24	3906.94	5360.26

* Excluding Depreciation.

Calculation of WACC

= 60% x 17.53% + 40% x 16% (1-0.30)

= 15%

Present Value (PV) of FCFF during the explicit forecast period is:

FCFF (₹ in crores)	**PVF @ 15%**	**PV (₹ in crores)**
2685.00	0.8696	2334.88
3239.24	0.7561	2449.19
3906.94	0.6575	2568.81
		7352.88

PV of the terminal, value is:

$$\frac{5360.26}{0.15 - 0.08} \times \frac{1}{(1.15)^3} = ₹\ 76575.14 \text{ Crore} \times 0.6575 = ₹\ 50348.16$$

Crore

The value of the firm is:

₹ 7352.88 Crores + ₹ 50348.16 Crores = ₹ 57701.04 Crores

(b) (i) Current Portfolio Beta

Current Beta for share portfolio = 1.6

Beta for cash = 0

Current portfolio beta = 170/200 x 1.6 + 0 x 30/200 = 1.36

(ii) Portfolio beta after 3 months:

Beta for portfolio of shares = $\frac{\text{Change in value of portfolio of share}}{\text{Change in value of market portfolio (Index)}}$

$$1.6 = \frac{0.032}{\text{Change in value of market portfolio (Index)}}$$

Change in value of market portfolio (Index) = (0.032 / 1.6) x 100 = 2%

Position taken on 100 lakh Nifty futures : Long

Value of index after 3 months = ₹ 200 lakh x (1.00 - 0.02)

= ₹ 196 lakh

Mark-to-market paid = ₹ 4 lakh

Cash balance after payment of mark-to-market = ₹ 26 lakh.

Value of portfolio after 3 months = ₹170 lakh x (1 - 0.032) + ₹26 lakh

= ₹190.56 lakh

Change in value of portfolio = $\frac{200\text{lakh} - 190.56\text{lakh}}{200 \text{ lakh}}$ = 4.72%

Portfolio beta = 0.0472/0.02 = 2.36

6. (a) (i) **Semi-annual fixed payment**

= (N) (AIC) (Period)

Where N = Notional Principal amount = ₹ 10,00,000

AIC = All-in-cost = 8% = 0.08

$= 10,00,000 \times 0.08 \left(\frac{180}{360}\right)$

= 10,00,000 × 0.08 (0.50)

= 10,00,000 × 0.04 = ₹ 40,000/-

(ii) **Floating Rate Payment**

$= \text{N (MIBOR)} \left(\frac{dt}{360}\right)$

$= 10,00,000 \times 0.06 \times \frac{181}{360}$

= 10,00,000 × 0.06 (0.503) or 10,00,000 × 0.06 (0.502777)

= 10,00,000 × 0.03018 or 10,00,000 × 0.030167 = ₹ 30,180 or 30,167

(iii) **Net Amount**

= (i) – (ii)

= ₹ 40,000 – ₹ 30,180 = ₹ 9820

or = ₹ 40,000 – ₹ 30,167 = ₹ 9,833

(b) (i) **Statement Showing the Net Present Value of Project M**

Year end	*Cash Flow (₹)* (a)	*C.E.* (b)	*Adjusted Cash flow (₹)* (c) = (a) × (b)	*Present value factor at 6%* (d)	*Total Present value (₹)* (e) = (c) × (d)
1	9,00,000	0.8	7,20,000	0.943	6,78,960
2	10,00,000	0.7	7,00,000	0.890	6,23,000
3	10,00,000	0.5	5,00,000	0.840	4,20,000
					17,21,960

Less: Initial Investment			17,00,000
Net Present Value			21,960

Statement Showing the Net Present Value of Project N

Year end	*Cash Flow (₹) (a)*	*C.E. (b)*	*Adjusted Cash flow (₹) (c) = (a) × (b)*	*Present value factor (d)*	*Total Present value (₹) (e) = (c) × (d)*
1	9,00,000	0.9	8,10,000	0.943	7,63,830
2	9,00,000	0.8	7,20,000	0.890	6,40,800
3	10,00,000	0.7	7,00,000	0.840	5,88,000
					19,92,630
Less: Initial Investment					16,50,000
Net Present Value					3,42,630

Decision: Since the net present value of Project N is higher, so the project N should be accepted.

(ii) Since Certainty - Equivalent (C.E.) Co-efficient of Project M (2.0) is lower than Project N (2.4), Project M is riskier than Project N and as "higher the riskiness of a cash flow, the lower will be the CE factor". Thus if risk adjusted discount rate (RADR) method is used, Project M would be analysed with a higher rate.

MODEL TEST PAPER - 7

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

ANSWER TO PART – I CASE SCENARIO BASED MCQS

1. Option (b)
2. Option (c)
3 Option (c)
4. Option (c)
5. Option (d)
6. Option (d)
7. Option (c)
8. Option (b)
9. Option (b)
10. Option (c)
11. Option (b)
12. Option (d)
13. Option (b)
14. Option (b)
15. Option (a)

ANSWERS OF PART – II DESCRIPTIVE QUESTIONS

1. (a) (i) **Expected Share Price**

= ₹ 600 X 0.05 + ₹ 700 X 0.20 + ₹ 800 X 0.50 + ₹ 900 X 0.10 +
₹ 950 X 0.15

= ₹ 30 + ₹ 140 + ₹ 400 + ₹ 90 + ₹ 142.50 = ₹ 802.50

(ii) **Value of Call Option**

= ₹ 750 - ₹ 750 = Nil

(iii) **If the option is held till maturity the expected Value of Call Option**

Expected price (X)	Value of call (C)	Probability (P)	CP
₹ 600	0	0.05	0
₹ 700	0	0.20	0
₹ 800	₹ 50	0.50	₹ 25
₹ 900	₹ 150	0.10	₹ 15
₹ 950	₹ 200	0.15	₹ 30
Total			₹ 70

* If the stock price goes below ₹ 750, option is not exercised at all.

(b) (i) Cost of Capital

Retained earnings (45%) ₹ 10 per share

Dividend (55%) ₹ 12.22 per share

EPS (100%) ₹ 22.22 per share

P/E Ratio 10 times

Market price ₹ 22.22 $\times$10 = ₹ 222.20

Cost of equity capital

$$= \left(\frac{\text{Div}}{\text{Price}} \times 100\right) + \text{Growth \%} = \frac{12.22}{222.20} \times 100 + 10\% = 15.50\%$$

(ii) Market Price = $\left(\frac{\text{Dividend}}{\text{Cost of Capital(\%) - Growth Rate(\%)}}\right)$

$$= \frac{₹\,12.22}{(15.50 - 12.00)\%} = ₹\ 349.14 \text{ per share}$$

(c) Need for succession planning in business is explained below:

❖ **Risk mitigation** – If existing leader quits, then searches can take six-nine months for suitable candidate to close. Keeping an organization without leader can invite disruption, uncertainty, conflict and endangers future competitiveness.

❖ **Cause removal** – If the existing leader is culpable of gross negligence, fraud, willful misconduct, or material breach while discharging duties and has been barred from undertaking further activities by court, arbitral tribunal, management, stakeholders or any other agency.

- **Talent pipeline** – Succession planning keep employees motivated and determined as it can help them obtaining more visibility around career paths expected, which would help in retaining the knowledge bank created by company over a period of time and leverage upon the same.
- **Conflict Resolution Mechanism** – This planning is very helpful in promoting open and transparent communication and settlement of conflicts.
- **Aligning** – In family owned business succession planning helps to align with the culture, vision, direction and values of the business.

2. (a) On January 28, 2023, the importer customer requested to remit SGD 25 lakhs.

To consider sell rate for the bank:

US $=		₹ 80.97
Pound 1	=	US$ 1.7775
Pound 1	=	SGD 3.1380
Therefore, SGD 1	=	$\frac{\text{Rs. } 80.97 * 1.7775}{\text{SGD } 2.1380}$
SGD 1	=	₹ 67.3172
Add: Exchange margin (0.125%)		₹ 0.0841
		₹ 67.4013

On February 4, 2023 the rates are

US $=		₹ 80.90
Pound 1	=	US$ 1.7850
Pound 1	=	SGD 2.1575
Therefore, SGD 1	=	$\frac{\text{Rs. } 80.90 * 1.7850}{\text{SGD } 2.1575}$
SGD 1	=	₹ 66.9323
Add: Exchange margin (0.125%)		₹ 0.0837

₹ 67.0160

Hence, Gain to the importer

= SGD 25,00,000 (₹ 67.4013 – ₹ 67.0160) = ₹ 9,63,250

(b) **(i)** Dirty Price

= Clean Price + Interest Accrued

$= 99.42 + 100 \times \frac{10}{100} \times \frac{272}{360} = 106.98$

(ii) First Leg (Start Proceed)

$= \text{Nominal Value x } \frac{\text{Dirty Price}}{100} \times \frac{100 - \text{Initial Margin}}{100}$

$= ₹8,00,00,000 \text{ x } \frac{106.98}{100} \times \frac{100-3}{100} = ₹\ 8,30,16,480$

Second Leg (Repayment at Maturity) = Start Proceed x $(1 + \text{Repo rate} \times \frac{\text{No. of days}}{360})$

$= ₹\ 8,30,16,480 \text{ x } (1 + 0.0565 \times \frac{14}{360}) = ₹\ 8,31,98,885.65$ (Approx.)

(c) Some of the parameters to identity the currency risk are as follows:

(i) **Government Action:** The Government action of any country has visual impact in its currency. For example, the UK Govt. decision to divorce from European Union i.e. Brexit brought the pound to its lowest since 1980's.

(ii) **Nominal Interest Rate:** As per interest rate parity (IRP) the currency exchange rate depends on the nominal interest of that country.

(iii) **Inflation Rate:** Purchasing power parity theory discussed in later chapters impact the value of currency.

(iv) **Natural Calamities:** Any natural calamity can have negative impact.

(v) **War, Coup, Rebellion etc.:** All these actions can have far reaching impact on currency's exchange rates.

(vi) **Change of Government:** The change of government and its attitude towards foreign investment also helps to identify the currency risk.

Ways to minimize such risk are:-

(1) Money Market Hedging.

(2) Currency Options.

(3) Forward Contract.

(4) Make Invoice in Home Currency.

3. **(a)** **(i)** Let the weight of stocks of Economy A be expressed as w, then

$(1- w) \times 20\% + w \times 30\% = 21\%$

i.e. w = 0.1 or 10%.

(ii) Variance of portfolio shall be:

$(0.9)^2 (0.16)^2 + (0.1)^2 (0.30)^2 + 2(0.9) (0.1) (0.16) (0.30) (0.30) = 0.02423$

Standard deviation is $(0.02423)^{½}$ = 0.15565 or 15.56%.

(iii) The Sharpe ratio will improve by approximately 0.09, as shown below:

$$\text{Sharpe Ratio} = \frac{\text{Expected Return - Risk Free Rate of Return}}{\text{Standard Deviation}}$$

Investment in stock of developed countries only: $\frac{20-6}{16} = 0.875$

Investment with inclusion of stocks of Economy A: $\frac{21-6}{15.56} = 0.964$

(b) Investment committed to each security would be:-

	X (₹)	**Y (₹)**	**Z (₹)**	**Total (₹)**
Portfolio A	3,00,000	4,00,000	3,00,000	10,00,000
Portfolio B	1,20,000	3,00,000	1,80,000	6,00,000
Combined Portfolio	4,20,000	7,00,000	4,80,000	16,00,000
∴ Stock weights	0.2625 Or 0.26	0.4375 Or 0.44	0.3000 Or 0.30	

(c) Blockchain, sometimes referred to as Distributed Ledger Technology (DLT) is a shared, peer-to-peer, and decentralized open ledger of transactions system with no trusted third parties in between. This ledger database has every entry as permanent as it is an append-only database which cannot be changed or altered. All transactions are fully irreversible with any change in the transaction being recorded as a new transaction.

Some of the risk associated with the use blockchain technology are as follows:

(i) With the use of blockchain, organizations need to consider risks with a wider perspective as different members of a particular blockchain may have different risk appetite/risk tolerances that may further lead to conflict when monitoring controls are designed for a blockchain. There may be questions about who is responsible for managing risks if no one party is in-charge, and how proper accountability is to be achieved in a blockchain.

(ii) The reliability of financial transactions is dependent on the underlying technology and if this underlying consensus mechanism has been tampered with, it could render the financial information stored in the ledger to be inaccurate and unreliable.

(iii) In the absence of any central authority to administer and enforce protocol amendments, there could be a challenge in the development and maintenance of process control activities and in such case, users of public blockchains find difficult to obtain an understanding of the general IT controls implemented and the effectiveness of these controls.

(iv) As blockchain involves humongous data getting updated frequently, risk related to information overload could potentially challenge the level of monitoring required. Furthermore, to find competent people to design and perform effective monitoring controls may again prove to be difficult.

OR

Financial Measures: - There are some financial measures that help in evaluation of performance of any Mutual Fund which are as follows:

(a) Expense Ratio: - Discussed in earlier section, it ultimately impacts the return of a Mutual Fund Scheme.

(b) Sharpe Ratio: - As discussed in the chapter on Portfolio Management, this ratio measures the Mutual Fund's performance measured against the total risk (both systematic and unsystematic) taken.

(c) Treynor Ratio: - As discussed in the chapter on Portfolio Management, beta measures the volatility of return of a security vis-à-vis to the market, in mutual funds the Beta of a mutual fund measures volatility of a fund's return to return from its Benchmark. Treynor Ratio measures performance of a mutual fund against the systematic risk it has taken.

(d) Sortino Ratio: - A variation of Sharpe Ratio that considers and uses downside deviation instead of total standard deviation in denominator.

4. (a)

Particulars of Securities	**Cost ₹**	**Market Price**	**Capital gain**	**Dividend/ Interest**
G Ltd.	20,000	19,600	–400	1,450
S Ltd.	30,000	30,400	400	1,000
B Ltd.	28,000	32,000	4,000	1,400
GOI Bonds	72,000	71,980	–20	5,060
Total	1,50,000	1,53,980	3,980	8,910

(i) Risk free return [Return on Govt. Security (GOI Bond)]

$$\frac{5{,}060+(72{,}000-71{,}980)}{72{,}000} = 7\%$$

(ii) Weighted Average of Beta

0.6 x 19,600/1,53,980 + 0.8 x 30,400/1,53,980 + 0.60 x 32,000/1,53,980 + 0.01 x 71,980/1,53,980

= 0.076 + 0.158 + 0.125 + 0.005 = 0.364

Average Return on Portfolio

(8,910+3,980) / 1,50,000 x 100% = 8.593%

Market Return

$8.593\% = 7\% + (R_m - 7\%) \times 0.364$

$R_m = 11.376\%$

Expected Rate of Return for each security is

Rate of Return $= Rf + \beta\ (Rm - Rf)$

G Ltd. $= 7.000\% + 0.6\ (11.376\% - 7.000\%) = 9.626\%$

S Ltd. $= 7.000\% + 0.8\ (11.376\% - 7.000\%) = 10.501\%$

B Ltd. $= 7.000\% + 0.6\ (11.376\% - 7.000\%) = 9.626\%$

(b) **(i)** Benchmark Return = (42 crore - 40 crore) / 40 crore x 100% = 5%

(ii) **(1)** **If return is 29%**

	₹
Fixed fee (A) 0.10% of ₹ 40 crore	4,00,000
New Fund Value (1.29 x ₹ 40 crore)	51.60 crore
Excess Value of best achieved (51.60 crore – 42.00 crore)	9.60 crore
Incentive Fee (2% of 9.60 crores) (B)	19,20,000
Total Fee (A)+(B)	23,20,000

(2) **If return is 4.5%**

	₹
Fixed (A) 0.10% of ₹ 40 crore	4,00,000
New Fund Value (1.045 x ₹ 40 crore)	41.80 crore
Excess Value of best achieved (41.80 crore – 42.00 crore)	(₹ 0.20 crore)
Incentive Fee (as does not exceed best achieved) (B)	Nil
Total Fee (A)+(B)	4,00,000

(c) Corporate level strategy fundamentally is concerned with selection of businesses in which a company should compete and with the development and coordination of that portfolio of businesses.

Corporate level strategy should be able to answer three basic questions:

Suitability	Whether the strategy would work for the accomplishment of common objective of the company.
Feasibility	Determines the kind and number of resources required to formulate and implement the strategy.
Acceptability	It is concerned with the stakeholders' satisfaction and can be financial and non-financial.

5. **(a)** Calculation of Purchase Consideration

	£
Issue of Share 17,50,000 x £1.50	26,25,000
External Liabilities settled	25,00,000
13% Debentures	15,00,000
	66,25,000
Less: Realization of Debtors and Inventories	10,00,000
Cash	2,50,000
	53,75,000

Net Present Value = PV of Cash Inflow + PV of Demerger of L plc – Cash Outflow

= £ 25,00,000 PVAF(16%,6) + £ 10,00,000 PVF(16%, 6) – £ 53,75,000

= £ 25,00,000 x 3.684 + £ 10,00,000 x 0.410 – £ 53,75,000

= £ 92,10,000 + £ 4,10,000 – £ 53,75,000

= £ 42,45,000

Since NPV of the decision is positive it is advantageous to acquire L plc.

(b) **<u>Plan – D</u>**

Unit acquired = $\frac{2,00,000}{38.20}$ = 5235.60

Date	Units held	Dividend		Re-investment Rate	New Units	Total Units
		%	Amount			
01.04.2018						5235.60
30.09.2018	5235.60	10	5235.60	39.10	133.90	5369.50
31.03.2020	5369.50	15	8054.25	44.20	182.22	5551.72
15.09.2021	5551.72	13	7217.24	45.05	160.20	5711.92
27.03.2022	5711.92	16	9139.07	44.80	204.00	5915.92
31.03.2023	Maturity Value	(₹ 40.40 X 5915.92)				₹ 2,39,003.17
	Less: Cost of Acquisition					₹ 2,00,000.00
	Total Gain					₹ 39,003.17

∴ Approximate Effective Yield = $\frac{₹39{,}003.17}{₹2{,}00{,}000} \times \frac{1}{5} \times 100$ = 3.90%

Now more accurate effective yield can be computed by using the IRR method as follows:

NPV at 4% = - ₹ 2,00,000 + ₹ 1,96,436.71 = - ₹ 3,563.29

NPV at 2% = - ₹ 2,00,000 + ₹ 2,16,465.17 = ₹ 16,465.17

IRR= $LR + \frac{NPV\ at\ LR}{NPV\ at\ LR - NPV\ at\ HR}(HR - LR)$ = $2\% + \frac{16465.17}{16465.17 - 3563.29}(4\% - 2\%)$

= 3.64%

Plan – B

Date	Particulars	Calculation Working	No. of Units	NAV (₹)
01.04.2018	Investment	₹ 2,00,000/35.60 =	5617.98	35.60
30.06.2019	Bonus	5617.98/5 =	1123.60	36.25
			6741.58	
30.10.2021	"	6741.58/8 =	842.70	38.30
			7584.28	
11.04.2022	"	7584.28/10 =	758.43	38.90
			8342.71	

31.03.2023	Maturity Value Less: Investment Gain	8342.71 x ₹ 39.70 =		3,31,205.59 <u>2,00,000.00</u> <u>1,31,205.59</u>

∴ Approximate Effective Yield = $\frac{1,31,205.59}{2,00,000} x \frac{1}{5} x100 = 13.12\%$

Now more accurate effective yield can be computed by using the IRR method as follows:

NPV at 13% = - ₹ 2,00,000 + ₹ 1,79,778.39 = - ₹ 20,221.61

NPV at 8% = - ₹ 2,00,000 + ₹ 2,25,418.52 = ₹ 25,418.52

$$IRR = LR + \frac{NPV\ at\ LR}{NPV\ at\ LR - NPV\ at\ HR}(HR - LR) =$$

$$8\% + \frac{25418.52}{25418.52 - (-20221.61)}(13\% - 8\%)$$

= 10.78%

6. (a) Working Note :

Year 1	Running Cost	₹ 8,000 x 0.917	= (₹ 7,336)
	Savings	₹ 24,000 x 0.917	= ₹ 22,008
Year 2	Running Cost	₹ 10,000 x 0.842	= (₹ 8,420)
	Savings	₹ 28,000 x 0.842	<u>= ₹ 23,576</u>
			₹ 29,828
Year 0	*Less:* P.V. of Cash Outflow	₹ 20,000 x 1	<u>₹ 20,000</u>
		NPV	<u>₹ 9,828</u>

(i) Sensitivity Analysis (by making NPV Zero)

(1) Increase of Plant Value by ₹ 9,828

$\therefore \frac{9,828}{20,000} x\ 100 = 49.14\%$

(2) Increase of Running Cost by ₹ 9,828

$$\frac{9828}{7336+8420}=\frac{9828}{15756}\times 100 = 62.38\%$$

(3) Fall in Saving by ₹ 9,828

$$\frac{9,828}{22,008+23,576}=\frac{9,828}{45,584}\times 100 = 21.56\%$$

Hence, savings factor is the most sensitive to affect the acceptability of the project as in comparison of other two factors a slight % change in this fact shall more affect the NPV than others.

(ii) Sensitivity Analysis if there is a variation of 10% in the factors.

(1) If the initial project cost is varied adversely by say 10%.

NPV (Revised) (₹ 9,828 – ₹ 2,000) = ₹ 7,828

$$\text{Change in NPV} = \frac{₹\,9,828 - ₹\,7,828}{₹\,9,828} = 20.35\%$$

(2) If Annual Running Cost is varied by say 10%.

NPV (Revised) (₹ 9828 – ₹ 800 X 0.917 – ₹ 1000 X 0.842)

= ₹ 9,828 – ₹ 733.60 – ₹ 842 = ₹ 8,252.40

$$\text{Change in NPV} = \frac{₹\,9,828 - ₹\,8252.40}{₹\,9,828} = 16.03\%$$

(3) If Saving is varied by say 10%.

NPV (Revised) (₹ 9,828 – ₹ 2400 X 0.917 – ₹ 2800 X 0.842)

= ₹ 9,828 – ₹ 2,200.80 – ₹ 2,357.60 = ₹ 5,269.60

$$\text{Change in NPV } \frac{₹\,9828 - ₹\,5269.60}{₹\,9828}\times 100\% = 46.38\%$$

Hence, savings factor is the most sensitive to affect the acceptability of the project.

(b)

Day	Principal (₹)	MIBOR (%)	Interest (₹)
Tuesday	20,00,00,000	7.75	42,466
Wednesday	20,00,42,466	8.15	44,667
Thursday	20,00,87,133	8.12	44,513
Friday	20,01,31,646	7.95	43,590
Saturday & Sunday (*)	20,01,75,236	7.98	87,529
Monday	20,02,62,765	8.15	44,716
Total Interest @ Floating			3,07,481
Less: Net Received			634
Expected Interest @ fixed			3,06,847
Thus, Fixed Rate of Interest			0.08
Shall be approx.			8%

(*) i.e. interest for two days.

MODEL TEST PAPER 8

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

ANSWER TO PART – I CASE SCENARIO BASED MCQS

1. **Option (d)**

2. **Option (b)**

3 **Option (b)**

4. **Option (a)**

5. **Option (a)**

6. **Option (b)**

7. **Option (d)**

8. **Option (a)**

9. **Option (c)**

10. **Option (d)**

11. **Option (b)**

12. **Option (a)**

13. **Option (d)**

14. **Option (b)**

15. **Option (d)**

ANSWERS OF PART – II DESCRIPTIVE QUESTIONS

1. **(a)**

Particulars	Amount (₹)
Amount available in bank account	7,00,000
Minimum balance to be kept	1,000
Available amount which can be used for potential exposure in market for 4 days	6,99,000
Maximum Loss for 4 days at 99% level	6,99,000

Maximum Loss for 1 day at 99 % level = Maximum Loss for 4 days / √No. of days = 699000/ √4	3,49,500
Z Score at 99% Level	2.33
Volatility in terms of Rupees (Maximum Loss/ Z Score at 99% level) = 349500/ 2.33	1,50,000
Maximum Possible Exposure (Volatility in Rupees/Std Deviation) = 150000/.015	1,00,00,000

(b) D_0 = ₹ 4

D_1 = ₹ 4 (1.20) = ₹ 4.80

D_2 = ₹ 4 $(1.20)^2$ = ₹ 5.76

D_3 = ₹ 4 $(1.20)^2$ (1.10) = ₹ 6.34

$$P = \frac{D_1}{(1+k_e)} + \frac{D_2}{(1+k_e)^2} + \frac{TV}{(1+k_e)^2}$$

$$TV = \frac{D_3}{k_e - g} \qquad = \frac{6.34}{0.15-0.10} = 126.80$$

$$P = \frac{4.80}{(1+0.15)} + \frac{5.76}{(1+0.15)^2} + \frac{126.80}{(1+0.15)^2}$$

= 4.80 x 0.8696 + 5.76 x 0.7561 + 126.80 x 0.7561

= 4.17 + 4.36 +95.87

= 104.40

(c) A Unicorn is a privately held start-up company which has achieved a valuation US$ 1 billion. This term was coined by venture capitalist Aileen Lee, first time in 2013. Unicorn, a mythical animal represents the statistical rarity of successful ventures.

A start-up is referred as a Unicorn if it has following features:

(i) A privately held start-up.

(ii) Valuation of start-up reaches US$ 1 Billion.

(iii) Emphasis is on the rarity of success of such start-up.

(iv) Other common features are new ideas, disruptive innovation, consumer focus, high on technology etc.

However, it is important to note that in case the valuation of any start-up slips below US$ 1 billion it can lose its status of 'Unicorn'. Hence a start-up may be Unicorn at one point of time and may not be at another point of time.

In September 2011, InMobi, an ad-tech startup, became the first Unicorn of India. SoftBank invested US$ 200 million in InMobi valuing the mobile advertising company at over US$ 1 billion, making it India's first unicorn. InMobi was founded in 2007 and took four years to achieve the Unicorn status in 2011 In 2018, Udaan, a B2B e-commerce marketplace, became the fastest growing startup by becoming a Unicorn in just over two years' time.

2. (a) (i) Rupee – Dollar Selling Rate: = ₹ 82.85

Dollar – Hong Kong Dollar Buying Rate: = H.K.$ 7.8880

Hong Kong Dollar (Selling) Cross Rate: = ₹ 82.85 / 7.8880

= ₹10.5033

(ii) Profit / Loss to the Bank

Amount received from customer (HK$ 10 million×10.55)	₹ 10,55,00,000
Amount paid on cover deal (HK$ 10 million× ₹ 10.5033)	₹ 10,50,33,000
Profit to Bank	₹ 4,67,000

(iii) To some extent I agree with views of Internal Auditor as the gain on the same transaction is bit lesser keeping in view the amount involved.

(b) Decision Tree showing pay off

Year 0	Year 1	Pay off
	260	0
200		
	120	160 - 120 = 40

First of all we shall calculate probability of high demand (P) using risk neutral method as follows:

8% = p x 30% + (1-p) x (-40%)

0.08 = 0.30 p - 0.40 + 0.40p

$p = \frac{0.48}{0.70} = 0.686$

The value of abandonment option will be as follows:

Expected Payoff at Year 1

= p x 0 + [(1-p) x 40]

= 0.686 x 0 + [0.314 x 40]

= ₹ 12.56 crore

Since expected pay off at year 1 is ₹ 12.56 crore. Present value of expected pay off will be:

$\frac{12.56}{1.08}$ = ₹ 11.63 crore.

This is the value of abandonment option (Put Option).

(c) Some of the Qualitative factors that need to be taken into account in addition to Quantitative Factors are as follows: -

(1) *Quality of Portfolio:* Quality of stocks and securities in the portfolio of the Mutual Funds is an important qualitative parameter. The reason is that the quality of the portfolio plays a big role in achieving superior returns. The qualitative characteristic of portfolio of Equity Mutual Fund involves allocation of funds in top Blue-chip companies, large companies and how diversified is the portfolio. The style followed can be growth, value or blend of the same. In Debt Funds, the quality of portfolio is measured on the basis of credit quality, average maturity and modified duration of the fixed asset securities.

Not only that it is necessary that Mutual Fund should hold good quality stocks or securities, but it is also necessary the investment should be as per the objective of the Fund. Under normal circumstances, the fund having lower Portfolio Turnover ratio is considered to be better.

(2) *Track record and competence of Fund Manager:* - Since Fund Manager decides about the selection of securities and takes

investment decisions, his/her competence and conviction plays a very big role. The competence of a Fund Manager is assessed from his/her knowledge and ability to manage in addition to past performance.

(3) *Credibility of Fund House Team:* - Team of Fund House also plays a big role towards the investors' interest. In addition to investment decisions, there are some other administrative tasks also such as redemption of units, crediting of dividend, providing adequate information etc. which play a crucial role in qualitative assessment of any mutual fund house.

3. **(a)** **(i)** Mr. A's position in the two securities are +1.50 in security X and -0.5 in security Y. Hence the portfolio sensitivities to the two factors:-

λ_1 =1.50 x 0.80 + (-0.50 x 1.50) = 0.45

λ_2 = 1.50 x 0.60 + (-0.50 x 1.20) = 0.30

(ii) Mr. A's revised position:-

Security X ₹ 9,00,000 / ₹ 3,00,000 = 3

Security Y - ₹ 3,00,000 / ₹ 3,00,000 = -1

Risk free asset - ₹ 300000 / ₹ 300000 = -1

λ_1 = 3.0 x 0.80 + (-1 x 1.50) + (- 1 x 0) = 0.90

λ_2 = 3.0 x 0.60 + (-1 x 1.20) + (-1 x 0) = 0.60

(iii) Expected Return = Risk Free Rate of Return + Risk Premium for each sensitivity factor

Accordingly

15 = 10 + 0.80 λ_1 + 0.60 λ_2

20 = 10 + 1.50 λ_1 + 1.20 λ_2

On solving equation, the value of λ_1 = 0

Yes, Mr. D is correct in his observation.

(b) To compute the value of A Ltd. first, we shall calculate WACC of the company. Since its share is not trading in the market, we shall use proxy beta to calculate the cost of equity. Since the unlevered beta of the industry is 1.8 the levered beta of the company will be:

1.8[1+(1-0.3)*40/60)] = 2.64

The Cost of equity in accordance with CAPM = r (f) + β (Rm – Rf)

= 5% + 2.64 (11% - 5%) = 20.84%

The WACC = Cost of Equity + Cost of Debt

= 20.84 (60/100) + 12.0 (1-0.3) (40/100) = 15.864

Finally, the future cash flows can be discounted at the WACC obtained above as under –

	Year 1	Year 2	Year 3
Future Cash flows	10	12	15
Discount factor	0.863	0.745	0.643
PVs of cash flows	8.63	8.94	9.645
Value of X Pvt. Ltd. (₹ Crore)			27.215

(c) The various types of Swaps are as follows:

(i) *Plain Vanilla Swap:* Also called Generic Swap or Coupon Swap and it involves the exchange of a fixed rate loan to a floating rate loan over a period of time and that too on notional principal. Floating rate basis can be LIBOR, MIBOR, Prime Lending Rate etc.

For example, Fixed interest payments on a generic swap are calculated assuming each month has 30 days and the quoted interest rate is based on a 360-day year. Given an All-In-Cost of the swap, the semi-annual fixed-rate payment would be:

(N)(AIC)(180/360),

Where,

N denotes the notional principal amount of the agreement.

AIC denotes the fixed rate

Then, the floating-rate receipt is determined by the formula:

(N)(R)(dt/360)

Where,

dt denotes the number of days since the last settlement date

R denotes the reference rate such as LIBOR, MIBOR etc.

(ii) *Basis Rate Swap:* Also, called Non-Generic Swap. Similar to plain vanilla swap with the difference that payments are based on the difference between two different variable rates. For example, one rate may be 1 month LIBOR and other may be 3-month LIBOR. In other words, two legs of swap are floating but measured against different benchmarks.

(iii) *Asset Swap:* Like plain vanilla swaps with the difference that it is the exchange fixed rate investments such as bonds which pay a guaranteed coupon rate with floating rate investments such as an index.

(iv) *Amortising Swap:* An interest rate swap in which the notional principal for the interest payments declines during the life of the swap. They are particularly useful for borrowers who have issued redeemable bonds or debentures. It enables them to do interest rate risk hedging attached with redemption profile of bonds or debentures.

OR

There are four principles of an Active Portfolio Strategy (APS). These are:

(i) *Market Timing:* This involves departing from the normal i.e., strategy for long run asset mix to reflect assessment of the prospect of various assets in the near future. Market timing is based on an explicit or implicit forecast of general market movement. In most cases investors may go largely by their market sense. Those who reveal the fluctuation in the market may be tempted to play the game of market timing but few will succeed in this game. Further an investment manager has to forecast the market correctly and 75% of the time he is only able to break even after taking into account the cost of errors and cost of transactions.

(ii) *Sector Rotation:* Sector or group rotation may apply to both stock and bond component of the portfolio. It is used more compulsorily with respect to strategy. The components of the portfolio are used when it involves shifting. The weighting for various industry sectors is based on their asset outlook.

With respect to bond portfolio sector rotation it implies a shift in the composition of the bond portfolio in terms of quality as reflected in credit rating, coupon rate, term of maturity etc.

(iii) *Security Selection:* Security selection involves a search for under-priced security. If one has to resort to active stock selection he may employ fundamental / technical analysis to identify stocks which seems to promise superior return and concentrate the stock components of portfolio on them.

As far as bonds are concerned security selection calls for choosing bonds which offer the highest yields to maturity and at a given level of risk.

(iv) *Use of Specialised Investment Concept:* To achieve superior return, one has to employ a specialised concept/philosophy particularly with respect to investment in stocks. The concept which have been exploited successfully are growth stock, neglected or out of favour stocks, asset stocks, technology stocks and cyclical stocks.

4. (a) (i) Receipts using a Forward Contract = US$ 10 Million/0.012195 = ₹ 820,008,200

(ii) Receipts using Currency Futures

The number of contracts needed is (US$ 10 Million/ 0.012189)/32,816,474 = 25

Initial margin payable is 25 contracts x ₹ 27,500 = ₹ 687,500

On April 1,2023 Close at 0.012198

Receipts = US$ 10 Million/0.012199 = ₹ 819,739,323

Variation Margin =

[(0.012198 – 0.012189) x 25 x 32,816,474]/0.012199

OR

(0.000009 x 25 x 32,816,474)/.012199 = 7383.71/0.012199

= ₹ 605,272

Less: Interest Cost – ₹ 6,87,500 x 0.07 x 3/12 = ₹ 12,031

Net Receipts ₹ 820,332,564

(iii) Receipt if exposure is kept unhedged

US$ 10 Million/0.012199 ₹ 819,739,323

Advise: The most advantageous option would to hedge with Futures because it has highest receipt.

(b) (i) Conversion rate is 14 shares per bond.

Market price of share is ₹ 400 then

Stock Value of Bond shall be: 14 × ₹ 400 = ₹ 5,600

(ii) Premium over Conversion Value (₹ 7375 - ₹ 5600) = $\frac{1775}{5600}$ x 100 = 31.70%

(c) Yes, this statement is correct since the securitization is based on the pools of assets rather than the originators, the assets must be assessed in terms of its credit quality and credit support available. Rating agency assesses the following:

❖ Strength of the Cash Flow.

❖ Mechanism to ensure timely payment of interest and principle repayment.

❖ Credit quality of obligors.

❖ Liquidity support.

❖ Strength of legal framework.

5. **(a)** Working Notes:

To prepare Revised Balance Sheet we need to calculate swap ratio, number of shares to be issued to Weak Bank and Capital Reserve or Goodwill on merger as follows:

(1) Calculation of Book Value per Share

Particulars	**Weak Bank (W)**	**Strong Bank (S)**
Share Capital (₹ Lakhs)	300	1,000
Reserves & Surplus (₹ Lakhs)	160	11,000

	460	12,000
Less: Preliminary Expenses (₹ Lakhs)	100	--
Net Worth or Book Value (₹ Lakhs)	360	12,000
No. of Outstanding Shares (Lakhs)	30	100
Book Value Per Share (₹)	12	120

(2) Swap Ratio

Gross NPA	1:8	1/8 x 30%	0.0375
CAR	5:16	5/16 x 28%	0.0875
Market Price	12:96	12/96 x 32%	0.0400
Book Value Per Share	12:120	12/120x 10%	0.0100
			0.1750

Thus, for every share of Weak Bank, 0.1750 share of Strong Bank shall be issued.

(3) No. of equity shares to be issued:

$\frac{300}{10} \times 0.1750$ = **5.25 lakh shares**

(4) Calculation of Capital Reserve

Book Value of Shares	₹ 360.00 lac
Less: Value of Shares issued	₹ 52.50 lac
Capital Reserve	₹ 307.50 lac

Balance Sheet after Merger

	₹ lac		₹ lac
Paid up Share Capital	1052.50	Cash in Hand & RBI	5800.00
Reserves & Surplus	11000.00	Balance with other banks	4000.00

Capital Reserve	307.50	Investment	40200.00
Deposits	96000.00	Advances	61000.00
Other Liabilities	6780.00	Other Assets	4140.00
	115140.00		**115140.00**

(b) The SWIFT plays an important role in Foreign Exchange dealings because of the following reasons:

- In addition to validation statements and documentation it is a form of quick settlement as messaging takes place within seconds.
- Because of security and reliability helps to reduce Operational Risk.
- Since it enables its customers to standardise transaction it brings operational efficiencies and reduced costs.
- It also ensures full backup and recovery system.
- Acts as a catalyst that brings financial agencies to work together in a collaborative manner for mutual interest.

6. (a) To determine which of the two projects bears more risk for every percent of expected return first we shall calculate Variance and Standard Deviation of both the projects.

(i) Project X

Expected Net Cash Flow

= (0.10 x 220) + (0.20 x 260) + (0.40 x 300) + (0.20 x 340) + (0.10 x 380)

= 22 + 52 + 120 + 68 + 38 = 300

$$\sigma^2 = 0.10(220-300)^2 + 0.20(260-300)^2 + 0.40(300-300)^2 + 0.20\,(340-300)^2 + 0.10(380-300)^2$$

= 640 + 320 + 0 + 320 + 640 = 1920

$$\sigma = \sqrt{1920} = 43.82$$

(ii) Project Y

Expected Net Cash Flow

= (0.10 X 180) + (0.25 X 260) + (0.30 X 340) + (0.25 X 420) + (0.10 X 500)

= 18 + 65 + 102 + 105 + 5 = 340

$\sigma^2 = 0.10\,(180-340)^2 + 0.25(260-340)^2 + 0.30\,(340-340)^2 + 0.25(420-340)^2 + 0.10(500-340)^2$ = 2560 + 1600 + 0 + 1600 + 2560 = 8320

$\sigma = \sqrt{8320} = 91.21$

Now we shall calculate Coefficient of Variation

Coefficient of Variation = $\frac{\text{Standard Deviation}}{\text{Mean}}$

Project X = $\frac{43.82}{300} = 0.146$ or 14.60%

Project Y = $\frac{91.21}{340} = 0.268$ or 26.80%

Project Y bears more risk for every percent of expected return.

(b) **(i)** Determination of Economic Value Added (EVA)

	$ Million
EBIT	360.00
Less: Taxes @ 35%	126.00
Net Operating Profit after Tax	234.00
Less: Cost of Capital Employed [W. No.1]	145.20
Economic Value Added	88.80

(ii) Determination of Market Value Added (MVA)

	$ Million
Market value of Equity Stock [W. No. 2]	1000
Equity Fund [W. No. 3]	850
Market Value Added	150

Working Notes:

(1) Total Capital Employed

Equity Stock	$ 200 Million
Reserves and Surplus	$ 650 Million
Loan	$ 360 Million
	$ 1210 Million
WACC	12%
Cost of Capital employed $ 1210 Million x 12%	$ 145.20 Million

(2)

Market Price per equity share (A)	$ 50
No. of equity share outstanding (B)	20 Million
Market value of equity stock (A) x (B)	$ 1000 Million

(3) Equity Fund

Equity Stock	$ 200 Million
Reserves & Surplus	$ 650 Million
	$ 850 Million

(c) As the name suggests, venture capital firms have made this famous. Such investors seek a return equal to some multiple of their initial investment or will strive to achieve a specific internal rate of return based on the level of risk they perceive in the venture.

The method incorporates this understanding and uses the relevant time frame in discounting a future value attributable to the firm.

The post-money value is calculated by discounting the rate representing an investor's expected or required rate of return.

The investor seeks a return based on some multiple of their initial investment. For example, the investor may seek a return of 10x, 20x, 30x, etc., their original investment at the time of exit.

New-age startups are disruptors in their own right and a necessary tool for global innovation and progress. By their very nature, startups disrupt set processes and industries to add value. In that process, they transcend traditional indicators of success like revenues, profitability, asset size, etc. Accordingly, it is no mean feat to uncover the actual value of a startup.

While the traditional methods fall short, there is no shortage of new innovative methods used to value startups based on their value drivers. However, the valuation of a startup is much more than the application of ways – it is about understanding the story of the future trajectory and communicating that narrative using substantial numbers.

MODEL TEST PAPER 9

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

ANSWER TO PART – I CASE SCENARIO BASED MCQS

1. Option (b)

2. Option (c)

3 Option (b)

4. Option (c)

5. Option (c)

6. Option (c)

7. Option (b)

8. Option (d)

9. Option (b)

10. Option (c)

11. Option (b)

12. Option (c)

13. Option (c)

14. Option (b)

15. Option (a)

ANSWERS OF PART – II DESCRIPTIVE QUESTIONS

1. (a) Valuation of Startup under different scenarios:

(i) Best Case Scenario

	Year 1	Year 2	Year 3	
Revenue	₹ 100,00,000	₹ 120,00,000	₹ 144,00,000	
Expenses	₹ 80,00,000	₹ 92,40,000	₹ 108,00,000	
Cash Flow/ Earnings	₹ 20,00,000	₹ 27,60,000	₹ 36,00,000	
Terminal Value				₹ 3,60,00,000

PVF @ 20%	0.8333	0.6944	0.5787	0.5787
PV	₹ 16,66,600	₹ 19,16,544	₹ 20,83,320	₹ 2,08,33,200
Value of Startup				₹ 2,64,99,664

(ii) Base Case Scenario

	Year 1	Year 2	Year 3	
Revenue	₹ 100,00,000	₹ 110,00,000	₹ 121,00,000	
Expenses	₹ 90,00,000	₹ 95,70,000	₹ 102,85,000	
Cash Flow/ Earnings	₹ 10,00,000	₹ 14,30,000	₹ 18,15,000	
Terminal Value				₹ 181,50,000
PVF @ 20%	0.8333	0.6944	0.5787	0.5787
PV	₹ 8,33,300	₹ 9,92,992	₹ 10,50,341	₹ 105,03,405
Value of Startup				₹ 133,80,038

(iii) Worst Case Scenario

	Year 1	Year 2	Year 3	
Revenue	₹ 100,00,000	₹ 102,00,000	₹ 104,04,000	
Expenses	₹ 95,00,000	₹ 98,94,000	₹ 101,95,920	
Cash Flow/ Earnings	₹ 5,00,000	₹ 3,06,000	₹ 2,08,080	
Terminal Value				₹ 20,80,800
PVF @ 20%	0.8333	0.6944	0.5787	0.5787
PV	₹ 4,16,650	₹ 2,12,486	₹ 1,20,416	₹ 12,04,159
Value of Startup				₹ 19,53,711

Value of ABC Startup as per First Chicago Method

= 0.30 x ₹ 2,64,99,664 + 0.60 x ₹ 133,80,038 + 0.10 x ₹ 19,53,711

= ₹ 79,49,899 + ₹ 80,28,023 + ₹ 1,95,371

= ₹ 1,61,73,293

(b) Some points to be kept in mind while preparing a Pitch Presentation are as follows:

(i) Introduction

(ii) Team

(iii) Problem

(iv) Solution

(v) Marketing/Sales

(vi) Projections or Milestones

(vii) Competition

(viii) Business Model

Financial projections include three basic documents that make up a business's financial statements.

- **Income statement:** This estimate how much money the business will generate by projecting income and expenses. It will show:
  - ❖ How much revenue did the business generate?
  - ❖ How much did it cost to generate and support that revenue?
  - ❖ How much did the business pay its employees?
  - ❖ How much did it pay towards rent?

  For your first year in business, you'll want to create a monthly income statement. For the second year, quarterly statements will suffice. For the following years, you'll just need an annual income statement.

- **Cash flow statement:** A projected cash flow statement will depict how much cash will be coming into the business and how much cash will be utilized. At the end of each period (e.g. monthly, quarterly, annually), one can tally it all up to show either the cash burn or the cash generated during the period and the cash balance remaining at the end of the period.

- **Balance sheet:** The balance sheet shows the business's overall finances including assets, liabilities and equity. Typically, one will create an annual balance sheet for one's financial projections. It shows:
  - ❖ How much cash is in the bank?
  - ❖ How much money does the company owe to suppliers?
  - ❖ How much money has been invested in the company?

2. **(a)** Profit After Tax (PAT) or Net Income = ₹ 8000 crores (1 – 0.30) = ₹ 5600 crores

Free Cash Flow to Equity (FCFE) = Net Income - Capital Expenditures + Depreciation -/+ Change in Net Working Capital + New Debt Issued - Debt Repayments + Net issue of Preference Shares – Preference Share Dividends

Free Cash Flow to Equity (FCFE) = ₹ 5600 crores - ₹ 20140 crore + ₹ 17100 crore - ₹ 1755.60 crore + ₹ 2062.108 crore = ₹ 2866.508 crore

Cost of Equity = $R_f + ß\ (R_m – R_f)$ or R_f + ß Market Risk Premium

= 9.50% + 0.1 x 3.10% = 9.81%

Value of Equity = $\frac{FCFE(1+g)}{K_e - g} = \frac{2866.508 \text{ crore}(1.07)}{0.0981 - 0.07} = \frac{3067.1636 \text{ crore}}{0.0281}$

= ₹ 109151.7295 crore

Value of one Equity Share = $\frac{109151.7295 \text{ crore}}{380 \text{ crore}}$ = ₹ 287.24

Alternatively, it can also be calculated by using per share basis as follows:

FCFE per share = $\frac{FCFE}{\text{No. of Equity Shares}} = \frac{2866.508 \text{ crore}}{380 \text{ crore}}$ = ₹ 7.5434

Value of per equity share = $\frac{FCFE(1+g)}{K_e - g} = \frac{7.5434(1.07)}{0.0981 - 0.07} = \frac{8.0714}{0.0281}$

= ₹ 287.24

(b) Financial Analysis whether to set up the manufacturing units in India or not may be carried using NPV technique as follows:

I. Incremental Cash Outflows

	$ Million
Cost of Plant and Machinery	500.00
Working Capital	50.00
Release of existing Working Capital	(15.00)
	535.00

II. Incremental Cash Inflow after Tax (CFAT)

(1) Generated by investment in India for 5 years

	$ Million
Sales Revenue (5 Million x $80)	400.00
Less: Costs	
Variable Cost (5 Million x $20)	100.00
Fixed Cost	30.00
Depreciation ($500Million/5)	100.00
EBIT	170.00
Taxes@35%	59.50
EAT	110.50
Add: Depreciation	100.00
CFAT (1-5 years)	210.50

(2) Cash flow at the end of the 5 years (Release of Working Capital) 35.00

(3) Cash generation by exports (Opportunity Cost)

	$ Million
Sales Revenue (1.5 Million x $80)	120.00
Less: Variable Cost (1.5 Million x $40)	60.00
Contribution before tax	60.00
Tax@35%	21.00
CFAT (1-5 years)	39.00

(4) Additional CFAT attributable to Foreign Investment

	$ Million
Through setting up subsidiary in India	210.50
Through Exports in India	39.00
CFAT (1-5 years)	171.50

III. Determination of NPV

Year	CFAT ($ Million)	PVF@12%	PV ($ Million)
1-5	171.50	3.6048	618.2232
5	35	0.5674	19.8590
			638.0822
Less: Initial Outflow			535.0000
			103.0822

Since NPV is positive the proposal should be accepted.

3. (a) (i) Portfolio Beta

0.20 x 0.40 + 0.50 x 0.50 + 0.30 x 1.10 = 0.66

(ii) Residual Variance

To determine Residual Variance first of all we shall compute the Systematic Risk as follows:

$\beta_A^2 \times \sigma_M^2 = (0.40)^2(0.01) = 0.0016$

$\beta_B^2 \times \sigma_M^2 = (0.50)^2(0.01) = 0.0025$

$\beta_C^2 \times \sigma_M^2 = (1.10)^2(0.01) = 0.0121$

Residual Variance

A 0.015 – 0.0016 = 0.0134

B 0.025 – 0.0025 = 0.0225

C 0.100 – 0.0121 = 0.0879

(iii) Portfolio variance using Sharpe Index Model

Systematic Variance of Portfolio = $(0.10)^2$ x $(0.66)^2$ = 0.004356

Unsystematic Variance of Portfolio = 0.0134 x $(0.20)^2$ + 0.0225 x $(0.50)^2$ + 0.0879 x $(0.30)^2$ = 0.014072

Total Variance = 0.004356 + 0.014072 = 0.018428

(iv) Portfolio variance on the basis of Markowitz Theory

= (w_A x w_Axσ_A^2) + (w_A x w_BxCov_{AB}) + (w_A x w_CxCov_{AC}) + (w_B x w_AxCov_{AB}) + (w_B x w_Bxσ_B^2) + (w_B x w_CxCov_{BC}) + (w_C x w_AxCov_{CA}) + (w_C x w_BxCov_{CB}) + (w_C x w_Cx σ_C^2)

= (0.20 x 0.20 x 0.015) + (0.20 x 0.50 x 0.030) + (0.20 x 0.30 x 0.020) + (0.20 x 0.50 x 0.030) + (0.50 x 0.50 x 0.025) + (0.50 x 0.30 x 0.040) + (0.30 x 0.20 x 0.020) + (0.30 x 0.50 x 0.040) + (0.30 x 0.30 x 0.10)

= 0.0006 + 0.0030 + 0.0012 + 0.0030 + 0.00625 + 0.0060 + 0.0012 + 0.0060 + 0.0090 = 0.0363

(b) Various types of Interest rate risk faced by companies/ banks are as follows:

(1) **Gap Exposure:** A gap or mismatch risk arises from holding assets and liabilities and off-balance sheet items with different principal amounts, maturity dates or re-pricing dates, thereby creating exposure to unexpected changes in the level of market interest rates. This exposure is more important in relation to banking business.

(2) **Basis Risk:** Market interest rates of various instruments seldom change by the same degree during a given period of time. The risk that the interest rate of different assets, liabilities and off-balance sheet items may change in different magnitude is termed as basis risk. For example, while assets may be benchmarked to Fixed Rate of Interest, liabilities may be benchmarked to floating rate of interest. The degree of basis risk is fairly high in respect of banks that create composite assets out of composite liabilities.

(3) **Embedded Option Risk:** Significant changes in market interest rates create another source of risk to banks' profitability by encouraging prepayment of cash credit/demand loans/term loans and exercise of call/put options on bonds/debentures and/or premature withdrawal of term deposits before their stated maturities.

(4) **Yield Curve Risk:** The movements in yield curve are rather frequent when the economy moves through business cycles.

Thus, banks should evaluate the movement in yield curves and its impact on the portfolio values and income.

(5) **Price Risk:** Price risk occurs when assets are sold before their stated maturities. In the financial market, bond prices and yields are inversely related. The price risk is closely associated with the trading book, which is created for making profit out of short-term movements in interest rates.

Banks which have an active trading book should, therefore, formulate policies to limit the portfolio size, holding period, duration, defeasance period, stop loss limits, marking to market, etc.

(6) **Reinvestment Risk:** Uncertainty with regard to interest rate at which the future cash flows could be reinvested is called reinvestment risk. Any mismatches in cash flows would expose the banks to variations in NII as the market interest rates move in different directions.

OR

(b) Some of the areas where the Blockchain can be applied are as follows:

(i) **Financial Services:** Blockchain can be used to provide an automated trade lifecycle in terms of the transaction log of any transaction of asset or property - whether physical or digital such as laptops, smartphones, automobiles, real estate, etc. from one person to another.

(ii) **Healthcare:** Blockchain provides secure sharing of data in healthcare industry by increasing the privacy, security, and interoperability of the data by eliminating the interference of third party and avoiding the overhead costs.

(iii) **Government:** At the government front, there are instances where the technical decentralization is necessary but politically should be governed by governments like land registration, vehicle registration and management, e-voting etc. Blockchain improves the transparency and provides a better way to monitor and audit the transactions in these systems.

(iv) **Travel Industry:** Blockchain can be applied in money transactions and in storing important documents like passports/other identification cards, reservations and managing travel insurance, loyalty, and rewards thus, changing the working of travel and hospitality industry.

(v) **Economic Forecasts:** Blockchain makes possible the financial and economic forecasts based on decentralized prediction markets, decentralized voting, and stock trading, thus enabling the organizations to plan and shape their businesses.

4. (a) Calculation of Income available for Distribution

	Units (Lakh)	Per Unit (₹)	Total (₹ In lakh)
Income from April	300	0.0765	22.9500
Add: Dividend equalization collected on issue	6	0.0765	0.4590
	306	0.0765	23.4090
Add: Income from May		0.1125	34.4250
	306	0.1890	57.8340
Less: Dividend equalization paid on repurchase	3	0.1890	(0.5670)
	303	0.1890	57.2670
Add: Income from June		0.1500	45.4500
	303	0.3390	102.7170
Less: Dividend Paid		0.2373	(71.9019)
	303	0.1017	30.8151

Calculation of Issue Price at the end of April

	₹
Opening NAV	18.750
Add: Entry Load 2% of ₹ 18.750	0.375
	19.125
Add: Dividend Equalization paid on Issue Price	0.0765
	19.2015

Calculation of Repurchase Price at the end of May

	₹
Opening NAV	18.750
Less: Exit Load 2% of ₹ 18.750	(0.375)
	18.375
Add: Dividend Equalization paid on Issue Price	0.1890
	18.564

Closing NAV

		₹ (Lakh)
Opening Net Asset Value (₹ 18.75 × 300)		5625.0000
Portfolio Value Appreciation		425.4700
Issue of Fresh Units (6 × 19.2015)		115.2090
Income Received (22.950 + 34.425 + 45.450)		102.8250
		6268.504
Less: Units repurchased (3 × 18.564)	-55.692	
Income Distributed	-71.9019	(-127.5939)
Closing Net Asset Value		6140.9101
Closing Units (300 + 6 – 3) lakh		303 lakh
∴ Closing NAV as on 30th June		₹ 20.2670

(b) The arbitrageur can proceed as stated below to realize arbitrage gains.

(i) Buy ₹ from USD 10,000,000 At Mumbai 48.30 × 10,000,000 ₹ 483,000,000

(ii) Convert these ₹ to GBP at London $\left(\frac{₹\ 483,000,000}{₹\ 77.52}\right)$

GBP 6,230,650.155

(iii) Convert GBP to USD at New York GBP 6,230,650.155 × 1.6231 USD 10,112,968.26

There is net gain of USD 10,112968.26 less USD 10,000,000 i.e. USD 112,968.26

5. (a) **Working Notes:**

(i) Computation of Net Worth Per Share of SVL

Total Assets (Fixed assets + Current Assets) (₹ Crores)	2260
Less: Liabilities (Current Liabilities + Borrowings) (₹ Crores)	690
Net Assets Value (₹ Crores)	1570
Current Value of Land after growing for three years @ 30% = 380 X 1.2475 (₹ Crores)	474.05*
Less: Book Value (₹ Crores)	380.00
Increase in the Value of land (₹ Crores)	94.05
Adjusted NAV (1570 + 94.05) (₹ Crores)	1664.05
No. Shares (Crores)	25
Net Worth Per Share	₹ 66.56

*Alternatively, this value can also be computed as ₹ 475 Crores.

(ii) Computation of Net Worth Per Share of ICL

Share Capital + Reserves and Surplus = ₹ 2600 Crore

Total Number of Shares = 50 Crore

Net Worth Per Share = ₹ 2600 Crore/ 50 Crore = ₹ 52.00

(iii) Earning Per Share (EPS)

	ICL	SVL
PAT	₹ 1580 Crore	₹ 500 Crore
No. of Shares	50 Crore	25 Crore
EPS	₹ 31.60	₹ 20.00

(iv) Share price as per Dividend Growth Model

	ICL	SVL
Total Dividend	₹ 470 Crore	₹ 304.35 Crore
No. of Shares	50 Crore	25 Crore
Dividend Per Share (D_0)	₹ 9.40	₹ 12.17
Expected Dividend (D_1)	₹ 9.40 (1 + 0.18) = ₹ 11.09	₹ 12.17 (1 + 0.15) = ₹ 14.00
Value of Per Share as Growth Model	$\frac{11.09}{0.25-0.18}$ = ₹ 158.43	$\frac{14.00}{0.20-0.15}$ = ₹ 280

Calculation of Swap Ratio

Net Worth Per Share	1 : 1.28 i.e.	1.28 × 25%	0.32
EPS	1 : 0.63 i.e.	0.63 × 30%	0.19
Share price as per Dividend Growth Model	1 : 1.77 i.e.	1.77 × 20%	0.35
Market Price	1 : 0.56 i.e.	0.56 × 25%	0.14
		Total	1.00

Swap ratio is for every one share of SVL, to issue 1 share of ICL. Hence, total no. of shares to be issued 25 crores.

(b) The characteristics of GDRs are as follows:

(i) Holders of GDRs participate in the economic benefits of being ordinary shareholders, though they do not have voting rights.

(ii) GDRs are settled through CEDEL & Euro-clear international book entry systems.

(iii) GDRs are listed on the Luxemburg stock exchange.

(iv) Trading takes place between professional market makers on an OTC (over the counter) basis.

(v) The instruments are freely traded.

(vi) They are marketed globally without being confined to borders of any market or country as it can be traded in more than one currency.

(vii) Investors earn fixed income by way of dividends which are paid in issuer currency converted into dollars by depository and paid to investors and hence exchange risk is with investor.

(viii) As far as the case of liquidation of GDRs is concerned, an investor may get the GDR cancelled any time after a cooling period of 45 days. A non-resident holder of GDRs may ask the overseas bank (depository) to redeem (cancel) the GDRs. In that case overseas depository bank shall request the domestic custodians bank to cancel the GDR and to get the corresponding underlying shares released in favour of non-resident investor. The price of the ordinary shares of the issuing company prevailing in the Bombay Stock Exchange or the National Stock Exchange on the date of advice of redemption shall be taken as the cost of acquisition of the underlying ordinary share.

6. **(a)** Initial Margin $= \mu + 3\sigma$

Where μ = Daily Absolute Change

σ = Standard Deviation

Accordingly

Initial Margin = ₹ 10,000 + ₹ 6,000 = ₹ 16,000

Maintenance margin = ₹ 16,000 x 0.75 = ₹ 12,000

Day	**Changes in future Values (₹)**	**Margin A/c (₹)**	**Call Money (₹)**
4/2/09	-	16000	-
5/2/09	50 x (3294.40 - 3296.50) = -105	15895	-
6/2/09	50 x (3230.40 - 3294.40) = -3200	12695	-
7/2/09	50 x (3212.30 - 3230.40) = -905	16000	4210
10/2/09	50 x (3267.50 - 3212.30) = 2760	18760	-
11/2/09	50 x (3263.80 - 3267.50) = -185	18575	-

12/2/09	50 x (3292 - 3263.80) =1410	19985	-
14/2/09	50 x (3309.30 - 3292) = 865	20850	-
17/2/09	50 x (3257.80 - 3309.30) = -2575	18275	-
18/2/09	50 x (3102.60 - 3257.80) = -7760	16000	5485

(b) To some extent this statement is correct. The advocates of technical analysis offer the following interrelated argument in their favour:

(i) Under influence of crowd psychology trend persist for some time. Tools of technical analysis help in identifying these trends early and help in investment decision making.

(ii) Shift in demand and supply are gradual rather then instantaneous. Technical analysis helps in detecting this shift rather early and hence provides clues to future price movements.

(iii) Fundamental information about a company is observed and assimilated by the market over a period of time. Hence price movement tends to continue more or less in same direction till the information is fully assimilated in the stock price.

Detractors of technical analysis believe that it is an useless exercise; their arguments are as follows:

(i) Most technical analysts are not able to offer a convincing explanation for the tools employed by them.

(ii) Empirical evidence in support of random walk hypothesis cast its shadow over the usefulness of technical analysis.

(v) By the time an uptrend and down trend may have been signalled by technical analysis it may already have taken place.

(iv) Ultimately technical analysis must be a self-defeating proposition. With more and more people employing it, the value of such analysis tends to decline.

MODEL TEST PAPER - 10

FINAL COURSE: GROUP – I

PAPER – 2: ADVANCED FINANCIAL MANAGEMENT

ANSWER TO PART – I CASE SCENARIO BASED MCQS

1. **Option (b)**

2. **Option (c)**

3 **Option (d)**

4. **Option (b)**

5. **Option (d)**

6. **Option (d)**

7. **Option (b)**

8. **Option (c)**

9. **Option (d)**

10. **Option (b)**

11. **Option (a)**

12. **Option (b)**

13. **Option (c)**

14. **Option (c)**

15. **Option (d)**

ANSWERS OF PART – II DESCRIPTIVE QUESTIONS

1. **(a)** **Determination of forecasted Free Cash Flow of the Firm (FCFF)**

(₹ in crores)

	Yr. 1	**Yr. 2**	**Yr. 3**	**Terminal Year**
Revenue	9000.00	10800.00	12960.00	13996.80
COGS	3600.00	4320.00	5184.00	5598.72

Operating Expenses	1980.00*	2376.00	2851.20	3079.30
Depreciation	720.00	864.00	1036.80	1119.74
EBIT	2700.00	3240.00	3888.00	4199.04
Tax @30%	810.00	972.00	1166.40	1259.71
EAT	1890.00	2268.00	2721.60	2939.33
Capital Exp. – Dep.	172.50	198.38	228.13	-
∆ Working Capital	375.00	450.00	540.00	259.20
Free Cash Flow (FCF)	1342.50	1619.62	1953.47	2680.13

* Excluding Depreciation.

Present Value (PV) of FCFF during the explicit forecast period is:

FCFF (₹ in crores)	**PVF @ 15%**	**PV (₹ in crores)**
1342.50	0.8696	1167.44
1619.62	0.7561	1224.59
1953.47	0.6575	1284.41
		3676.44

PV of the terminal, value is:

$$\frac{2680.13}{0.15 - 0.08} \times \frac{1}{(1.15)^3} = ₹\ 38287.57 \text{ Crore} \times 0.6575 = ₹\ 25174.08 \text{ Crore}$$

The value of the firm is:

₹ 3676.44 Crores + ₹ 25174.08 Crores = ₹ 28,850.52 Crores

(b) Maximum decline in one month = $\frac{(17025-15322.5)}{17025} \times 100 = 10\%$

(1) Immediately to start with

Investment in equity = Multiplier x (Portfolio value – Floor value)

= 2 (5,00,000 – 4,50,000) = ₹ 1,00,000

Shiva may invest ₹ 1,00,000 in equity and balance in risk free securities.

(2) After 15 days

Value of equity = 1,00,000 x 16321.89 / 17025 = ₹ 95,870

Value of risk free investment ₹ 4,00,000

Total value of portfolio = ₹ 4,95,870

Investment in equity = Multiplier x (Portfolio value – Floor value)

= 2 (4,95,870 – 4,50,000) = ₹ 91,740

Revised Portfolio:

Equity = ₹ 91,740

Risk free Securities = ₹ 4,95,870 – ₹ 91,740 = ₹ 4,04,130

(3) After another 15 days

Value of equity = 91,740 x 17512.14 / 16321.89 = ₹ 98,430

Value of risk free investment = ₹ 4,04,130

Total value of portfolio = ₹ 5,02,560

Investment in equity = Multiplier x (Portfolio value – Floor value)

= 2 (5,02,560 – 4,50,000) = ₹ 1,05,120

Revised Portfolio:

Equity = ₹ 1,05,120

Risk Free Securities = ₹ 5,02,560 – ₹ 1,05,120 = ₹ 3,97,440

The investor should off-load ₹ 6,690 of risk free securities and divert to Equity.

2. (a) (1) Impact of Financial Restructuring

Particulars	₹ in Lac
Benefits to PK Ltd.	
1. Reduction in Equity Share capital (90×8)	720
2. Reduction in Preference Share Capital (3×50)	150

3. Waiver of Trade payables (400 @ 40%)	160
(A) Total (1+2+3)	**1030**
Amount of ₹ 1030 Lacs utilised to write off losses & overvalued assets	
1. Losses	500
2. Over valued Non Current Assets (1000-500)	500
(B) Total (1+2)	**1000**
Amount unutilized transfer to Capital Reserve (A - B)	30

(2) Balance Sheet of PK Ltd. as on 31.03.2015 (after reconstruction)

Particulars	₹ in Lac
I. EQUITY & LIABILITIES	
Shareholder's Fund	
Equity Share Capital (₹ 2 each)	700.00
8% Preference Share Capital (₹ 50 each)	150.00
Reserves & Surplus (Capital Reserve)	30.00
Current Liabilities	
Trade Payable	120.00
Total (I)	**1000.00**
II. ASSETS	
Non-Current Asset	500.00
Current Assets	
Inventory	300.00
Trade Receivables	100.00
Cash & Bank balance	100.00
Total (II)	**1000.00**

Calculation of Equity Share Capital

1. Equity share capital after reconstruction	180.00
2. Issued in Cash (200×2)	400.00
3. Issued to Trade payables [50% of (60% of ₹ 400 Lacs)]	120.00
Total (1+2+3)	**700.00**

(b) The following are some of the 'sell-side' imperatives

- Competitor's pressure is increasing.
- Sale of company seems to be inevitable because company is facing serious problems like:
  - No access to new technologies and developments
  - Strong market entry barriers. Geographical presence could not be enhanced
  - Badly positioned on the supply and/or demand side
  - Critical mass could not be realised
  - No efficient utilisation of distribution capabilities
  - New strategic business units for future growth could not be developed
  - Not enough capital to complete the project
- Window of opportunity: Possibility to sell the business at an attractive price
- Focus on core competencies

In the best interest of the shareholders – where a large well known firm brings-up the proposal, the target firm may be more than willing to give-up.

3. (a) Let WA, WB, WC and WD be the weights of Stock A, B, C and Debenture respectively.

W_A = 4,00,000 ÷ 20,00,000 = 0.20

W_B = 5,00,000 ÷ 20,00,000 = 0.25

Now = $W_C + W_D = 1 – W_A – W_B = 0.55$

It is given in the question that Portfolio should be as risky as that of the market. It means Beta of the portfolio should be 1.

Hence,

$W_A (0.7) + W_B (1.1) + W_C (1.6) + W_D (0) = 1$

$0.2 \times 0.7 + 0.25 \times 1.1 + 1.6W_C + W_D \times 0 = 1$

$0.14 + 0.275 + 1.6WC + 0 = 1$

$1.6W_C = 1 - 0.415$

$1.6\ W_C = 0.585$

$$W = \frac{0.585}{1.6}$$

$= 0.3656$

Weight of Debenture (WD) = 1- 0.2 – 0.25 – 0.3656 = 0.1844

Hence, Amount invested in Stock C

= 0.3656 × 20,00,000

= ₹ 7,31,200

Amount invested in Debenture (D)

= 0.1844 × 20,00,000

= ₹ 3,68,800

Thus, amount to be invested in Stock (C) is ₹ 7,31,200 and in Debenture is ₹ 3,68,800.

(b)

	Growth Fund	**Balanced Fund**	**Regular Fund**	**Market**
Average Return (%)	7	6	5	9
Variance	92.16	54.76	40.96	57.76
Std. Deviation	9.60	7.40	6.40	7.60
Coefficient of Determination	0.3025	0.6561	0.9604	
Coefficient of Correlation	0.55	0.81	0.98	
Beta (β)	$\frac{9.60 \times 0.55}{7.60}$ = 0.695	$\frac{7.40 \times 0.81}{7.60}$ = 0.789	$\frac{6.40 \times 0.98}{7.60}$ = 0.825	

(i) Ranking of Funds as per Sharpe Ratio

$$\text{Sharpe Ratio} = \frac{\text{Expected Return - Risk Free Rate of Return}}{\text{Standard Deviation}}$$

	Growth Fund	Balanced Fund	Regular Fund
Sharpe Ratio	$\frac{7-9}{9.60} = -0.208$	$\frac{6-9}{7.40} = -0.405$	$\frac{5-9}{6.40} = -0.625$
Ranking	1	2	3

(ii) Ranking of Funds as per Treynor Ratio

$$\text{Treynor ratio} = \frac{\text{Expected Return - Risk Free Rate of Return}}{\text{Beta}}$$

	Growth Fund	Balanced Fund	Regular Fund
Treynor Ratio	$\frac{7-9}{0.695} = -2.878$	$\frac{6-9}{0.789} = -3.802$	$\frac{5-9}{0.825} = -4.85$
Ranking	1	2	3

(b) As per GSR Notification 127 (E) dated 19th February 2019, an entity shall be considered as a Startup:

(i) Upto a period of ten years from the date of incorporation/ registration, if it is incorporated as a private limited company (as defined in the Companies Act, 2013) or registered as a partnership firm (registered under section 59 of the Partnership Act, 1932) or a limited liability partnership (under the Limited Liability Partnership Act, 2008) in India.

(ii) Turnover of the entity for any of the financial years since incorporation/ registration has not exceeded one hundred crore rupees.

(iii) Entity is working towards innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.

Provided that an entity formed by splitting up or reconstruction of an existing business shall not be considered a 'Startup'.

OR

(c) Factors affecting the value of an option are:

(i) **Price Movement of the Underlying:** The value of calls and puts are **affected** by changes in the underlying stock price in a relatively straightforward manner. When the stock price goes up, calls should gain in value and puts should decrease. Put options should increase in value and calls should drop as the stock price falls.

(ii) **Time till expiry:** The option's future expiry, at which time it may become worthless, is an important and key factor of every option strategy. Ultimately, time can determine whether your option trading decisions are profitable. To make money in options over the long term, you need to understand the impact of time on stock and option positions.

With stocks, time is a trader's ally as the stocks of quality companies tend to rise over long periods of time. But time is the enemy of the options buyer. If days pass without any significant change in the stock price, there is a decline in the value of the option. Also, the value of an option declines more rapidly as the option approaches the expiration day. That is good news for the option seller, who tries to benefit from time decay, especially during that final month when it occurs most rapidly.

(iii) **Volatility in Stock Prices:** Volatility can be understood via a measure called Statistical (sometimes called historical) Volatility, or SV for short. SV is a statistical measure of the past price movements of the stock; it tells you how volatile the stock has actually been over a given period of time.

But to give you an accurate fair value for an option, option pricing models require you to put in what the future volatility of the stock will be during the life of the option. Naturally, option traders don't know what that will be, so they have to try to guess. To do this, they work the options pricing model "backwards" (to put it in simple terms). After all, you already know the price at which the option is trading; you can also find the other variables (stock price, interest rates, dividends, and the time left in the option) with just a bit of research. So, the only missing number is future volatility, which you can calculate from the equation.

(iv) **Interest Rate**: Another feature which affects the value of an Option is the time value of money. The greater the interest rates, the present value of the future exercise price are less.

4 **(a)** **(i)** As borrower does not want to pay more than 8.5% p.a., on this loan where the rate of interest is likely to rise beyond this, hence, he is advised to hedge the risk by entering into an agreement to buy interest rate caps with the following parameters:

- National Principal: ₹ 40,00,000/-
- Strike rate: 8.5% p.a.
- Reference rate: the rate of interest applicable to this loan
- Calculation and settlement date: 31st March every year.
- Duration of the caps: till 31st March 2016
- Premium for caps: negotiable between both the parties

To purchase the caps this borrower is required to pay the premium upfront at the time of buying caps. The payment of such premium will entitle him with right to receive the compensation from the seller of the caps as soon as the rate of interest on this lo an rises above 8.5%. The compensation will be at the rate of the difference between the rate of none of the cases the cost of this loan will rise above 8.5% calculated on ₹ 40,00,000/-. This implies that in none of the cases the cost of this loan will rise above 8.5%. This hedging benefit is received at the respective interest due dates at the cost of premium.

(ii) To evaluate the position of the borrower on respective dates we shall compute the interest cost as follows:

Dates	Interest Rate (a)	Exercise of Option	Compensation (b)	Net Cost (a) – (b)
31st March, 2013	10.20%	Yes	10.20% - 8.50% = 1.70%	8.50%
31st March, 2014	11.50%	Yes	11.50% - 8.50% = 3.00%	8.50%
31st March, 2015	9.25%	Yes	9.25% - 8.50% = 0.75%	8.50%
31st March, 2016	8.25%	No	Nil	8.25%

Thus, form above it can be evaluated that the by paying an upfront premium of ₹ 30,000 each year the borrower can ensure that its interest rate cost does not exceed 8.50% p.a.

(b) Instead of selling the stock of Reliance Ltd., Ram must cover his Risk by buying or long position in Put Option with appropriate strike price. Since Ram's risk appetite is 5%, the most suitable strike price in Put Option shall be ₹ 950 (₹ 1000 – 5% of ₹ 1000).

If Ram does so, then his overall position will be as follows:

Spot Price after 1 month	Stock Value	Put Payoff	Initial Cash Flow	Total
S < 950	S	950 – S	- 8	942 - S
S > 950	S	-	- 8	S – 8

Now assuming that the spot price after 1 month happens to be ₹ 941* per share then position of Ram will be as follows:

(₹ 950 - ₹ 941) - ₹ 8 + ₹ 941

Thus, from the above, it can be seen that the value of holding of Ram shall never be less than

₹ 942 as Put Option will compensate for loss below spot price of ₹ 950. However, this strategy will involve a cost of ₹ 8.

* Students can assume any price other than ₹ 941 and could answer accordingly

5. (a) Working Notes:

(i) Decomposition of Funds in Equity and Cash Components

	D Mutual Fund Ltd.	K Mutual Fund Ltd.
NAV on 31.12.14	₹ 70.71	₹ 62.50
% of Equity	99%	96%
Equity element in NAV	₹ 70	₹ 60
Cash element in NAV	₹ 0.71	₹ 2.50

(ii) Calculation of Beta

(a) D Mutual Fund Ltd.

Sharpe Ratio = 2 $= \frac{E(R) - R_f}{\sigma_D} = \frac{E(R) - R_f}{11.25}$

E(R) - Rf = 22.50

Treynor Ratio = 15 = $\frac{E(R)\text{-}R_f}{\beta D} = \frac{22.50}{\beta D}$

βD = 22.50/15 = 1.50

(b) K Mutual Fund Ltd.

Sharpe Ratio = 3.3 $= \frac{E(R) - R_f}{\sigma_k} = \frac{E(R) - R_f}{5}$

E(R) - Rf = 16.50

Treynor Ratio = 15 = $\frac{E(R)\text{-}R_f}{\beta k} = \frac{16.50}{\beta k}$

βk = 16.50/15 = 1.10

(iii) Decrease in the Value of Equity

	D Mutual Fund Ltd.	K Mutual Fund Ltd.
Market goes down by	5.00%	5.00%
Beta	1.50	1.10
Equity component goes down	7.50%	5.50%

(iv) Balance of Cash after 1 month

	D Mutual Fund Ltd.	K Mutual Fund Ltd.
Cash in Hand on 31.12.14	₹ 0.71	₹ 2.50
Less: Exp. Per month	₹ 0.25	₹ 0.25
Balance after 1 month	₹ 0.46	₹ 2.25

NAV After 1 Month

	D Mutual Fund Ltd.	K Mutual Fund Ltd.
Value of Equity after 1 month		
70 x (1 - 0.075)	₹ 64.75	-
60 x (1 - 0.055)	-	₹ 56.70
Cash Balance	0.46	2.25
	65.21	58.95

(b) (i) Rate of discount quoted by the bank

$$= \frac{(45.20 - 45.60) \times 365 \times 100}{45.60 \times 60} = 5.33\%$$

(ii) Probable loss of operating profit:

(45.20 – 45.50) × 1,00,000 = ₹ 30,000

(c) In order to be sustainable, an organisation must:

- have a clear strategic direction;
- be able to scan its environment or context to identify opportunities for its work;
- be able to attract, manage and retain competent staff;
- have an adequate administrative and financial infrastructure;
- be able to demonstrate its effectiveness and impact in order to leverage further resources; and
- get community support for, and involvement in its work.

6. (a) (i) Net Present Value (All Equity Financed) – Base NPV

Particulars	Period	USD Lakhs	PVF @ 12%	PV (USD Lakhs)
Initial Investment	0	(250.00)	1.000	(250.000)
EBIDTA	1 to 20	33.00	7.469	246.477
Tax	1 to 20	(9.90)	7.469	(73.943)
Depreciation	1 to 10	(25.00)		
Tax Saving on Dep	1 to 10	7.50	5.650	42.375
			NPV	**(35.091)**

(ii) Present Value of Impact of Financing by Debt

Particulars	Period	USD Lakhs	PVF @ 8%	PV (USD Lakhs)
Loan	0	150.00	1.000	150.000
Interest	1 to 15	(9.00)	8.559	(77.031)
Tax Saving on Interest	1 to 15	2.70	8.559	23.109
Repayment of Principal	15	(150.00)	0.315	(47.250)
			NPV	**48.828**

Adjusted Present Value of the Project

= Base NPV + PV of Impact of Financing

= - US$ 35.091 + US $ 48.828 lakh

= US$ 13.737 lakh

Advise: Since APV is positive, TL Ltd. should accept the project.

Alternatively, if instead of PV of overall impact of Financing the PV of impact of tax shield on Interest is considered then APV shall be computed as follows:

Base NPV + PV of Tax Shield on Interest

= - US$ 35.091 + US $ 23.109 lakh

= - US$ 11.982 lakh

Advise: Since APV is negative, TL Ltd. should not accept the project.

(b) **(i)** Expected Share Price

= ₹ 120X 0.05 + ₹ 140X 0.20 + ₹ 160X 0.50 + ₹ 180X 0.10 + ₹ 190X 0.15

= ₹ 6 + ₹ 28 + ₹ 80 + ₹ 18 + ₹ 28.50 = ₹ 160.50

(ii) Value of Call Option

= ₹150 - ₹150 = Nil

(c) The securitization has the following features:

(i) *Creation of Financial Instruments* – The process of securities can be viewed as process of creation of additional financial product of securities in market backed by collaterals.

(ii) *Bundling and Unbundling* – When all the assets are combined in one pool it is bundling and when these are broken into instruments of fixed denomination it is unbundling.

(iii) *Tool of Risk Management* – In case of assets are securitized on non-recourse basis, then securitization process acts as risk management as the risk of default is shifted.

ANSWERS OF MODEL TEST PAPER 1

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING, ASSURANCE AND PROFESSIONAL ETHICS

Part I: MULTIPLE CHOICE QUESTION

1. (a)
2. (c)
3. (d)
4. (c)
5. (d)
6. (b)
7. (c)
8. (b)
9. (b)
10. (b)
11. (a)
12. (c)
13. (b)
14. (a)
15. (b)

Part II - DESCRIPTIVE QUESTION

1. (a) The set of instructions and procedures given in the case scenario are incomplete and not properly followed, which are discussed as under:

   - The physical inventory count process should be supervised by a responsible officer of the company, preferably from finance department. The supervision of the count process should not be done by person responsible for storage function. However, storage in-charge of each area should be present during inventory count process for co-ordination and facilitation.

- During inventory count process, inward and outward movement of goods should not be allowed as allowing such movement may distort the results or make it difficult to arrive at proper results.
- The instruction relating to the constitution of teams for counting process does not specify that counting shall be undertaken by members drawn from departments not connected with storage function. For example, these members may be from the finance department. Further, within each team, duties should be fixed separately for counting and recording on serially numbered count sheets. It is nowhere stated that once counting in an area is complete, certain distinctive marks or tags are required to be put.
- Count sheets should contain description of products in accordance with inventory records of company.
- The management's instructions are silent about how team members would proceed with their work. Team members should be provided with lay out plans for different sections/ storage areas so that all areas are covered.
- The management's instructions are silent on how paddy lying in open is to be counted and verified. Paddy in jute bags lying in open in heaps should be verified by counting number of bags in one heap. As each bag is of nearly standard size, the quantity of paddy can be determined by counting number of bags in a heap and correlating it with the weight of standard bag.
- Paddy in steel silos should be determined using measuring strain gauges on silos. Determining quantity in silos based on silo capacity may lead to wrong results as paddy may have been used from such silos.
- Quantities of work in progress should be estimated at each stage of production and not for the plant as a whole. Estimating WIP inventories for plant as a whole would give inaccurate picture of work in progress inventories.

- Finished goods inventories need to be counted category wise. Rice bags should be verified by checking the name of brand.
- There is no instruction regarding damaged or obsolete stock items particularly in the case of finished goods i.e. rice. Damaged/obsolete inventories should be counted and shifted to a separate area for assessment of their condition and to prevent mix-up with other standard inventories.
- Count sheets need to be signed by each team member.
- The responsible officer should ensure that stocks have been counted/verified in all areas and distinctive marks are put to confirm completion of counting.

(b) A liability is a present obligation of the entity to transfer an economic resource as a result of past events. Instead of fulfilling an obligation to transfer an economic resource to the party that has a right to receive that resource, entities sometimes decide to, for example: -

(a) settle the obligation by negotiating a release from the obligation;

(b) transfer the obligation to a third party; or

(c) replace that obligation to transfer an economic resource with another obligation by entering into a new transaction.

In the above situations, an entity has the obligation to transfer an economic resource until it has settled, transferred or replaced that obligation.

In the given situation, the company has written back liabilities due to creditors unilaterally. The company has not settled the obligation by negotiating a release from the obligation from respective creditors. Such an accounting treatment by management is questionable and against the conceptual framework for financial reporting under Ind AS.

CA. Srishti wanted to send external confirmations in accordance with SA 505," External Confirmations" but management informed her that sending such requests may be used by creditors as proof of existence of liability. In fact, she should display professional skepticism and be alert to the possibility of misstatements in financial statements, if restrained by management from obtaining external confirmations. The reasons advanced by management do not appear to be valid and reasonable. In accordance with SA 505, she should reassess risks and perform alternative audit procedures to mitigate such risks. Besides, she should consider implications of same for her audit opinion.

Further, SA 705," Modifications to the Opinion in the Independent Auditor's Report" requires that the auditor shall modify the opinion in the auditor's report when: -

(a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

SA 705 also states that misstatements in financial statements arise when selected accounting policies are not in accordance with an applicable financial reporting framework. It also states that examples of an inability to obtain sufficient appropriate audit evidence arise from a limitation on the scope of audit imposed by management when management prevents the auditor from requesting external confirmation of specific account balances. Therefore, she needs to issue a modified opinion.

Keeping in view above, her contemplation of including above matters under "Key Audit Matters" is not proper and is not in accordance with SA 701," Communicating Key Audit Matters in the Independent Auditor's Report". It states that the auditor shall not communicate a matter in the Key Audit Matters section of the auditor's report when the auditor would be required to modify the opinion in accordance with SA 705 as a result of the matter. Communicating key audit matters in the auditor's report is not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705.

(c) **Reporting by the User Auditor**: As per SA 402, "Audit Considerations Relating to an Entity Using a Service Organisation", the user auditor shall modify the opinion in the user auditor's report in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report", if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements.

The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion.

Thus, in view of the above, contention of CA. Akram in removing reference of the work done by service auditor is in order as in case of unmodified audit report, user auditor cannot refer to the work done by service auditor.

2. **(a)** In accordance with SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Services Engagements" the firm should establish policies and procedures designed to maintain confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.

In the given situation, the physical files are neither scanned and incorporated in the electronic files nor cross-referenced to the electronic files. Inability to do so shows that firm has not established policies and procedures to maintain integrity of engagement documentation. Lack of ensuring the same makes it difficult to demonstrate completeness of audit files and whether these were assembled within 60 days timeframe stipulated in SQC 1.

Where engagement documentation is in paper, electronic, or other media, the integrity, accessibility or retrievability of the underlying data may be compromised if the documentation could be altered, added to or deleted without the firm's knowledge, or if it could be permanently lost or damaged. One of the reasons for designing and implementing appropriate controls for engagement documentation in this regard is the protection of the integrity of information at all stages of engagement.

For the practical reasons, original paper documentation may be electronically scanned for inclusion in engagement files. In that case, the firm implements appropriate procedures requiring engagement teams to:

(a) Generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;

(b) Integrate the scanned copies into the engagement files, including indexing and signing off on the scanned copies as necessary; and

(c) Enable the scanned copies to be retrieved and printed as necessary.

It has also been stated that there are many instances where audit working papers do not contain details as to whether information was obtained from the client or prepared by the engagement team. It is important to identify the source of the document, and the information used as audit evidence to ensure its reliability. It could have potential risks of non-compliance with standards on auditing.

(b) IT dependencies are created when IT is used to initiate, authorize, record, process, or report transactions or other financial data for inclusion in the financial statements.

System generated reports are the information generated by the IT systems. These reports are often used in an entity's execution of a manual control, including business performance reviews, or may be the source of entity information used by us when selecting items for the testing, performing substantive tests of details or performing a substantive analytical procedure. e.g. (Vendor master report, customer ageing report).

Interfaces are programmed logic that transfer the data from one IT system to another. For example, an interface may be programmed to transfer data from a payroll subledger to the general ledger.

In this manner, IT dependencies arise due to “system generated reports” and “interfaces”.

Identifying and documenting the entity's IT dependencies in a consistent, clear manner helps to identify the entity's reliance upon

IT, understand how IT is integrated into the entity's business model, identify potential risks arising from the use of IT, identify related IT General Controls and enables us to develop an effective and efficient audit approach.

(c) As per section 2(2)(iv) of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed "to be in practice" when individually or in partnership with the Chartered Accountants in practice or in partnership with members of such other recognised professions as may be prescribed, he, in consideration of remuneration received or to be received, renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice.

Pursuant to section 2(2) (iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services" which, inter alia, includes rendering services of valuation of shares and business and advice regarding amalgamation, merger and acquisition, acting as Registered Valuer under the Companies Act, 2013 read with the Companies (Registered Valuers and Valuation) Rules, 2017. In this regard, such rules qualify Chartered Accountants for valuation of the securities or the financial Assets only and not for the Plant and Machinery. Therefore, valuation of plant and machinery does not form part of Management Consultancy and other services permitted by the council.

Further, in accordance with resolution passed under Regulation 190A of the Chartered Accountant Regulations, 1988, members in practice are generally permitted for attending classes and appearing for any examination. There is no need to take prior permission of ICAI in this regard. Therefore, it is generally permitted for a member in practice to attend classes and appear for any examination, and accordingly, doing the Registered valuer course would be deemed as permissible.

Hence, keeping in view above and in terms of the provisions of the Chartered Accountants Act, 1949 and Code of Ethics, it is not permissible for a Chartered Accountant in practice to work as an Engineer/ valuer in plant & machinery simultaneously.

3. **(a)** As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.

The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time.

In the given case, the management is not correct in refusing the relevant information to the auditor.

(b) Gross NPAs represent opening balances of NPAs as increased by fresh NPAs during the year and reduced by upgradations, recoveries and write-offs during the year.

Net NPAs are arrived at after deducting amounts on account of the total provision held against NPAs, balance in the interest suspense account to park accrued interest on NPAs and certain other adjustments.

The Net NPAs to Net advances ratio is higher in the case of IND Bank as compared to other public sector banks. This indicates that there is a risk that the bank may not have made the required provisions in accordance with RBI guidelines. A higher net NPAs to Net advances ratio indicates the probability and risk of under-provisioning. Keeping in view the above, audit procedures have to be tailored towards the examination and verification of this crucial area.

(c) **Gross Negligence in Conduct of Duties:** As per Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he certifies or submits, in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another Chartered Accountant in practice, under Clause (2); does not exercise due diligence, or is grossly negligent in the conduct of his professional duties, under Clause (7); or fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion, under Clause (8).

The primary duty of physical verification and valuation of investments is of the management. However, the auditor's duty is also to verify the physical existence and valuation of investments placed, at least on the last day of the accounting year. The auditor should verify the documentary evidence for the cost/value and physical existence of the investments at the end of the year. He should not blindly rely upon the Management's representation.

In the instant case, such non-verification happened for two years. It also appears that auditors failed to confirm the value of investments from any proper source. In case the auditor has simply relied on the management's representation, the auditor has failed to perform his duty.

Conclusion: Accordingly, CA. Mayank, will be held liable for the professional misconduct under Clauses (2), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

4. (a) (i) As per SA 560, 'Subsequent Events', the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

(1) Discuss the matter with management and, where appropriate, those charge

(2) Determine whether the financial statements need amendment and, if so,

(3) Inquire how management intends to address the matter in the financial statements.

In the given case, on becoming aware of the court case filed against Rare (P) Ltd., Mr. Rishabh discussed the said matter with the management and was determined to amend the financial statements. Also, he inquired how the management intended to address the said matter in the financial statements.

Thus, it can be said that Mr. Rishabh has properly adhered to his responsibilities in accordance with SA 560, on becoming aware of the court case filed against Rare (P) Ltd.

(ii) As per SA 706, 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report', an Emphasis of Matter paragraph is not a substitute for:

(a) A modified opinion in accordance with SA 705 (Revised) when required by the circumstances of a specific audit engagement;

(b) Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or

(c) Reporting in accordance with SA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

In the given case, the management of Rare (P) Ltd. has presumed that as the auditor was going to provide a description of the said court case and its outcome in the 'Emphasis of Matter' paragraph in his amended audit report, there was no further need for it to provide additional disclosures about the court case in the financial statements.

The said contention of management of Rare (P) Ltd. is not valid as 'Emphasis of Matter' paragraph cannot be used as a substitute for disclosures required to be made in the financial statements as per the applicable financial reporting framework or that is otherwise necessary to achieve fair presentation, which is the responsibility of the management.

(b) The given case highlights that CTO Limited, engaged in Fintech business, is a member of Chamber of Commerce/associations. Such information needs to be disclosed under Principle 7 of Principle-wise Performance Disclosures.

Principle 7 recognizes that businesses, when engaging in influencing public and regulatory policy, operate within the framework of statutory and legislative policies of the governing authority. Collective associations such as trade groups and industry chambers have to be utilized when moving ahead with policy advocacy and formulation.

The information under each principle is to be disclosed under Essential indicators (mandatory disclosures) and Leadership indicators (optional disclosures).

Information relating to membership of Chamber/associations is in the nature of Essential Indicators and requires mandatory disclosures.

Information relating to inputs provided by company to the Ministry on a legislative bill and inputs provided to one of the prominent chambers on leveraging India's digital public infrastructure for creating solutions by banks and Fintechs together as a taskforce member on the subject are in nature of leadership positions taken by the company. These are in the nature of Leadership Indicators and are optional disclosures.

(c) In the present case, with respect to the loans and advances of ₹ 75 Lacs given to Hariharan Pvt. Limited, the Company has not furnished any agreement to CA. Navya. In the absence of such an agreement, CA. Navya is unable to verify the terms of repayment, chargeability of interest and other terms. For an auditor, while verifying any loans and advances, one of the most important audit evidence is the loan agreement. Therefore, the absence of such a document in the present case, tantamount to a material misstatement in the financial statements of the company. However, the inability of CA. Navya to obtain such audit evidence is though material but not pervasive so as to require him to give a disclaimer of opinion.

Thus, in the present case, CA. Navya should give a qualified opinion.

The relevant extract of the Qualified Opinion Paragraph and Basis for Qualified Opinion paragraph is as under:

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the financial statements of Lakshay Ltd. give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as on 31.03.2024 and profit/ loss for the year ended on that date.

Basis for Qualified Opinion

The Company is unable to furnish the loan agreement with respect to loans and advances of ₹ 75 Lacs given to Hariharan Pvt. Ltd. Consequently, in the absence of such an agreement, we are unable to verify the terms of repayment, chargeability of interest and other terms.

5. (a) **Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists**: As per SA 720, "The Auditor's Responsibility in Relation to Other Information", descriptions of trends in market prices of key commodities or raw materials is an example of amounts or other Items that may be included in the other information.

The auditor's discussion with management about a material inconsistency (or other information that appears to be materially misstated) may include requesting management to provide support for the basis of management's statements in the other information. Based on management's further information or explanations, the auditor may be satisfied that the other information is not materially misstated. For example, management explanations may indicate reasonable and sufficient grounds for valid differences of judgment.

Auditor's duties with regard to reporting in the given case are given hereunder:

As per SA 720, "The Auditor's Responsibility in Relation to Other Information", if the auditor concludes that a material misstatement of the other information exists, the auditor shall request management to correct the other information. If management:

(i) Agrees to make the correction, the auditor shall determine that the correction has been made; or

(ii) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made.

Contention of the partner of the firm that auditors are not concerned with such disclosures made by the management in its annual report, is incorrect.

(b) The likely objectives of performance audit to be conducted by office of C & AG of India of some selected social security pension schemes and scholarship schemes in a state could be: -

- Whether proper planning and process were in place to capture data of beneficiaries under above schemes

- Whether necessary steps were taken for implementation of DBT like preventing delay in payments to the intended beneficiaries and pilferage and duplication
- Whether the infrastructure, organization and management of DBT were adequate and effective.

"Audit criteria" are standards used to determine whether a programme meets or exceeds expectations. It provides a context for understanding the results of the audit. Audit criteria are reasonable and attainable standards of performance against which economy, efficiency and effectiveness of programmes and activities can be assessed.

In the above situation, various documents issued by Government of India and state government like circulars, instructions, Standard operating procedure manuals, guidelines of schemes on identification and authentication of beneficiaries etc, general management and subject matter literature can be used to determine "audit criteria".

(c) As per provisions of Council Guidelines for Advertisement, 2008, it is not permissible for members to list themselves with online application based service provider Aggregators, wherein other categories like businessmen, technicians, maintenance workers, event organizers etc. are also listed.

Further, as per explanation to Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949, the government departments, government Companies/ corporations, courts, cooperative societies and banks and other similar institutions prepare panels of Chartered Accountants for allotment of audit and other professional work. Where the existence of such a panel is within the knowledge of a member, he is free to write to the concerned organization with a request to place his name on the panel. However, it would not be proper for the Chartered Accountant to make roving enquiries by applying to any such organization for having his name included in any such panel. It is permissible to quote fees on enquiries being received or respond to tenders from the organizations requiring professional services, which maintain such panel.

Getting registered on GeM portal by members does not appear to amount either to empanelment or listing on Aggregator. In Aggregator, it is the third party which is operating, and not the client itself. GeM is operated by the client itself.

It is a pre-requirement of rendering professional services to the Government departments, as stipulated by them, and be considered as ancillary requirement to providing services to the Government departments. Firms of Chartered Accountants are permitted to register on GeM Portal for rendering professional services as there is no violation of the ethical norms of the Institute in registering on the GeM portal and such registration on the Portal is a pre-requirement for providing services to the Government departments/ organisations.

However, firms should ensure compliance with the tender guidelines issued by the Institute while participating in tender or bid floated through GeM Portal. The ICAI has made an announcement in relation to the above.

6. **(a)** When the auditor's report on the audited financial statements contains a qualified opinion, but the auditor is satisfied that the summary financial statements are consistent, in all material respects, with or are a fair summary of the audited financial statements, in accordance with the applied criteria, the auditor's report on the summary financial statements shall, in addition to the elements of auditor's report on summary financial statements described in SA 810: -

(a) State that the auditor's report on the audited financial statements contains a qualified opinion and

(b) Describe:

   (i) The basis for the qualified opinion on the audited financial statements, and that qualified opinion; and

   (ii) The effect thereof on the summary financial statements, if any

If the summary financial statements are not consistent, in all material respects, with or are not a fair summary of the audited financial statements, in accordance with the applied criteria, and management does not agree to make the necessary changes, the auditor shall express an adverse opinion on the summary financial statements.

Or

(a) In a review engagement performed under SRE 2400, the practitioner performs primarily inquiry and analytical procedures to obtain sufficient appropriate evidence as the basis for a conclusion on the financial statements as a whole expressed in accordance with the requirements of SRE 2400.

In a review engagement, evidence obtained through inquiry is often the principal source of evidence about management intent. Application of professional skepticism in evaluating responses provided by management is important to enable the practitioner to evaluate whether there are any matters that would cause the practitioner to believe that the financial statements may be materially misstated. Performing inquiry procedures also assists the practitioner in obtaining or updating the practitioner's understanding of the entity and its environment, to be able to identify areas where material misstatements are likely to arise in the financial statements.

In a review of financial statements, performing analytical procedures assists the practitioner in: -

- Obtaining or updating the practitioner's understanding of the entity and its environment, including to be able to identify areas where material misstatements are likely to arise in the financial statements.
- Identifying inconsistencies or variances from expected trends, values or norms in the financial statements such as the level of congruence of the financial statements with key data, including key performance indicators.
- Providing corroborative evidence in relation to other inquiry or analytical procedures already performed.
- Serving as additional procedures when the practitioner becomes aware of matters that cause the practitioner to believe that the financial statements may be materially misstated. An example of such an additional procedure is a comparative analysis of monthly revenue and cost figures

across profit centers, branches or other components of the entity, to provide evidence about financial information contained in line items or disclosures contained in the financial statements.

In a review engagement, practitioner's report contains a description of a review of financial statements and its limitations, and the following statements in this respect: -

(i) A review engagement under this SRE is a limited assurance engagement.

(ii) The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained and

(iii) The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Standards on Auditing (SAs), and, accordingly, the practitioner does not express an audit opinion on the financial statements.

(b) Clause 11 of Part I of First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he engages in any business or occupation other than the profession of Chartered Accountants unless permitted by the Council so to engage.

Provided that nothing contained herein shall disentitle a Chartered accountant from being a director of a Company, (not being a managing director or a whole time director), unless he or any of his partners is interested in such company as an auditor.

Ethical Standards Board of ICAI has announced that it is permissible for a member in practice to engage in derivative transactions in his personal capacity but not in professional capacity i.e. for clients. Such engagements in derivatives are not violative of provisions of Clause 11 of Part I of First Schedule to the Chartered Accountants Act, 1949. Further, members are allowed to transact in equity and currency derivatives. There is no requirement to take permission of Council in this matter.

Therefore, there is no difference if CA. Z had earned income from currency derivatives. However, in accordance with announcement of Ethical Standards Board of ICAI, it is not permissible for members in practice to transact in commodity derivative transactions. In such a case, CA. Z would be held guilty of professional misconduct for engaging in business other than profession of Chartered Accountancy.

(c) In a forensic accounting engagement, professional undertakes a scrutiny and detailed examination of all transactions and balances relevant to the mandate so that evidence gathered is suitable in a Court of Law i.e. in compliance with legal requirements where it can be challenged through cross-examination by the defending party.

It is important that team is skilled in collecting evidence that can be used in a court case keeping a clear chain of custody till evidence is presented in court. If there are gaps in chain of custody, then the evidence may be challenged in court or even become inadmissible.

In the given case, team has failed to keep record of matters such as persons gathering relevant evidence, date and time of collection and storage of evidence. Therefore, team has failed to maintain the chain of custody.

It can, therefore, defeat the objective of forensic accounting engagement as evidence may be challenged in Court of law by defending parties and may become inadmissible.

ANSWERS OF MODEL TEST PAPER 2

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING, ASSURANCE AND PROFESSIONAL ETHICS

PART I: MULTIPLE CHOICE QUESTION

1. (a)
2. (b)
3. (c)
4. (c)
5. (c)
6. (d)
7. (a)
8. (b)
9. (d)
10. (a)
11. (c)
12. (a)
13. (d)
14. (a)
15. (b)

PART II - DESCRIPTIVE QUESTION

1. (a) As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", the auditor is required to obtain an understanding and need to evaluate the impact of other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements.

The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

(a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and

(b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities

As per section 143(3)(j) read with Rule 11(a), the auditor is required to report whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement.

As per SA 570, "Going Concern", if the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(i) Adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(ii) Disclose clearly that there is material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall (a) Express a Qualified opinion or Adverse opinion, as appropriate, in accordance with SA 705; and (b) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

In the current scenario, Nandini Ltd. has received a show cause notice from the National Green Tribunal of an amount which is more than the net profit and the turnover of the company for the year. In the event of an unfavourable order for Nandini Ltd., there will be an impact on Nandini Ltd.'s ability to continue as a going concern.

As a result, appropriate disclosure should be provided by management for such events, which cast significant doubt on the entity's ability to continue as a going concern. As no appropriate disclosure has been provided by Nandini Ltd. for such show cause notice, Vasu & Co. should report this matter in their audit report under "Going Concern Para" as per SA 570 and under clause (j) of section 143(3) of the Companies Act, 2013. Also, the auditor is required to issue an Adverse opinion as per SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

(b) As per SA 220, "Quality Control for an Audit of Financial Statement", the engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. For audits of financial statements of listed entities, the engagement partner shall:

- Determine that an engagement quality control reviewer has been appointed;
- Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
- Not date the auditor's report until the completion of the engagement quality control review.

Further, SA 700," Forming an Opinion and Reporting on Financial Statements", requires the auditor's report to be dated not earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements. In cases of an audit of financial statements of listed entities where the engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction on or before the date of the auditor's report.

In this case, the audit of BB Ltd. for the year ending on 31st March 2024 was conducted by Pine & Associates and was completed on 1st May, 2024. Subsequently, the engagement partner reviewed the audit by 12th May, 2024. The audit report issued by Pine and Associates was dated 15th May, 2024. However, the engagement quality control review was finalized on 18th May, 2024, which is later than the date of the audit report. In view of above, the date of auditors' report before the completion of the engagement quality control review, is not correct.

(c) As per SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" and SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.

In accordance with SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" and SA 330, "The Auditor's Responses to Assessed Risks" the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level and assertion level.

The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property. However, when there is a complex revenue structure or when there is lack of controls on revenue recognition, then there is a high probability of fraud risk in revenue recognition.

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit.

In the current scenario, the company was earning revenue from multiple streams. Also, it was identified that the controls are not properly designed to mitigate the risk of fraud and risk of improper revenue recognition. During the year it was identified that the management did not account for revenue from corporate hotel bookings amounting to ₹ 43 crore. These amounts were partially received in the company's bank accounts and partially received in the CFO's personal account. The amounts received in the bank account of the company were disclosed as advances received against future bookings.

Therefore, the auditor while performing the risk assessment procedures should consider the complexity and nature of the revenue for determining the fraud risks in revenue recognition. Also, there were no adequate controls addressing the risk of improper revenue recognition or fraud risk, the audit team rebutted the fraud risk. Moreover, the audit team should have recognised fraud risk by identifying the deficiencies of internal control over the revenue recognition process and should have treated the risk of improper revenue recognition as a significant risk. Also, as per Section 143(12), the auditor is required to report all the frauds identified during the course of the audit involving amounts above ₹ 1 crore within the prescribed time frame to the Central Government

2. (a) **Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole:** As per SA 320**,** "Materiality in Planning and Performing an Audit" determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

In case if PCM Ltd. is engaged in manufacture and sale of air conditioner, and is having regular profits: CA. Suneel, the auditor may consider profit before tax /Earnings.

In case if PCM Ltd. is engaged in the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic: CA. Suneel, the auditor may consider Revenue or Gross Profit as benchmarking. Alternatively, CA. Suneel, the auditor may consider the criteria relevant for audit of the entities doing public utility programs/ projects, Total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

(b) Some examples of technology risks where Mr. Ravi should test the appropriate controls for relying on the digital systems

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both
- Unauthorized access to data that might result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions or inaccurate recording of transactions (specific risks might arise when multiple users access a common database)
- The possibility of information technology personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby leading to insufficient segregation of duties
- Unauthorized or erroneous changes to data in master files
- Unauthorized changes to systems or programs
- Failure to make necessary or appropriate changes to systems or programs
- Inappropriate manual intervention
- Potential loss of data or inability to access data as required
- Risks introduced when using third-party service providers
- Cybersecurity risks

Mr. Ravi should focus on the following control considerations to mitigate risks effectively:

1. Auditors should gain a holistic understanding of changes in the industry and the information technology environment to effectively evaluate management's process for initiating, processing, and recording transactions and then design appropriate auditing procedures.
2. Auditors, as appropriate, should consider risks resulting from the implementation of new technologies and how those risks may differ from those that arise from more traditional, legacy systems.

3. Auditors should consider whether digital upskilling or specialists are necessary to determine the impact of new technologies and to assist in the risk assessment and understanding of the design, implementation, and operating effectiveness of controls. E.g., cybersecurity control experts, IT specialists in the team etc.

(c) Given situation can be visualize in following parts:

(i) Mr. S used to involve himself in equity research and used to advise his friends, relatives and other known people: As per the recent decisions taken by the Ethical Standards Board of ICAI, a Chartered Accountant in practice may be an equity research adviser, but he cannot publish a retail report, as it would amount to other business or occupation.

In the given case, though Mr. S is involved in doing equity research and in advising people, it is clear that he does not publish any retail report of his research. Hence, this act of Mr. S shall not make him guilty of professional misconduct.

(ii) Mr. S is involved in paper-setting for the Accountancy subject in the school where he studied. He also owns agricultural land and does agriculture activities: As per Clause 11 of Part I of First Schedule of the Chartered Accountants Act, 1949 and regulation 190A of Chartered Accountants Regulations, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

Further, Regulation 190A mentions the 'Permissions granted Generally' to engage in a certain category of occupations, for which no specific permission of Council is required. Those cases include:

- Valuation of papers, acting as paper-setter, head examiner or a moderator, for any examination.
- Owning agricultural land and carrying out agricultural activities.

Therefore, in the given case, the activities of Mr. S as a paper-setter and involvement in agricultural activities do not make him guilty of professional misconduct.

(iii) Mr. S was discharged insolvent: Disabilities for the Purpose of Membership : Section 8 of the Chartered Accountants Act, 1949 enumerates the circumstances under which a person is debarred from having his name entered in or borne on the Register of Members, If he, being a discharged insolvent, has not obtained from the court a certificate stating that his insolvency was caused by misfortune without any misconduct on his part. Here it may be noted that a person who has been removed from membership for a specified period shall not be entitled to have his name entered in the Register until the expiry of such period.

In addition, failure on the part of a person to disclose the fact that he suffers from any one of the aforementioned disabilities would constitute professional misconduct. The name of the person, who is found to have been subject at any time to any of the disabilities discussed in section 8, can be removed from the Register of Members by the Council.

In the given case, it is clearly stated that Mr. S was discharged insolvent, and he has also obtained from the court a certificate stating that his insolvency was caused by misfortune without any misconduct on his part. Hence, Mr. S has not violated the provisions of section 8, and he is not debarred from having his name entered in the Register of Members.

3. **(a)** **Observation 1** - The management had disclosed in the financials that, during the year, one of the warehouses of the Company was affected due to a major flood. As a result of the same, the Company had incurred some losses. But the management was of the view that it was not material. As per SA 706, “Emphasis of Matter Paragraph & Other Matter Paragraph in the Independent Auditor’s Report”, an Emphasis of Matter Paragraph refers to matter appropriately disclosed in the financials, that in the auditor’s judgement is of such importance that it is fundamental to users’ understanding of the financials. Hence, in this case, the auditor shall report about the consequences of the flood which affected the company's warehouse under Emphasis of Matter Paragraph.

Observation 2 - Due to flood, few records maintained by the Company with respect to a particular transaction were destroyed and no duplicate records were maintained by the Company. However, those details were not pervasive, but material. As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", where the auditor is unable to obtain sufficient and appropriate audit evidence and where such matter is material but not pervasive, the auditor shall issue a Qualified opinion.

Thus, in the given situation, on account of flood few records pertaining to particular transactions were completely destroyed and in the absence of duplicate records, the auditor was unable to obtain sufficient and appropriate audit evidence and those details were material but not pervasive. Therefore, in accordance with SA 705, the auditor is required to issue Qualified opinion.

(b) In case of Sale of NPA by Bank, the auditor should examine that:

- The policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers including non-performing financial assets that may be sold, norms or such sale, valuation procedure and accounting policy.
- Only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.
- The assets have been sold "without recourse' only i.e., the entire credit risk associated with the non-performing asset should be transferred to the purchasing bank.
- Subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.

- The NPA has been sold at cash basis only. Under no circumstances, NPA can be sold to another bank at a contingent price. The entire sale consideration has to be received on upfront basis.
- The bank has not purchased an NPA which it had originally sold.
- On the sale of the NPA, the same has been removed from the books of the account of selling bank on transfer;
- If the sale is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year.
- If the sale is for a value higher than the NBV, the excess provision shall not be reversed but will be utilised to meet the shortfall/ loss on account of sale of other non-performing financial assets.

In the given situation, management of NRF Bank Ltd. is considering to sell following NPAs, during the month of April, 2023:

Name	NPA since F.Y.	Amount (₹ in lakh)
Fin Pvt. Ltd.	2019-20	36.55
Dairy Works	2021-22	55.24
Book Store	2018-19	29.85
Fancy Corp.	2017-18	61.42
RSM and Associates	2020-21	19.25

In view of above-mentioned conditions, the auditor is required to ensure that only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.

Considering the facts given in the question all the NPAs, except for Dairy Works, are prior to April 2021 i.e., 2 years prior to April 2023. In view of the above provisions, management of NRF Bank Ltd. can sell all the NPAs except for NPA of 55.24 lakh rupees of Dairy Works as it has remained NPA in the books of the banks less than 2-year duration.

(c) **Soliciting Clients:** As per Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means except applying or requesting for or inviting or securing professional work from another Chartered Accountant in practice and responding to tenders.

Further, section 140(4)(iii) of the Companies Act, 2013, provides a right, to the retiring auditor, to make representation in writing to the company. The retiring auditor has the right for his representation to be circulated among the members of the company and to be read out at the meeting. However, the content of letter should be set out in a dignified manner how he has been acting independently and conscientiously through the term of his office and may, in addition, indicate, if he so chooses his willingness to continue as auditor, if re- appointed by the shareholders.

The proposition of the auditor to highlight contributions made by him in strengthening the control procedures in the representation should not be included in such representations because the representation letter should not be prepared in a manner to seek publicity.

Thus, highlighting contributions made by him in strengthening the control procedures, while submitting representation u/s 140(4)(iii) of the Companies Act, 2013 would amount to canvassing or soliciting for his continuance as auditor.

Therefore, CA. Anuj will be held guilty of professional misconduct under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949.

4. **(a)** As per SA 600, "Using the work of Another auditor", the principal auditor is normally entitled to rely upon the work of component auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor.

The principal auditor should consider the significant findings of the other auditor.

The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components. He may also decide that supplemental tests of the records or the financial statements of the component are necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

Accordingly, CA. Soni, can perform the above-mentioned audit procedures. However, the audit of the component's financial statements by the principal auditor is not required.

So, the contention of CA. Soni that for the purpose of audit of consolidated financial statements he is required to conduct an audit of the components financial statements is not correct.

Further, SA 230 issued by ICAI on Audit Documentation, and "Standard on Quality Control (SQC) 1, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Accordingly, it is the discretion of the component auditor as the working papers with respect to the components examined by the component auditor are the property of the component auditor.

So, the contention of CA. Soni is not correct.

(b) Sustainability reporting is an organization's practice of reporting publicly on its economic, environmental, and/or social impacts, and hence its contributions – positive or negative – towards the goal of sustainable development

Sustainability reporting refers to the information that companies provide about their performance to the outside world on a regular basis in a structured way. It is a comprehensive mechanism of measuring and disclosing sustainability data with performance indicators and management disclosures.

Expected Benefits: It can help stakeholders to understand organizations performance vis a vis sustainability and impacts. The reporting process emphasizes the link between financial and non-financial performance.

Such reporting can help entities to focus on long-term value creation, by addressing environmental, social and governance (ESG) issues. Since investors are increasingly recognizing that environmental and social issues provide both risks and opportunities in respect of their investments and are seeking disclosures on environmental and social performance of businesses, they can use ESG performance of companies to make investment decisions.

Investing in social and environmental issues will not only improve own business continuity of companies but also put them in a better position with their B2B (Business to Business) customers as well as enable them to acquire new ones.

(c) SA 610, "Using the Work of Internal Auditor" states that in determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned. Examples of activities and tasks that would not be appropriate to use internal auditors to provide direct assistance include the discussion of fraud risks, determination of unannounced audit procedures as addressed in SA 240 etc.

In the above case, engagement partner had designed certain substantive procedures on some selected assertions in response to assessed risk of material misstatements in year under audit. Such assertions were not tested by him in the previous years due to materiality or risk considerations. It is being done now for incorporating an element of unpredictability in audit procedures to be performed as individuals within the company who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting.

Therefore, in such matters, using an internal auditor to provide direct assistance could prove to be counter-productive and defeat the very purpose of designing such substantive procedures. Hence, decision of senior engagement team member to use Mr. X to provide direct assistance on above said matters is not in accordance with SA 610 and is not proper.

Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall: -

(a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and

(b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

5. (a) Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists: As per SA 720, "The Auditor's Responsibility in Relation to Other Information", descriptions of trends in market prices of key commodities or raw materials is an example of amounts or other Items that may be included in the other information.

The auditor's discussion with management about a material inconsistency (or other information that appears to be materially misstated) may include requesting management to provide support for the basis of management's statements in the other information. Based on management's further information or explanations, the auditor may be satisfied that the other information is not materially misstated. For example, management explanations may indicate reasonable and sufficient grounds for valid differences of judgment.

Auditor's duties with regard to reporting in the given case are given hereunder:

As per SA 720, "The Auditor's Responsibility in Relation to Other Information", if the auditor concludes that a material misstatement of the other information exists, the auditor shall request management to correct the other information. If management:

(i) Agrees to make the correction, the auditor shall determine that the correction has been made; or

(ii) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made.

Contention of the partner of the firm that auditors are not concerned with such disclosures made by the management in its annual report, is incorrect.

(b) In the given case, it is a "Compliance Audit" performed by Office of Comptroller & Auditor General of India.

Compliance audit is the independent assessment of whether a given subject matter is in compliance with the applicable criteria.

This audit is carried out by assessing whether activities, financial transactions and information comply in all material respects with the regulatory and other rules which govern the audited entity. Compliance auditing is concerned with: -

(a) Regularity- adherence of the subject matter to the formal criteria emanating from relevant laws, regulations, and agreements applicable to the entity.

(b) Propriety- observance of the general principles governing sound financial management and the ethical conduct of public officials.

While regularity is emphasized in compliance auditing, propriety is equally pertinent in the public sector context, in which there are certain expectations concerning financial management and the conduct of officials.

Under Article 151, audit reports of the C&AG relating to the accounts of the Central/ State Government should be submitted to the President/Governor of the State who shall cause them to be laid before Parliament/State Legislative Assemblies.

In the given situation, the report relates to the State Department. Therefore, report was likely to have been submitted to Governor of state to be laid before State legislative assembly.

(c) **Maintenance of Books of Account by a CA in Practice:** Chapter V of the Council General Guidelines, 2008 specifies that a member of the Institute in practice or the firm of Chartered Accountants of which he is a partner, shall maintain and keep in respect of his professional practice, proper books of accounts including the following-

(i) a Cash Book

(ii) a Ledger

Thus, a Chartered Accountant in practice is required to maintain proper books of accounts.

In the instant case, CA. Evan does not maintain proper books of accounts and writes the fees received from various clients in notes on his mobile. Notes maintained by him in mobile cannot be treated as books of accounts.

Hence, CA. Evan, being a practicing Chartered Accountant will be held guilty of misconduct for violation of Council General Guidelines, 2008.

6. **(a)** As per SRS 4410, "Compilation Engagements", if the practitioner is unable to complete the engagement because management has failed to provide records, documents, explanations or other information, including significant judgments, as requested, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing.

If the practitioner becomes aware during the course of the engagement that:

(a) The compiled financial information does not adequately refer to or describe the applicable financial reporting framework

(b) Amendments to the compiled financial information are required for the financial information not to be materially misstated; or

(c) The compiled financial information is otherwise misleading

the practitioner shall propose the appropriate amendments to management.

If management declines, or does not permit the practitioner to make the proposed amendments to the compiled financial information, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing.

If withdrawal from the engagement is not possible, the practitioner shall determine the professional and legal responsibilities applicable in the circumstances.

The practitioner shall obtain an acknowledgement from management or those charged with governance, as appropriate, that they have taken responsibility for the final version of the compiled financial information.

Or

(a) Prospective financial information can be in the form of a forecast, a projection, or a combination of both, for example, a one year forecast plus a five- year projection.

"Forecast" means prospective financial information prepared on the basis of:

- Assumptions as to future events which management expects to take place and
- The actions management expects to take as of the date the information is prepared (best-estimate assumptions- an assumption that reflects anticipated experience with no provision for risk of adverse deviation).

Example- In present market conditions, supply availability, historical buying patterns and seasonal trends, the CFO of X Ltd. expects sales to increase by 5% over the next quarter. Therefore, a 5% sales increase is his financial forecast for the period.

"**Projection"** means prospective financial information prepared on the basis of:

- Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or
- A mixture of best-estimate and hypothetical assumptions (imagined or suggested)

Example- X Ltd. may project a course of action to take when one or more hypothetical situations arise, such as creating a new product to meet the demand of expected market growth. As a result of assuming the possibility of different events occurring, financial projections typically serve as an outline for evaluating the desired outcomes X Ltd. expects to see, including its financial, cash flow and operational outcomes.

Prospective financial information relates to events and actions that have not yet occurred and might not occur. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future- oriented and, therefore, speculative in nature, as distinct from the evidence ordinarily available in the examination of historical financial information. Therefore, an opinion as to whether the results shown in the prospective financial information will be achieved cannot be expressed.

(b) **Issuing Certificate without having Certificate of Practice:** As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the Regulations made thereunder or any Guidelines issued by the Council.

This clause requires every member of the Institute to act within the framework of the Chartered Accountants Act,1949 and the Regulations made thereunder. Any violation either of the Act or the Regulations by a member would amount to misconduct.

In the given case, CA. Rahul has issued a certificate in respect of a consumption statement of raw material to the manager of Miskin (P)

Ltd., as a Chartered Accountant in practice when he had not even applied for the CoP to the Institute, thereby contravening the provisions of section 6 of the Chartered Accountants Act, 1949.

Therefore, CA. Rahul will be held guilty of professional misconduct in terms of Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949 for contravention of provisions of this Act.

(c) **Inventory Frauds-**Inventory frauds are many and varied but we are concerned with misappropriation of goods and their concealment.

(i) Employees may simply remove goods from the premises.

(ii) Theft of goods may be concealed by writing them off as damaged goods, etc.

(iii) Inventory records may be manipulated by employees who have committed theft so that book quantities tally with the actual quantities of inventories in hand.

(iv) Inflating the quantities issued for production is another way of defalcating raw materials and store items.

(v) Stocks actually dispatched but not entered in sales/ debtor's account.

Verification Procedure for Defalcation of inventory - It may be of trading stock, raw materials, manufacturing stores, tools or of other similar items (readily) capable of conversion into cash. The loss may be the result of a theft by an employee once or repeatedly over a long period, when the same have not been detected. Such thefts usually are possible through collusion among a number of persons. Therefore, for their detection, the entire system of receipts, storage and dispatch of all goods, etc. should be reviewed to localise the weakness in the system.

The determination of factors which have been responsible for the theft and the establishment of guilt would be difficult in the absence of: (a) a system of inventory control, and existence of detailed record of the movement of inventory, or (b) availability of sufficient data from which such a record can be constructed. The first step in such an investigation is to establish the different items of inventory defalcated and their quantities by checking physically the quantities in inventory held and those shown by the Inventory Book.

Investigating accountant should ascertain the exact duties of persons handling the stocks received in and issued from store for production/ sale or any other purpose. Identify the excessive control in the hands of a single person, without any supervision as it will widen the scope of investigation.

Afterwards, all the receipts and issues of inventory recorded in the Inventory Book should be verified by reference to entries in the Goods Inward and Outward Registers and the documentary evidence as regards purchases and sales. This would reveal the particulars of inventory not received but paid for as well as that issued but not charged to customers. Further, entries in respect of returns, both inward and outward, recorded in the financial books should be checked with corresponding entries in the Inventory Book. Also, the totals of the Inventory Book should be checked. Finally, the shortages observed on physical verification of inventory should be reconciled with the discrepancies observed on checking the books in the manner mentioned above. In the case of an industrial concern, issue of raw materials, stores and tools to the factory and receipts of manufactured goods in the godown also should be verified with relative source documents.

Defalcations of inventory, sometimes, also are committed by the management, by diverting a part of production and the consequent shortages in production being adjusted by inflating the wastage in production; similar defalcations of inventories and stores are covered up by inflating quantities issued for production. For detecting such shortages, the investigating accountant should take assistance of an engineer. For that he will be more conversant with factors which are responsible for shortage in production and thus will be able to correctly determine the extent to which the shortage in production has been inflated. In this regard, guidance can also be taken from past records showing the extent of wastage in production in the past. Similarly, he would be able to better judge whether the material issued for production was excessive and, if so to what extent. The per hour capacity of the machine and the time that it took to complete one cycle of production, also would show whether the issues have been larger than those required.

ANSWERS MODEL TEST PAPER 3

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

Part I: MULTIPLE CHOICE QUESTION

1. **(c)**
2. **(a)**
3. **(d)**
4. **(b)**
5. **(a)**
6. **(d)**
7. **(b)**
8. **(b)**
9. **(c)**
10. **(d)**
11. **(a)**
12. **(c)**
13. **(a)**
14. **(c)**
15. **(c)**

Part II - DESCRIPTIVE QUESTION

1. (a) As per SA 550, "Related Parties", communicating significant matters arising during the audit in connection with the entity's related parties helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters. Examples of significant related party matters include, non-disclosure (whether intentional or not) by management to the auditor of related parties or significant related party transactions, which may alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware; The identification of significant related party transactions that have not been appropriately authorised and approved, which may give rise to suspected fraud; etc.

It may be noted that unless all of those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

The auditor is also required to ensure the compliance of Ind AS 24 Related Party Disclosures.

In view of above in the given scenario, the auditor is required to prepare a summary of following items to be reported to those charged with governance in accordance with SA 260 Communication with Those Charged with Governance:

(i) A related party transaction with M/s. MNJ Associates involving ₹4.75 lakh per month for marketing services was identified, where ₹0.18 lakh per month exceeds the arm's length price. This transaction has not been disclosed as a related party transaction in accordance with Ind AS 24 Related Party Disclosures.

(ii) The refusal by the CFO of the company to provide details of a related party transaction amounting to ₹ 35 lakh on the grounds of confidentiality, is not in order, as denying for the related party details of ₹ 35 lakh is imposing limitation of scope of auditor in view of SA 705.

(iii) The receipt of free-of-cost computers and long-term borrowings (without agreed terms for repayment of interest and principal) from the parent company needs to be separately disclosed in the financial statements as per Ind AS 24 Related Party Disclosures.

Further, in all the above cases, the auditor would also need to assess his reporting requirements under the clause (xiii) of Paragraph 3 of CARO 2020 with respect to related party transactions that whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the financial statements etc., as required by the applicable Accounting Standards.

(b) Auditor's responsibility in cases where audit report for an earlier year is qualified is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements".

As per SA 710, when the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

SA 710 further states that if the auditor's report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

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

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

In the instant case, if Param Limited does not correct the treatment of depreciation extent of ₹ 3.75 crore for previous year, the auditor will have to modify his report for both current and previous year's figures as mentioned above. If, however, the figures and provisions are corrected, the auditor need not refer to the earlier year's modification.

(c) **Written Representations**: As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

SA 580, "Written Representations" discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognised or disclosed in the financial statements may include representations:

(i) About the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.

(ii) That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.

(iii) That disclosure related to accounting estimates are complete and appropriate under the applicable financial reporting framework.

(iv) That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

2. (a) **Acceptance and Continuance of Client Relationships and Specific Engagements**: As per SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", the firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will undertake or continue relationships and engagements only where it is competent to perform the engagement and has the capabilities, time and resources to do so.

In the given case, JPG & Associates, Chartered Accountants, statutory auditors of VS Limited for the last three years, came to know that the company has expanded its operations into a new segment as well as new geography. JPG & Associates does not possess the necessary expertise for the same, therefore, JPG & Associates wish to withdraw from the engagement and client relationship. Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:

Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.

If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.

Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.

Documenting significant issues, consultations, conclusions, and the basis for the conclusions.

JPG & Associates should address the above issues before deciding to withdraw.

(b) Key Steps for Auditors in a Changing Technology Environment

As auditors obtain an understanding of the impact of technology on a company's business, its systems of internal control, and its financial reporting. Some key steps to be taken by the auditor include the following:

- Maintain sufficient professional skepticism when reviewing management's risk assessment for new systems.
- Understand the direct and indirect effects of new technology and determine how its use by the entity impacts the auditor's overall risk assessment.
- Understand how the technologies impact the flow of transactions, assess the completeness of the in-scope ICFR systems, and design a sufficient and appropriate audit response.

- Assess the appropriateness of management's processes to select, develop, operate, and maintain controls related to the organization's technology based on the extent the technology is used.

(c) **Failure to Exercise Reasonable Care and Skill:** Clause (7) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

In the given case, CA. T did not detect any fraud. However, the C & AG audit staff, during their routine inspection, found that the chief cashier of the company committed fraud in debtor's ledger and absconded with the amount.

Apparently, it appears that the auditor did not exercise proper skill and care and that he performed his work in an improper manner. In this matter, the test for auditor's liability lies in whether he has applied reasonable care, skill and caution called for in the circumstances of the case and whether he reasonably used all the information that he came across during the audit.

The auditor should have been highly concerned about the cashbook's state due to the unexpected disappearance of the head cashier. This unexplained absence is a major red flag and demands a thorough investigation by the auditor.

As per SA 240, "The auditor's responsibilities relating to fraud in an audit of financial statements", it can be concluded that the auditor did not plan and perform the audit with an attitude of professional skepticism. Thus, having regard to this that fraud has actually taken place during the year committed by the absconding cashier, it is reasonable to think that prima facie there is a case against the auditor for gross negligence.

As it appears from the facts of the case, CA. T has been grossly negligent in performing his duties which constitutes professional misconduct. Thus, such instances require reference to Disciplinary Committee of the Council of the Institute.

3. **(a)** As per SA 530, "Audit Sampling", the auditor shall evaluate:

(a) The results of the sample; and

(b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

In the given case, Ridhi concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, Ridhi may:

(I) request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or

(II) tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

(b) The areas of advances which need to be verified are as under:

i. Interest rates fed in the system need to be verified with respect to corresponding sanction letters. It would help ensure that the correct rate of interest is fed into the system and interest is applied properly at stipulated intervals on advances.

ii. Processing fees in respect of freshly sanctioned advances and renewed limits need to be levied in accordance with bank guidelines and these need to be verified. Any revision in processing fees from time to time has to be given effect to in accordance with circulars/manual of bank.

iii. Sanction of cash credit limits is generally accompanied with stipulation to submit stock statements. Non-submission of stock statements can involve levying of penal interest. Verification of this aspect is required.

iv. Verification of overdue interest on export bills purchased and packing credit facilities for overdue period.

v. Verification of charges/commission in respect of letters of credit issued in accordance with Bank's circulars/manual.

(c) Disclosure of Material Facts: A Chartered Accountant in practice is deemed to be guilty of professional misconduct under Clause (5) of Part I of the Second Schedule if he "fails to disclose a material fact known to him which is not disclosed in a financial statement but disclosure of which is necessary to make the financial statement not misleading".

In the given case, Mr. Anuj was aware of some part of the expenses not applied towards the object i.e. contraventions and irregularities committed by the trust as these were referred to in the separate report given by him to the Board of Trustees of the company. However, he issued an audit report without any qualification is not in order.

Therefore, CA Anuj is deemed to be guilty of professional misconduct.

4. (a) (i) Matters to be reported by Mr. Sodi as per CARO, 2020 are as follows:-

According to Clause (i) (d) of Para 3 of CARO 2020, the auditor is required to report whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if the change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant And Equipment or intangible assets;

In the given situation, Capital Limited has revalued one of the Plant and Equipment taken on a lease ('right of use' asset) based on the valuation by a registered valuer. The amount of change in the value of such Plant and Equipment is ₹ 35 lakh. As the net carrying value of Plant and Equipment in aggregate was changed from ₹ 3 crore to ₹ 3.35 crore i.e. change was 10% or more.

Thus, the auditor is required to report the amount of change of ₹ 35 lakh in accordance with Clause (i) (d) of Para 3 of CARO 2020.

(ii) As per Clause (ii) (b) of Para 3 of CARO 2020, the auditor is required to report whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

In the instant case, Capital Limited has been sanctioned a cash credit limit of ₹ 5.10 crore by BDD Bank during the year under consideration, which is exceeding the prescribed limit of ₹ 5 crore based on the security of current assets. Further, quarterly returns have also been filed by the company with the BDD bank in this connection which is in agreement with Books of Accounts.

In view of the above, the auditor is required to report the same in accordance with Clause (ii) (b) of Para 3 of CARO 2020.

(b) Principle 3 – Promote well-being of all employees including those in the value chain:

The third principle relates to all the initiatives an entity has to take for the benefit of its employees from the point of view of their dignity, health, well-being.

The essence of the core elements associated with the principle is:

a) The entity should ensure compliance with all regulatory requirements as far as employees are concerned.

b) The entities are to respect the dignity of employee as a human being and should not restrict their freedom of associations, unions, and other participatory mechanism for collective bargaining of their rights and redressal of issues they face at the workplace.

c) The entities should prevent all kinds of child labour, bonded labour, and any other forms of involuntary labour.

d) The entities should have a system in which the work-life balance of the employees is not compromised.

e) The businesses have to ensure timely payment of the worker's wages and compensation.

f) The payment of the wages has to be as per the living wages, that can take care of the basic needs and provide economic security to the employees.

g) The entities are responsible to create a workplace and work environment that is safe, hygienic, and comfortable for people to work for long durations.

h) The skill development, career development and training of the workforce is another responsibility of the entities employing them.

i) The creation of a workplace which is free of harassment and violence is also a responsibility of the entity.

(c) Auditor's duties in case of inconsistency in Audit evidence: SA 705 "Modifications to the Opinion in the Independent Auditor's Report", deals with auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(b) The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Further, the auditor shall modify the opinion in the auditor's report when the auditor concludes that based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement:

In the present case, during the course of the audit, CA. Suchi obtained certain audit evidence which was not consistent with the affirmation made in financial statements. Therefore CA. Suchi should modify her report in accordance with SA 705 as per the circumstances of the case.

- CA. Suchi shall express Qualified opinion when, having obtained sufficient appropriate audit evidence, she concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements.
- CA. Suchi shall express an Adverse opinion, where the auditor, having obtained sufficient appropriate evidence, concludes that misstatements, individually, or in the aggregate, are both material and pervasive to the financial statements.

5. **(a)** According to SA-200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the Audit Risk is a risk that Auditor will issue an inappropriate opinion while Financial Statements are materially misstated.

Audit Risk has two components namely: Risk of material Misstatement and Detection Risk.

The relationship can be defined as follows.

Audit Risk = Risk of material Misstatement x Detection Risk

Risk of material Misstatement: - Risk of Material Misstatement is anticipated risk that a material Misstatement may exist in Financial Statement before start of the Audit. It has two components namely Inherent risk and Control risk.

The relationship can be defined as

Risk of material Misstatement = Inherent risk X control risk

Inherent risk: it is a susceptibility of an assertion about account balance; class of transaction, disclosure towards misstatements which may be either individually or collectively with other Misstatement becomes material before considering any related internal control which is 40% in the given case.

Control risk: it is a risk that there may be chances of material Misstatement even if there is a control applied by the management and it has prevented defalcation to 75%.

Hence, control risk is 25% (100%-75%)

Risk of material Misstatement: Inherent risk X control risk i.e. 40% X 25% = 10%

Chances of material Misstatement are reduced to 10% by the internal control applied by management.

Detection risk: It is a risk that a material Misstatement remained undetected even if all Audit procedures were applied, Detection Risk is 100-60 = 40%

In the given case, overall Audit Risk can be reduced up to 4% as follows:

Audit Risk: Risk of Material Misstatement X Detection Risk = 10X 40% = 4%

(b) **Applicability of Provisions of Internal Audit:** As per section 138 of the Companies Act, 2013, following class of companies (prescribed in Rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(A) every listed company;

(B) every unlisted public company having-

(1) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(2) turnover of two hundred crore rupees or more during the preceding financial year; or

(3) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(4) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(C) every private company having-

(1) turnover of two hundred crore rupees or more during the preceding financial year; or

(2) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

In the given case, IDI Limited is a listed company. As per section 138 of the Companies Act, 2013, every listed company is required to appoint an internal auditor or a firm of internal auditors. Thus, in view of the above, IDI Limited is required to appoint an internal auditor.

Further, TIJ Limited is unlisted public company. The company is having ₹ 60 crore as equity share capital which is exceeding the prescribed limit of rupees fifty crore as per section 138. Thus, TIJ Limited is required to appoint an internal auditor as per section 138 of the Companies Act, 2013.

MIN Limited is unlisted private company and having ₹ 60 crore as equity share capital, ₹ 190 crore as turnover and ₹ 50 crore loan from Bank and PFI. In view of provisions of section 138 of the Companies Act, 2013 discussed above, all the limits are below the prescribed limit for a private company. Therefore, MIN Limited is not required to appoint an internal auditor.

It can be concluded that IDI Limited and TIJ Limited is required to appoint the internal auditor as per the provisions of the Companies Act, 2013 whereas MIN Limited is not required to do the same.

(c) **Sharing Professional Fees with Registered Valuer:** As per Clause (3) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant will be guilty of professional misconduct if he accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute.

A member cannot share his fees with a non-member similarly he is also not permitted to receive and share the fees of others except for sharing with member of such professional body or other person having such qualification as may be prescribed (Regulation 53A of the Chartered Accountants Regulations, 1988) by the council.

Under the Regulation 53A of the Chartered Accountants Regulations, 1988, registered valuer is not included.

In the instant case Mr. Rishi, who is a newly qualified Chartered Accountant in practice entered into an agreement with Mr. Krish, a qualified and experienced registered valuer, to share 18% professional fees for all case of valuation referred to him by CA. Rishi. CA. Rishi also received ₹ 1,15,000 for the same from Mr. Krish. Thus, CA. Rishi will be held guilty for misconduct under clause (3) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

6. (a) As per SAE 3400, "The Examination of Prospective Financial Information", when determining the nature, timing and extent of examination procedures, the auditor should consider matters such as:

(i) the knowledge obtained during any previous engagements;

(ii) management's competence regarding the preparation of prospective financial information;

(iii) the likelihood of material misstatement;

(iv) the extent to which the prospective financial information is affected by the management's judgment;

(v) the sources of information considered by the management for the purpose, their adequacy, reliability of the underlying data, including data derived from third parties, such as industry statistics, to support the assumptions;

(vi) the stability of entity's business; and

(vii) the engagement team's experience with the business and the industry in which the entity operates and with reporting on prospective financial information.

Or

As per SRE 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity", when in the auditor's judgment, those charged with governance do not respond appropriately within a reasonable period, the auditor should consider:

(a) Whether to modify the report or

(b) The possibility of withdrawing from the engagement and

(c) The possibility of resigning from the appointment to audit the annual financial statements.

In the given case, CA. Tripti who was conducting review of the quarterly financial information of a company, communicated the matter to the CFO and audit committee. However, no response was received even after waiting for a reasonable time. In such case, she has above mentioned options as per SRE 2410.

(b) Mr. Nandkishore has violated following provisions of the Chartered Accountants Act, 1949:

(i) As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

In this connection, members sponsoring activities relating to Corporate Social Responsibility may mention their individual name with the prefix "CA". However, mentioning a firm's name or CA Logo is not permitted.

An event relating to Corporate Social Responsibility was sponsored by NK & Associates, whereby in the sponsorship banner, name of Mr. Nandkishore as 'CA Nandkishore, Proprietor, NK & Associates' was mentioned. Thus, firm's name was mentioned which is not allowed and thus, Mr. Nandkishore has violated the restriction imposed under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

(ii) As per Clause (3) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, a member of the ICAI shall be deemed to be guilty of professional misconduct, if he includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary

Committee, Quality Review Board or the Appellate Authority, any particulars knowing them to be false.

Mr. Nandkishore in the statement of appeal submitted with the Appellate Authority mentioned some facts knowing them to be false and thus, he has violated the restriction imposed under Clause (3) of Part II of the Second Schedule to the Chartered Accountants Act, 1949.

(c) Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank - The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

(i) Fixed assets - A full description of each item, its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

(ii) Inventory - The value of different types of inventories held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued.

Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of inventory subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.

If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.

(iii) Trade Receivables, including bills receivable - Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.

Further, the total amount outstanding at the close of the period should be segregated as follows:

(i) debts due in respect of which the period of credit has not expired;

(ii) debts due within six months; and

(iii) debts due but not recovered for over six months.

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The recoveries out of various debts subsequent to the date of the Balance sheet should be stated.

(iv) Investments - The schedule of investments should be prepared. It should disclose the ¬date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.

(v) Secured Loans - Debentures and other loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re-payment of a liability should be disclosed.

(vi) Provision of Taxation - The previous years up to which taxes have been assessed should be ascertained. If provision for taxes not assessed appears in be inadequate, the fact should be stated along with the extent of the shortfall.

(vii) Other Liabilities - It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade payables should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.

(viii) Insurance - A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets.

(ix) Contingent Liabilities - By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced those of machinery suppliers and the legal adviser, for example, the investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.

Finally, the investigating accountant should ascertain whether any application for loan to another bank or any other party has been made. If so, the result thereof should be examined.

ANSWERS OF MODEL TEST PAPER - 4

FINAL COURSE: GROUP I

PAPER-3: ADVANCED AUDITING, ASSURANCE AND PROFESSIONAL ETHICS

Part I: MULTIPLE CHOICE QUESTION

1. (c)
2. (a)
3. (b)
4. (d)
5. (b)
6. (c)
7. (d)
8. (b)
9. (a)
10. (c)
11. (d)
12. (a)
13. (b)
14. (c)
15. (a)

Part II - DESCRIPTIVE QUESTION

1. (a) M/s Dharam & Associates are unable to obtain sufficient appropriate audit evidence about the financial information of a joint venture investment that represents over 89% of the group's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are both material and pervasive to the consolidated financial statements. Therefore, the statutory auditor should issue a disclaimer of opinion.

The relevant extract of the Disclaimer of Opinion paragraph and basis for Disclaimer of Opinion paragraph is as under:

Disclaimer of Opinion

We were engaged to audit the accompanying consolidated financial statements of Spice Ltd., (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group), which comprise the consolidated balance sheet as at March 31, 2024, the consolidated statement of Profit and Loss, (consolidated statement of changes in equity) and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "Consolidated Financial Statements").

We do not express an opinion on the accompanying consolidated financial statements of the group. Because of the significance of the matter described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

Basis for Disclaimer of Opinion

The Group's investment in its joint venture Croptop Ltd. company is carried at ₹ 120 crore on the Group's consolidated balance sheet, which represents over 89% of the Group's net assets as at March 31, 2024. We were not allowed access to the management and the auditors of Croptop Ltd., including audit documentation of auditors of Croptop Ltd. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of Croptop Ltd.'s assets that it controls jointly, its proportional share of Croptop Ltd.'s liabilities for which it is jointly responsible, its proportional share of Croptop Ltd.'s income and expenses for the year, (and the elements making up the consolidated statement of changes in equity) and the consolidated cash flow statement.

(b) SA 505, "External Confirmations", states that if the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

In the instant case, GST registrations of 38 concerns have been cancelled in the year 2023-24. It indicates that businesses at those addresses were closed. Further, there are no fresh registrations pertaining to the PANs of these parties. However, the auditor sent external confirmation requests in March 2024, which were duly responded. It raises questions on the reliability of responses received.

SA 500, “Audit Evidence” indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form or by electronic or other medium. Factors that may indicate doubts about the reliability of a response include:

- Was received by the auditor indirectly or
- Appeared not to come from the originally intended confirming party.

Keeping in view the circumstances described in the given situation, there is a risk that the response has not come from the originally intended confirming party. Unreliable responses may indicate a fraud risk factor that requires evaluation.

(c) In the given case, the auditor has come to know the legal claim against the company before the issuance of the audit report. It has also come to his knowledge that the management of the company has agreed to an out of court settlement of ₹ 4 crore.

This is an example of a subsequent event between the date of the financial statements and the date of the auditor’s report. It provides evidence of conditions that existed at the date of the financial statements and requires adjustment in financial statements.

Further as per SA 560, “Subsequent Events”, the auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, “Written Representations” that all the events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

CA Shobit should ensure that appropriate adjustments and disclosures are made by the management. In the absence of the same, he should consider the impact of the said event and report accordingly.

2. (a) **Audit procedure to verify Current Accounts and Saving Accounts are:**

- Verify on a sample basis current account and saving accounts opened during the year for adherence to KYC norms. Verify that saving accounts are opened in name of individuals, HUF, some approved institutions like trusts, educational institutes etc. Remember that saving accounts are not opened for business or professional concern. The business transactions are carried in current accounts which can be opened for all kind of customers like companies, individuals, partnership firms etc.
- Verify the balances in individual accounts on a sample basis.
- Check the calculations of interest on a test check basis. Remember that no interest is paid generally on current accounts by banks.
- Examine whether the procedure for obtaining balance confirmation periodically has been followed consistently. Examine, on a sampling basis, the confirmations received.
- Ensure that debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head ‘advances’.
- Inoperative accounts (both current and saving) are a high-risk area of frauds in banks. As per RBI guidelines, a savings/ current account should be treated as inoperative/dormant if there are no transactions in the account for over a period of two years. Verify on a sample basis some of inoperative accounts revived/closed during the year. Ensure that inoperative accounts are revived only with proper authority. In this regard, cases where there is a significant reduction in balances of such accounts as compared to previous year, examine authorisation for withdrawals.

(b) As per Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he, certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice, under Clause (2); does not exercise due diligence, or is grossly negligent in the conduct of his professional duties, under Clause (7); or fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion, under Clause (8).

The primary duty of physical verification and valuation of investments is of the management. However, the auditor's duty is also to verify the physical existence and valuation of investments placed, at least on the last day of the accounting year. The auditor should verify the documentary evidence for the cost/value and physical existence of the investments at the end of the year. He should not blindly rely upon the management's representation.

In the instant case, the investment of ₹ 23 lakh appeared in the Balance Sheet of the company and was the same amount as in the last year. Later, it was found that the company's investments were only ₹ 76,000, but the value of investments was inflated for the purpose of obtaining higher amount of bank loan. Such non-verification happened for two years. It also appears that auditors failed to confirm the value of investments from any proper source. In case auditor has simply relied on the management's representation, the auditor has failed to perform his duty.

Thus, in view of above, CA Aditya will be held liable for professional misconduct under Clauses (2), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

(c) **Key considerations that CA Kabir should address for effectiveness and security of the remote audits are:**

Feasibility and Planning

- Planning should involve agreeing on audit timelines, meeting platform (Zoom calls/ Microsoft Teams/Google Meet) to be used for audit sessions, data exchange mechanisms, any access authorization requests. Ensure feasibility is determining what technology may be used, if auditors and auditees have competencies and that resources are available.

- The execution phases of a remote audit involve video/tele conferencing with auditees. The documentation for audit evidence should be transferred through a document sharing platform.

Confidentiality, Security and Data Protection

- To ensure data security and confidentiality, access to document sharing platform should be sufficiently restricted and secured by encrypting the data that is sent across the network. The information, once reviewed and documented by auditor, is removed from the platform, and stored according to applicable archiving standards and data protection requirements.

  Auditors should take into consideration legislation and regulations, which may require additional agreements from both sides (e.g., there will be no recording of sound and images, or authorizations to using people's images). Auditors should not take screenshots of auditees as audit evidence. Any screenshots of documents or records or other kind of evidence should be previously authorized by the audited organization. In case of accessing the auditee's IT system auditor should use VPN (Virtual private network). VPN is a service which creates safe and encrypted online connections. It prevents unauthorized users to enter into the network and allows the users to perform work remotely.

Risk assessment

- The communication from auditor as well as auditees need to clear and consistent, and this becomes crucial during remote audit. The risks for achieving the audit objectives are identified, assessed and managed. The assessment if remote audit would be sufficient to achieve the audit objectives should be done and documented for each audit involving all members of the audit team and the audited organization representative.

3. **(a)** As per SA 320, "Materiality in Planning and Performing an Audit", when establishing the overall audit strategy, the auditor shall determine materiality for the financial statement as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

If the auditor concludes a lower materiality for the same, he shall determine whether it is necessary to revise performance materiality and whether the nature, timing and extent of the further audit procedures remain appropriate.

In the given case, Deepti & Co., as an auditor has applied the concept of materiality for the financial statements as a whole. But they want to re-evaluate the materiality concept on the basis of additional information of import of machinery for production of new product which draws attention to a particular aspect of the company's business.

Thus, Deepti & Co. can re-evaluate the materiality concepts after considering the necessity of such revision.

(b) In order to identify a particular company as Non-Banking Financial Company (NBFC), it will consider both assets and income pattern as evidenced from the audited balance sheet of the previous year to decide its principal business. The company will be treated as NBFC when

(i) Financial assets of the company constitute more than 50 percent of the total assets (netted off by intangible assets) and

(ii) Income from financial assets of the company constitutes more than 50 percent of the gross income.

A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by RBI.

In the given case of Singh Ltd, its financial assets are ₹ 374 Crore i.e., (₹ 61.75 + ₹ 312.25).

Total Assets (netted off by intangible assets) = ₹ 608 Crore.

Income from financial assets = ₹ 68 Crore.

Gross Income = ₹ 118.75 Crore.

From the above, it can be concluded that financial assets of Singh Ltd. constitute more than 50 per cent of the total assets (netted off by intangible assets) and income from financial assets of Singh Ltd. constitutes more than 50 per cent of the gross income. Hence, Singh Ltd. fulfills both the criteria to qualify as an NBFC.

Thus Singh Ltd. can apply for registration under Section 45-IA of the Reserve Bank of India (Amendment) Act, 1997 in prescribed form along with the necessary documents.

(c) As per Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice will be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of the Chartered Accountant unless permitted by the Council so to engage.

As per the Guidelines for Corporate Form of Practice, the Council has allowed the members in practice to hold the office of Managing Director, Whole-time Director or Manager of a body corporate within the meaning of the Companies Act, 2013 provided that the body corporate is engaged exclusively in rendering Management Consultancy and Other Services permitted by the Council in pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 and complies with the conditions(s) as specified by the Council from time to time in this regard. The name of the Management Consultancy Company is required to be approved by the Institute and such a Company has to be registered with the Institute.

The members can retain a full-time Certificate of Practice besides being the Managing Director, Whole-time Director or Manager of such management consultancy company. There will be no restriction on the quantum of the equity holding of the members, either individually and/ or along with the relatives, in such a company. Such members shall be regarded as being in full- time practice and therefore can continue to do attest function either in individual capacity or in Proprietorship/Partnership firm in which capacity they practice and wherein they are also entitled to train articled/audit assistants.

In the given case, CA Shubh, a Chartered Accountant specializing in Information Systems Audit and considered an expert in the field, was offered the position of Managing Director by ZX Limited, a management consultancy firm. He accepted the role without obtaining prior permission from the Institute of Chartered Accountants of India

From the above provisions, it can be concluded that the action of CA Shubh is valid.

4. **(a)** (i) The auditor is required to report the transaction as per Clause (xv) of Paragraph 3 of the CARO, 2020 which states that whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with.

Further, as per Clause (xiii) of Paragraph 3 of the CARO, 2020, auditor should report whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards.

In the given situation, Candy Ltd. has entered into non-cash transactions with one of the directors, Mr. Sidhant during the year, by transferring the property (by Mr. Sidhant) in favour of the Company in a deed of exchange of a site owned by the company.

Thus, the auditor is required to report the same as per Clause (xv) and Clause (xiii) of Paragraph 3 of the CARO, 2020.

(ii) As per clause (vii) (b) of Paragraph 3 of CARO,2020, the auditor is required to report where statutory dues have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned.

In the given situation, the survey team pointed out certain lapses regarding non-deduction of TDS and demand raised by DCIT(TDS). TDS dues are in the nature of statutory dues and the company has filed appeal against order of DCIT (TDS) raising a demand of ₹ 25 lacs with JCIT (Appeals). Therefore, these are in the nature of disputed statutory dues. Thus, it should be reported in accordance with Clause (vii) (b) of Paragraph 3 of CARO, 2020.

(b) As per section 138 of the Companies Act, 2013, following class of companies (prescribed in Rule 13 of the Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(A) every listed company;

(B) every unlisted public company having-

(1) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(2) turnover of two hundred crore rupees or more during the preceding financial year; or

(3) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(4) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(C) every private company having-

(1) turnover of two hundred crore rupees or more during the preceding financial year; or

(2) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

In the given case, XYX Limited is a listed company. As per section 138 of the Companies Act, 2013, every listed company is required to appoint an internal auditor or a firm of internal auditors. Thus, in view of the above, XYX Limited is required to appoint an internal auditor.

Further, MNM Limited is unlisted public company. The company is having ₹ 60 crore as equity share capital which is exceeding the prescribed limit of rupees fifty crore as per section 138. Thus, MNM Limited is required to appoint an internal auditor as per section 138 of the Companies Act, 2013.

GFG Limited is unlisted private company and having ₹ 70 crore as equity share capital, ₹ 180 crore as turnover and ₹ 80 crore loan from Bank and PFI. In view of provisions of section 138 of the Companies Act, 2013 discussed above, all the limits are below the prescribed limit for a private company. Therefore, GFG Limited is not required to appoint an internal auditor.

It can be concluded that XYX Limited and MNM Limited are required to appoint the internal auditor as per the provisions of the Companies Act, 2013 whereas GFG Limited is not required to do the same.

(c) As per Clause (7) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty if he does not exercise due diligence or is grossly negligent in the conduct of this professional duties.

In the given case, Pitch Private Limited requested CA Angad, a practicing Chartered Accountant, to digitally sign the form related to resignation of Mr. Ravi, one of the Director of Pitch Private Limited, along with the copy of Resignation Letter to be uploaded on the website of Registrar of Companies. The signature of Mr. Ravi was simply copied and pasted by another Director of Pitch Private Limited.

CA Angad, without verifying the genuineness of the Resignation Letter, digitally signed the Form and the said form was uploaded on the website of Registrar of Companies.

Due to forged resignation letter, the resignation of Mr. Ravi from directorship of the Pitch Private Limited had been occurred. It was noted that CA Angad had not taken any step to verify forged signature on resignation letter which anyone would have taken in normal circumstances.

Hence, CA Angad would be held liable for professional misconduct as per Clause (7) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

5. (a) As per SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", the firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will undertake or continue relationships and engagements only where it is competent to perform the engagement and has the capabilities, time and resources to do so.

In the given case, SPS & Associates, Chartered Accountants, statutory auditors of Grec Limited for the last two years, came to know that the company has expanded its operations into a new segment as well as in new country. SPS & Associates does not possess the necessary expertise for the same, therefore, SPS & Associates wish to withdraw from the engagement and client relationship. Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:

Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.

If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.

Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.

Documenting significant issues, consultations, conclusions, and the basis for the conclusions.

SPS & Associates should address the above issues before deciding to withdraw.

(b) CA H should consider the requirement of SA 600, "Using the Work of Another Auditor", if he decides to use the work of another auditor in relation to the audit of consolidated financial statements and he should comply with the requirements of SA 600.

In carrying out the audit of the standalone financial statements, the computation of materiality for the purpose of issuing an opinion on the standalone financial statements of each component would be done component-wise on a standalone basis.

However, with regard to determination of materiality during the audit of consolidated financial statements (CFS), the auditor should consider the following:

(i) The auditor is required to compute the materiality for the group as a whole. This materiality should be used to assess the appropriateness of the consolidation adjustments (i.e. permanent consolidation adjustments and current period consolidation adjustments) that are made by the management in the preparation of CFS.

(ii) The parent auditor can also use the materiality computed on the group level to determine whether the component's financial statements are material to the group to determine whether they should scope in additional components, and consider using the work of other auditors as applicable.

(iii) The principal auditor also computes materiality for each component and communicates to the component auditor, if he believes is required for true and fair view on CFS.

(iv) The principal auditor also obtains certain confirmations from component auditors like independence, code of ethics, certain information required for consolidation and disclosure requirements etc.

However, while considering the observations (for instance modification and /or emphasis of matter in accordance with SA 705/706) of the component auditor in his report on the standalone financial statements, the principles of SA 600 need to be considered i.e. CA H (the parent auditor) should comply with the requirements of SA 600, "Using the Work of Another Auditor".

(c) As per SA 402 "Audit Considerations relating to an Entity using a Service Organization", when obtaining an understanding of the user entity in accordance with SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment", the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including:

(i) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;

(ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;

(iii) The degree of interaction between the activities of the service organisation and those of the user entity; and

(iv) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organization.

Based on above, while conducting the audit, CA Harish will assess the effect on the audit risk and take necessary steps.

6. **(a)** As per SAE 3400, "The Examination of Prospective Financial Information", when determining the nature, timing and extent of examination procedures, the auditor should consider matters such as:

(i) the knowledge obtained during any previous engagements;

(ii) management's competence regarding the preparation of prospective financial information;

(iii) the likelihood of material misstatement;

(iv) the extent to which the prospective financial information is affected by the management's judgment;

(v) the sources of information considered by the management for the purpose, their adequacy, reliability of the underlying data, including data derived from third parties, such as industry statistics, to support the assumptions;

(vi) the stability of entity's business; and

(vii) the engagement team's experience with the business and the industry in which the entity operates and with reporting on prospective financial information.

(b) In the given situation, Shri Limited, a listed company, has installed pollution control equipment for processing the pollutants to keep the level of pollution below the prescribed standard. The company managed to get pollution certificate by unfair means whereas breach of pollution control laws still continues. For arranging clearance certificate amount of ₹ 18.75 lacs had been incurred unlawfully. CA Gopal, Director Finance, came to know about these matters on review of the same during the period.

NOCLAR, under Code of Ethics, is applicable on professional accountants in service, and in practice. Among those in practice, it applies to Auditors, as well as professional services other than Audit.

It is applicable to Senior Professional Accountants in service, being employees of listed entities. Senior professional accountants in service ("senior professional accountants") includes directors.

NOCLAR takes into account non-compliance that causes substantial harm resulting in serious consequences in financial or non-financial terms.

As per NOCLAR, in exceptional circumstances, the professional accountant might become aware of an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. Having first considered whether it would be appropriate to discuss the matter with management or those charged with governance of the company, the accountant shall exercise professional judgment and determine whether to disclose the matter immediately to an appropriate authority in order to prevent or mitigate the consequences of such imminent breach. If disclosure is made, that disclosure is permitted.

CA Gopal, Director-Finance is expected of taking the following action/responses:

- Obtaining an understanding of the Matter.
- Addressing the matter.
- Seeking advice.
- Determining whether further action is needed.
- Determining whether to disclose the matter to an Appropriate Authority.
- Imminent breach.
- Documentation.

(c) The objective of the Due Diligence exercise will be to look specifically for any hidden liabilities or over-valued assets.

Example of Hidden Liabilities:

- The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.
- The company may have given "Letters of Comfort" to banks and Financial Institutions. Since these are not "guarantees", these may not be disclosed in the Balance sheet of the target company.
- The Company may have sold some subsidiaries/businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer. These may not be reflected in the books of accounts of the company.

- Product and other liability claims; warranty liabilities; product returns/discounts; liquidated damages for late deliveries etc. and all litigation.
- Tax liabilities under direct and indirect taxes.
- Long pending sales tax assessments.
- Pending final assessments of customs duty where provisional assessment only has been completed.
- Agreement to buy back shares sold at a stated price.
- Future lease liabilities.
- Environmental problems/claims/third party claims.
- Unfunded gratuity/superannuation/leave salary liabilities; incorrect gratuity valuations.
- Huge labour claims under negotiation when the labour wage agreement has already expired.
- Unresolved labour litigations.

OR

As per SA 810, "Engagements to Report on Summary Financial Statements", when the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion, the auditor's report on the summary financial statements shall, additionally:

(a) State that the auditor's report on the audited financial statements contains an adverse opinion or disclaimer of opinion;

(b) Describe the basis for that adverse opinion or disclaimer of opinion; and

(c) State that, as a result of the adverse opinion or disclaimer of opinion, it is inappropriate to express an opinion on the summary financial statements.

ANSWERS OF MODEL TEST PAPER 5

FINAL COURSE: GROUP I

PAPER-3: ADVANCED AUDITING, ASSURANCE AND PROFESSIONAL ETHICS

Part I: MULTIPLE CHOICE QUESTION

1. **(c)**

2. **(b)**

3. **(c)**

4. **(d)**

5. **(a)**

6. **(d)**

7. **(c)**

8. **(c)**

9. **(d)**

10. **(a)**

11. **(d)**

12. **(d)**

13. **(b)**

14. **(d)**

15. **(a)**

Part II - DESCRIPTIVE QUESTION

1. **(a)** As per SA 710, "Comparative Information – Corresponding Figures and Comparative Financial Statements", when the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

SA 710 further states that if the auditor's report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

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

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

In the instant case, if Neptune Ltd. does not make provision for diminution in the value of investment to the extent of ₹ 70 lakh, the auditor will have to modify his report for both the current and previous year's figures as mentioned above. If, however, the provision is made, the auditor need not refer to the earlier year's modification.

(b) In the present case based on the audit evidence obtained, CA Shiv has concluded that a material uncertainty exists related to the outcome of the legal dispute, which is uncertain, but if it results in an unfavorable judgment, it could severely impact the Company's financial position and cash flows. In such circumstances, CA Shiv should express an adverse opinion because the effects on the financial statements of such omission are material and pervasive.

The relevant extract of the Adverse Opinion Paragraph and Basis for Adverse Opinion paragraph is as under:

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly, the financial position of the entity as at March 31, 2024, and of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

Basis for Adverse Opinion

The financing arrangements of Pratibha Ltd. has expired, and the amount outstanding was payable on March 31, 2024. The entity has been unable to conclude re-negotiations or obtain replacement financing and is considering filing for bankruptcy. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this fact.

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

In the given case, CA Guru has reason to believe that a fraud involving ₹ 75 lakhs has been committed in the company by its employees. Therefore, he is under no statutory obligation to report this matter to Central Government by filing prescribed Form (ADT-4) on MCA portal.

In case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed. Besides, auditor has obligation to report matters pertaining to fraud under clause (xi) of paragraph 3 of CARO, 2020.

2. **(a)** As per SA 701, 'Communicating Key Audit Matters in the Independent Auditor's Report', the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

(i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.

(ii) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.

(iii) The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the aforesaid matters considered were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

These aforesaid considerations focus on the nature of matters communicated with those charged with governance. Such matters are often linked to matters disclosed in the financial statements and are intended to reflect areas of the audit of the financial statements that may be of particular interest to intended users.

The fact that these considerations are required is not intended to imply that matters related to them are always key audit matters; rather, matters related to such specific considerations are key audit matters only if they are determined to be of most significance in the audit.

In addition to matters that relate to the specific required considerations, there may be other matters communicated with those charged with governance that required significant auditor attention and that therefore may be determined to be key audit matters. Such matters may include, for example, matters relevant to the audit that was performed that may not be required to be disclosed in the financial statements. For example, the implementation of a new IT system (or significant changes to an existing IT system) during the period may be an area of significant auditor attention, in particular if such a change had a significant effect on the auditor's overall audit strategy or related to a significant risk (e.g., changes to a system affecting revenue recognition).

In the given case, there was implementation of ERP system in the company due to which some of its business processes got automated and which had a significant effect on the auditor's overall audit strategy during the period.

As per Mr. Arjun, Engagement Partner, above mentioned matter can be considered as a key audit matter and should be reported in the audit report since it requires significant attention that had affected his overall audit strategy. Mr. Krishna, EQCR, considered the significance of said matter, however, he was of the opinion that ERP implementation did not appear to link with the matters disclosed in the financial statements, therefore, no need to disclose such matter as a key audit matter.

In view of the above, the contention of Mr. Krishna is not appropriate as matters that do not link with the matters disclosed in the financial statements can also be considered as a key audit matter, if it requires significant attention.

(b) Clause 11 of Part I of First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he engages in any business or occupation other than the profession of Chartered Accountants unless permitted by the Council so to engage.

Provided that nothing contained herein shall disentitle a Chartered accountant from being a director of a Company, (not being a managing director or a whole-time director), unless he or any of his partners is interested in such company as an auditor.

Ethical Standards Board of ICAI has announced that it is permissible for a member in practice to engage in derivative transactions in his personal capacity but not in professional capacity i.e. for clients. Such engagements in derivatives are not violative of provisions of Clause 11 of Part I of First Schedule to the Chartered Accountants Act, 1949. Further, members are allowed to transact in equity and currency derivatives. There is no requirement to take permission of Council in this matter.

Therefore, there is no difference if CA. Kapila had earned income from currency derivatives. However, in accordance with announcement of Ethical Standards Board of ICAI, it is not permissible for members in practice to transact in commodity derivative transactions. In such a case, CA. Kapila would be held guilty of professional misconduct for engaging in business other than profession of Chartered Accountancy.

(c) Advantages and Disadvantages of Remote Audit:

ADVANTAGES	DISADVANTAGES
Cost and time effective: No travel time and travel costs involved.	Due to network issues, interviews and meetings can be interrupted.
Comfort and flexibility to the audit team as they would be working from home environment,	Limited or no ability to visualize facility culture of the organization, and the body language of the auditees. Time zone issues could also affect the efficiency of remote audit session.
Time required to gather evidence can spread over several weeks, instead of concentrated into a small period that takes personnel from their daily activities.	The opportunity to present doctored documents and to omit relevant information is increased. This may call for additional planning, some additional/different audit procedures, Security and confidentiality violation.
Auditor can get first-hand evidence directly from the IT system as direct access may be provided.	Remote access to sensitive IT systems may not be allowed. Security aspects related to remote access and privacy needs to be assessed
Widens the selection of auditors from global network of experts.	Cultural challenges for the auditor. Lack of knowledge for local laws and regulations could impact audit. Audit procedures like physical verification of assets and stock taking cannot be performed.

3. (a) Responsibility and Co-ordination among Joint Auditors: As per SA 299, "Joint Audit of Financial Statements", where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of the work would usually be in terms of audit identifiable units or specified area. In some cases, due to the nature of the business entity under audit, such a division of the work may not be possible. In such situations, the division of the work may be with reference to items of assets or liabilities or income or expenditure or with reference to period of time. The division of the work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

In respect of the audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate audit of the work performed by him. On the other hand all the joint auditors are jointly and severally responsible –

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

(ii) Decisions taken by all the joint auditors under audit planning phase concerning the nature, timing and extant of the audit procedure to be performed by each of the auditor;

(iii) Matters which are bought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(iv) Examining that the financial statements of the entity comply with the requirements of the relevant statute;

(v) Presentation and disclosure of financial statements as required by the applicable financial reporting framework;

(vi) Ensuring that the audit report complies with the requirements of the relevant statutes, the applicable Standards on Auditing and the other relevant pronouncements issued by ICAI;

The joint auditors shall also discuss and document the nature, timing, and the extent of the audit procedures for common and specific allotted areas of audit to be performed by each of the joint auditors and the same shall be communicated to those charged with governance. After identification and allocation of work among the joint auditors, the work allocation document shall be signed by all the joint auditors and the same shall be communicated to those charged with governance of the entity.

Hence, in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures.

In the instant case, Studio Ltd. appointed two CA Firms AB & Associates and CD & Co. as joint auditors for conducting audit. As observed during the course of audit that there is a significant understatement in the value of trade receivable and valuation of trade receivable work was looked after by AB & Associates.

In view of SA 299, AB & Associate will be held responsible for the same as trade receivable valuation work was looked after by AB & Associates only. Further, there is violation of SA 299 as the division of work has not been documented.

(b) As per Clause (xvi) of Paragraph 3 of CARO 2020, the auditor is required to report that "whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained."

The auditor is required to examine whether the company is engaged in the business which attracts the requirement of the registration. The registration is required where the financing activity is a principal business of the company. The RBI restrict companies from carrying on the business of a non-banking financial institution without obtaining the certificate of registration.

Audit Procedures and Reporting:

(i) The auditor should examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.

(ii) The financial statements should be examined to ascertain whether company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.

(iii) Whether the company has net owned funds as required for the registration as NBFC.

(iv) Whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.

(v) The auditor should report incorporating the following:-

(1) Whether the registration is required under section 45-IA of the RBI Act, 1934.

(2) If so, whether it has obtained the registration.

(3) If the registration not obtained, reasons thereof.

In the given case, Manu Finance Ltd. is a Non-Banking Finance Company and was in the business of accepting public deposits and giving loans since 2019. The company was having net owned funds of ₹ 1,75,00,000/-(one crore seventy five lakhs) which is less in comparison to the prescribed limit i.e. 2 crore rupees and was also not having registration certificate from RBI (though applied for it on 29th March 2024). The auditor is required to report on the same as per Clause (xvi) of Paragraph 3 of CARO 2020.

(c) According to Clause (7) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he "does not exercise due diligence or is grossly negligent in the conduct of his professional duties".

It is a vital clause which usually gets attracted whenever it is necessary to judge whether the accountant has honestly and reasonably discharged his duties. The expression negligence covers a wide field and extends from the frontiers of fraud to collateral minor negligence.

In the instant case, DIGI & Associate did not exercise due diligence and is grossly negligent in the conduct of his professional duties since it did not visit the site where the stock was lying and instead the firm relied on the MIS report along with inspection reports and photographs of stock taken by the employees of PQR Ltd, which is incorrect.

To conduct stock audit, ascertainment of existence and physical condition of stocks, cross tallying the stock with Stock statement submitted by bank borrower, correct classification of stocks for valuation purpose etc. is essential. Further submitting stock audit report without physically verifying the stock amounts to gross negligence.

From the above, it can be concluded that DIGI & Associate is guilty of professional misconduct under Clause (7) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

4. (a) **Consolidation of Financial Statement:** As per Ind AS 110, there is no such exemption for 'temporary control', or "for operation under severe long-term funds transfer restrictions" and consolidation is mandatory for Ind AS compliant financial statement in this case. Paragraph 20 of Ind AS 110 states that "Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee".

However, as per Section 129(3) of the Companies Act, 2013 read with rule 6 of the Companies (Accounts) Rules, 2014, where a company having subsidiary, which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with the provisions on consolidated financial statements provided in Schedule III to the Act.

In the given case, Girdhar Ltd.'s intention is disposal of the shares in the near future as shares are being held as stock in trade and it is quite clear that the control is temporary, Therefore, Girdhar Ltd. is required to prepare Consolidated Financial Statements in accordance with Ind AS 110 as exemption for 'temporary control' is not available in the same.

(b) Section 2(45) of the Companies Act, 2013, defines a "Government Company" as 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.

The auditors of these government companies are firms of Chartered Accountants, appointed by the Comptroller & Auditor General, who gives the auditor directions on the manner in which the audit should be conducted by them.

In the given situation, Abhinandan Ltd. is a company wholly owned by Delhi Government was disinvested during the previous year, resulting in 38% of the shares being held by public. The shares were also listed on the NSE. The listing of company's shares on a stock exchange is irrelevant for this purpose and hence, opinion of finance manager Paras is not correct.

(c) Under Section 2(2)(iv) of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice.

Pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949, read with Regulation 191 of Chartered Accountants Regulations, 1988 a member shall be deemed to be in practice if he, in his professional capacity and neither in his personal capacity nor in his capacity as an employee, acts as representative for taxation matters.

In the given situation, CA Ram, a practicing Chartered Accountant, provides non-assurance services. He is approached by DEF Limited, a non-audit client, to file an appeal in GST Tribunal against GST Demand of ₹ 6 crore, which was imposed by the Commissioner (Appeals) and to plead on behalf of DEF Limited in the matter. CA Ram offers to accept the case and agrees to charge fees of ₹ 3,50,000.

Therefore, CA Ram is not guilty of professional misconduct.

5. (a) In the instant case, Quality Ltd. is engaged in the business of manufacturing and distribution of various ready-to-cook products like vegetables, noodles etc. Further, management was looking for some financial investor to fund some part of the proposed expansion. Aman is interested in funding; therefore, he initiated investigation of audited financial statements to ensure the appropriateness of the valuation of the shares. For initiating the same it may be considered that if the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited statement of account arises. However, if the investigator has been requested to establish value of a business or a share or the amount of goodwill payable by an incoming partner, ordinarily the investigator would be entitled to put reliance on audited materials made available to him unless, in the course of his test verification, he finds the audit to have been carried on very casually or unless his terms of appointment clearly require to test everything afresh.

- If the statements of account produced before the investigator were not audited by a qualified accountant, then of course there arises a natural duty to get the figures in the accounts properly checked and verified.
- However, when the accounts produced to the investigator have been specially prepared by a professional accountant, who knows or ought to have known that these were prepared for purposes of the investigation, he could accept them as correct relying on the principle of liability to third parties.
- It would be prudent to see first that such accounts were prepared with objectivity and that no bias has crept in to give advantage to the person on whose behalf these were prepared.

(b) As per SA 450, “Evaluation of Misstatements Identified during the Audit”, the auditor is required to reassess materiality, in accordance with SA 320 “Materiality in Planning and Performing an Audit”, before evaluating the impact of uncorrected misstatements. This reassessment is crucial to confirm the ongoing appropriateness of materiality in light of the entity's actual financial results.

The determination of materiality under SA 320 often relies on estimates of the entity's financial results, given that the actual results may not be known during the early stages of the audit. Therefore, before the auditor proceeds to assess the effect of uncorrected misstatements, it becomes necessary to adjust the materiality calculated under SA 320 based on the now available actual financial results.

SA 320 outlines that, as the audit progresses, materiality may be revised for the financial statements as a whole or for specific classes of transactions, account balances, or disclosures. This revision is prompted by the auditor's awareness of information that would have led to a different initial determination. Typically, significant revisions occur before the evaluation of uncorrected misstatements. However, if the reassessment of materiality under SA 320 results in a lower amount, the auditor must reconsider performance materiality and the appropriateness of the audit procedures' nature, timing, and extent. This is crucial for obtaining sufficient and appropriate audit evidence on which to base the audit opinion.

In the present case involving MINI Builders Private Limited, it has been identified that the materiality calculated at the beginning of the audit for revenue was based on estimates provided by the management. The management extrapolated sales for the full year using the actual amount of 11 months, but since the company experiences significant monthly variations in sales, the actual sales for the last month were only 30% of the estimated figure. This discrepancy arose due to an unexpected slowdown in project completions.

In this audit scenario, Mr. Gautam, the auditor, must review and re-assess the materiality initially determined under SA 320 to ensure its continued validity in light of the actual financial results. If the re-assessed materiality is lower than the previously calculated amount, Mr. Gautam must reconsider performance materiality and the appropriateness of the nature, timing, and extent of further audit procedures. This meticulous approach is essential to gather sufficient and appropriate audit evidence, enabling Mr. Gautam to form an independent and objective opinion on the financial statements of MINI Builders Private Limited.

(c) The information given in situation [i] states that company has secured a loan to expand its operations and invests the funds in purchasing raw materials and machinery. The loan, along with revenue generated from existing sales, contributes to the pool of resources available for production. Therefore, it involves pool of funds that is available to the organization for use in the production of goods or provision of services. Further, it is obtained through financing, such as debt, equity, or grants, or generated through operations or investments. The capital referred to at [i] is "**Finance Capital**".

Further, situation [ii] describes increase in number of beneficiaries under flagship CSR programmes providing value for communities and sustainable livelihood is an example of relationships established within and between each community, group of stakeholders and other networks to enhance individual and collective well-being. The capital referred to at [ii] is "**Social and Relationship Capital**."

6. (a) As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, have regard to the significance of that expert's work for the auditor's purposes evaluate the competence, capabilities and objectivity of that expert.

A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats and may be created either by external structures (for example, the management's expert's profession, legislation or regulation), or by the management's expert's work environment (for example, quality control policies and procedures). Although safeguards cannot eliminate all threats to a management expert's objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- Financial interests.
- Business and personal relationships.
- Provision of other services.

In the current case, Black Mountain Mining Ltd. re-appointed Mr. Aman for this engagement as an independent expert. The audit team was of the view that the objectivity of the independent expert cannot be questioned just because he was appointed by management as their expert. However, the audit partner had a contrary view.

Hence, the audit team should evaluate the objectivity of an expert engaged by the entity as the threat to objectivity, created by being an employee of the entity, will always be present. An expert appointed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity. As a result, audit partner Atharva is correct in his view.

(b) **Delegation of Authority to the Employee:** As per Clause (12) of Part I of the First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct "if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements".

In this case CA Jay proprietor of M/s Adhya & Co., went to abroad and delegated the authority to another Chartered Accountant Mr. Vijay, his employee, for taking care of routine matters of his office who is not a partner but a member of the Institute of Chartered Accountants of India.

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated and such delegation will not attract provisions of this clause.

In the given case, Mr. Vijay, a Chartered Accountant being employee of M/s Adhya & Co. has asked for information or issued questionnaire. He has also proceeded for initiating and stamping of vouchers and of schedules prepared for the purpose of audit. Apart from the same, he acknowledged and carried out routine correspondence with clients. Here Vijay is right in doing the same, since the same falls under routine work which can be delegated by the auditor. Therefore, there is no misconduct in this case as per Clause (12) of Part I of First Schedule to the Act.

(c) The practitioner shall not accept the compilation engagement unless the practitioner has agreed the terms of engagement with management, and the engaging party if different. In accordance with SRS 4410, “Compilation Engagement”, the responsibilities of the management to be agreed on for the compilation engagement are that:

(i) The financial information, and for the preparation and presentation thereof, in accordance with a financial reporting framework that is acceptable in view of the intended use of the financial information and the intended users.

(ii) Design, implementation and maintenance of such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

(iii) The accuracy and completeness of the records, documents, explanations and other information provided by management for the compilation engagement and

(iv) Judgments needed in the preparation and presentation of the financial information, including those for which the practitioner may provide assistance in the course of the compilation engagement.

OR

(c) As per SRE 2400, “Engagements to Review Historical Financial Statements”, a review of financial statements includes consideration of the entity’s ability to continue as a going concern. If, during the performance of the review, the practitioner becomes aware of events or conditions that may cast significant doubt about the entity's ability to continue as a going concern, the practitioner shall:

(i) Inquire of management about plans for future actions affecting the entity's ability to continue as a going concern and about the feasibility of those plans, and also whether management believes that the outcome of those plans will improve the situation regarding the entity's ability to continue as a going concern.

(ii) Evaluate the results of those inquiries, to consider whether management's responses provide a sufficient basis to: -

  (1) Continue to present the financial statements on the going concern basis if the applicable financial reporting framework includes the assumption of an entity's continuance as a going concern or

  (2) Conclude whether the financial statements are materially misstated or are otherwise misleading regarding the entity's ability to continue as a going concern.

(iii) Consider management's responses in light of all relevant information of which the practitioner is aware as a result of the review.

ANSWERS OF MODEL TEST PAPER 6

FINAL COURSE: GROUP I

PAPER-3: ADVANCED AUDITING, ASSURANCE AND PROFESSIONAL ETHICS

Part I: MULTIPLE CHOICE QUESTION

1. (d)
2. (b)
3. (c)
4. (c)
5. (b)
6. (c)
7. (a)
8. (c)
9. (a)
10. (d)
11. (a)
12. (b)
13. (d)
14. (d)
15. (b)

Part II - DESCRIPTIVE QUESTION

1. (a) **Acceptance and Continuance of Client Relationships:** As per SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements," a firm before accepting an engagement should acquire vital information about the client. Such an information should help firm to decide about: -

- Integrity of Client, promoters, and key managerial personnel.
- Competence (including capabilities, time, and resources) to perform engagement.

- Compliance with ethical requirements.

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

Further, as per SA 220, "Quality Control for an Audit of Financial Statements", the engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence.

In view of the above, PQR Associates should:

✓ follow their firm's policies and procedures for client acceptance and continuance. This includes evaluating the integrity of the client, assessing potential risks associated with the engagement, and ensuring the firm has the necessary resources and expertise to perform the engagement effectively. The engagement team, should assess, whether the company is involved in any funding activities, to the political parties, and if so enquire and assess the risks related to such transactions.

✓ communicate clearly with the client regarding the scope of the engagement, the responsibilities of both parties, and any limitations on the services to be provided. This helps manage expectations and ensures alignment between the firm and the client.

✓ independence and objectivity throughout the engagement. Any potential threats to independence, such as relationships with the client's affiliates or involvement in political activities by related parties, should be evaluated and mitigated appropriately. Since the senior manager who was on this engagement is providing certain accounting services, to one of the group companies, the engagement partner, should assess, whether it would have any impact on the audit and examine the relevant ethical/independence requirements.

✓ continually monitor the client relationship for any changes or developments that may impact the firm's ability to provide services effectively. This includes staying informed about significant events such as the income-tax search, changes in client management, or potential conflicts of interest. Since there was an income-tax raid on the organisation, the engagement partner should evaluate the risks of material misstatements, and non-disclosure of tax disputes and liabilities.

✓ ensure that their engagement team possesses the necessary competence and capabilities to perform the audit effectively. The departure of a senior manager and the need to recruit a replacement with specific industry experience should be addressed promptly to maintain audit quality. Since one of the senior engagement team members has left PQR Associates, the engagement partner should assess, whether he would be in a position to devote adequate time on the engagement or whether to recruit another resource, before commencement of the audit.

(b) Drafting of Opinion Paragraph and basis thereof along with disclosure of Note XX:

INDEPENDENT AUDITOR'S REPORT

To the Members of Delhi Branch Office of Fancy Limited

Report on the Audit of the Standalone Financial Statements

Opinion

We have audited the standalone financial statements of Delhi Branch Office of Fancy Limited ("the Company"), which comprise the balance sheet as at March 31, 2024, and the statement of Profit & Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, give a true and fair view, in conformity with the accounting principles generally accepted in India, of the state of affairs of the Delhi Branch Office of the Company as at March 31, 2024 and profit/loss, *(changes in equity)* and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements as per the ICAI's Code of Ethics and the provisions of the Companies Act, 2013, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter

We draw attention to Note XX regarding Delhi Branch Office management's intention to close the operations of the Branch Office subject to regulatory approvals. Accordingly, the financial statements have been prepared on the basis that the Delhi Branch Office does not continue to be a going concern and provisions have been made in the books of account for the losses arising or likely to arise on account of closure of operations including the losses on the realizability of current assets.

Our opinion is not modified in respect of this matter.

(c) In the given situation, Mr. BK has been engaged by XYZ Ltd. to report on summary financial statements derived from the financial statements audited by him in accordance with SAs. Mr. BK, wants to determine whether the applied criteria are acceptable before accepting such assignment.

As per SA 810, "Engagements to Report on Summary Financial Statements", before accepting an engagement to report on summary of financial statements, the auditor shall determine whether applied criteria are acceptable. 'Applied criteria' refers to the criteria applied by management in the preparation of the summary financial statements.

Factors affecting the auditor's determination of the acceptability of the applied criteria are:

- The nature of the entity;
- The purpose of the summary financial statements;
- The information needs of the intended users of the summary financial statements; and
- Whether the applied criteria will result in summary financial statements that are not misleading in the circumstances.

2. (a) In the given scenario, CA. Z, as the statutory auditor of Happy Hospital, is concerned about the effectiveness of controls at the service organization, specifically the system managed by CT Contractors. To address this concern, CT Contractors should provide a Type 2 assurance report from a practicing chartered accountant as per SA 402, "Audit Considerations Relating to an Entity Using a Service Organisation". This report will offer an opinion on the description of the system in use at Happy Hospital, as well as evaluate the effectiveness of the controls implemented by CT Contractors.

Using a Type 2 report as audit evidence that controls at the service organisation are operating effectively: If, the user auditor plans to use a Type 2 report as audit evidence that controls at the service organisation are operating effectively, the user auditor shall determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by:

(a) Evaluating whether the description, design, and operating effectiveness of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;

(b) Determining whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;

(c) Evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and

(d) Evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment.

(b) As per Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing.

Although the mandatory requirement of communication with previous auditor being Chartered Accountant applies, in uniform manner, to audits of both government and Non-Government entities, yet in the case of audit of government Companies/ banks or their branches, if the appointment is made well in time to enable the obligation cast under this clause to be fulfilled, such obligation must be complied with before accepting the audit. However, in case the time schedule given for the assignment is such that there is no time to wait for the reply from the outgoing auditor, the incoming auditor may give a conditional acceptance of the appointment and commence the work which needs to be attended to immediately after he has sent the communication to the previous auditor in accordance with this clause. In his acceptance letter, he should make clear to the client that his acceptance of appointment is subject to professional objections, if any, from the previous auditors and that he will decide about his final acceptance after taking into account the information received from the previous auditor.

In the given case, PN and Associates are appointed as the Statutory Auditors of The Iron Company Ltd. which is a government company as Central Government holds 65% of the paid-up share capital of the company and CA N has given a conditional acceptance of the appointment and commenced the audit. In view of above, it can be concluded that CA N has complied with the provisions of the Chartered Accountants Act, 1949 and the Schedules thereunder.

(c) In order to demonstrate that the audit trail feature was functional, operated and was not disabled, a company would have to design and implement specific internal controls (predominantly IT controls) which in turn, would be evaluated by the auditors, as appropriate. An illustrative list of internal controls which may be required to be implemented and operated are given below:

- Controls to ensure that the audit trail feature has not been disabled or deactivated.
- Controls to ensure that User IDs are assigned to each individual and that User IDs are not shared.
- Controls to ensure that changes to the configurations of the audit trail are authorized and logs of such changes are maintained.
- Controls to ensure that access to the audit trail (and backups) is disabled or restricted and access logs, whenever the audit trails have been accessed, are maintained.
- Controls to ensure that periodic backups of the audit trails are taken and archived as per the statutory period specified under the provisions of the Act.

3. (a) To investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by the borrower, as well as the value of the security in the form of assets of the business already possessed and those which will be created out of the loan, the investigating accountant should take the under-mentioned steps:

(1) Prepare a condensed income statement from the Statement of Profit and Loss for the previous five years, showing separately therein various items of income and expenses, the amounts of gross and net profits earned and taxes paid

annually during each of the five years. The amount of maintainable profits determined on the basis of foregoing statement should be increased by the amount by which these would increase on the investment of borrowed funds.

(2) Compute the under-mentioned ratios separately and then include them in the statement to show the trend as well as changes that have taken place in the financial position of the company:

(i) Sales to Average Inventories held.

(ii) Sales to Fixed Assets.

(iii) Equity to Fixed Assets.

(iv) Current Assets to Current Liabilities.

(v) Quick Assets (the current assets that are readily realisable) to Quick Liabilities.

(vi) Equity to Long Term Loans.

(vii) Sales to Book Debts.

(viii) Return on Capital Employed.

(3) Enter in a separate part of the statement the break-up of annual sales product-wise to show their trend.

(b) In the given situation, CA N is carrying out an audit of restated financial statements of BQR Limited for past 3 financial years i.e., 2023-24, 2022-23 and 2021-22 so he requested Management Representation Letter from the management of the Company for this assignment before issuance of the report. The management of the Company provided the Management Representation Letter only for the financial year 2023-24 as they were not in place during that period.

As per SA 580, "Written Representations", as written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated before the date of the written representations.

As per SA 560, "Subsequent Events", the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

In some circumstances it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole.

Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies. Therefore, as per the above requirement of SA 580 CA. N should take written representation letter from management of BQR Limited for the financial year 2022-23 and 2021-22 also.

In case the management of BQR Limited does not provide written representation as requested, the auditor shall discuss with the management, re-evaluate the integrity of management, and take appropriate actions including the impact on the audit report as per SA 705.

(c) As per Section 2(2)(iv) of the Chartered Accountant Act, 1949 as amended from time to time, a member of the Institute shall be deemed 'to be in practice' when individually or in partnership with

Chartered Accountants in practice, or in partnership with members of such other recognized professional as may be prescribed, he, in consideration of remuneration received or to be received, renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice.

As per Clause (11) of Part I of First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

However, the Council of the Institute is empowered to permit chartered accountants in practice to engage in any other business or occupation considered fit and proper. Accordingly, the Council formulated Regulations 191 to the Chartered Accountants Regulations, 1988 specifying the activities with which a member in practice can associate himself with or without the permission of the Council. As per Regulation 191 a Chartered Accountant in practice may take up an appointment that may be made by the Central Government or a State Government or a court of law or any other legal authority or may act as a secretary in his professional capacity, provided his employment is not on a salary-cum-full-time basis".

In the instant case, CA Raj, a practicing chartered accountant has been appointed as a "Secretary" in his professional capacity by the Central Government for a metro project for a term of 2 years not on a salary-cum-full-time basis.

Conclusion: In view of above, in the given scenario, CA Raj will not be held liable for misconduct for acceptance of appointment as Secretary in terms of compliance of Regulations 191 read with Clause (11) of Part I of First Schedule of the Chartered Accountants Act, 1949.

4. **(a)** As per SA 220, "Quality Control for an Audit of Financial Statements", for audits of financial statements of listed entities, CA. Giri, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:

(i) The engagement team's evaluation of the firm's independence in relation to the audit engagement;

(ii) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations;

(iii) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments made and supports the conclusions reached.

As per SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", there might be difference of opinion within engagement team, with those consulted and between engagement partner and engagement quality control reviewer. The report should only be issued after resolution of such differences. In case, recommendations of engagement quality control reviewer are not accepted by engagement partner and matter is not resolved to reviewer's satisfaction, the matter should be resolved by following established procedures of firm like by consulting with another practitioner or firm, or a professional or regulatory body.

In the given situation, under completion of review, CA. Giri, Engagement Quality Control Reviewer has identified certain issues. However, the view of CA Giri, the EQCR are not accepted by the Engagement Partner. This difference of opinion among the CA Giri and Engagement Partner should be resolved with abovementioned manner as per SQC 1.

(b) As per SRS 4410, Compilation engagement is an engagement in which a practitioner applies accounting and financial reporting expertise to assist management in the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework and issues a report.

Management may request a professional accountant in public practice to assist with the preparation and presentation of financial information of an entity. Financial information that is the subject of a compilation engagement may be required for various purposes including: -

- To comply with mandatory periodic financial reporting requirements established in law or regulation, if any or

- For purposes unrelated to mandatory financial reporting under relevant law or regulation, including for example: -
  - ✓ For management or those charged with governance, prepared on a basis appropriate for their particular purposes (such as preparation of financial information for internal use).
  - ✓ For periodic financial reporting undertaken for external parties under a contract or other form of agreement (such as financial information provided to a funding body to support provision or continuation of a grant).
  - ✓ For transactional purposes, for example to support a transaction involving changes to the entity's ownership or financing structure (such as for a merger or acquisition).

"Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. It means that the practitioner gives an opinion about specific information due to which users of information are able to make confident decisions knowing well that chance of information being incorrect is diminished.

A compilation engagement is not an assurance engagement. A compilation engagement does not require the practitioner to verify the accuracy or completeness of the information provided by management for the compilation, or otherwise to gather evidence to express an audit opinion or a review conclusion on the preparation of the financial information.

Further, SQC 1 is applicable to all Engagement and Quality Control Standards. Since SRS 4410 is also one of Engagement and Quality Control Standards, SQC 1 applies to firms in respect of firm's compilation engagements too which is covered in Related Services.

(c) **Principle 1 – Ethics, Transparency and Accountability:** The first principle emphasizes that the business decisions in an organisation should be open to disclosure and accessible to the relevant interested parties.

The essence of the core elements associated with the first principle are:

(i) The entities' governing structure should develop policies, procedures, and practices for their offices, factories, and work areas, ensuring that ethics is not compromised.

(ii) The information relating to the policies, procedures, and practices along with the performance should be made available to the stakeholders.

(iii) In case of adverse effects, more care has to be taken for transparent disclosures.

(iv) The entities in the value chain should be encouraged to adopt these principles by the governance structure.

(v) The entities should proactively respond to the outside entities that violate the nine principles of the BRSRs. This includes their suppliers, distributors, sub-contractors, or regulatory officers that may engage with the business concern.

5. (a) When assessing the presentation and disclosure of the prospective financial information and the underlying assumptions, in addition to the specific requirements of any relevant statutes, regulations as well as the relevant professional pronouncements, it needs to be considered whether: -

(i) the presentation of prospective financial information is informative and not misleading

(ii) the accounting policies are clearly disclosed in the notes to the prospective financial information

(iii) the assumptions are adequately disclosed in the notes to the prospective financial information. It needs to be clear whether assumptions represent management's best-estimates or are hypothetical and, when assumptions are made in areas that are material and are subject to a high degree of uncertainty, this uncertainty and the resulting sensitivity of results needs to be adequately disclosed

(iv) the date as of which the prospective financial information was prepared is disclosed. Management needs to confirm that the assumptions are appropriate as of this date, even though the underlying information may have been accumulated over a period of time

(v) the basis of establishing points in a range is clearly indicated and the range is not selected in a biased or misleading manner when results shown in the prospective financial information are expressed in terms of a range and

(vi) if there is any change in the accounting policy of the entity from that disclosed in the most recent historical financial statements, whether reason for the change and the effect of such change on the prospective financial information has been adequately disclosed.

(b) For consolidation of subsidiaries in accordance with the Companies (Indian Accounting Standards) Rules, 2015:

- the financial statements of the parent and its subsidiaries are combined as per Ind AS 110, "Consolidated Financial Statements" on a line-by-line basis by adding together like items of assets, liabilities, income, expenses, and cash flows;
- related goodwill/ capital reserve (or gain on bargain purchase) and non-controlling interest is determined as per Ind AS 103;
- business combinations involving entities or businesses under common control shall be accounted for using the pooling of interest method in accordance with Ind AS 103;
- adjustments like elimination of intra-group transactions, balances, unrealised profits and deferred tax etc. are made in accordance with the requirements of Ind AS 110;
- investments in associates and joint ventures are accounted for using the Equity Method as prescribed in Indian Accounting Standard (Ind AS) 28, "Investments in Associates and Joint Ventures". Interests in assets, liabilities, revenues, and expenses in a joint operation are accounted for as part of separate financial statements of the entity in accordance with Indian Accounting Standard (Ind AS) 111, "Joint Arrangements";
- in a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the

acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate in accordance with Ind AS 103.

In the given situation, R Limited is, a listed company having investment in the (i) 2 Subsidiary Companies, (ii) 1 Joint Venture Company, (iii) 2 Associate Companies, (iv) 3 Business entities under common control, (v) Interest in assets, liabilities, revenues, and expenses in a joint operation with 1 Company. R Limited and all its components are required to present their accounts as per Ind AS. In view of above, R Limited consolidated its components on a line-by-line basis by adding together like items of assets, liabilities, income, expenses, and cash flows while preparing its consolidated financial statements which is correct for the subsidiaries, however the treatment is not correct for other components as per abovementioned Companies (Indian Accounting Standards) Rules, 2015.

(c) In the given situation, CA R is looking after the audit of the TP Limited, a listed company. During audit, CA R observed that there are number of notices received from GST Department and Income-tax Department for various issues. Further during plant visit, CA R observed that few child labourers are engaged in some of the activity. In response to the observation made, CA R followed the procedure as envisaged in SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". assuming the provisions of SA 250 and the provisions of NOCLAR (Non-Compliance with Laws and Regulations) under Revised Code of Ethics are one and the same. However, following points indicates that the provisions of SA 250 and NOCLAR (Non-Compliance with Laws and Regulations) under the Revised Code of Ethics are not one and same:

(i) SA 250 is applicable only on Audit, and not on other Assurance engagements. However, NOCLAR is applicable on professional accountants in service, and in practice.

(ii) SA 250 talks of auditor's responsibilities for laws having direct effect on the determination of material amounts and disclosures in the financial statements (such as tax and labour laws); and other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business. NOCLAR, while being alike to SA 250 till this point, is further ahead of it in that it takes into account non-compliance that causes substantial harm resulting in serious consequences in financial or non-financial terms.

(iii) SA 250 does not define stakeholders. NOCLAR is related to affect of non-compliance on investors, creditors, employees as also the general public.

(iv) As per NOCLAR, in exceptional circumstances, the professional accountant might become aware of an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. Having first considered whether it would be appropriate to discuss the matter with management or those charged with governance of the company, the accountant shall exercise professional judgment and determine whether to disclose the matter immediately to an appropriate authority in order to prevent or mitigate the consequences of such imminent breach. If disclosure is made, that disclosure is permitted. This provision is not existent in SA 250.

6. **(a)** **Reporting under Paragraph 3 of CARO, 2020:** Clause (viii) of Paragraph 3 of CARO, 2020 requires the auditor to report whether any transactions not recorded in the books of account have been surrendered or disclosed as income during the year in the tax assessments under the Income-tax Act, 1961 (43 of 1961), if so, whether the previously unrecorded income has been properly recorded in the books of account during the year.

In addition, Clause (xviii) of Paragraph 3 of CARO, 2020 requires the auditor to report whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors.

In the given situation, during audit an order dated 01.05.2023 under section 148 of the Income-tax Act,1961 was noticed wherein tax of

₹50 lakh were demanded owing to undisclosed cash sales of 150 lakh for the financial year 2020-21 which was accepted by the company and the applicable tax was paid by the company during the year 2023-24. The company has not recorded such undisclosed income in their books of account during the year 2023-24. The auditor would be required to report as per Clause (viii) of Paragraph 3 of CARO, 2020.

Further CA T, the auditor of SDA Limited resigned due to non-recording of such undisclosed income in their books of account. The auditor would be required to report the same in CARO, 2020 as per Clause (xviii) of Paragraph 3 of CARO, 2020.

Hence, the auditor would be required to report as per Clause (viii) and Clause (xviii) of Paragraph 3 of CARO 2020 for the year 2023-24.

(b) **Key Areas for an Auditor to Understand IT Environment:** Key Areas for an Auditor to Understand IT Environment are as follows:

1. **Understand the flow of transaction:** The auditor's understanding of the IT environment may focus on identifying and understanding the nature and number of the specific IT applications and other aspects of the IT environment that are relevant to the flows of transactions and processing of information in the information system. Changes in the flow of transactions, or information within the information system may result from program changes to IT applications, or direct changes to data in databases involved in processing or storing those transactions or information.

2. **Identification of Significant Systems:** The auditor may identify the IT applications and supporting IT infrastructure concurrently with the auditor's understanding of how information relating to significant classes of transactions, account balances and disclosures flows into, through and out the entity's information system.

3. **Identification of Manual and Automated Controls:** An entity's system of internal control contains manual elements and automated elements (i.e., manual, and automated controls and other resources used in the entity's system of

internal control). An entity's mix of manual and automated elements varies with the nature and complexity of the entity's use of IT. The characteristics of manual or automated elements are relevant to the auditor's identification and assessment of the risks of material misstatement.

4. **Identification of the technologies used:** The need to understand the emerging technologies implemented and the role they play in the entity's information processing or other financial reporting activities and consider whether there are risks arising from their use.

   Given the potential complexities of these technologies, there is an increased likelihood that the engagement team may decide to engage specialists and/or auditor's experts to help understand whether and how their use impacts the entity's financial reporting processes and may give rise to risks from the use of IT.

5. **Assessing the complexity of the IT environment:** Not all applications of the IT environment have the same level of complexity. The level of complexity for individual characteristics differs across applications. Complexity is based on the following factors – automation used in the organization, entity’s reliance on system generated reports, customization in IT applications, business model of the entity, any significant changes done during the year and implementation of emerging technologies.

   After considering the above factors for each application the over complexity is assessed of the IT environment.

(c) **Restriction on Fees based on a Percentage:** According to Clause (10) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

However, Regulation 192 allow the Chartered Accountant in practice to charge the fees in respect of any professional work which are based on a percentage of profits, or which are contingent upon the findings or results of such work, in the case of a non-assurance services to non-audit clients, and the fees may be based on a percentage of Tax Demand Reduced.

In the given case, CA Kumar, a practicing Chartered Accountant, provides non-assurance services. He is approached by XYZ Limited, a non-audit client, to file an appeal in Tribunal against Income-tax Demand of ₹10 crore which was added by the CIT(A) and to plead on behalf of XYZ Limited in the matter. CA Kumar offers to accept the case and agrees to charge fees either ₹ 5,00,000 or 10% of Tax Demand reduced whichever is higher.

Conclusion: Therefore, Mr. Kumar will not be held guilty of professional misconduct since he is not providing any assurance services to non-audit client pursuant to Regulation 192 read with Clause 10 of Part I of First Schedule.

Or

(c) In order to identify a particular company as Non-Banking Financial Company (NBFC), it will consider both assets and income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. The company will be treated as NBFC when a company's financial assets constitute more than 50 per cent of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by Reserve Bank of India.

In the given case, though Kushal Pvt. Ltd. is fulfilling the criteria on the asset side, but however is not fulfilling the criteria on the income side, the company cannot be classified as a deemed NBFC.