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- EXAM INSIGHTS
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1

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To the one who's not just dreaming CA —
but becoming it

CA _____

Write your name here

What Matters in CA?

1 CONCEPTUAL CLARITY

Understand the 'substance' and 'measurement' behind every Ind AS, Standard and Framework . You need to understand the concept of Ind AS and apply it correctly

Use this Reviewer to bridge the gap between understanding a concept and writing it technically.

2 CONSISTENCY

To master FR, you need to solve one comprehensive problem every day. Success in this subject depends on your ability to correctly link multiple standards to reach the right accounting treatment.

This Question Bank is designed to build that daily solving habit, so standards remain fresh in your memory.

3 CONFIDENCE

Confidence comes from solving lengthy problems under timed conditions; consider enrolling in the **Vivitsu Test Series**.

Use the LDR questions for a powerful final boost, ensuring you walk into the exam hall fully prepared.

What does the book include?

- RTP: Revision Test papers
- MTP: Mock Test papers
- PYP: Past Years Papers
- MP: Model Test Papers (ICAI releases a set of Model Test Papers on the website for your practice, We have added them in Chapter-wise format in this book as well.)
- SM: This includes the references to ICAI Study Material, Only to the extent that the question is same as RTP, MTP, PYP or MP.

NOTE ON ICAI STUDY MATERIAL (SM) QUESTIONS.

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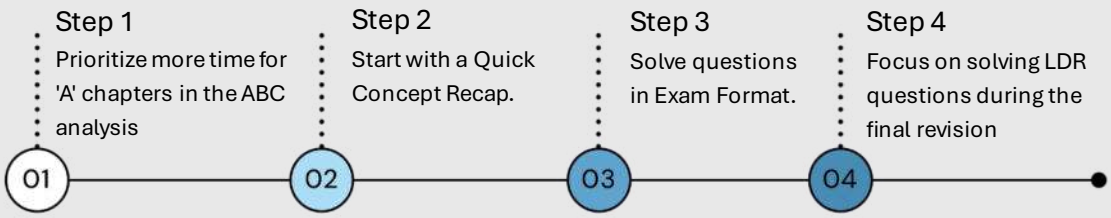
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STRATEGY TO SCORE

60+ in Financial Reporting



Step 1: Prioritize your chapters

Chapters in the index are categorized as A, B, or C based on their importance. Focus more on 'A' chapters, as they carry the most weight, and give adequate attention to 'B' chapters. While all chapters must be covered, this approach helps manage time efficiently for better results.

Step 2: Start with a Quick Concept Recap

Use this powerful summary for a quick brush-up on key concepts before you attempt the chapter. This helps you identify and understand the core principles. If a question gives you trouble, return to this section / main study material to solidify the concept, then come back and solve it again.

Step 3: Practice in Exam Format

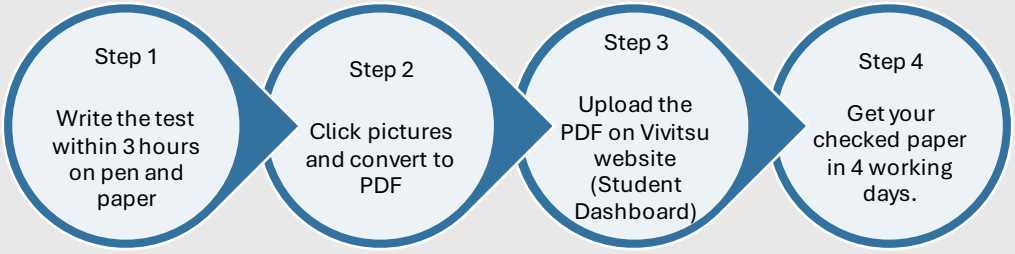
Practise in exam format and focus on writing answers in ICAI-oriented language; it trains you to present exactly the way the examiner expects. Always solve the question on your own before looking at the answer. If you make a conceptual mistake, be sure to mark it to review during your next revision.

Step 4: Last Day Revision (LDR)

Focus on solving LDR questions during the final revision. In the 1.5 days before the exam, prioritize these questions as they cover the most critical concepts from each chapter. You'll find a quick summary of LDR question numbers listed right before each chapter for easy reference.

***This book includes a Test paper which we will evaluate and give it back to you**

STEPS TO GET YOUR FREE EVALUATED MOCK PAPER.



8 Ways Vivitsu Reviewer will help you
CLEAR CA INTER

2	Conceptual Framework for Financial Reporting under Indian Accounting Standards (Ind AS)	2-1 –2-6	C
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3.1	Ind AS 1 "Presentation of Financial Statements"	3.1-1 – 3.1-8	C
3.2	Ind AS 34 "Interim Financial Reporting"	3.2-1 – 3.2-8	C
3.3	Ind AS 7 "Statement of Cash Flows"	3.3-1 – 3.3-13	
4	Ind AS on Measurement based on Accounting Policies		C
4.1	Ind AS 8 "Accounting Policies, Changes in Accounting Estimates and Errors"	4.1-1 – 4.1-10	C
4.2	Ind AS 10 "Events after the Reporting Period"	4.2-1 – 4.2-6	B
4.3	Ind AS 113 "Fair Value Measurement"	4.3-1 – 4.3-4	
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5.1	Ind AS 2 "Inventories"	5.1-1 – 5.1-9	C
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5.4	Ind AS 36 "Impairment of Assets"	5.4-1 – 5.4-11	C
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			A
			B

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Prioritize using ABC Analysis

Each chapter is categorized as A , B or C

A : Very Important, Read on priority

B : Moderately Important

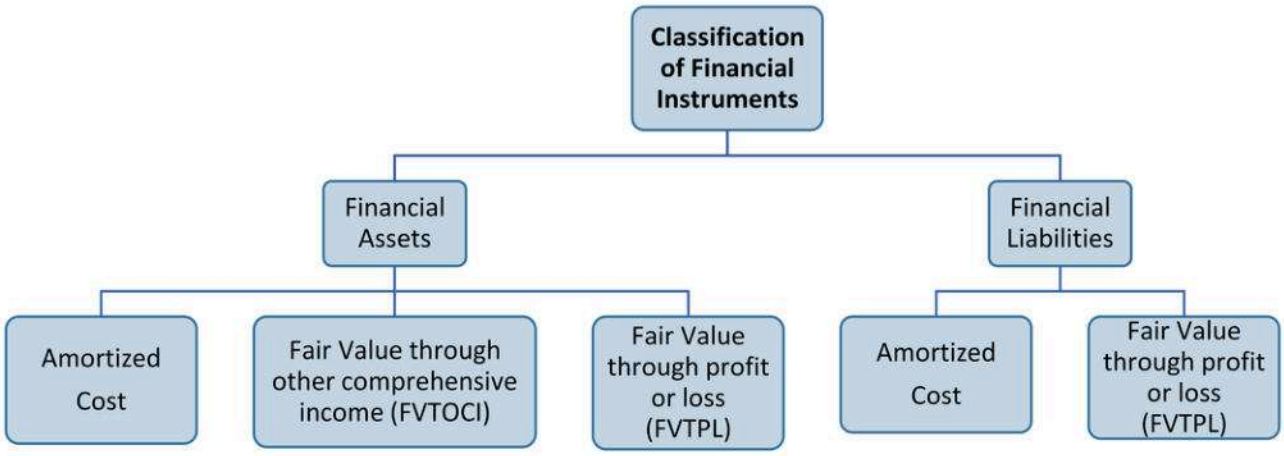
C : Less Critical but still essential

07

Last Day Revision Questions

LDR Questions	Q 14, Q 18, Q 19, Q 20, Q 23

QUICK REVIEW OF IMPORTANT CONCEPTS



Initial Measurement & Transaction Costs – Financial Assets & Liabilities

Financial asset	Initial measurement	Transaction costs
At amortized cost	Fair value	Capitalize
At fair value through OCI	Fair value	Capitalize
At fair value through profit or loss	Fair value	Expense
Financial liability	**Initial measurement**	**Transaction costs**
Amortized cost	Fair value	Deduct from the amount originally recognized
At fair value through profit or loss	Fair value	Expense

06

Concept Summary

Sharpen your memory with lightning-fast concepts recap before you hit the questions. Also perfect for the final 1.5-day revision!

Exam Insights: A common mistake is treating the present value of the final payment as the extra amount owed. Always compare the carrying amount with the total cash outflow to determine the true additional payment.

05

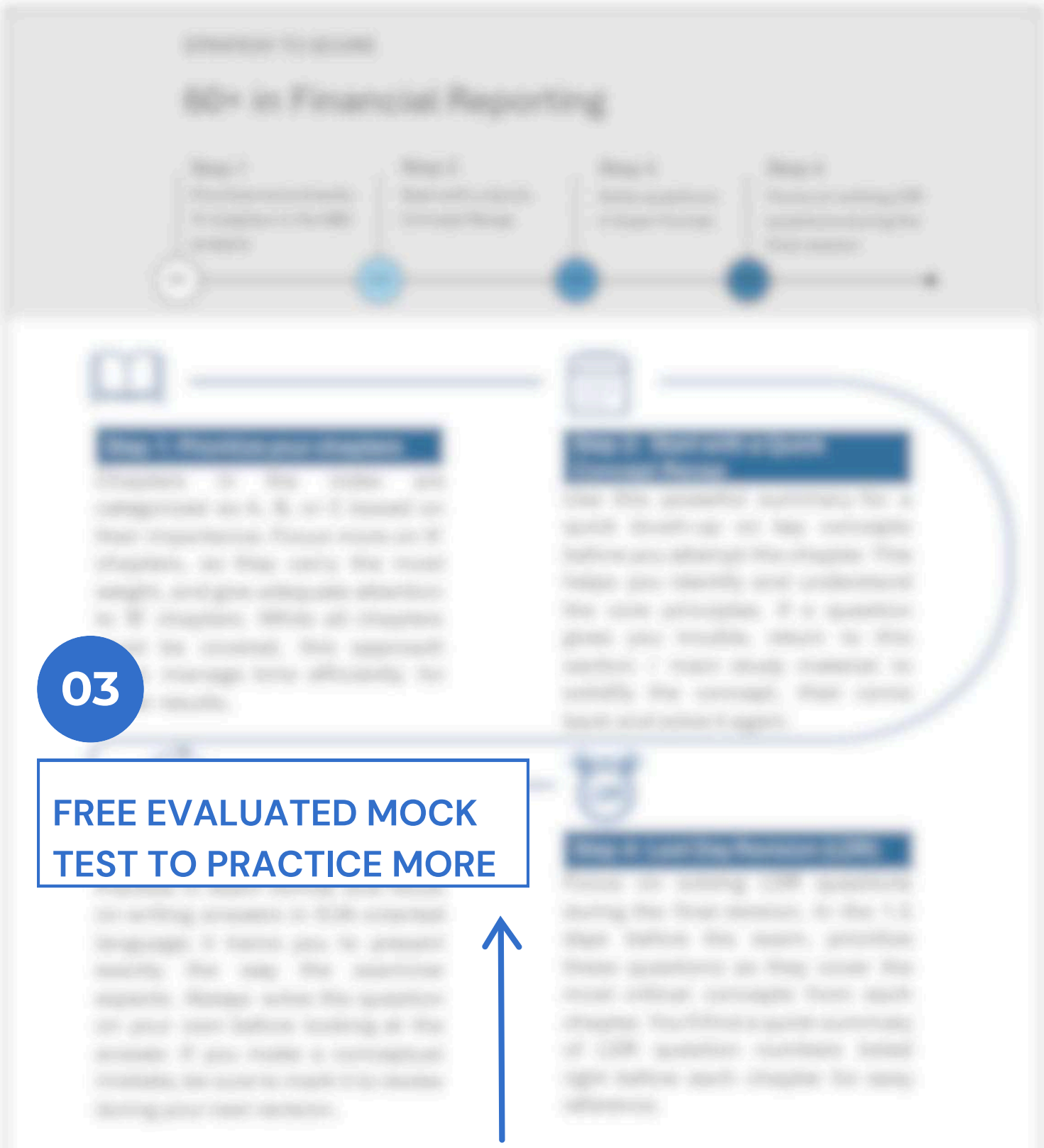
Exam Insights

Use exam insights to learn common mistakes and avoid them. Stay ahead of others

Question 7 (RTP May'23)

04

Reference's to Attempts in all Questions

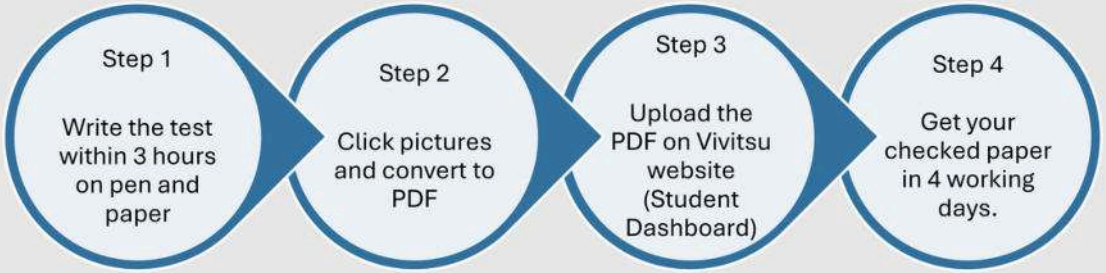


03

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02

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DIFFERENT QUESTIONS TO PRACTICE EXCEPT FOR RTP, MTP AND PYPS WHICH ARE IN THE BOOK.

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3.1	Ind AS 1 "Presentation of Financial Statements"	3.1-1 – 3.1-8	C
3.2	Ind AS 34 "Interim Financial Reporting"	3.2-1 – 3.2-8	C
3.3	Ind AS 7 "Statement of Cash Flows"	3.3-1 – 3.3-13	B
4	**Ind AS on Measurement based on Accounting Policies**		
4.1	Ind AS 8 "Accounting Policies, Changes in Accounting Estimates and Errors"	4.1-1 – 4.1-10	C
4.2	Ind AS 10 "Events after the Reporting Period"	4.2-1 – 4.2-6	C
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ABC ANALYSIS

A — Very Important, Read on priority

B — Moderately Important

C — Less critical but still essential

Ensure you thoroughly read all chapters without skipping any. The ABC analysis is designed to help you prioritize based on past trends, but it should not replace comprehensive preparation.

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Question & Answers

Question 1 (PYP 4 Marks May'24, MTP 4 Marks, Mar'24, MP [2])

List out the entities which were covered under Phase I & II under the Companies (Indian Accounting Standards) Rules 2015 as notified by the MCA along with the specific date of coverage with its exclusions, if any.

Answer 1

MCA has notified the Companies (Indian Accounting Standards) Rules, 2015. Accordingly, it has notified 39 Ind AS and has laid down mandatory Ind AS transition roadmap for companies and non- banking finance companies excluding banking companies and insurance companies under following two phases:

Phase I

Following companies were covered under Phase I for accounting periods beginning on or after 1st April 2016, with the comparatives for the periods ending on 31st March 2016:

(a) companies whose equity or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of rupees five hundred crore or more;

(b) companies other than those covered by sub-clause (a) above and having net worth of rupees five hundred crore or more;

(c) holding, subsidiary, joint venture or associate companies of companies covered by sub-clause (a) and sub-clause (b) as mentioned above.

Phase II

Following companies were covered under Phase II for accounting periods beginning on or after 1st April 2017, with the comparatives for the periods ending on 31st March 2017:

(a) companies whose equity or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of less than rupees five hundred crore;

(b) companies other than those covered in sub-clause (a) above i.e. unlisted companies having net worth of rupees two hundred and fifty crore or more but less than rupees five hundred crore.

(c) holding, subsidiary, joint venture or associate companies of companies covered by sub-clause (a) and sub-clause (b) as mentioned above.

Exclusions: The roadmap shall not be applicable to companies whose securities are listed or are in the process of being listed on SME without initial public offering in accordance with the provisions of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

Ind AS would not be applicable to companies other than listed companies whose net worth is less than ₹ 250 Crores and they will continue to follow AS. However, they can voluntary adopt Ind AS any time.

Question 2 (MTP 5 Marks Oct'24,MP[5]) LDR

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?

Answer 2

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 CompaniesAct, 2013	**505**

Note – Revaluation Reserve would not be included in the calculationof 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 worthis 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.

Question 3 (MTP 4 Marks Mar'25)

ABC Inc., incorporated in a foreign country has a net worth of ₹700 crores. It has two Indian subsidiaries X Ltd. whose net worth as on 31st March 2014 is ₹ 600 crores and Y Ltd. whose net worth is ₹ 150 crores. Whether X Ltd. and Y Ltd. would be required to follow Ind AS from the accounting period commencing on or after 1st April 2016 on the basis of their own net worth or on the basis of the net worth of ABC Inc.?

Answer 3

As per Rule 4(1)(ii)(a) of the Companies (Indian Accounting Standards) Rules, 2015, X Ltd. having net worth of ₹ 600 crores at the end of the financial year 2015-2016, would be required to prepare its financial statements for the accounting periods commencing from 1st April, 2016, as per the Companies (Indian Accounting Standards) Rules, 2015. While Y Ltd. having net worth of ₹ 150 crores in the year 2015-2016, would be required to prepare its financial statements as per the Companies (Accounting Standards) Rules, 2006.

Since, the foreign company ABC Inc., is not a company incorporated under the Companies Act, 2013 or the earlier Companies Act, 1956, it is not required to prepare its financial statements as per the Companies (Indian Accounting Standards) Rules, 2015. As the foreign company is not required to prepare financial statements based on Ind AS, the net worth of foreign company ABC Inc. would not be the basis for deciding whether Indian Subsidiary X Ltd. and Y Ltd. are required to prepare financial statements based on Ind AS.

Question 4 (MTP 4 Marks Jul'25)

Company A is the parent company of a group. Company A is an unlisted company having net worth of 60 crores as on 31st March 20X1. Following are the other companies of the group.

Name of the company	Relationship	Net worth as on 31st March 20X1
Company B (Unlisted)	Subsidiary of Company A	₹ 600 Crore
Company C (Unlisted)	Subsidiary of Company B	₹ 150 Crore

Whether Ind AS be applicable to companies A, B and C?

Answer 4

Company A and C are unlisted and do not exceed the net worth criteria. However, the net worth of Company B exceeds ₹ 500 crore hence it would be covered as per the roadmap for implementation of Ind AS in the preparation of its Financial Statements. As Ind AS be applicable to Company B, the parent company of Company B i.e. Company A and subsidiary of Company B i.e. Company C would also get covered under Ind AS irrespective of net worth criteria. Hence Ind AS would be applicable to all three companies i.e. Company A, B and C.

Question 5 (PYP 4 Marks Jan'26)

In view of the increasing inflow of foreign capital and the resultant complexities in financial instruments and transactions, critically examine the necessity for the introduction of Indian Accounting Standards (Ind AS) in place of the erstwhile Accounting Standards (AS).

Answer 5

The increasing inflow of foreign capital and the resulting complexities in financial transactions necessitated the introduction of Indian Accounting Standards (Ind AS) to replace the earlier Accounting Standards (AS) due to the following reasons:

1. **Complex Financial Instruments:** AS lacks explicit guidance on accounting for complex capital-raising instruments such as optionally or compulsorily convertible shares and debentures, leading to inconsistent treatment across entities.
2. **Derivative Instruments and Embedded Features:** The proliferation of derivative instruments embedded in foreign currency bonds, equity instruments and commodity derivatives require comprehensive accounting principles which are inadequately addressed under AS.
3. **Group Restructuring and Business Combinations:** Activities such as mergers, acquisitions, demergers and slump sales are increasingly common but lack a uniform accounting framework, creating discrepancies in recognition and measurement.
4. **Emerging Business Models and Revenue Arrangements:** The rise of innovative digital economy business models introduce complex revenue recognition issues that are not explicitly covered in AS, leading to divergent practices.
5. **Stock-based Compensation:** Diverse and innovative remuneration models, especially for senior management and executives, demand detailed standards which AS do not comprehensively provide.
6. **Complex Tax Provisions:** The determination of current and deferred tax was complicated by changing tax laws and business structures, requiring enhanced guidance beyond the limited scope of AS.
7. **Shareholder Returns and Investments in Kind:** Varied modes of providing returns to shareholders and investments during group reorganizations lacked clear accounting principles under AS.
8. **Need for Enhanced Disclosures:** The limited disclosure requirements under AS in areas such as revenue, related party transactions, segment reporting and business combinations were insufficient for providing investors with a complete understanding of business risks and performance.
9. **Alignment with Global Standards:** To attract foreign investment and ensure comparability with international financial reporting, adoption of Ind AS aligned with IFRS became essential.

Ind AS was introduced to address the above complexities and to provide a comprehensive, consistent and transparent accounting framework that improves the quality of financial reporting and enables investors to make informed decisions.

Exam Insights: A large number of examinees either did not attempt the question or provided vague, general and incomplete answers without addressing the specific requirements. Key provisions, particularly relating to the introduction of Ind AS and relevant sections of the Companies Act, 2013 were largely missing or incorrectly stated. Even among those who attempted, answers lacked precision, proper structure and depth, reflecting weak theoretical understanding and inability to present relevant points effectively.

Question 6 (PYP 4 Marks Jan'26)

Discuss the key relevant provisions of the Companies Act, 2013 with reference to Ind AS and the matters to be included in the Report of the Board of Directors and the Report of the Statutory Auditors of the company in respect of the compliance of Indian Accounting Standards as notified by the Central Government under Section 133 of the Companies Act, 2013.

Answer 6

Following are the some of the key relevant provisions of the Companies Act 2013, which gives reference to Ind AS:

1. Section 2(2) states that accounting standards means the standards of accounting or any addendum thereto for companies or class of companies referred to in Section 133.
2. Section 133 states the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority. Under the power given to the Central Government under section 133, it notified the Companies (Indian Accounting Standards) Rules, 2015.

3. Section 129 suggests the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III.
4. Section 134(5)(a), a statement that the applicable accounting standards had been followed with proper explanation relating to material departures shall be given in the Director Responsibility Statement to be issued under section 134(3)(c) in the Director's report to be published in Annual General Meeting.

Section 143, auditor has to opine whether the financial statements comply with the accounting standards.

Exam Insights: A large number of examinees either did not attempt the question or provided vague, general and incomplete answers without addressing the specific requirements. Key provisions, particularly relating to the introduction of Ind AS and relevant sections of the Companies Act, 2013 were largely missing or incorrectly stated. Even among those who attempted, answers lacked precision, proper structure and depth, reflecting weak theoretical understanding and inability to present relevant points effectively.

Multiple Choice Questions (MCQs)

1. With respect to the best practices applicable to all companies, which of the following statements is incorrect? *(MTP 2 Marks Sep'24,MP[4])*

(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.

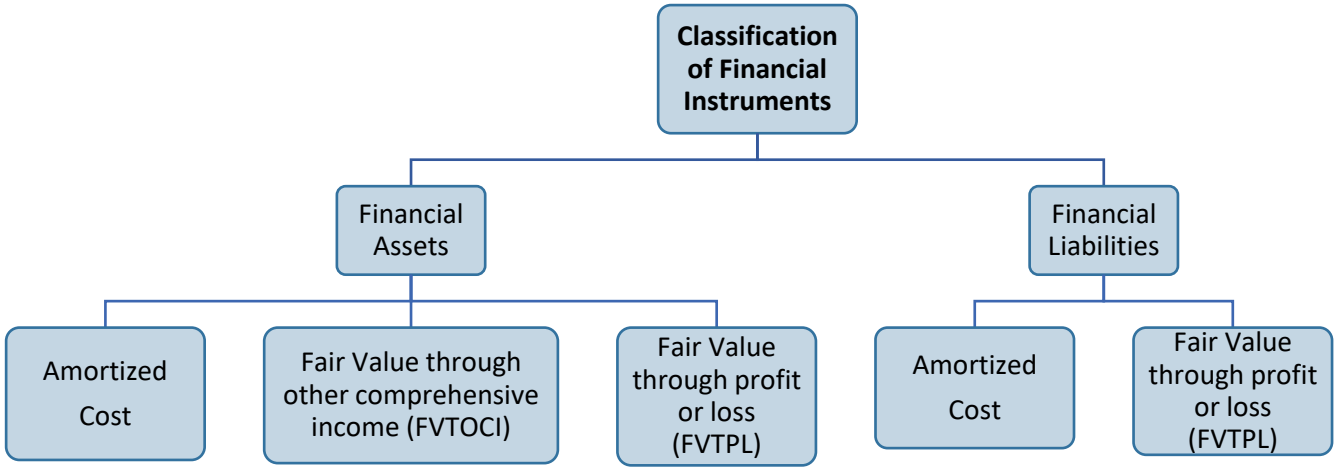
Ans: (d)

CHAPTER 11: ACCOUNTING AND REPORTING OF FINANCIAL INSTRUMENTS

A

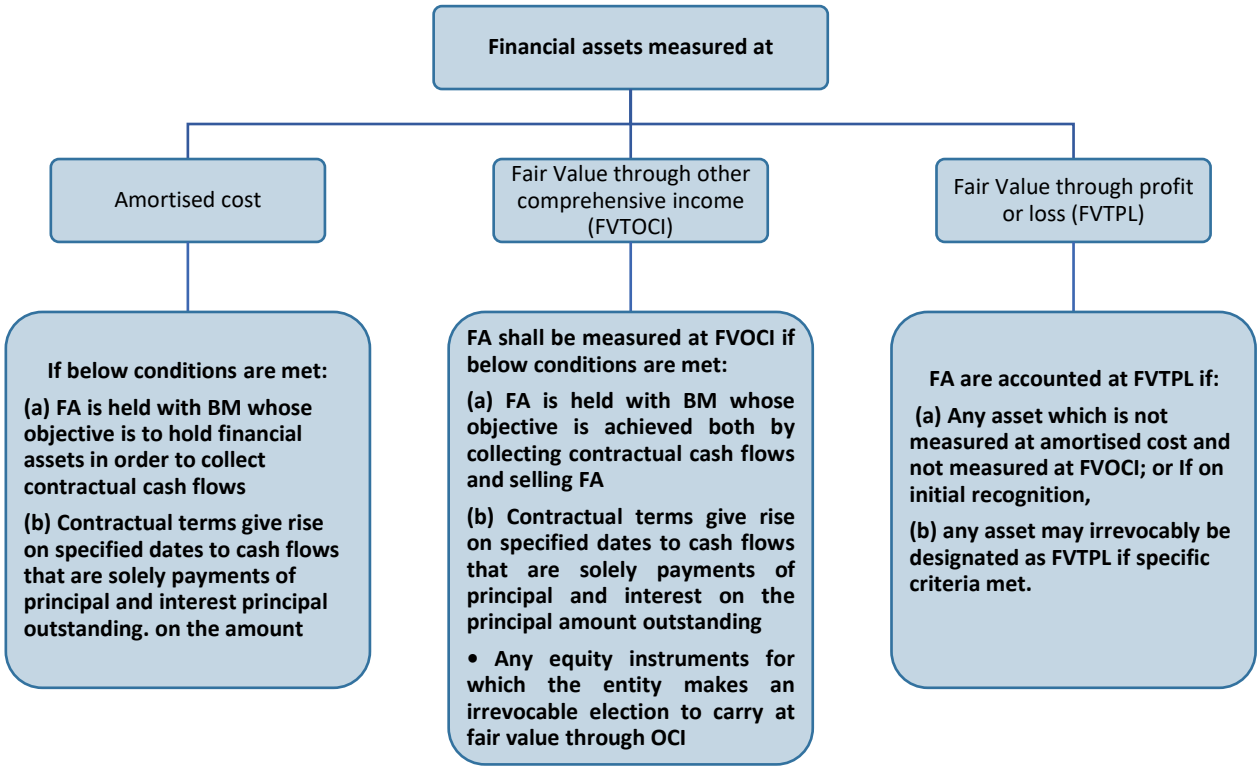
LDR Questions	Q 14, Q 18, Q 19, Q 20, Q 23

QUICK REVIEW OF IMPORTANT CONCEPTS



Initial Measurement & Transaction Costs – Financial Assets & Liabilities

Financial asset	Initial measurement	Transaction costs
At amortized cost	Fair value	Capitalize
At fair value through OCI	Fair value	Capitalize
At fair value through profit or loss	Fair value	Expense
Financial liability	**Initial measurement**	**Transaction costs**
Amortized cost	Fair value	Deduct from the amount originally recognized
At fair value through profit or loss	Fair value	Expense



RECLASSIFICATION OF FINANCIAL ASSETS – ACCOUNTING

Original classification	Revised classification	Accounting Treatment
Amortised Cost	FVTPL	• Fair value is measured at reclassification cost date • Difference between previous amortized cost and fair value is recognised in P&L
	FVTOCI	• Fair value is measured at reclassification cost date. • Difference between previous amortised cost and fair value is recognised in OCI • No change in EIR due to reclassification.
FVTPL	Amortised Cost	• Fair value at reclassification date becomes its new gross carrying amount • EIR is calculated based on the new gross carrying amount
	FVTOCI	• Fair value at reclassification date becomes its new carrying amount • No other adjustment is required
FVTOCI	Amortised Cost	• Fair value at reclassification date becomes its new amortised cost carrying amount • However, cumulative gain or loss in OCI is adjusted against fair value Consequently, the asset is measured as if it had always been measured at amortised cost
	FVTPL	• Assets continue to be measured at fair value • Cumulative gain or loss previously recognized in OCI is reclassified to P&L at the reclassification date
• Reclassification of financial liability is not allowed		

Tree Stage Model for Impairment

Particular	Stage 1 Initial Recognition	Stage 2 Significant increase in credit risk	Stage 3 Credit Impaired
Credit Risk	Low	Moderate to High	Significant
ECL Model	12 Month ECL	Life-time ECL	Life-time ECL
Interest recognition	Interest on gross	Interest on gross recognition	Interest on net carrying amount

Accounting Treatment Derivative

All derivatives are measured at fair value with changes in fair value being recognized in profit or loss for the period, except derivatives that qualify as hedging instruments

Particulars	DR/CR	Amount
Derivative Assets (BS)	Dr	XXXX
To income on account of derivative (PL) (Derivative assets is recorded in case of MTM gain)	Cr	XXXX
Expense on account of derivative (PL)	Dr	XXXX
Derivative Liability (BS) (Derivative liability is recorded in case of MTM loss)	Cr	XXXX

Question & Answers

Question 1 **(RTP May'23)**

State whether the following items meet the definition of Financial Asset or Financial Liability for an entity:

(i) A bank advances an entity a five-year loan. The bank also provides the entity with an overdraft facility for a number of years.

(ii) Entity A owns preference shares in Entity B. The preference shares entitle Entity A to dividends, but not to any voting rights.

(iii) An entity has a present obligation in respect of income tax due for the prior year.

(iv) In a lawsuit brought against an entity, a group of people is seeking compensation for damage to their health as a result of land contamination believed to be caused by waste from the entity's production process. It is unclear whether the entity is the source of the contamination since many entities operate in the same area and produce similar waste.

Answer 1

(i) The entity has two financial liabilities namely (a) the obligation to repay the five- year loan and (b) the obligation to repay the bank overdraft to the extent that it has borrowed using the overdraft facility. Both the loan and the overdraft result in contractual obligations for the entity to pay cash to the bank for the interest incurred and for the return of the principal.

(ii) For Entity B: The preference shares may be equity instruments or financial liabilities of Entity B, depending on their terms and conditions.
For Entity A: Irrespective of Entity B's treatment, the preference shares are a financial asset because the investment satisfies the definition of a financial asset.

(iii) An income tax liability is created as a result of statutory requirements imposed by the government. The rights and obligations are not created by a contract. Hence, the liability for income-tax dues is not a financial liability.

(iv) The fact that a lawsuit may result in the payment of cash does not create a financial liability for the entity because there is no contract between the entity and the affected group. The entity will need to consider providing for the payment as per Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets'.

Question 2 **(MTP 7 Marks, Oct'23)**

Evaluate whether the following items are financial assets or not.

Sr. No.	Particulars
1	Investment in bonds debentures
2	Loans and receivables
3	Deposits given
4	Trade & other receivables
5	Cash and cash equivalents
6	Bank balance
7	Investments in equity shares
8	Perpetual debt instruments like perpetual bonds, debentures and capital notes.
9	Physical assets like inventories, property, plant and equipment etc.
10	Right to use assets like lease vehicle etc.
11	Intangibles like patents, trademark etc.
12	Prepaid expenses like prepaid insurance, prepaid rent etc.
13	Advance given for goods and services

Answer 2

Sr. No.	Particulars	Whether FA or not	Remarks
1	Investment in bonds debentures	FA	Contractual right to receive cash.
2	Loans and receivables	FA	Contractual right to receive cash.
3	Deposits given	FA	Contractual right to receive cash.
4	Trade & other receivables	FA	Contractual right to receive cash.
5	Cash and cash equivalents	FA	Specifically covered in the definition.
6	Bank balance	FA	Contractual right to receive cash.
7	Investments in equity shares	FA	Equity instrument of another entity.
8	Perpetual debt instruments like perpetual bonds, debentures and capital notes.	FA	Such instruments provide the contractual right to receive interest for indefinite future or a right to return of principal under terms that make it very unlikely or very far in the future.
9	Physical assets like inventories, property, plant and equipment etc.	No	Control of such assets does not create a present right to receive cash or another financial asset.

10	Right to use assets like lease vehicle etc.	No	Control of such assets does not create a present right to receive cash or another financial asset.
11	Intangibles like patents, trademark etc.	No	Control of such assets does not create a present right to receive cash or another financial asset.
12	Prepaid expenses like prepaid insurance, prepaid rent etc.	No	These instruments provide future economic benefit in the form of goods or services, rather than the right to receive cash.
13	Advance given for goods and services	No	These instruments provide future economic benefit in the form of goods or services, rather than the right to receive cash.

Question 3 **(RTP May'23)**

SEL has applied for a term loan from a bank for business purposes. As per the loan agreement, the loan required a personal guarantee of one of the directors of SEL to be executed. In case of default by SEL, the director will be required to compensate for the loss that bank incurs. Mr. Pure Joy, one of the directors had given guarantee to the bank pursuant to which the loan was sanctioned to SEL. SEL does not pay premium or fees to its director for providing this financial guarantee.

Whether SEL is required to account for the financial guarantee received from its director? Will there be any disclosures under Ind AS 24?

Answer 3

Ind AS 109 'Financial Instruments', defines a financial guarantee contract as 'a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Based on this definition, an evaluation is required to be done to ascertain whether the contract between director and Bank qualifies as a financial guarantee contract as defined in Appendix A to Ind AS 109. In the given case, it does qualify as a financial guarantee contract as:

- the reference obligation is a debt instrument (term loan);
- the holder i.e. Bank is compensated only for a loss that it incurs (arising on account of non-repayment); and
- the holder is not compensated for more than the actual loss incurred.

Ind AS 109 provides principles for accounting by the issuer of the guarantee. However, it does not specifically address the accounting for financial guarantees by the beneficiary. In an arm's length transaction between unrelated parties, the beneficiary of the financial guarantee would recognize the guarantee fee or premium paid as an expense.

It is also pertinent to note that the entity needs to exercise judgment in assessing the substance of the transaction taking into consideration relevant facts and circumstances, for example, whether the director is being compensated otherwise for providing guarantee. Based on such an assessment, an appropriate accounting treatment based on the principles of Ind AS should be followed.

In the given case, SEL is the beneficiary of the financial guarantee and it does not pay a premium or fees to its director for providing this financial guarantee. Accordingly, SEL will not be required to account for such financial guarantee in its financial statements considering the unit of account as being the guaranteed loan, in which case the fair value would be expected to be the face value of the loan proceeds that SEL received.

In the given case based on the limited facts provided, SEL will be required to make necessary disclosures of such financial guarantee in accordance with Ind AS 24 as follows:

(a) the amount of the transactions;

(b) the amount of outstanding balances, including commitments, and:

  (i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and

  (ii) details of any guarantees given or received;

(c) provisions for doubtful debts related to the amount of outstanding balances; and

(d) the expense recognized during the period in respect of bad or doubtful debts due from related parties.

Question 4 **(SM, MTP 8 Marks Sep'23)**

Company Z is engaged in the business of importing oil seeds for further processing as well as trading purposes. It enters into the following types of contracts as on 1 October 20X1:

Particulars	Contract 1	Contract 2	Contract 3
Nature of Contract	Import of oil seeds from a foreign supplier	Purchase of oil seeds from a domestic producer / supplier	Contract to sell oil seeds on the commodity exchange
Quantity and rate	100 MT at USD 400 per MT to be delivered as on 31 March 20X2	50 MT at ₹ 30,000 per MT to be delivered as on 31 January 20X2	50 MT at USD 450 per MT, maturing as on 15 January 20X2
Net settlement clause included in the contract	Yes	Yes	Yes
Net settlement in practice for similar contracts	There have also been several instances of the oil seeds being sold prior to or shortly after taking delivery. These instances of net settlement constitute approximately 30 per cent of the value of total import contracts.	Yes – company Z has net settled some of the domestic purchase contracts. However, these instances constitute only 1 per cent of the total domestic purchase contracts in value. The remaining contracts are settled by taking delivery of oil seeds which are used for further processing.	Yes – these contracts are required to be net settled with the exchange on the maturity date. Company Z enters into these types of derivative contracts to hedge the risks on its domestic oil seeds purchase contracts

Company Z is required to determine if the contracts entered into for purchase and sale of oil seeds are derivatives within the scope of Ind AS 109 or are executory contracts outside the scope of Ind AS 109.

Answer 4

Contract 1:

The following factors indicate that this contract does not meet the 'own use' exemption:

- The contract permits net settlement, and
- There is a past practice of a significant proportion (30 per cent in this illustration) of similar contracts being settled on a net basis either in cash or by sale of the oil seeds prior to delivery/shortly after taking delivery.

Therefore, this contract would fall within the scope of Ind AS 109 and should be recognised as a derivative instrument as on 1 October 20X1. The contract would be in the nature of a forward contract to buy 100 MT of oil seeds as on 31 March 20X2 at USD 400 per MT. Company Z would have to recognise the fair value changes (based on change in forward purchase rate) on this contract in the statement of profit and loss at each reporting date.

Contract 2

Contract 2 also permits net settlement in cash. Further, there have been some instances of similar domestic purchase contracts being settled net in cash in the past. However, these have been infrequent in nature and insignificant in proportion to the total value of similar contracts (i.e.1%).

Company Z is in the practice of taking delivery of the oil seeds purchased under similar contracts and using them for further processing in its plants.

This indicates that the domestic purchase contract meets the criteria for the 'own-use' exemption and should be considered as an executory contract.

Therefore, this contract would not fall within the scope of Ind AS 109.

Contract 3

This contract is in the nature of a derivative contract transacted on a commodity exchange and is required to be net settled in cash on maturity. Therefore, this derivative contract would be covered by Ind AS 109 and required to be classified and measured at FVTPL.

Question 5 (MTP 5 Marks Oct'24,MP[5])

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.

Answer 5

Accounting Treatment:

Trade Receivables fall within the ambit of financial assets underInd AS 109, Financial Instruments. Thus, the issue in question is whetherthe 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 derecognize 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, althoughthe 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. wouldbe 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 suchby Natasha Ltd. in its Balance Sheet.

Question 6 (PYP 5 Marks, Nov'23)

Poor Limited borrowed 120 Lakhs from a Scheduled Bank. The terms of loan are as under:

- **Rate of Interest @ 10% per annum, payable yearly**
- **Tenure of Loan 12 Years.**
- **Principal to be paid at the end of tenure i.e. 12th Year.**

Poor Limited defaulted in payment of Interest in year 5, 6, 7 and 8. A loan reschedule agreement took place at the end of 9th year with the Bank. As per the agreement, Poor Limited is required to pay ₹ 220 Lakhs at the end of 10th year. The default continued till the end of 10th year.

You are required to calculate as per relevant Ind AS:

(i) Book Value of the Loan at the end of the 10th Year.

(ii) Additional amount to be paid to the Bank on Account of Rescheduling.

(assume interest is compounded in the case of default).

Answer 6

(i) Computation of book value of the loan at the end of 10th year

= ₹ 1,20,00,000 x 1.10 x 1.10 x 1.10 x 1.10 x 1.10 x 1.10 = ₹ 2,12,58,732 (i.e. adding interest for 5th to 10th year)

(ii) Computation of additional amount to be paid to bank on rescheduling

Rescheduled amount to be paid at the end of the 10th year = ₹ 2,20,00,000

Additional amount to be paid on rescheduling = ₹ 2,20,00,000 - ₹ 2,12,58,732 = ₹ 7,41,268

Exam Insights: A common mistake is treating the present value of the final payment as the extra amount owed. Always compare the carrying amount with the total cash outflow to determine the true additional payment.

Question 7 (RTP May'23)

In an arm's length transaction, Entity X buys 10,000 convertible preference shares in Company Z for cash payments of ₹ 40,000, with ₹ 25,000 payable immediately and ₹ 15,000 payable in two years. The market rate of annual interest for a two-year loan to the entity would be 6%.

Explain the accounting treatment for the said transaction.

Answer 7

Since payment of ₹ 15,000 is deferred for two years, the fair value of the consideration given for the shares is equal to ₹ 25,000 plus the present value of ₹ 15,000. The present value of ₹ 15,000 deferred payment is ₹ 13,350 (₹ 15,000 ÷ 1.06^2). Entity X will initially measure the shares purchased at ₹ 38,350 (i.e., ₹ 25,000 + ₹ 13,350).

Since this transaction took place at an arm's length, this is considered to be fair value for initial recognition in the absence of evidence to the contrary.

The difference between the ₹ 40,000 cash paid out and the ₹ 38,350, i.e. ₹ 1,650, will be recognised as interest expense in profit or loss over the two-year period of deferred payment.

Question 8 (RTP May'25)

On 1st April, 20X1, ABC Ltd. issues a 10- year bond with a par value of ₹ 15,00,000 and an annual fixed coupon rate of 8%, which is consistent with market rates for bonds with similar characteristics. ABC Ltd. uses Secured Overnight Financing Rate (SOFR) as its benchmark interest rate. At the date of inception of the bond, SOFR is 5%. At the end of the first year:

- **SOFR has decreased to 4.75%; and**
- **The fair value of bond is ₹ 15,38,110. This value is consistent with an interest rate of 7.6%.**
- **The remaining cash flows on bond are ₹ 1,20,000 per year for nine years and ₹ 15,00,000 at the end of nineth year. These cash flows discounted at 7.6% equals ₹ 15,38,110.**

ABC Ltd. assumes a flat yield curve, that all changes in interest rates result from a parallel shift in the yield curve, and that the changes in SOFR are the only relevant changes in market conditions.

Following discounting factors may be considered

Discount rate @7.75%	Present value of ₹ 1 payable
At the end of year 9	51.1 paise
Cumulatively for the years 1–9	6.312
At the end of year 10	47.4 paise
Cumulatively for the years 1–10	6.786

Required: What is the amount transferred to the OCI at the end of Year 1?

Answer 8

The amount of change in fair value of the bond that is not attributable to changes in market conditions giving rise to market risk is estimated as follows:

Step (a) : The bond's IRR at the start of the period is 8%.

Step (b): Because the benchmark interest rate (SOFR) is 5%, the instrument - specific component of the IRR is 3%.

Step (c)

The contractual cash flows of the instrument at the end of the period are:

- Interest of ₹ 1,20,000 [₹ 15,00,000 x 8%] per year for the next 9 years.
- Principal repayment of ₹ 15,00,000 at the end of 9th year.

The present value of these cash flows is calculated using a discount rate of 7.75%. This rate is arrived at as below:

- 4.75% end of period SOFR, plus
- 3% instrument - specific component calculated as at the start of the period

This gives a notional present value of ₹ 15,23,670 = [(15,00,000 x 0.511) + (1,20,000 x 6.312)].

Step (d)

The fair value of the liability at the end of the period is ₹ 15,38,110. Hence, ABC Ltd. should present ₹ 14,440 [₹ 15,38,110 – ₹ 15,23,670] in the OCI.

Question 9 (MTP 5 Marks, Oct'23,Jul'25 SM)

A Ltd has made a security deposit whose details are described below. Make necessary journal entries for accounting of the deposit in the first year and last year. Assume market interest rate for a deposit for similar period to be 12% per annum.

Particulars	Details
Date of Security Deposit (Starting Date)	1-Apr-20X1
Date of Security Deposit (Finishing Date)	31-Mar-20X6
Description	Lease
Total Lease Period	5 years
Discount rate	12.00%
Security deposit (A)	10,00,000
Present value factor at the 5th year	0.567427

Answer 9

The above security deposit is an interest free deposit redeemable at the end of lease term for ₹10,00,000. Hence, this involves collection of contractual cash flows and shall be accounted at amortised cost.

Upon initial measurement –

Particulars	Details
Security deposit (A)	10,00,000
Total Lease Period (Years)	5
Discount rate	12.00%
Present value factor of 5th year end	0.56743
Present value of deposit at beginning (B)	5,67,427
Prepaid lease payment at beginning (A-B)	4,32,573

Journal Entries

Year – 1 beginning

Particulars		Amount	Amount
Security deposit A/c	Dr.	5,67,427	
ROU Asset	Dr.	4,32,573	
To Bank A/c			10,00,000

Subsequently, every annual reporting year, interest income shall be accrued @ 12% per annum and prepaid expenses shall be amortised on straight line basis over the lease term.

Year 1 end

Particulars		Amount	Amount
Security deposit A/c (5,67,427 x 12%)	Dr.	68,091	
To Interest income A/c			68,091

At the end of 5th year, the security deposit shall accrue ₹ 10,00,000 and prepaid lease expenses shall be fully amortised (i.e. depreciated as per Ind AS 116, this prepaid lease rent would be shown as ROU asset).

Journal entry for realisation of security deposit –

Particulars		Amount	Amount
Security deposit A/c	Dr.	1,07,143	
To Interest income A/c			1,07,143
Bank A/c	Dr.	10,00,000	
To Security Deposit A/c			10,00,000

Question 10 (RTP Nov'23, MTP 10 Marks Nov'25)

On 1st April, 20X1, a bank provides an entity with a four-year loan of ₹ 5,000 on normal market terms, including charging interest at a fixed rate of 8% per year. Interest is payable at the end of each year. The figure of 8% is

CHAPTER 3.3: IND AS 7: STATEMENT OF CASH FLOWS

B

LDR Questions	Q 1, Q 6, Q 8

QUICK REVIEW OF IMPORTANT CONCEPTS

OPERATING ACTIVITIES

These are the principal revenue producing activities of the entity other than investing or financing activities

Reporting

- Under Direct Method
- Under Indirect Method

Whereby major classes of gross cash receipts and gross cash payments are disclosed

Whereby Profit and Loss is adjusted by:

1. non-cash transactions
2. any deferrals or accruals of past or future operating cash receipts or payments
3. Items of income or expense associated with investing or financing cash flows.

INVESTING ACTIVITIES

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents

An entity shall report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities

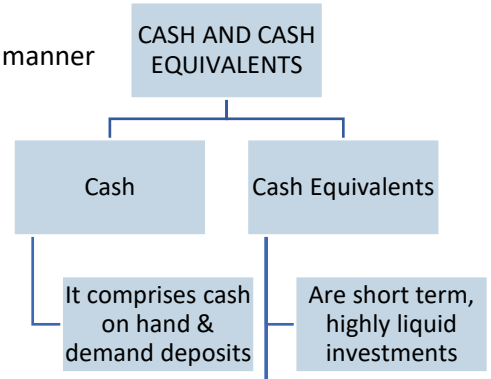
FINANCING ACTIVITIES

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity

An entity shall report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities

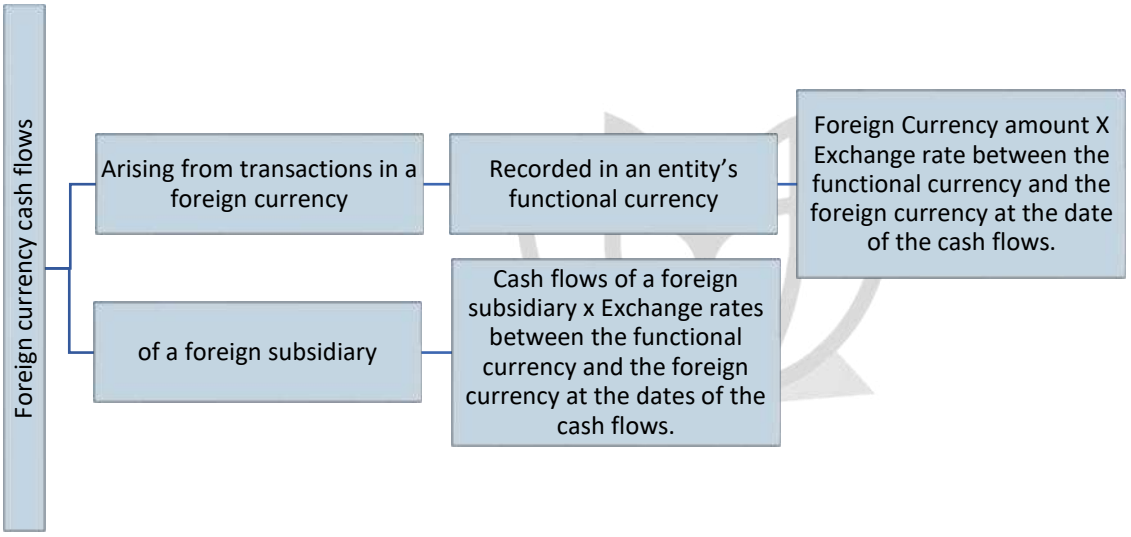
FOREIGN CURRENCY CASH FLOWS

1. Cash flows denominated in a foreign currency are reported in a manner consistent with Ind AS 21.
2. A weighted average exchange rate for a period may be used for recording foreign currency transactions or the translation of the Cash Flows of a foreign subsidiary.
3. Ind AS 21 does not permit use of the exchange rate at the end of the reporting period when translating the cash flows of a foreign Subsidiary.



Important Points:

1. Unrealised gains and losses arising from changes in foreign currency exchange rates are not Cash Flows.
2. The effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency:
   - is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and the end of the period.
   - is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at end of period exchange rates.



Important Points/Disclosures:

Investing and financing transactions that do not require the use of cash or cash equivalents	• Shall be excluded from a statement of cash flows • Disclosed elsewhere in the financial statements
Components of cash and cash equivalents	• Disclose the components of cash and cash equivalents • Shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the balance sheet • Disclose the policy which entity adopts in determining the composition of cash and cash equivalents.
Other Disclosures	Disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held and are not available for use by the group

Note: The requirements shall be equally applicable to the entities in the case of separate financial statements also.

Question & Answers

Question 1 **(MTP 6 Marks, Oct'23)** LDR

From the following transactions taken from a parent company having multiple businesses and multiple segments, identify which transactions will be classified as Operating, Investing and Financing:

Sr. No.	Nature of transaction
1	Issued preference shares
2	Purchased the shares of 100% subsidiary company
3	Dividend received from shares of subsidiaries
4	Dividend received from other companies
5	Bonus shares issued
6	Purchased license for manufacturing of special drugs
7	Royalty received from the goods patented by the company
8	Rent received from the let-out building (letting out is not main business)
9	Interest received from loans and advances given
10	Dividend paid
11	Interest paid on security deposits
12	Purchased goodwill
13	Acquired the assets of a company by issue of equity shares (not parting any cash)
14	Interim dividends paid
15	Dissolved the 100% subsidiary and received the amount in final settlement

Answer 1

Sr. No.	Nature of transaction	Operating/Investing/ Financing/Not to be considered
1	Issued preference shares	Financing
2	Purchased the shares of 100% subsidiary company	Investing
3	Dividend received from shares of subsidiaries	Investing
4	Dividend received from other companies	Investing
5	Bonus shares issued	No cash flow
6	Purchased license for manufacturing of special drugs	Investing
7	Royalty received from the goods patented by the company	Operating
8	Rent received from the let-out building (letting out is not main business)	Investing
9	Interest received from loans and advances given	Investing
10	Dividend paid	Financing
11	Interest paid on security deposits	Financing
12	Purchased goodwill	Investing
13	Acquired the assets of a company by issue of equity shares (not parting any cash)	Not to be considered
14	Interim dividends paid	Financing
15	Dissolved the 100% subsidiary and received the amount in final settlement	Investing

Question 2 **(MTP 5 Marks, Mar'21, Apr'23, RTP Nov'20, SM)**

During the financial year 20X1-20X2, Vivit Su Limited have paid various taxes & reproduced the below mentioned records for your perusal:

Capital gain tax of Rs. 20 crore on sale of office premises at a sale consideration of Rs. 100 crore.

- **Income Tax of Rs. 3 crore on Business profits amounting Rs. 30 crore (assume entire business profit as cash profit).**
- **Dividend Distribution Tax of Rs. 2 crore on payment of dividend amounting Rs. 20 crore to its shareholders.**
- **Income tax Refund of Rs. 1.5 crore (Refund on taxes paid in earlier periods for business profits).**

You need to determine the net cash flow from operating activities, investing activities and financing activities of Vivit Su Limited as per relevant Ind AS.

Answer 2

Para 36 of Ind AS 7 inter alia states that when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

Accordingly, the transactions are analyzed as follows:

Particulars	Amount (in crore)	Activity
Sale Consideration	100	Investing Activity
Capital Gain Tax	(20)	Investing Activity
Business profits	30	Operating Activity
Tax on Business profits	(3)	Operating Activity
Dividend Payment	(20)	Financing Activity
Dividend Distribution Tax	(2)	Financing Activity
Income Tax Refund	1.5	Operating Activity
Total Cash flow	**86.5**	

Activity wise	Amount (in crore)
Operating Activity	28.5
Investing Activity	80
Financing Activity	(22)
Total	**86.5**

Question 3 (RTP May'25)

The opening balance sheet at 1st April, 20X1 of an Indian company (which account for its transactions in INR (₹), which consists of cash of ₹ 1,00,000 and share capital of ₹ 100,000. The Company borrows a long term loan on 30th September, 20X1 for US $ 2,200 when the rate of exchange is 1 US $= ₹ 87. There are no other transactions during the year. The exchange rate at the balance sheet date of 31st March, 20X2 is 1 US $ = ₹ 85. The summarized balance sheet at 31st March, 20X2 is as follows:

	₹	₹
Assets		**2,91,400**
Cash (1,00,000+1,91,400)		
		2,91,400
Equity and liabilities		
Capital and reserves		
Share capital Other Equity	**1,00,000**	
Foreign Currency Translation Reserves	**4,400**	**1,04,400**
Non- current liabilities		
Long -term loan		**1,87,000**
Total equity and liabilities		**2,91,400**

Required: How the foreign exchange difference arising from unsettled transactions will reflect in the Statement of Cash Flows?

Answer 3

The foreign currency loan, having been translated at the rate ruling at the receipt date to ₹ 1,91,400 (US $ 2,200 x ₹87), is translated at the balance sheet date to ₹1,87,000(US $2,200x₹85).The exchange gain of ₹ 4,400 is recognised in the Statement of profit and loss. The cash is made up of ₹ 1,00,000 (received from the share issue) and ₹ 1,91,400 (received on converting the currency loan immediately to ₹).

Statement of Cash Flows

	₹
Cash flows from operating activities	
Profit	4,400
Less: Foreign exchange gain	(4,400)
Net cash flow from operating activities A	0
Cash flows from financing activities	

Receipts of foreign currency loan		1,91,400
Net cash flow from financing activities	B	1,91,400
Net increase in cash and cash equivalent A+B		1,91,400
Cash and cash equivalents at the beginning of the reporting period		1,00,000
Cash and cash equivalents at the end of the reporting period*		2,91,400

* Represents year end cash balances.

The exchange gain of ₹ 4,400 does not have any cash flow effect and is related to financing activities. Therefore, it needs to be eliminated from profit. A similar adjustment would be necessary if the loan remains outstanding at 31st March, 20X3.

Question 4 (PYP 6 Marks Dec '21, MTP 5 Marks Jul'25)

In the year 20X1-20X2, one land was sold for ₹ 5 crore and another land purchased for ₹ 3 crore by XYZ Limited. Company reported Cash Flow on a Net Basis in Cash Flow Statement i.e. ₹ 2 crore in Investing Activity as Cash receipt from Sale of Land. Advise whether treatment given as above is correct or not as per the provisions of Ind AS 7. Also, calculate the cash from operations by indirect method from the following information:

Operating Statement of XYZ Limited for the year ended 31st March, 20X2

Particulars	₹
Sales	20,00,000
Less: Cost of goods sold	(14,00,000)
Administration & selling overheads	(2,20,000)
Depreciation	(28,000)
Interest paid	(12,000)
Loss on sale of asset	(8,000)
Profit before tax	3,32,000
Less: Tax	(1,20,000)
Profit after tax	2,12,000

Balance Sheet as on 31st March

	20X2 (₹)	20X1 (₹)
Assets		
Non-current assets		
Property, plant and equipment	3,00,000	2,60,000
Investment	48,000	40,000
Current assets		
Inventories	48,000	52,000
Trade receivables	40,000	28,000
Cash and cash equivalents	24,000	20,000
Total	4,60,000	4,00,000
Equity and liabilities		
Shareholders' funds	2,40,000	2,00,000
Non-current Liabilities	1,32,000	1,40,000
Current liabilities		
Trade payables	48,000	32,000
Expenses payables	40,000	28,000
Total	4,60,000	4,00,000

Answer 4

(i) Correct treatment of cash flow:

If nothing is specifically mentioned, then as per Ind AS 7, the cash flows will be presented on gross basis. Gross basis means the receipts would be shown separately and the payments will be shown separately. Accordingly, in the year 20X1-20X2, while presenting the information, entity will show separately cash outflow from investing activity of ₹ 3 crore for purchase of land and cash inflow from investing activity of ₹ 5 crore from sale of land.

(ii) Cash flow from Operations by Indirect Method

	₹
Profit After Tax	2,12,000
Add back / (Less): Depreciation	28,000
Interest paid	12,000
Loss on sale of an asset	8,000
	2,60,000
Adjustments for changes in inventory and operating receivables and payables	
Decrease in inventory	4,000
Increase in trade receivables	(12,000)
Increase in trade payables	16,000
Increase in expenses payables	12,000
Net cash generated from operating activity	2,80,000

Question 5 **(RTP May'24)**

Following is the Balance Sheet of Vivi Ltd: **(₹ in Lakhs)**

Particulars	31.3.20X3	31.3.20X2
ASSETS		
Non-Current Assets		
Property, Plant and Equipment	450	410
Intangible asset	90	90
Deferred Tax Asset (net)	45	45
Other Non-current Asset	95	85
Total Non-current Assets	680	630
Current Assets		
Financial Asset		
Investments	100	60
Trade Receivables	580	600
Cash and Cash Equivalents	300	300
Inventories	800	700
Other Current Assets	160	120
Total Current Assets	1,940	1,780
Total Assets	2,620	2,410
Equity and Liabilities		
Equity		
Equity Share Capital	280	250
Other Equity	980	820
Total Equity	1,260	1,070
Non-current Liabilities		
Financial Liabilities		
Borrowings	360	300
Other Non-current Liabilities	90	80
Total Non-current Liabilities	450	380
Current Liabilities		
Financial Liabilities		
Trade Payable	455	450
Bank Overdraft	410	420
Other current liabilities	45	90
Total Current Liabilities	910	960
Total Liabilities	1,360	1,340
Total Equity and Liabilities	2,620	2,410

Additional Information:

(a) Profit before tax for the year is ₹ 200 lakhs and provision for tax is ₹ 40 lakhs.

(b) Property, Plant and Equipment purchased during the year ₹ 100 lakhs.
(c) Current liabilities include Capital creditors of ₹ 25 lakhs as at 31st March 20X3(Nil – 31st March 20X2)
(d) Long Term Borrowings raised during the year ₹ 120 lakhs.
From the information given, prepare a Statement of Cash Flows following Indirect Method. Assume that Bank overdraft is an integral part of the entity's cash management.

Answer 5

Statement of Cash Flows for the year ended 31st March, 20X3

	(₹ in lakhs)	(₹ in lakhs)
Cash flows from operating activities		
Profit before taxation	200	
Adjustments for non-cash items:		
Depreciation [410 - (450 - 100)]	60	
	260	
Increase in inventories (800 - 700)	(100)	
Decrease in trade receivables (600 - 580)	20	
Increase in other non-current assets (95 - 85)	(10)	
Increase in other current assets (160 - 120)	(40)	
Increase in non-current liabilities (90 - 80)	10	
Increase in trade payables (455 – 25 - 450)	(20)	
Other current liabilities (Refer Note 1) [(90 + 40) - 45]	(85)	
Net cash generated from operating activities		35
Cash flows from investing activities		
Cash paid to purchase PPE (100-25)	(75)	
Cash paid to acquire investment (100-60)	(40)	
Net cash outflow from investing activities		(115)
Cash flows from financing activities		
Raising of equity share capital (280 - 250)	30	
Long-term borrowings raised during the year	120	
Long-term borrowings repaid during the year [(300 + 120) - 360]	(60)	
Net cash outflow from financing activities		90
Increase in cash and cash equivalents during the year		10
Cash and cash equivalents at the beginning of the year (420-300) (Refer Note 2)		(120)
Cash and cash equivalents at the end of the year (410-300) (Refer Note 2)		(110)

Note: Other current liabilities are assumed to consist of provision for taxation.

Question 6 (MTP 8 Marks Sep'24, RTP Nov'23, MP[4]) LDR

One of the subsidiaries of Wavelength 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

CA FINAL

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2

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but becoming it

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- SM: This includes the references to ICAI Study Material, Only to the extent that the question is same as RTP, MTP, PYP or MP.

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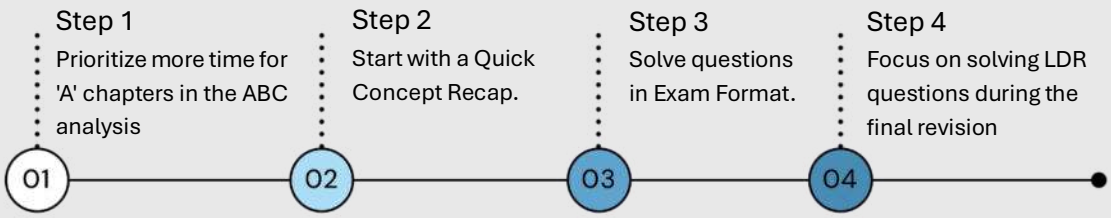
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Step 1: Prioritize your chapters

Chapters in the index are categorized as A, B, or C based on their importance. Focus more on 'A' chapters, as they carry the most weight, and give adequate attention to 'B' chapters. While all chapters must be covered, this approach helps manage time efficiently for better results.

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Use this powerful summary for a quick brush-up on key concepts before you attempt the chapter. This helps you identify and understand the core principles. If a question gives you trouble, return to this section / main study material to solidify the concept, then come back and solve it again.

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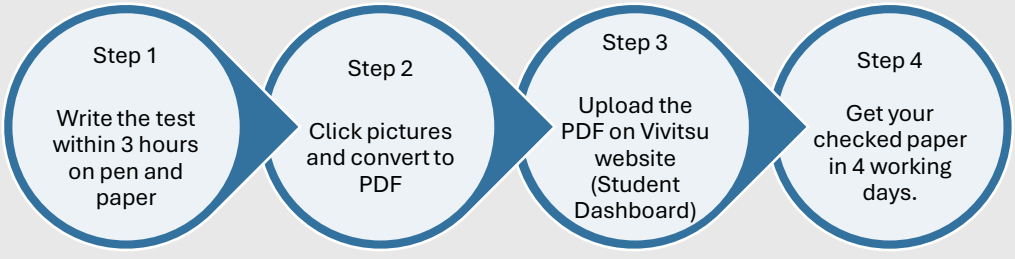
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Step 4: Last Day Revision (LDR)

Focus on solving LDR questions during the final revision. In the 1.5 days before the exam, prioritize these questions as they cover the most critical concepts from each chapter. You'll find a quick summary of LDR question numbers listed right before each chapter for easy reference.

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			IMP
3	Advanced Capital Budgeting Decisions	3-1 – 3-30	B
4	Security Analysis	4-1 – 4-10	C
5	Security Valuation	5-1 – 5-31	A
6	Portfolio Management	6-1 – 6-38	C
7	Securitization	7-1 – 7-8	B
8	Mutual Funds	8-1 – 8-25	A
9	Derivatives Analysis and Valuation	9-1 – 9-28	B
10	Foreign Exchange Exposure and Risk Management	10-1 – 10-33	B
11	International Financial Management	11-1 – 11-22	A
12	Interest Rate Risk Management	12-1 – 12-20	A
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16	Case Scenarios	16-1 – 16-46	A
17	Vivitsu Test Paper	17-1 – 17-4	B
			A

ABC ANALYSIS

A Very Important, Read on priority

B Moderately Important

C Less critical essential

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Questions:

08

Prioritize using ABC Analysis

Each chapter is categorized as A , B or C
A : Very Important, Read on priority
B : Moderately Important
C : Less Critical but still essential

07

Last Day Revision Questions

LDR Questions	Q 12, Q 22, Q 25, Q 27

QUICK REVIEW OF IMPORTANT FORMULAS

1. Cash Flow after tax: (R-C) × (1-T) + D × T. Where R is Revenue, C is Cost, T is Tax rate and D is Depreciation.

Conversion of cashflow from real to nominal or nominal to real

$R_n = R_r * (1+P)$ Where, R_n is Nominal return, R_r is Real return, P is Expected Inflation Rate (%).

Conversion of discount rate from real to nominal or nominal to real

$(1+ R_n) = (1+ R_r) * (1+P)$ Where, R_n is Nominal rate of return (%), R_r is Real rate of return (%)

P is Expected Inflation Rate (%).

2. Statistical Methods of Incorporating Risk in Capital Budgeting:

2.1 **Probability weighted Cashflows: Expected Value :** $\sum Pi\ NCFi$

Where, Pi is the probability and NCF_i is the Net Cash flows.

2.2 **Variance:** $\frac{\sum(x-\bar{x})^2}{n} = \sum \mathbf{Pi}(x-\bar{x})^2$

Where x is Net cash flow, $\bar{x}$ is the expected net cashflow and Pi is the probability.

Variance as per Hillers Model: $\sigma^2 = \sum(1+r)^{-2i}\sigma_i^2$

Where, 1+r is the discount rate and i is the time.

2.3 **Standard Deviation:** $\sqrt{\sigma^2} = \sqrt{\text{Variance}}$

2.4 **Coefficient of Variation:** $\frac{\text{Standard Deviation}}{\text{Expected Cashflow}}$

06

Concept Summary

Sharpen your memory with lightning-fast concepts recap before you hit the questions. Also perfect for the final 1.5-day revision!

Question 8 (PYP 4 Marks May'25, RTP May'24,MP[3],MP[4])

Exam Insights: In this theoretical question on theoretical question on the post pandemic additional role of CFO, overall performance was above average though some examinees mentioned traditional role of CFO.

04

Exam Insights

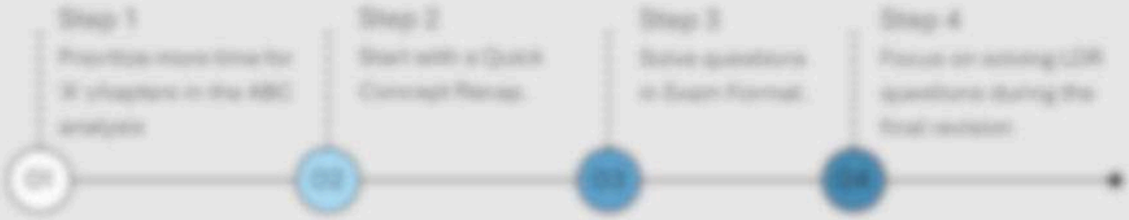
Use exam insights to learn common mistakes and avoid them. Stay ahead of others

05

Reference's to Attempts in all Questions

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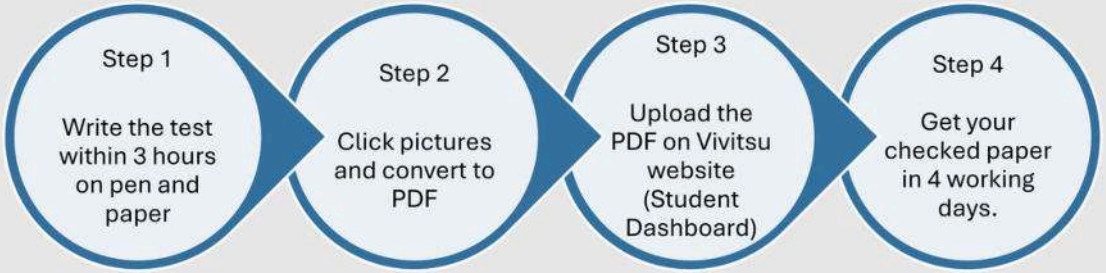


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4	Security Analysis	4-1 – 4-10	
5	Security Valuation	5-1 – 5-31	
6	Portfolio Management	6-1 – 6-38	A
7	Securitization		
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17	Vivitsu Test Paper	17-1 – 17-4	

01

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A Very Important, Read on priority

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C Less critical but still essential

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CHAPTER 1: FINANCIAL POLICY AND CORPORATE STRATEGY B

LDR Questions	Q 10, Q 11, Q 13

Question & Answers

Question 1 **(MTP 4 Marks Apr'25)**

What are the key factors that influence corporate-level strategy decisions?

Answer 1

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.

The key factors that influence corporate-level strategy decisions

(i) Suitability: Whether the strategy would work for the accomplishment of common objective of the company.

(ii) Feasibility: Determines the kind and number of resources required to formulate and implement the strategy.

(iii) Acceptability: It is concerned with the stakeholders' satisfaction and can be financial and non-financial.

Question 2 **(MP [5] 4 Marks)**

What are the major components of Financial planning.

Answer 2

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

Question 3 **(MTP 4 Marks, Apr'22, RTP May'21,PYP 4 Marks Sep'25)**

EXPLAIN what makes an organization financially sustainable.

Answer 3

To be financially sustainable, an organization must:

- Have more than one source of income;
- Have more than one way of generating income;
- Do strategic, action and financial planning regularly;
- Have adequate financial systems;
- have a good public image;
- Be clear about its values (value clarity); and have financial autonomy.

Exam Insights: In this theoretical question requiring examinees to identify the key points that makes an organization financially sustainable overall performance was good.

Question 4 **(MTP 4 Marks, Oct'19, Apr'21, Mar'23, Mar'26, PYP 4 Marks, Nov'19, Jan'21, Nov'24, RTP Nov'20, May'26, MP[2])**

Discuss briefly the key decisions falling within the scope of financial strategy.

OR

As a financial strategist you will depend on certain key financial decisions. Discuss.

OR

This decision determines the division of earnings between payments to shareholders and reinvestment in the company. What this decision is called? What are other decisions falling in this strategy? Briefly explain.

Answer 4

The key decisions falling within the scope of financial strategy include the following:

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.

Exam Insights: This theoretical question, based on key decisions within the scope of financial strategy, saw good overall performance.

Question 5 (MTP 4 Marks Apr'24, Sep'23, PYP 4 Marks, Nov'23,MP[1],MP[7])

Explain the term Corporate Level Strategy and what are the three basic questions it answers?

Or

What do you mean by Corporate Level Strategy. Also explain three basic questions Corporate Level Strategy should be able to answer.

Answer 5

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:

(1) Suitability: Whether the strategy would work for the accomplishment of common objective of the company.

(2) Feasibility: Determines the kind and number of resources required to formulate and implement the strategy.

(3) Acceptability: It is concerned with the stakeholders' satisfaction and can be financial and non-financial.

Exam Insights: In this theoretical question, performance was good.

Question 6 (MTP 4 Marks Oct'20 & Mar'24,MP[6])

"Sustainable growth is important to enterprise long-term development". Explain this statement in context of planning healthy corporate growth.

Answer 6

Sustainable growth is important to enterprise long-term development. Too fast or too slow growth will go against enterprise growth and development, so financial should play important role in enterprise development, adopt suitable financial policy initiative to make sure enterprise growth speed close to sustainable growth ratio and have sustainable healthy development.

The sustainable growth rate (SGR) 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 beginning of period 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 models 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.

Question 7 (MTP 4 Marks Oct '23, Apr'23, PYP 4 Marks May'23,MP[10])

What makes an organization sustainable as well as financially sustainable?

OR

Explain the various requirements that makes an organization sustainable.

Answer 7

In order to be sustainable, an organization 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.

To be financially sustainable, an organization must:

- have more than one source of income;
- have more than one way of generating income;
- do strategic, action and financial planning regularly;
- have adequate financial systems;
- have a good public image;
- be clear about its values (value clarity); and
- have financial autonomy.

Question 8 (PYP 4 Marks May'25, RTP May'24,MP[3],MP[4])

Identify the role of CFOs in addition to traditional role in post pandemic time.

OR

In the current scenario of globalization and growth in information and communication technologies etc. the responsibilities of CFOs have been drastically expanded. Explain.

Answer 8

Traditionally, the main role of CFO was concentrated to wealth maximization for shareholders by taking care of financial health of anorganization and overseeing and implementing adequate financial controls.

However, in recent time because of globalization, growth in informationand communications, pandemic situation etc. their range of responsibilities has been drastically expanded, driven by complexity, and changing expectations.

Now a days in addition to fulfilling traditional role relating to governance, compliances and controls, and business ethics as a part ofthe leadership of role CFOs are also expected to contribute their supportin strategic and operational decision making.

In post-pandemic time their role has been advanced in the following areas in addition to traditional role:

a. **Risk Management:** Now a days the CFOs are expected to look after the overall functioning of the framework of Risk Management system of an organization.
b. **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.
c. **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.
d. **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 organization and that too on sustainable basis for a longer period.

Exam Insights: In this theoretical question on theoretical question on the post pandemic additional role of CFO, overall performance was above average though some examinees mentioned traditional role of CFO.

Question 9 (PYP 4 Marks May'24 & May '18)

"The starting point of an organisation is money and the end point of that organization is also money". Explain the statement to clearly understand this interface of strategic management and financial policy.

Answer 9

No organization can run an existing business and promote a new expansion project without a suitable internally mobilized financial base or both i.e. internally and externally mobilized financial base.

Sources of finance and capital structure are the most important dimensions of a strategic plan. The need for fund mobilization to support the expansion activity of firm is very vital for any organization. The generation of funds may arise out of ownership capital and or borrowed capital.

Along with the mobilization of funds, policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital.

Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions. A planner has to frame policies for regulating investments in fixed assets and for restraining of current assets. In fact, project evaluation and project selection are the two most important jobs under fund allocation. Planner's task is to make the best possible allocation under resource constraints.

Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all. Dividend policy decision deals with the extent of earnings to be distributed as dividend and the extent of earnings to be retained for future expansion scheme of the firm. Stability of the dividend payment is a desirable consideration that can have a positive impact on share prices.

Thus, the financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth. These policies being related to external awareness about the firm, especially the awareness of the investors about the firm, in respect of its internal performance. There is always a process of evaluation active in the minds of the current and future stake holders of the company.

Exam insights: In this theoretical question overall there was poor performance as most of the examinees written broader point without any explanation. Even examinees could not write the required conclusion that both financial policy and functional policies could not work in isolation.

Question 10 (SM, PYP 8 Marks May'19, Jul'21, MP[2],RTP Jan'26) LDR

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 payout 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?

Answer 10

Workings:

Asset turnover ratio	= 1.1
Total Assets	= ₹ 600
Turnover ₹ 600 lakhs × 1.1	= ₹ 660 lakhs

Effective interest rate	= $\frac{\text{Interest}}{\text{liabilities}}$ = 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 Pay-out	= 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 = $\frac{\text{PAT}}{\text{NW}}$ and NW = Rs. 100 lakh +Rs. 300 lakh = 400 lakh

ROE = $\frac{\text{Rs. 31.2 lakhs}}{\text{Rs. 400 lakhs}} \times 100$ = 7.8%

SGR = 0.078(1-0.1667) = 6.5% or $\frac{0.078 \times 0.8333}{1-0.078 \times 0.8333}$ = 6.95%

(iii) Calculation of fair price of share using dividend discount model

$P_0 = \frac{D_0(1+g)}{k_e - g}$

Dividends = $\frac{\text{Rs.5.2 lakhs}}{\text{Rs.10 lakhs}}$ = Rs. 0.52

Growth Rate = 6.5% or 6.95%

Hence $P_0 = \frac{\text{Rs.0.52}(1+0.065)}{0.15-0.065} = \frac{\text{Rs.0.5538}}{0.085}$ = Rs. 6.51 or $\frac{0.52(1+0.0695)}{0.15-0.0695} = \frac{0.5561}{0.0805}$ = Rs. 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.

Exam Insights: In this question on Security Valuation most of the students have performed well though in some cases students could not compute effective interest rate correctly. Even in some cases ROE and SGR were also wrongly calculated.

Question 11 (MTP 4 Marks Nov'25) LDR

Explain how Distributed Ledger Technology (DTL) is already in use in fields like financial services, healthcare, travel industry and economic forecasts.

Answer 11

The already existing use of DTL or Blockchain in various fields are discussed below:

(a) 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.

(b) 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.

(c) 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.

(d) 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.

(e) 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.

Question 12 (MTP 4 Marks Nov'25)

Explain two approaches that are used to calculate External Funding Requirement (EFR) and the type of funding.

Answer 12

To compute EFR and the type of funding, the following approaches can be used:

(1) Analytical Approach: In this approach, we begin by analyzing each item on the balance sheet in relation to changes in sales and determine their amounts while considering prescribed conditions, such as maintaining specific Debt-to-Equity or Current Ratios, among others.

(2) Formula based Approach: In this approach, we first calculate the amount of EFR using the following formula:

$$\text{EFR} = \frac{\text{TA}}{\text{Sales}} \times \Delta S - \frac{\text{Payable and Liabilities}}{\text{Sales}} \times \Delta S - {}_{m}S_1(1-d)$$

Where:

ΔS = Change in Sales

S_1 = Revised Sales

TA = Total Assets

Payable and Liabilities = Payables and liabilities that change spontaneously in accordance with level of sales.

m = Profit Multiplier or percentage of Net Profit after Tax

d = Dividend Pay-out Ratio

Question 13 (PYP 4 Marks Jan'26) LDR

MNC Limited company's financial statements for FY 2024-25 are provided:

Income Statement	(₹ in Cr.)
Sales revenues	7500
Costs and expenses	7300
Income before taxes	200
Taxes (30%)	60
Net income	140

MNC Limited's Balance Sheet as at 31st March, 2025

Liabilities	(₹ in Cr.)	Assets	(₹ in Cr.)
Equity	2000	Net Fixed Assets	4000
Long term Debt	2500	Current Assets	2000
Current Liabilities	1500		
	6000		6000

Additional Information:

(i) The company expects a 40% sales growth next financial year.

(ii) The company will have a 25% dividend payout ratio next year.

(iii) All costs, current assets and current liabilities are expected to increase with sales.

(iv) Except retained earnings no new Equity is to be raised.

Required:

Compute External Funding Requirement through raising Long-term Debt:

(1) If the company is operating at 65% capacity usage for fixed assets.

(2) If the company is operating at 95% capacity usage for fixed assets.

Answer 13

(i) External Funding Requirement in case of 65% capacity utilization

With only 65% Utilization, growth by 40% can be achieved without any corresponding increase in Fixed Assets (65*1.4 times = 91%)

External Funding Requirement through Long Term Debt	(₹ in Crore)
Expected Sales Revenue (7500 x 1.4)	10500
Costs and Expenses (7300 x 1.4)	10220

Income before taxes	280
Taxes (30%)	84
Net Income	196
Dividend Payout@25% of ₹ 196	49
Retained Earnings/ Internal Sources of Funds	147
Additional Funds Required (2000 – 1500)*0.4	200
Balance to be met from Long Term Debt	53

(ii) External Funding Requirement in case of 95% capacity utilization

With only 95% Utilization, growth by 40% can be achieved by corresponding increase in Fixed Assets of ₹ 1320 Crore (95%*1.4 times = 1.33 times of existing Fixed Assets of ₹ 4000 Crore). Projected Fixed Assets increase to ₹ 5320 Crore.

External Funding Requirement through Long Term Debt	(₹ in Crore)
Expected Sales Revenue (7500 x 1.4)	10500
Costs and Expenses (7300 x 1.4)	10220
Income before taxes	280
Taxes (30%)	84
Net Income	196
Dividend Payout@25% of ₹ 196	49
Retained Earnings/ Internal Sources of Funds	147
Additional Funds Required (8120 – 2100 – 2000 – 2500)	1520
Balance to be met from Long Term Debt	1373

Alternative Solution

(i) Computation of EFR if company is operating at 65% capacity usage of Fixed Assets.

Full Capacity Sales = $\frac{\text{Actual Sales}}{\text{\% of capacity at which fixed assets were operated}} = \frac{₹\ 7,500\ \text{crore}}{0.65}$ = ₹ 11538.4615 Crore

Actual Fixed Asset Ratio should be = $\frac{₹\ 4,000\ \text{Crore}}{₹\ 11,538.4615\ \text{Crore}} = 0.3467$

Revised Fixed Assets = ₹ 10,500 x 0.3467 = ₹ 3640.35 crore

Proforma Income Statement

	₹ in Crore
Sales Revenue	10,500
Less: Cost and Expenses	10,220
Income Before Tax	280
Tax @ 30%	84
Profit after Tax	196
Less: Dividend Paid	49
Retained Earning	147

Proforma Balance Sheet

	₹ in Crore		₹ in Crore
Equity	2000.00	Fixed Assets	3640.35
Retained Earnings	147.00	Current Assets	2800.00
Long Term Debt (Bal. Figure)	2193.35		
Current Liabilities	2100.00		
	6440.35		6440.35

EFR = ₹ 2193.35 Crore - ₹ 2500 Crore = - ₹ 306.65 Crore

Alternatively, it can also be computed using the Formula as follows:

$=\left(\frac{F_0}{S_0} \times \text{Revised Sales} - F_0\right) + \left(\frac{CA}{S} - \frac{CL}{S}\right) \times \Delta S - \text{Net Profit}(1-d)$

$=(3,640.35 - 4,000) + \left(\frac{2,000}{7,500} - \frac{1,500}{7,500}\right) \times 3,000 - (196 - 49)$ = - 359.65 + 200 – 147 = - ₹ 306.65 Crore

(ii) Computation of EFR if company is operating at 95% capacity usage of Fixed Assets.

Full Capacity Sales = $\frac{\text{Actual Sales}}{\text{\% of capicity at which fixed assests were operated}} = \frac{₹\ 7,500\ \text{Crore}}{0.95} = ₹\ 7,894.7368\ \text{Crore}$

Actual Fixed Asset Ratio should be = $\frac{₹\ 4,000\ \text{Crore}}{₹\ 7,894.7368\ \text{Crore}} = 0.5067$

Revised Fixed Assets = ₹ 10,500 x 0.5067 = ₹ 5320.35 crore

Proforma Income Statement

	₹ in Crore
Sales Revenue	10,500
Less: Cost and Expenses	10,220
Income Before Tax	280
Tax @ 30%	84
Profit after Tax	196
Less: Dividend Paid	49
Retained Earning	147

Proforma Balance Sheet

	₹ in Crore		₹ in Crore
Equity	2000.00	Fixed Assets	5320.35
Retained Earnings	147.00	Current Assets	2800.00
Long Term Debt (Bal. Figure)	3873.35		
Current Liabilities	2100.00		
	8120.35		**8120.35**

EFR = ₹ 3873.35 Crore - ₹ 2500 Crore = ₹ 1373.35 Crore

Alternatively, it can also be computed using the Formula as follows:

$$=\left(\frac{F_0}{S_0} \times \text{Revised Sales} - F_0\right) + \left(\frac{CA}{S} - \frac{CL}{S}\right) \times \Delta S - \text{Net Profit}(1-d)$$

$$= (5{,}320.35 - 4{,}000) + \left(\frac{2{,}000}{7{,}500} - \frac{1{,}500}{7{,}500}\right) \times 3{,}000 - (196 - 49) = 1320.35 + 200 - 147 = ₹\ 1373.35\ \text{Core}$$

Exam Insights: Poor performance was observed in this question, which required determining External Funding Requirements through long-term debt under two alternative levels of fixed asset capacity utilisation. The primary issue was a lack of understanding of capacity utilisation adjustments and their impact on fixed assets and funding needs.

Question 14 (PYP 4 Marks May'26)

MT Ltd. has approached you for an additional loan of ₹ 20 crores to fund its aggressive expansion plans. The company's current sustainable growth rate is 10%, but it aims to grow at 16% annually. Its debt-to-equity ratio is already at the maximum permissible limit of 2.5:1. Additionally, the industry is experiencing 5% inflation, which is increasing the company's asset financing requirements.

As a credit analyst, you explain the key concerns regarding this loan request and suggest two alternative courses of action available to the company to achieve its growth objectives sustainably.

Answer 14

Key Concerns:

(i) **Excessive Debt Risk:** The loan request creates a potentially risky situation of too much debt and too little equity, as the company's debt-to-equity ratio is already at the maximum limit of 2.5:1.

(ii) **Growth Rate Mismatch:** The company's planned growth rate (16%) exceeds its sustainable growth rate (10%), which cannot be maintained without increasing financial leverage beyond permissible limits.

(iii) **Inflationary Impact:** The 5% inflation increases the amount of external financing required and increases the debt-to-equity ratio when measured on a historical cost basis. Thus, inflation lowers the firm's sustainable growth rate.

Alternative Courses of Action:

(i) **Raise Additional Equity:** The Company must raise additional equity capital to support the higher growth rate while maintaining the debt-to-equity ratio within permissible limits.

(ii) **Reduce Expansion Rate:** The Company will have to reduce the rate of expansion to a level (10% or lower) that can be sustained without an increase in financial leverage, aligning actual growth with sustainable growth rate.

LDR Questions	Q 7, Q 8, Q 10

QUICK REVIEW OF IMPORTANT FORMULAS

1. **Variance**: $\frac{\sum(x-\bar{x})}{n}$ where x is observation, n is number of observations and $\bar{x}$ is the mean of observations.
2. **Standard Deviation**: $\sigma = \sqrt{\text{Variance}}$
3. **Covariance**: $\frac{\sum(x-\bar{x})(x-\bar{y})}{n}$
4. **Correlation**: $\rho = \frac{cov(X,Y)}{\sigma_x \sigma_y}$ where, Cov(X,Y) is covariance and σ is Standard Deviation
5. **Standard Deviation of portfolio**: $\sigma_\rho = \sqrt{\sigma_1^2 + \sigma_2^2 + (2(\sigma_1\sigma_2\rho))}$
   Where σ_1 is standard deviation of 1st security and σ_2 is standard deviation of 2nd security in Rupee terms
   Or, $\sqrt{W_1^2\sigma_1^2 + W_2^2\sigma_2^2 + (2(W_1W_2\sigma_1\sigma_2\rho))}$
   Where W_1 & W_2 are the weights of respective securities & SDs are in %
6. **Value at Risk (VAR)**:
   $\sigma_p \times$ Portfolio Value x Cumulative Z score $\times \sqrt{\text{N Days}}$
   Where, Z score indicates how many standard deviation away from mean
7. **Market Capitalization**: Total number of shares × Market price of share

Question & Answers

Question 1 (MTP 4 Marks Apr'25, PYP 4 Marks, Dec'21,MP[5])

How can a company identify and manage counterparty risk effectively?

Answer 1

A company can identify and manage counterparty risk effectively by recognizing potential warning signs and implementing risk mitigation techniques.

The various hints that may provide counter party risk are as follows:

(a) Failure to obtain necessary resources to complete the project or transaction undertaken.
(b) Any regulatory restrictions from the Government.
(c) Hostile action of foreign government.
(d) Let down by third party.
(e) Have become insolvent.

The various techniques to manage this type of risk are as follows:

(1) Carrying out Due Diligence before dealing with any third party.
(2) Do not over commit to a single entity or group or connected entities.
(3) Know your exposure limits.
(4) Review the limits and procedure for credit approval regularly.
(5) Rapid action in the event of any likelihood of defaults.
(6) Use of performance guarantee, insurance or other instruments.

Exam Insights: Overall students have performed at an above average level but in some cases, students were not able to identify type of risk asked in the question, so could not explain correct techniques.

Question 2 (PYP 4 Marks Nov'23)

List out the four methods for Identification and Management of Financial Risk. What are the parameters to identify the currency risk?

Answer 2

Following are the four methods for identification and management of financial risk:

- Counter Party risk
- Political risk
- Interest Rate Risk
- Currency Risk

Parameters to identity the currency risk are as follows:

(1) Government Action: The Government action of any country has visual impact in its currency.

(2) Nominal Interest Rate: As per interest rate parity (IRP) the currency exchange rate depends on the nominal interest of that country.

(3) Inflation Rate: Purchasing power parity theory discussed in later chapters impact the value of currency.

(4) Natural Calamities: Any natural calamity can have negative impact.

(5) War, Coup, Rebellion etc.: All these actions can have far reaching impact on currency's exchange rates.

(6) Change of Government: The change of government and its attitude towards foreign investment also helps to identify the currency risk.

Exam Insights: In this theoretical question on Risk Management, overall performance was average.

Question 3 (MTP 4 Marks, Oct'23, Oct'19)

What do you mean by term "Counter Party Risk." Explain various hints that may provide an indicator of the same risk.

Answer 3

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.

The various hints that may provide counter party risk are as follows:

(a) Failure to obtain necessary resources to complete the project or transaction undertaken.

(b) Any regulatory restrictions from the Government.

(c) Hostile action of foreign government.

(d) Let down by third party.

(e) Have become insolvent.

Question 4 (MTP 4 Marks, Oct'19, Oct'22 & Apr'23, Aug'25, RTP Nov'18)

Explain some of the parameters to identify the currency risk.

Answer 4

Some of the parameters to identity the currency risk are as follows:

(1) 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.

(2) Nominal Interest Rate: As per interest rate parity (IRP) the currency exchange rate depends on the nominal interest of that country.

(3) Inflation Rate: Purchasing power parity theory impact the value of currency.

(4) Natural Calamities: Any natural calamity can have negative impact.

(5) War, Coup, Rebellion etc.: All these actions can have far reaching impact on currency's exchange rates.

(6) Change of Government: The change of government and its attitude towards foreign investment also helps to identify the currency risk.

Question 5 (MTP 4 Marks May'20, Mar'21, Oct'18, Mar'18, Oct'21, Sept'22 & Sep '23, Mar'26, PYP 4 Marks Nov'18, RTP Nov'20,MP[2])

Explain how Financial Risk can be viewed from different viewpoints.

OR

Explain Financial Risk from the point of view of Stakeholder, Company and the Government.

Answer 5

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.

Question 6 **(PYP 4 Marks May'25)**

Mr. PK imports raw materials from China, processes them in India and manufactures finished goods which are then sold in the American market. In this transaction what types of risk faced by Mr. PK?

Answer 6

In this transaction, possible types of risks are:

(i) **Currency Risk (Exchange Rate Risk):** Since raw materials imported from China and finished goods sold in the USA, fluctuation in exchange rates between Yuan, Indian rupee and US Dollar could impact cost and revenue.

(ii) **Political and Trade Risk:** Changes in trade policies, tariffs, or political instability in China, India, or the U.S. may affect the cost and availability of raw materials or access to markets.

(iii) **Market Risk:** The demand for the finished products in the US may fluctuate, affecting sales and profitability.

(iv) **Regulatory Risk** – Mr. PK must comply with various regulations in each country, including import/export laws, quality standards, and customs regulations.

Exam Insights: This theoretical question on Risk Management overall performance was of above average level.

Question 7 **(MP [4] 4 Marks)** LDR

Explain the categories in which Financial Risk can be divided.

Answer 7

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.

Question 8 **(RTP May'18, PYP 4 Marks Nov'22, , Jul'21, MTP 4 Marks Mar'24, Aug '18, Apr'18, Mar'22 & Mar'23, Jul'25, Apr'26, MP[1],MP[3],MP[6])** LDR

DESCRIBE Value at Risk and its application.

Answer 8

VAR is a measure of risk of investment. Given the normal market condition in a set of periods, say, one day it estimates how much an investment might lose. This investment can be a portfolio, capital investment or foreign exchange etc., VAR answers two basic questions -

(i) What is worst case scenario?

(ii) What will be loss?

It was first applied in 1922 in New York Stock Exchange, entered the financial world in 1990s and become world's most widely used measure of financial risk.

Features of VAR

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) Control Risk: Risk can be controlled by selling 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.

Application of VAR

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) enable the management to decide the trading strategies.

(v) as a tool for Asset and Liability Management especially in banks.

Exam Insights: Average performance was observed in this theoretical question as most of students not properly mentioned the features of VaR.

Question 9 **(MTP 8 Marks Sep'24,MP[8])**

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.

Answer 9

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
MaximumLoss 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

Question 10 (PYP 8 Marks, May'23) LDR

Mr. Wivitsu is a rational risk taker. He takes his position in a single stock for 4 days in a week. He does not take a position on Friday to avoid weekend effect and takes position only for four days in a week i.e. Monday to Thursday. He transfers the amount on Monday morning and withdraws the balance on Friday morning. He desires to make a maximum investment where Value At Risk (VAR) should not exceed the balance lying in his bank account. The position by his manager, as per standing instructions, is taken on the free balance lying in the bank account in the morning on each Monday.

On Monday morning (before opening of the capital market) he has transferred an amount of ₹11 Crore to his bank account. A fixed deposit also matured on this Monday. The maturity amount of ₹63,42,560 was also credited to his account by the bank in the morning of the Monday. However, Mr. Wivitsu received the intimation of the same in the evening. The bank needs a minimum balance of ₹1,000 all the time. The value of Z score, at the required confidence level of 99 percent is 2.33.

The other information with respect to stocks X and Y, which are under consideration for this week, is as under:

X		Y	
Return	Probability	Return	Probability
6	0.10	4	0.10
7	0.25	6	0.20
8	0.30	8	0.40
9	0.25	10	0.20
10	0.10	12	0.10

You are required to recommend a single stock, where maximum investment can be made.

Answer 10

Working Notes:

(1) Security X

Return (1)	Prob. (2)	(1) x (2)	Dev.	Dev.^{2}	Dev.^{2} x Prob.
6	0.10	0.60	-2	4	0.40
7	0.25	1.75	1	1	0.25
8	0.30	2.40	0	0	0
9	0.25	2.25	1	1	0.25
10	0.10	1.00	2	4	0.40
		8.00			1.30

Expected Return (Rx) = 8.00%

Variance (σ_X^2) = 1.30

Standard Deviation (σ_x) = $\sqrt{1.30}$ = 1.14

(2) Security Y

Return (1)	Prob. (2)	(1) x (2)	Dev.	Dev.^{2}	Dev.^{2} x Prob.
4	0.10	0.40	-4	16	1.60
6	0.20	1.20	-2	4	0.80
8	0.40	3.20	0	0	0

CHAPTER 3: ADVANCED CAPITAL BUDGETING DECISIONS A

LDR Questions	Q 12, Q 22, Q 25, Q 27

TOPICS OF THIS CHAPTER

- Different Methods for Best Project Calculation (Q 1- Q 16)
- Sensitivity Analysis (Q 17- Q 22)
- Scenario Analysis (Q 23- Q 26)
- Replacement of Machine (Q 27- Q 31)

QUICK REVIEW OF IMPORTANT FORMULAS

1. Cash Flow after tax: (R-C) × (1-T) + D × T. Where R is Revenue, C is Cost, T is Tax rate and D is Depreciation.

Conversion of cashflow from real to nominal or nominal to real

$R_n = R_r * (1+P)$ Where, R_n is Nominal return, R_r is Real return, P is Expected Inflation Rate (%).

Conversion of discount rate from real to nominal or nominal to real

$(1+ R_n) = (1+ R_r) * (1+P)$ Where, R_n is Nominal rate of return (%),R_r is Real rate of return (%)

P is Expected Inflation Rate (%).

2. Statistical Methods of Incorporating Risk in Capital Budgeting:

2.1 **Probability weighted Cashflows: Expected Value :** $\sum Pi\ NCFi$

Where, Pi is the probability and NCF_i is the Net Cash flows.

2.2 **Variance:** $\frac{\sum(x-\bar{x})^2}{n} = \sum \mathbf{Pi}(\mathbf{x}-\bar{\mathbf{x}})^{\mathbf{2}}$

Where x is Net cash flow, $\bar{x}$ is the expected net cashflow and Pi is the probability.

Variance as per Hillers Model: $\sigma^2 = \sum(\mathbf{1}+\mathbf{r})^{-\mathbf{2i}}\,\sigma_{\mathbf{i}}^{\mathbf{2}}$

Where, 1+r is the discount rate and i is the time.

2.3 **Standard Deviation:** $\sqrt{\sigma^2} = \sqrt{\text{Variance}}$

2.4 **Coefficient of Variation:** $\frac{\text{Standard Deviation}}{\text{Expected Cashflow}}$

3. Conventional Methods of Incorporating Risk in Capital Budgeting:

3.1 **Risk Adjusted Discount Rate (RADR)**

RADR= $R_f + \beta(R_m - R_f)$ or RADR = R_f + Risk Premium

Where,R_m is Market return R_f is Risk free rate of return and β is beta

Risk premium = Risk index × (Minimum required return of firm – Risk free rate)

3.2 **Certainty Equivalent =** $\frac{\text{Certain Cashflows}}{\text{Expected Risky Cashflows}}$

4. NPV= $\sum \frac{\alpha \times NCF}{(1+k)^n}$ − Initial Investment

Where, α is Risk Adjustment factor, NCF is net cash flow without risk adjustment, K is Risk free rate and n is number of periods.

5. Higher the CE of project - lower the risk and

- Lower the CE of project - higher the risk

Expected Net Present Value (Multiple Periods) = Sum of Present Value of Cashflows calculated Individually – Initial Investment

Adjusted Present Value: Base Case NPV (on unlevered cost of capital) + PV of tax benefits on interest

6. Profitability Index = $\frac{\textbf{Discount Cash inflow}}{\textbf{Initial Investment}}$

7. Replacement Decision:

Step 1: Net Cash flow = Cost of new Machine – (tax saving + market value of old machine)**[**usually a negative value]

Step 2: (Change in Sales +/- Change in Operating Cost – Change in Depreciation) × (1- Tax) + Change in Depreciation) × (1- Tax) + Change in Deprecation

Or

(Change in Sales +/- Change in Operating Cost) ×(1- Tax) + (Change in Depreciation × Tax)

Step 3: Present Value of Cashflows = Present Value of Yearly Cash Flows + Present Value of Salvage

Step 4: NPV = Step 1 [cash outflow i.e - ve value] + Step 3 [cash inflow i.e +ve value]

8. **Optimum Replacement Cycle:** **Equivalent Annual Cost (EAC) =** $\frac{\text{Present Value of Cash Outflow (PVCF)}}{\text{Present Value Annuity Factor(PVAF)}}$

Different Methods for Best Project Calculation

Question & Answers

Question 1 (MTP 5 Marks, Oct'23, SM)

EXPLAIN the concept of risk adjusted discount rate.

Answer 1

Risk Adjusted Discount Rate: The use of risk adjusted discount rate (RADR) is based on the concept that investors demand higher returns from the risky projects. The required rate of return on any investment should include compensation for delaying consumption plus compensation for inflation equal to risk free rate of return, plus compensation for any kind of risk taken. If the risk associated with any investment project is higher than risk involved in a similar kind of project, discount rate is adjusted upward in order to compensate this additional risk borne.

A risk adjusted discount rate is **a sum of risk-free rate and risk premium**. The Risk Premium depends on the perception of risk by the investor of a particular investment and risk aversion of the Investor.

So Risks adjusted discount rate = Risk free rate+ Risk premium

Risk Free Rate: It is the rate of return on Investments that bear no risk. For e.g., Government securities yield a return of 6 % and bear no risk. In such case, 6 % is the risk -free rate.

Risk Premium: It is the rate of return over and above the risk-free rate, expected by the Investors as a reward for bearing extra risk. For high-risk project, the risk premium will be high and for low risk projects, the risk premium would be lower.

Question 2 (PYP 4 Marks Jan'26)

Differentiate how real options are different from financial options on the basis of following four points:

(i) Underlying Asset

(ii) Pay-off

(iii) Exercise period

(iv) Approach

Answer 2

Basis	Financial Options	Real Options
Underlying	Have underlying assets that are normally traded in the market i.e. shares, stocks, bonds, commodity etc.	Have underlying the projects that are not traded in the market.
Pay-off	In most of the cases it is specified in the contracts and hence is fixed.	It is estimated from the project cash flows and hence can be varied.
Exercise Period	Mostly the period of these options is short and can go maximum upto 1 year.	The period of these options mostly starts from the end of 1st year and higher than the Financial Options.
Approach	Since these options are normally traded in the market they are "Priced".	Since these options are used to make decisions, they are "Valued".

Question 3 (MTP 4 Marks Apr'25, Nov'25, MP[4])

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

Required:

(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?

Answer 3

(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 maximisation in terms of time value.

Question 4 (MTP 5 Marks Sep'23, PYP 5 Marks Jan'21)

A new project "Wiwitsu" requires an initial outlay of ₹4,50,000. The company uses certainty equivalent method approach to evaluate the project. The risk-free rate is 7%. Following information is available:

Year	Cash Flow After Tax (₹)	Certainty Equivalent Coefficient
1	1,50,000	0.90
2	2,25,000	0.80
3	1,75,000	0.58
4	1,50,000	0.56
5	70,000	0.50

PV Factor at 7%

Year	1	2	3	4	5
PV Factor	0.935	0.873	0.816	0.763	0.713

Is investment in the project beneficial based on above information?

Answer 4

Calculation of Net Present Value of the Project

Year	Cash Inflows After Tax (in ₹)	C.E.	Adjusted Cash Inflows (in ₹)	Present Value Factor	Present Value (in ₹)
1	1,50,000	0.90	1,35,000	0.935	1,26,225
2	2,25,000	0.80	1,80,000	0.873	1,57,140
3	1,75,000	0.58	1,01,500	0.816	82,824
4	1,50,000	0.56	84,000	0.763	64,092
5	70,000	0.50	35,000	0.713	24,955
Total Present Value of Cash Inflows					**4,55,236**
Less: Initial Investment or Cash Outflow required for "Wiwitsu"					(4,50,000)
Net Present Value					**5,236**

Conclusion: As the Net Present Value of the project after considering the Certainty Equivalent factors are still positive; it may be advised to invest in project "Wiwitsu"

Question 5 (MP[1] 6 Marks)

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)

Answer 5

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

(₹ in 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.

Question 6 (RTP Nov'24)

JB Consultancy Group has determined relative utilities of cash flows of two forthcoming projects of its client company as follows:

Cash Flow in ₹	-150000	-100000	-40000	150000	100000	50000	10000
Utilities	-100	-60	-3	40	30	20	10

The distribution of cash flows of project X and Project Y are as follows:

Project X					
Cash Flow (₹)	-150000	- 100000	150000	100000	50000
Probability	0.10	0.20	0.40	0.20	0.10
Project Y					
Cash Flow (₹)	- 100000	-40000	150000	50000	100000
Probability	0.10	0.15	0.40	0.25	0.10

Which project should be selected and why?

Answer 6

Evaluation of project utilizes of Project X and Project Y

	Project X		
Cash flow (in ₹)	Probability	Utility	Utility value
-1,50,000	0.10	-100	-10
-1,00,000	0.20	-60	-12
1,50,000	0.40	40	16
1,00,000	0.20	30	6
50,000	0.10	20	2
			2

Cash flow (in ₹)	Project Y		
	Probability	Utility	Utility value
-1,00,000	0.10	-60	-6
-40,000	0.15	-3	-0.45
1,50,000	0.40	40	16
50,000	0.25	20	5
1,00,000	0.10	30	3
			17.55

Project X should be selected as its expected utility is more.

Question 7 (MP [5] 6 Marks)

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 Years	0.30 (₹ in lakhs)	0.40 (₹ in lakhs)	0.30 (₹ in 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.

Answer 7

Project X		Cashflow	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

(i) Calculation of NPV of XY Co.:

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.

Question 8 (MTP 6 Marks Sep'24, Jul'25,MP[2],MP[8], MTP 6 Marks Mar'26)

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.

Answer 8

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

σ^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 + 50 = 340

σ^2 = 0.10 $(180 - 340)^2$ + 0.25 $(260 - 340)^2$ + 0.30 $(40 - 340)^2$ + 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 14.61%

Project Y = $\frac{91.21}{340}$ = 0.268 or 26.83%

Question 9 (MTP 5 Marks Apr'22 & Aug'18, RTP May'19, Nov'19 & Nov'23, SM)

An enterprise is investing ₹ 100 lakhs in a project. The risk-free rate of return is 7%. Risk premium expected by the Management is 7%. The life of the project is 5 years. Following are the cash flows that are estimated over the life of the project.

Year	Cash flows (₹ in lakhs)
1	25
2	60
3	75
4	80
5	65

CALCULATE Net Present Value of the project based on Risk free rate and also on the basis of Risks adjusted discount rate.

Answer 9

The Present Value of the Cash Flows for all the years by discounting the cash flow at 7% is calculated as below:

Year	Cash flows (₹ in lakhs)	Discounting Factor @7%	Present value of Cash Flows (₹ in Lakhs)
1	25	0.935	23.38
2	60	0.873	52.38
3	75	0.816	61.20
4	80	0.763	61.04
5	65	0.713	46.35
Total of present value of Cash flow			244.34
Less: Initial investment			100
Net Present Value (NPV)			**144.34**

Now, when the risk-free rate is 7 % and the risk premium expected by the Management is 7 %.

So, the risk adjusted discount rate is 7 % + 7 % =14%.

Discounting the above cash flows using the Risk Adjusted Discount Rate would be as below:

Year	Cash flows (₹ in Lakhs)	Discounting Factor @14%	Present Value of Cash Flows (₹ in lakhs)
1	25	0.877	21.93
2	60	0.769	46.14
3	75	0.675	50.63
4	80	0.592	47.36
5	65	0.519	33.74
Total of present value of Cash flow			199.80
Initial investment			100
Net present value (NPV)			**99.80**

Question 10 (MTP 8 Marks Mar'24, SM,MP[6])

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?

Answer 10

(i) Statement Showing the Net Present Value of Project M

Year end	Cash Flow (₹) (a)	C.E. (b)	djusted 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

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3

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Reviewer™

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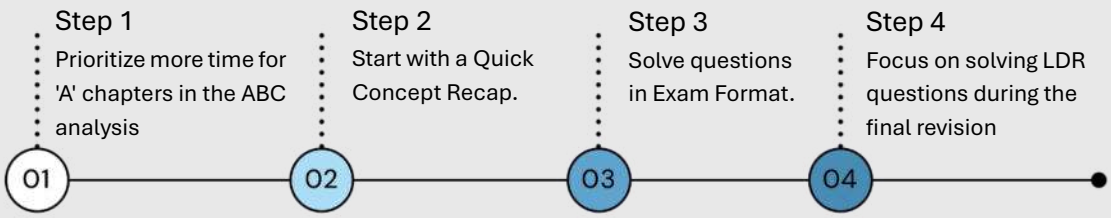
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Step 1: Prioritize your chapters

Chapters in the index are categorized as A, B, or C based on their importance. Focus more on 'A' chapters, as they carry the most weight, and give adequate attention to 'B' chapters. While all chapters must be covered, this approach helps manage time efficiently for better results.

Step 2: Start with a Quick Concept Recap

Use this powerful summary for a quick brush-up on key concepts before you attempt the chapter. This helps you identify and understand the core principles. If a question gives you trouble, return to this section / main study material to solidify the concept, then come back and solve it again.

Step 3: Practice in Exam Format

Audit papers require precise articulation. Don't just "audit" the answer in your head; write it down. Time your practice based on marks (1.8 mins per mark). Structure your answers clearly (Issue -> Provision -> Conclusion). If you miss a keyword or cite the wrong SA, highlight it immediately to review later.

Step 4: Last Day Revision (LDR)

Focus on solving LDR questions during the final revision. In the 1.5 days before the exam, prioritize these questions as they cover the most critical concepts from each chapter. You'll find a quick summary of LDR question numbers listed right before each chapter for easy reference.

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ICAI Study Material (SM) questions are freely available to all students. Including them here would only **raise costs without real value addition**.

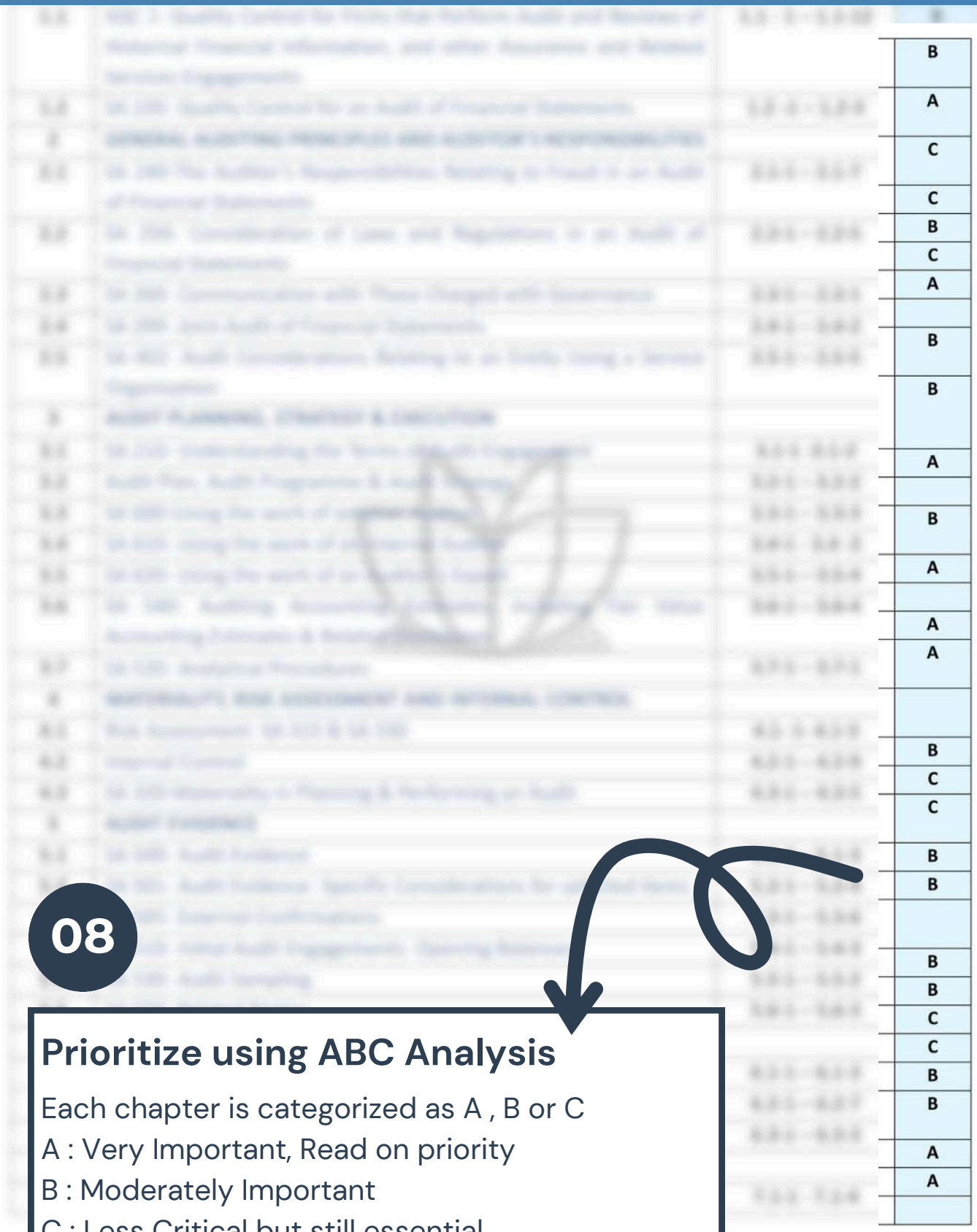
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08

Prioritize using ABC Analysis

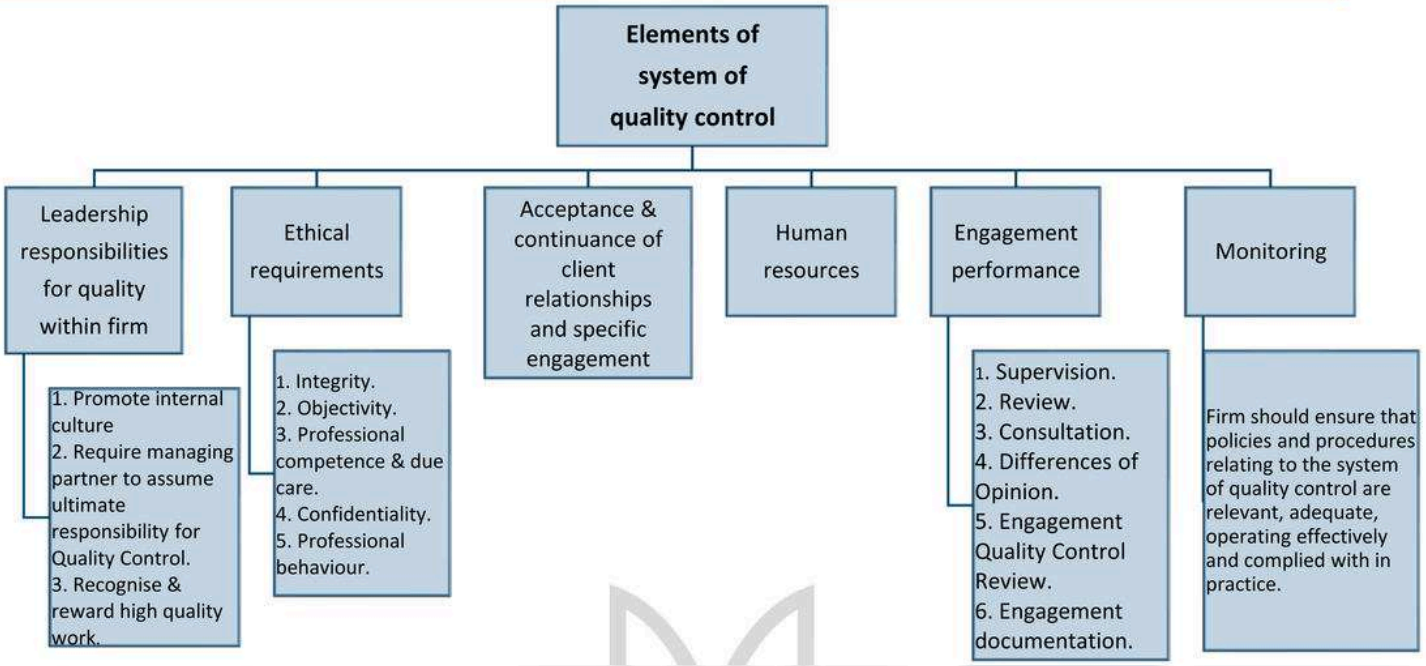
Each chapter is categorized as A , B or C
A : Very Important, Read on priority
B : Moderately Important
C : Less Critical but still essential

07

Last Day Revision Questions

LDR Questions	Q 10, Q 15

QUICK REVIEW OF IMPORTANT CONCEPTS



06

Concept Summary

Sharpen your memory with lightning-fast concepts recap before you hit the questions. Also perfect for the final 1.5-day revision!

05

Exam Insights

Use exam insights to learn common mistakes and avoid them. Stay ahead of others

Exam Insights: Students often name SQC 1 and SA 220 but never show how independence is actually ensured at the firm and engagement-partner level. State the concrete requirements—independence checks, safeguards, confirmations, and monitoring—so your answer moves beyond labels to the provisions themselves.

Question 6 (PYP 5 Marks May '24,MP[6], MTP 5 Marks Nov'25)

04

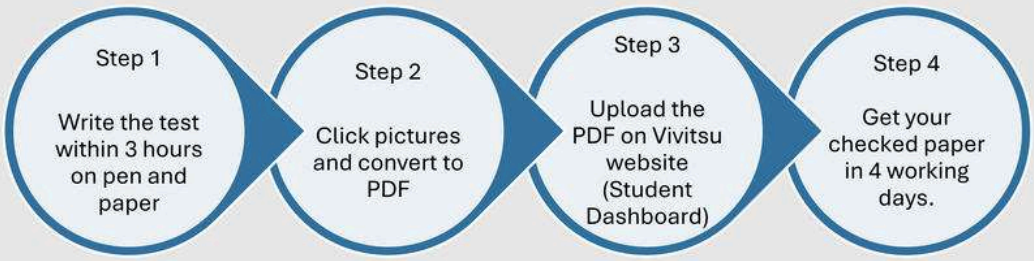
Reference's to Attempts in all Questions

03

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ABC ANALYSIS

A Very Important, Read on priority

B Moderately Important

C Less critical but still essential

Ensure you thoroughly read all chapters without skipping any. The ABC analysis is designed to help you prioritize based on past trends, but it should not replace comprehensive preparation.

ABBREVIATIONS: -

TCWG= Those Charged with Governance
FRF= Financial Reporting Framework
EOM= Emphasis of Matter Paragraph
SAAE= Sufficient Appropriate Audit Evidence
AFS= Audited Financial Statements
CFS= Consolidated Financial Statements
FS= Financial Statements
RPT= Related Party Transactions
OMP= Other Matters Paragraph
KAM= Key Audit Matters
SFS= Summary Financial Statements

WHAT DOES THE BOOK INCLUDE?

- RTP: Revision Test papers

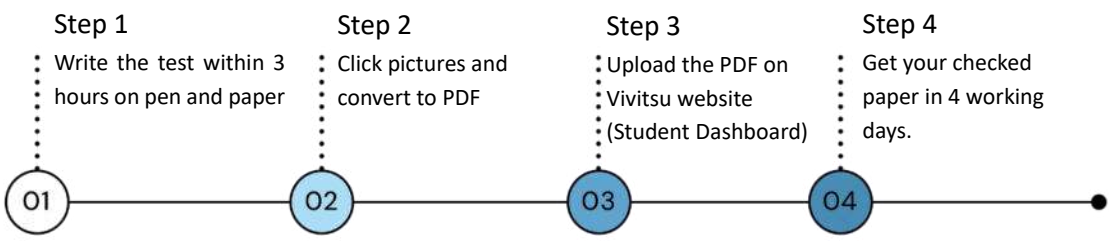
- MTP: Mock Test papers

- PYP: Past Years Papers

- MP: Model Test Papers (ICAI releases a set of Model Test Papers on the website for your practice, We have added them in Chapter-wise format in this book as well.)

- SM: This includes the references to ICAI Study Material, Only to the extent that the question is same as RTP, MTP, PYP or MP.

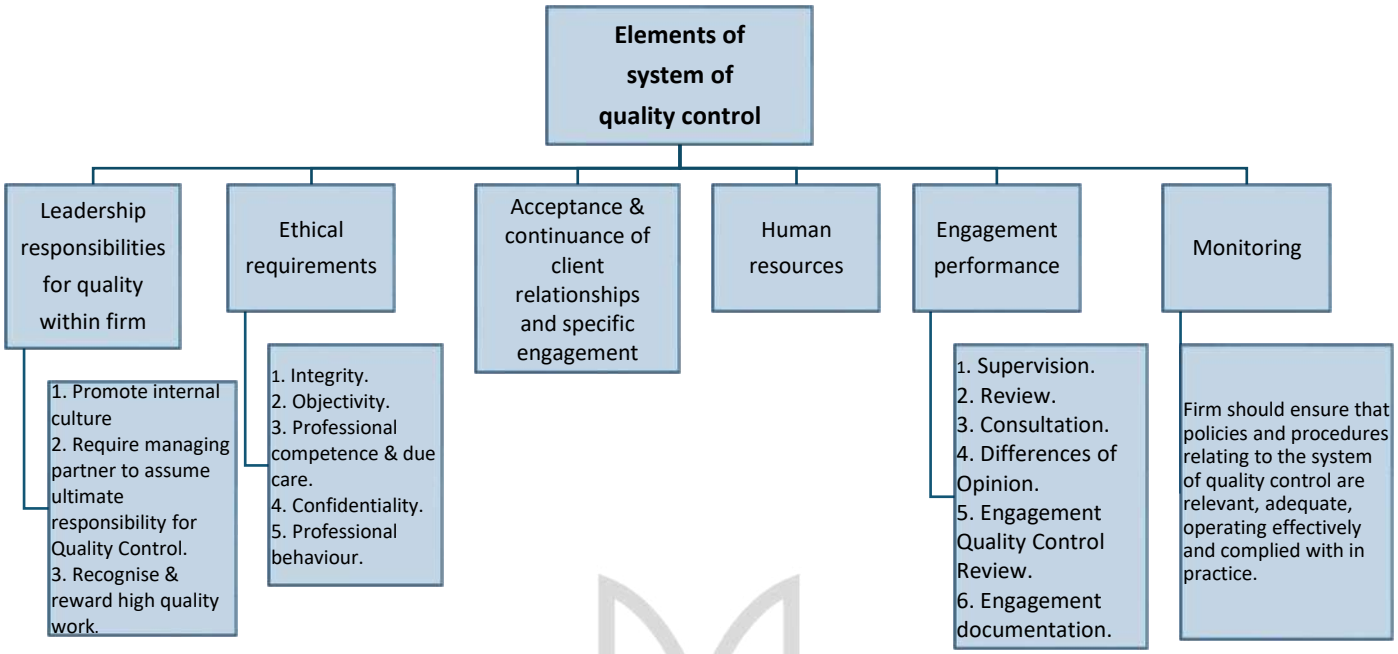
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CHAPTER 1.1: SQC 1: QUALITY CONTROL FOR FIRMS THAT PERFORM AUDIT

LDR Questions	Q 10, Q 15

QUICK REVIEW OF IMPORTANT CONCEPTS



Questions & Answers

Question 1 (MTP 5 Marks Sep'23, Oct'23)

(Includes concepts of SA 220-Quality Control for an Audit of Financial Statements)

CA Ragini is offered an appointment to act as Engagement Quality Control Reviewer (EQCR) for the audit of the financial year 20X1-X2 of XPM Limited, a listed company operating from a small town. She is also based in the same town and was not engaged previously to conduct an audit of a listed entity. She accepts the appointment to act as EQCR. She performs the review by ticking a Yes/No checklist and signing on some of the working papers prepared by the engagement team. The audit file does not contain any material misstatement which shows that the work of EQCR is separate from the work of the engagement team. Do you agree with the approach adopted by EQCR? Comment.

Answer 1

As per SQC 1 engagement quality control reviewer can be a partner, other person in the firm (member of ICAI), suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report.

It also states that the engagement quality control reviewer for an audit of the financial statements of a listed entity is an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities.

In addition, the work of EQCR involves objective evaluation of the significant judgments made by the engagement team and ensuring that the conclusions reached by the team in formulating audit report are appropriate. It is necessary for EQCR to have the requisite technical expertise and experience to enable her to perform the assigned role of evaluating the work of engagement team so that any possible misstatement can be avoided. Without ensuring the appropriate technical expertise and experience, the whole purpose of EQCR is defeated. Therefore, it was not appropriate for her to accept appointment as EQCR for listed entity.

Further, SA 220 states that the engagement quality control reviewer shall document, for the audit engagement reviewed, that the procedures required by the firm's policies on engagement quality control review have been performed. It also states that it shall also be documented that the reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the

engagement team made and the conclusions they reached were not appropriate.
In the given situation, CA Ragini is offered an appointment to act as Engagement Quality Control Reviewer (EQCR) for the audit of the financial year 20X1-X2 of XPM Limited, a listed company operating from a small town. She has accepted the appointment and performed the review by ticking a Yes / No checklist and signing on some of the working papers prepared by the engagement team.
In the instant case, there are no working papers to show that evaluation has been done by EQCR on conclusions reached by engagement team. Mere ticking of a Yes/No checklist and signing on some working papers of engagement team shows that no such evaluation and review of work performed by engagement team has been made by EQCR. Therefore, her approach was not proper in performing work of EQCR.
As CA Ragini has allowed the issuance of an audit report of the company without carrying out due procedures as discussed above, she is guilty of professional misconduct under clauses 8 and 9 of Part I of the Second Schedule to Chartered Accountants Act, 1949. Under Clause 8, a Chartered Accountant is held guilty of professional misconduct in case of failure to obtain sufficient information which is necessary for the expression of an opinion, or its exceptions are sufficiently material to negate the expression of an opinion.
Clause 9 is applicable in case of failure to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances. Therefore, she is guilty of professional misconduct, as discussed above.

Question 2 (MTP 5 Marks Oct'23)

JJJ & Associates, an audit firm working mainly in field of statutory audits, has been selected by Quality Review Board (QRB) for review. During review, it has been found that Audit Firm Under Review (AFUR) has not maintained quality of audits of selected companies as evidenced from their respective audit files. AFUR has not complied with requirements of SA 501 and SA 505 in these cases. Further, in these cases, companies had not complied with accounting standards as required by law and AFUR has issued clean audit reports. Dwell upon functions of QRB in this regard.

Answer 2

Central Government has constituted a Quality Review Board as an independent body under the Chartered Accountants Act, 1949 to review the quality of services provided by the Chartered Accountants in India including audit services. Accordingly, u/s 28B of the Chartered Accountants Act, 1949, the Board shall perform the following functions, namely: -

(a) to make recommendations to the Council with regard to the quality of services provided by the members of the Institute
(b) to review the quality of services provided by the members of the Institute including audit services
(c) to guide the members of the Institute to improve the quality of services and adherence to the various statutory and other regulatory requirements and
(d) to forward cases of non-compliance with various statutory and regulatory requirements by the members of the Institute or firms, noticed by it during the course of its reviews, to the Disciplinary Directorate for its examination.

In the given situation, AUFR has not performed audits of selected companies qualitatively and has failed to perform audits in accordance with Standards on Auditing, Further, it has issued clean reports despite non-adherence to accounting standards by respective companies. Therefore, QRB is empowered to act on the lines mentioned above in respect of AUFR.

Question 3 (PYP 5 Marks Nov'22)

AP & Associates, Chartered Accountants, are Statutory Auditors of XP Limited for the last four years. XP Limited is engaged in the manufacture and marketing of FMCG Goods in India. During 20X1-X2, the Company has diversified and commenced providing software solutions in the area of "e-commerce" in India as well as in certain European countries. AP & 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 new geography. AP & 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.

Answer 3

Acceptance and Continuance of Client Relationships and Specific Engagements: As per SQC 1, "Quality Control for Firms that Perform Audit 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, AP & Associates, Chartered Accountants, statutory auditors of XP Limited for the last four years, came to know that the company has expanded its operations into a new segment as well as new geography. AP & Associates does not possess necessary expertise for the same, therefore, AP & 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 its 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.

AP & Associates should address the above issues before deciding to withdraw.

Exam Insights: Students often drift into resignation procedures and ROC filings instead of addressing SQC 1. Stay focused on SQC 1—state the conditions for withdrawal and the required documentation of reasons, discussions, and conclusions—so the answer meets the standard's intent.

Question 4 (MTP 5 Marks Mar'24,MP[1]) (RTP Jan'26)

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.

Answer 4

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.

Question 5 (PYP 5 Marks Nov'23, MTP 5 Marks Jul'25)

SS Ltd. is a company listed in India. The Company has appointed M/s Z & Co. as auditors. Mr. Q, a CA has recently joined the firm and has been appointed as the engagement partner for the first time. He understands that it is necessary to ensure the compliance of independence for the audit team as per standard audit practices. But he could not find as such, any policies and procedures available with the firm in documented form. Why do you think that the firm should have policies and procedures to ensure the independence of the firm in every assignment? How does an engagement partner ensure the compliance of independence? Discuss with reference to relevant SAs.

Answer 5

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 designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence where required by the Code. Such policies and procedures should enable the firm to:

(i) Communicate its independence requirements to its personnel and, where applicable, to others subject to them; and

(ii) Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.

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:

(i) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence.

(ii) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and

(iii) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

Exam Insights: Students often name SQC 1 and SA 220 but never show how independence is actually ensured at the firm and engagement-partner level. State the concrete requirements—independence checks, safeguards, confirmations, and monitoring—so your answer moves beyond labels to the provisions themselves.

Question 6 (PYP 5 Marks May '24,MP[6], MTP 5 Marks Nov'25)

(Includes concepts of SA 220)

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 issues 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, 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.

Answer 6

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 Reviewsof 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 shouldbe resolved with abovementioned manner as per SQC 1.

Question 7 (MTP 5 Marks Sep'24,MP[3],[4])

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 20X1-X2, 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.

Answer 7

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.

Question 8 (PYP 5 Marks Nov'24)

STA and Associates, Chartered Accountants, is an upcoming firm and its good professional services are hired by diverse clients for assurance services. With a standing of seven years in practice, the firm has clients in various industries like health care, education, hospitality, manufacturing and many more. With the increasing assignments, changes in regulatory compliances and appointment of new personnel, the senior partner CA T is concerned with the proper functioning of the system of Quality control within the firm. He wants to ensure that policies and procedures relating to the system of quality control of the firm are complied with properly. CA T suggests that a proper monitoring of quality control will be the right approach. Discuss the factors that are to be considered by CA T for monitoring the quality control of engagements to ensure that they comply with SQC.

Answer 8

Factors considered for Monitoring Quality Control 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," factors to be considered by CA T for monitoring the quality control of engagements to ensure that they comply with SQC:

- Deciding whether the quality control system of the firm has been appropriately designed and effectively implemented.
- Examining whether new developments in the professional standards, legal, and regulatory requirements have been reflected in the quality control policies.
- Conducting monitoring by entrusting responsibility of monitoring process to a partner or other persons with sufficient and appropriate experience and authority in the firm.
- Dealing with complaints and allegations against the firm or any employees of it of noncompliance with professional standards or appropriate regulatory requirements by a person within or outside the firm.
- Taking appropriate remedial actions against the personnel who did not conform to quality control policies.
- Taking action when deficiencies in the design or operation of the firm's quality control policies and procedures, or non-compliance with the firm's system of quality control are identified.

Exam insights: Many students mix up monitoring with engagement-level reviews and end up describing EQCR procedures instead of SQC-1 monitoring factors. Focus on the real test—whether the firm's quality controls work in practice—by addressing inspection results, recurring deficiencies, corrective actions, and follow-up.

Question 9 (MTP 5 Marks Mar'25)

Rajni Ltd., a listed company, has appointed M/s Amit & Co. as its statutory auditor. CA Sunil, who recently joined the firm, has been appointed as the engagement partner for the first time. While preparing for the audit, he realises the importance of ensuring the audit team's independence, as required by standard audit practices. However, when reviewing the firm's framework, he is unable to find any documented policies or procedures addressing independence compliance.

What steps should CA Sunil take to ensure compliance with independence requirements for the audit engagement? Why is it necessary for an audit firm to have well-documented policies and procedures to maintain independence? Discuss with reference to the relevant Standards on Auditing.

Answer 9

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 designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence where required by the Code. Such policies and procedures should enable the firm to:

(i) Communicate its independence requirements to its personnel and, where applicable, to others subject to them; and

(ii) Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.

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:

(i) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;

(ii) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and

(iii) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

Question 10 (RTP Sep'25) LDR

SDC & Associates, a medium-sized audit firm, is appointed as an auditor of Neuronix Ltd., a listed pharmaceutical company engaged in extensive R&D with complex global operations. CA Rashi an engagement partner of SDC & Associates is leading the audit team for the audit of the same. Neuronix Ltd. was earlier audited by a Big 4 firm that withdrew from the engagement citing scope limitations. During the audit planning, CA Rashi realises that while her team is skilled in standard manufacturing audits, they lack experience in pharma R&D and associated regulatory frameworks. The firm is under pressure to complete the audit in time to meet the listing obligations of Neuronix Ltd. The Managing Partner insists on continuing the audit and advises CA Rashi to rely on the firm's standard procedures to ensure timely delivery.

In light of SQC 1 and SA 220, analyse the quality control considerations CA Rashi must evaluate before continuing with the engagement. What actions should she take to uphold audit quality and professional standards?

Answer 10

As per SQC 1, "Quality Control for firms that perform audits and reviews of historical financial information, and other assurance and related services engagements", CA Rashi, as the engagement partner, is required to evaluate whether the firm has the capabilities, competence, time and resources to undertake an engagement, following matters have to be taken into consideration: -

- Firm personnel have knowledge of relevant industries or subject matters;
- Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively;
- The firm has sufficient personnel with the necessary capabilities and competence;
- Experts are available, if needed;
- Individuals meeting the criteria and eligibility requirements to perform engagement quality control review are available, where applicable; and
- The firm would be able to complete the engagement within the reporting deadline.

Under SA 220, "Quality Control for an audit of financial statements", the responsibility of an engagement partner in this regard in an audit engagement is on lines of SQC 1 which requires 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.

Information like integrity of principal owners, competence of engagement team and consideration of necessary capabilities including time and resources, compliance with relevant ethical requirements and significant matters arisen during current or previous audit engagement and their implications assist the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate.

In the given case:

- SDC & Associates lacks experience in pharmaceutical R&D audits, a highly regulated and technical field.
- The previous auditor's withdrawal citing scope limitations is a warning sign that must be evaluated.
- The engagement team lacks relevant expertise, and there is pressure from the managing partner to proceed regardless.
- Proceeding without addressing these issues would violate the requirements of SQC 1 and SA 220.

CA Rashi must not proceed with the engagement unless satisfied that all conditions under SQC 1 and SA 220 are met. She should:

- Assess the firm's capability and consider engaging external experts.
- Understand the reason for previous auditor's withdrawal.
- Ensure that a qualified EQCR reviewer is appointed and review is completed before issuing the audit report.

This will help maintain audit quality, ensure compliance with professional standards, and protect the firm from regulatory repercussions.

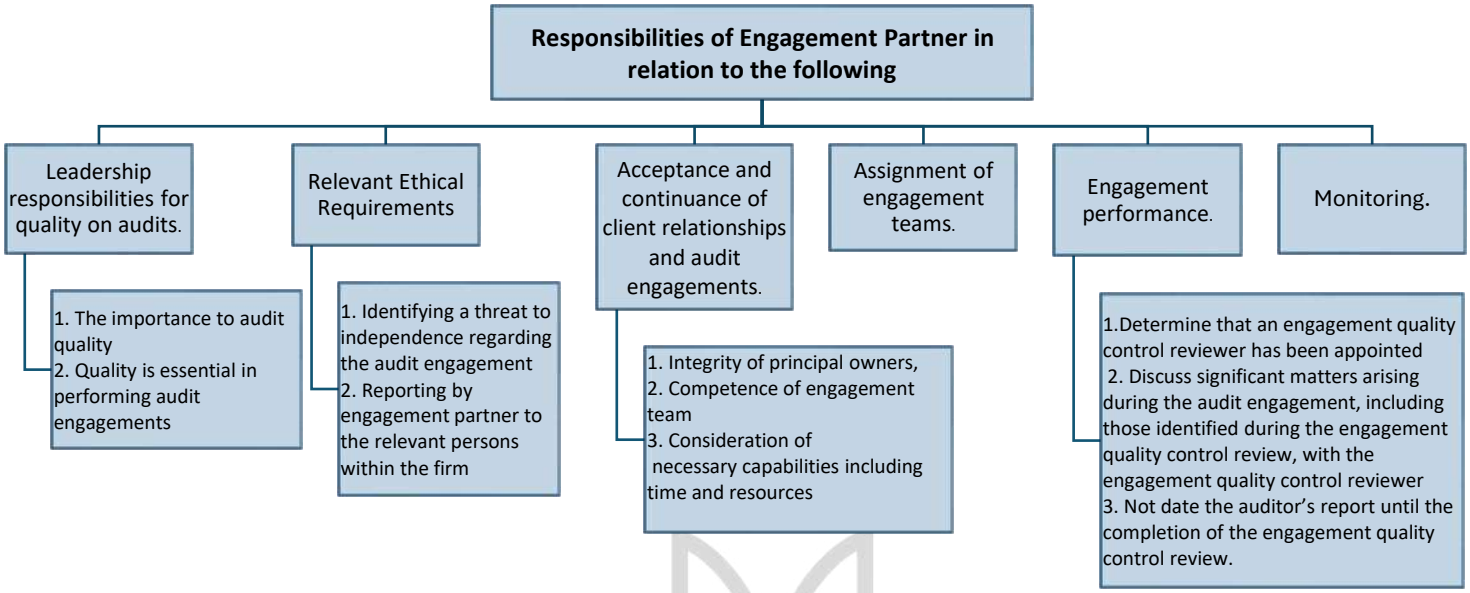
Exam insights: Students often stop at naming the familiarity threat and rotation rule but skip when safeguards become necessary. Always spell out the criteria—length of association, significance of judgments, and risk level—before deciding which safeguards to apply.

CHAPTER 1.2: SA 220- QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS

C

LDR Questions	Q 3

QUICK REVIEW OF IMPORTANT CONCEPTS



Questions & Answers

Question 1 (MTP 5 Marks Sep'22)

(Includes concepts of SQC 1)

NEMI Limited (manufacturer of textile goods) got an order of manufacturing of PPE kits in December 20X1. But there was shortage of machinery and manpower to accomplish the ordered requirement of PPE kits. NEMI Limited approached another manufacturing unit Rathnemi Limited for purchase of the unit. Rathnemi Limited was interested in the sale of unit, so the deal went through, and NEMI Limited acquired ninety-five percent shares of Rathnemi Limited. The new management of Rathnemi Limited proposed and appointed Mani Associates, Chartered Accountants, (already auditors of NEMI Limited) as new auditors of Rathnemi Limited. Mani Associates accepted the assignment without considering information whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate. Comment with respect to appropriate Standard on Auditing what type of information assists the engagements partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate or not?

Answer 1

Acceptance and Continuance of Client Relationships and Audit Engagements : As per SA 220, "Quality Control for an Audit of Financial Statements" , SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", requires the firm to obtain information considered 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.

Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

(i) The integrity of the principal owners, key management and those charged with governance of the entity.

(ii) Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources.

(iii) Whether the firm and the engagement team can comply with relevant ethical requirements; and

(iv) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

Question 2 **(MTP 4 Marks Apr'24, Mar'19 & Oct'18, MTP 5 Marks Dec'25,MP[2])**

(Includes concepts of SA 700 Forming an Opinion)

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, 20X2 was completed on 1st May, 20X2. The auditor's report was dated 15th May, 20X2. During the documentation review of the engagement, it was observed that the engagement quality control review was completed on 18th May, 20X2. The engagement partner had completed his reviews in entirety by 12th May, 20X2. Comment

Answer 2

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 20X2 was conducted by Pine & Associates and was completed on 1st May, 20X2. Subsequently, the engagement partner reviewed the audit by 12th May, 20X2. The audit report issued by Pine and Associates was dated 15th May, 20X2. However, the engagement quality control review was finalized on 18th May, 20X2, 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.

Question 3 **(PYP 5 Marks May'24, MTP 5 Marks Apr'25, MP[6])** LDR

(Includes concepts of SQC 1)

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 issuethe 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.

Answer 3

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 performengagement.
- 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 toindependence.
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.

Exam insights: Many students list issues superficially without tying them to the acceptance and continuance checks under SQC 1/SA 220. Always link each point—integrity, competence, resources, independence, and significant risks—to the standards so your assessment actually reflects the required framework.

Question 4 (RTP May '25,MTP 4 Marks Apr'26)

M/s JinKushal & Co. has been appointed as an auditor of SC Ltd. for the financial year 20X1-X2. CA Jin, one of the partners of M/s JinKushal & Co., completed entire routine audit work by 19th June, 20X2. Unfortunately, on the very next morning, while roving towards office of SC Ltd. to sign final audit report, he met with a road accident and died. CA Kushal, another partner of M/s JinKushal & Co., therefore, signed the accounts of SC Ltd., without reviewing the work performed by CA Jin. State with reasons whether CA Kushal is right in expressing an opinion on financial statements, the audit of which is performed by another auditor.

Answer 4

Relying on Work Performed by Another Auditor: As per SA 220 "Quality Control for an Audit of Financial Statements", an engagement partner taking over an audit during the engagement may apply the review procedures such as the work has been performed in accordance with professional standards and regulatory and legal requirements; significant matters have been raised for further consideration; appropriate consultations have taken place and the resulting conclusions have been documented and implemented; there is a need to revise the nature, timing and extent of work performed; the work performed supports the conclusions reached and is appropriately documented; the evidence obtained is sufficient and appropriate to support the auditor's report; and the objectives of the engagement procedures have been achieved.

Further, as per the Code of Ethics it is the auditor's professional responsibilities and should be complied with that when the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied.

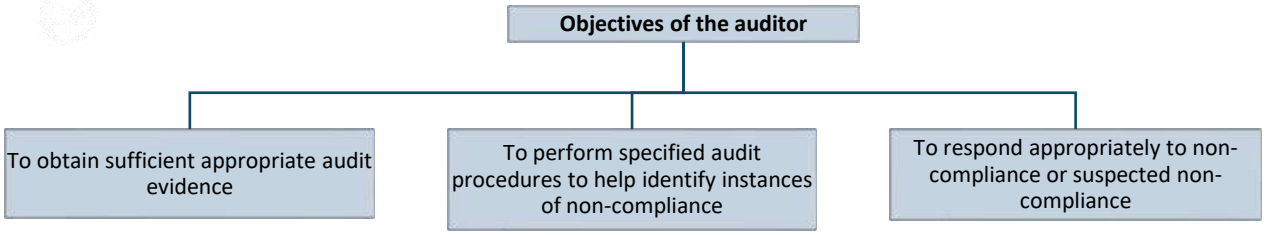
However, the auditor should carefully direct, supervise and review the work delegated. He should obtain reasonable assurance that work performed by other auditors/experts and assistants is adequate for his purpose.

In the given case, all the auditing procedures before the moment of signing of final report have been performed by CA Jin. However, the report could not be signed by him due to his unfortunate death. Later on, CA Kushal signed the report relying on the work performed by CA Jin. Here, CA Kushal is allowed to sign the audit report, though, will be responsible for expressing the opinion. He may rely on the work performed by CA Jin provided he further exercises adequate skill and due care and review the work performed by him.

CHAPTER 2.2: SA 250- CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

LDR Questions	Q 4

QUICK REVIEW OF IMPORTANT CONCEPTS



Management's Responsibilities

- Monitoring Legal Requirements
- Instituting & operating internal controls
- Developing, publicizing and following a code of conduct
- Monitoring compliance with the code of conduct and ensuring employees are trained regarding it
- Engaging Legal Advisors to assist in monitoring legal requirements
- Maintaing a Register of significant Laws

Auditor's Responsibilities

- Reasonable Assurance that Financial Statements as a whole are free from material misstatement
- Responsibilities relating to compliance with those laws and regulations
  - that do not have a direct effect on the determination of amounts and disclosures in FS but their compliance may be fundamental to operating aspects of business. Perform specific audit procedures such as Inquiry and inspecting correspondence with relevant licensing/regulatory authority.
  - those that generally recognised to have a direct effect on the determination of material amounts and disclosures in FS. Perform Audit procedures to obtain SAAE.
- Obtain written representations in case of non-compliance or suspected non-compliance

Indicators of Non- Compliance

Investigation by Regulatory Authorities, Payment for unspecified services, Excessive Sales commission or agents fees, Purchasing at prices significantly above or below market price, Unusual Payments in cash or for legal and retainership fees, Unusual Transactions with companies in tax havens, Payments for goods or services made other than to the country from which the goods or services originated or without proper exchange control documentation, Existence of an information system which fails to provide an adequate audit trail or sufficient evidence, Unauthorized transactions or improperly recorded transactions and Adverse media comment.

Audit Procedures when Non-Compliance is Identified or Suspected

- An understanding of the nature of the act and the circumstances in which it has occurred and
- Further information to evaluate the possible effect on the financial statements.

Reporting of Identified or Suspected Non-Compliance

- Reporting Non-Compliance to TCWG, in the auditor's report on the financial statements and to regulatory and enforcement authorities.

Questions & Answers

Question 1 **(RTP Nov '23)**

CA Paras has been appointed as the Chief Financial Officer (CFO) of Prashanth Limited. In this role, CA Paras is tasked with the responsibility of ensuring that the company's entity's operations are conducted in accordance with relevant laws and regulations. As part of his duties, CA Paras is emphasising the importance of adhering to all applicable laws and regulations that could impact the entity's specific disclosures in its financial statements. Additionally, he is focusing on compliance with laws and regulations that dictate the appropriate financial reporting framework for the company. CA Paras is also highlighting the significance of avoiding any non-compliance, as certain laws and regulations may impose penalties in the event of violations.

Now CA Paras wants to implement policies and procedures in an entity that can assist in the prevention and detection of non-compliance with the laws and regulations. Help CA Paras by citing examples of such policies and procedures.

Answer 1

Management Responsibility for Compliance with Laws and Regulations:

SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", states that it is the responsibility of management, with the oversight of those charged with governance to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations. For this purpose, management may apply the following procedures:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate systems of internal control.
- Developing, publicizing and following a code of conduct.
- Ensuring employees are properly trained and understand the code of conduct.
- Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
- Engaging legal advisors to assist in monitoring legal requirements.
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

Question 2 (MTP 5 Marks Apr'24, RTP Nov'22, MP[2])

(Includes concepts of Duties of Auditor & SA 570 Going Concern)

Nandini Ltd. a chemical manufacturing company, having its factory located at Kanawali Village, for the year 20X1-X2 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 20X1-X2 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.

Answer 2

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".

Question 3 **(RTP May'24)**

While conducting the audit of Quantum Mechanics Limited, Mr. Manoj, the audit manager, identified significant payments made by the company for legal and retainership fees related to litigation. The litigation pertained to the Thirunelly manufacturing plant, situated on forest land reserved for the Elephant Corridor, which was declared illegally constructed. The company had received a notice to decommission the plant by 31-05-20X1, but it had challenged decommissioning order in the High Court and matter was still pending there. The company had not disclosed any information related to the litigation in its financial statements for Financial Year 20X1-X2. The Thirunelly plant accounted for over 75% of the company's annual production, and the audit team expressed concerns that decommissioning could significantly disrupt operations and potentially lead to bankruptcy. The audit was near to completion. When Mr. Manoj sought advice from audit partner Mr. Shalabh on this matter, he suggested that no immediate action was necessary from the auditors, as the matter was still pending in Kerala High Court. However, Mr. Manoj feels that situation requires action from auditors and to be indicated in the report. Whose view seems to be appropriate? Comment with reference to applicable Standards on Auditing.

Answer 3

In accordance with SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", if the auditor concludes that the non- compliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor shall in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report", express a qualified or adverse opinion on the financial statements. In the specific case of Quantum Mechanics Limited, where significant legal and retainership fees have been paid related to a lawsuit concerning the Thirunelly manufacturing plant, the auditor needs to assess the impact of non-compliance on the financial statements. Given that the Thirunelly plant constitutes over 75% of the company's annual production and the audit team believes that decommissioning the plant could potentially lead to bankruptcy, the non-disclosure of such a significant matter would have a material and pervasive impact on the financial statements.

Contrary to the audit partner's suggestion that no action is necessary as the matter is pending in the Kerala High Court, the requirements of SA 250 and SA 705 necessitate a different approach. The auditor should express either a qualified or an adverse opinion on the financial statements based on the level of impact of non-disclosure. Further, above situation involves pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity may not be able to satisfy. It is an example of events or conditions that may cast a significant doubt on entity's ability to continue as a going concern. However, no disclosure is made in financial statements about the material uncertainty. SA 570, "Going Concern" also mandates auditor to express a qualified or an adverse opinion in accordance with SA 705, if adequate disclosure is not made about material uncertainty in financial statements. As a non-disclosure of

such a significant matter would have material and pervasive impact of financial statements, adverse opinion in this situation appears appropriate. Therefore, Mr. Manoj's view seems to be proper.

Question 4 **(PYP 5 Marks Sep'25)** LDR

AJ Private Limited is a company involved in the business of textile manufacturing and having its factory at NOIDA. The business of the company is spread across India. Due to the recent fire incidents, the local authority of NOIDA passed a regulation wherein it is compulsory for any organisation in its jurisdictional area to have a valid Fire No Objection Certificate (Fire NOC) issued by the regulatory authority. You are appointed as the statutory auditor of the company for the financial year 20X1-X2. During initial risk assessment phase, you observed that the company is not in possession of Fire NOC as stipulated by the regulatory authority. You approached those charged with governance regarding this matter and requested them to provide their justification on the same. They are of the opinion that obtaining Fire NOC is outside the purview of the financial statements, hence, you are not required to look after this aspect. What are the auditor's responsibilities in relation to compliance with laws and regulations?

Answer 4

SA 250, "Considerations of Laws and Regulations in an Audit of Financial Statements" distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows:

(i) The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws; and

(ii) 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. Non-Compliance with such laws and regulations may, therefore, have a material effect on the financial statements.

For the compliance with provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements, the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations.

For 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, the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

Therefore, auditor should ensure as to whether any penal provisions will be there for non-compliance of such law and also whether the same has been duly disclosed by the company. If auditor concludes that such non-compliance has a material effect on the financial statements and the same has not been adequately reflected in the financial statements by the company, he shall express an adverse or a qualified opinion on the financial statements.

Exam Insights: Auditor's responsibility for non-compliance under SA 250: Most of the examinees understood the two categories of laws and regulations that have direct and indirect effects on financial statements. However, they did not clearly explain the auditor's responsibilities regarding compliance with these laws—particularly those with indirect implications.

Multiple Choice Questions (MCQS)

1. M/s Pihu & Associates are the statutory auditors of Brick Ltd. for FY 20X1-X2. 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: (MTP 2 Marks Sep'24, RTP May'23, MP[4])

(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.

Ans: (b)