

PAPER – 1 : ADVANCED ACCOUNTING

Answer all questions.

Working notes should form part of the answer.

Question 1

The following information has been extracted from the Books of 'X' Limited group (as at 31st December, 2006):

	X Ltd. Rs.	Y Ltd. Rs.	Z Ltd. Rs.		X Ltd. Rs.	Y Ltd. Rs.	Z Ltd. Rs.
Share capital				Fixed Assets			
(Fully paid equity shares of Rs.10 each)				Less			
				Depreciation	4,20,000	3,76,000	5,22,000
	8,00,000	6,00,000	4,00,000	Investment at Cost	6,30,000	4,00,000	---
Profit and Loss Account	2,10,000	1,90,000	1,28,000	Current Assets	1,20,000	60,000	40,000
Dividend received:							
From Y Ltd. in 2005	60,000						
From Y Ltd. in 2006	60,000						
From Z Ltd. in 2006		36,000					
Current Liabilities	<u>40,000</u>	<u>10,000</u>	<u>34,000</u>				
	<u>11,70,000</u>	<u>8,36,000</u>	<u>5,62,000</u>		<u>11,70,000</u>	<u>8,36,000</u>	<u>5,62,000</u>

All the companies pay dividends of 12 percent of paid-up share capital in March following the end of the accounting year. The receiving companies account for the dividends in their books when they are received.

'X' Limited acquired 50,000 equity shares of Y Ltd. on 31st December, 2004.

'Y' Limited acquired 30,000 equity shares of Z Ltd. on 31st December, 2005.

The detailed information of Profit and Loss Accounts is as follows:

	X Ltd. Rs.	Y Ltd. Rs.	Z Ltd. Rs.
Balance of Profit and Loss Account on 31 st December, 2004 after dividends of 12% in respect of			

calendar year 2004, but excluding dividends received	86,000	78,000	60,000
Net profit earned in 2005	<u>1,20,000</u>	<u>84,000</u>	<u>56,000</u>
	2,06,000	1,62,000	1,16,000
Less – Dividends of 12% (paid in 2006)	<u>96,000</u>	<u>72,000</u>	<u>48,000</u>
	1,10,000	90,000	68,000
Net profit earned in 2006 (Before taking into account proposed dividends of 12% in respect of calendar year 2006)	<u>1,00,000</u>	<u>1,00,000</u>	<u>60,000</u>
	<u>2,10,000</u>	<u>1,90,000</u>	<u>1,28,000</u>

Taking into account the transactions from 2004 to 2006 and ignoring taxation, you are required to prepare:

- (i) The Consolidated Balance Sheet of X Limited group as at 31st December, 2006.
- (ii) The Consolidated Profit and Loss Account for the year ending 31st December, 2006.
- (iii) Cost of control.
- (iv) Minority shareholders interest. (16 Marks)

Answer

- (i) Consolidated Balance Sheet of X Ltd. and its subsidiaries Y Ltd. and Z Ltd.
as on 31st December, 2006

Liabilities	Rs.	Assets	Rs.
Share Capital:		Fixed Assets:	
80,000 Equity shares of Rs.10 each fully paid	8,00,000	Goodwill [Refer (iii)]	18,000
Minority Interest [Refer (iv)]	2,47,167	Other Fixed Assets less depreciation	13,18,000
Reserves and Surplus:		Current Assets, Loans and Advances:	
Profit and Loss Account [Refer (ii)]	3,04,833	Current Assets	2,20,000
Current Liabilities and Provision:			
Current Liabilities	84,000		
Proposed Dividend:			
X Ltd.	96,000		
Minority Interest [Refer (iv)]	<u>24,000</u>		
	<u>15,56,000</u>		<u>15,56,000</u>

(ii) Consolidated Profit and Loss Account for the year ending 31 st December, 2006 (in Rs.)											
Particulars	X Ltd.	Y Ltd.	Z Ltd.	Adjust- ments	Total	Particulars	X Ltd.	Y Ltd.	Z Ltd.	Adjust ments	Total
To Dividend (paid for 2005)	96,000	72,000	48,000	96,000	1,20,000	By Balance b/d	2,06,000	1,62,000	1,16,000	-	4,84,000
To Minority Interest	-	39,167	32,000	-	71,167	By Dividend received in 2005 (for 2004)	60,000	-	-	-	60,000
To Capital Reserve (Cost of Control)	-	65,000	51,000	-	1,16,000	By Dividend received in 2006 (for 2005)	60,000	36,000	-	96,000	-
To Investments Accounts						By Profit for the year	1,00,000	1,00,000	60,000	-	2,60,000
(Dividend received out of capital profit)	60,000*	36,000*	-	-	96,000						
To Proposed Dividend	96,000	-	-	-	96,000						
To Balance c/d	<u>1,74,000</u>	<u>85,833</u>	<u>45,000</u>	<u>- -</u>	<u>3,04,833</u>						
	<u>4,26,000</u>	<u>2,98,000</u>	<u>1,76,000</u>	<u>96,000</u>	<u>8,04,000</u>		<u>4,26,000</u>	<u>2,98,000</u>	<u>1,76,000</u>	<u>96,000</u>	<u>8,04,000</u>

Notes:*

- (1) X Ltd. receives from Y Ltd., dividend amounting to Rs.60,000 for the year 2004 in the year 2005 for shares acquired in 2004. It is a capital profit, therefore it has been transferred to cost of control to reduce the cost of investment.
- (2) Y Ltd. receives a dividend of Rs.36,000 from Z Ltd. for the year 2005 in the year 2006. The shares were acquired by Y Ltd on 31st December, 2005. The entire amount is therefore, a capital profit and hence transferred to cost of control to reduce the cost of investment.

(iii) Cost of Control:

	Rs.	Rs.
Cost of Investment in Y Ltd. on 31 st December 2004	6,30,000	
Less: Dividend of the year 2004 received in 2005 out of Pre-acquisition profit	<u>60,000</u>	5,70,000
Cost of Investment in Z Ltd.	4,00,000	
Less: Dividend of the year 2005 received in 2006 out of Pre-acquisition Profit	<u>36,000</u>	<u>3,64,000</u>
		9,34,000

Less: Paid up value of shares in Y Ltd.	5,00,000	
Paid up value of shares in Z Ltd.	3,00,000	
Capital Profits in Y Ltd. (Refer W.N. 2)	65,000	
Capital Profits in Z Ltd. (Refer W.N. 2)	<u>51,000</u>	<u>9,16,000</u>
Goodwill		<u>18,000</u>
(iv) Minority shareholders' interest:	Y Ltd.	Z Ltd.
	Rs.	Rs.
Share Capital (Y Ltd. – 1/6 and Z Ltd. – 1/4)	1,00,000	1,00,000
Capital Profits (Refer W.N. 2)	13,000	17,000
Revenue Profits (Refer W.N. 2)	<u>26,167</u>	<u>15,000</u>
	<u>1,39,167</u>	<u>1,32,000</u>
Total (1,39,167 + 1,32,000)		2,71,167
Less: Minority shareholders' share of proposed dividend (shown separately in the Balance Sheet)		
$(\frac{1}{6} \text{ of Rs.72,000} + \frac{1}{4} \text{ of Rs.48,000})$		<u>24,000</u>
Balance		<u>2,47,167</u>

Working Notes:

1. Shareholding Pattern	Number of shares	share of holding
In Y Ltd.		
X Ltd.	50,000	5/6
Minority Interest	10,000	1/6
In Z Ltd.		
Y Ltd.	30,000	3/4
Minority Interest	10,000	1/4
2. Analysis of Profits	Pre - acquisition	Post - acquisition
	Capital Profit	Revenue Profit
Z Ltd.	Rs	Rs.
Balance on 31 st December, 2005 after dividend for 2005 (1,16,000 – 48,000)	68,000	-

Profit for the year ending 31 st December, 2006 before proposed dividends for 2006	-	60,000
	<u>68,000</u>	<u>60,000</u>
Share of Y Ltd. (3/4)	51,000	45,000
Minority Interest (1/4)	<u>17,000</u>	<u>15,000</u>
Y Ltd.		
Balance on 31 st December, 2004	78,000	-
Profit for the year 2005 after payment of dividend for 2005 (84,000 – 72,000)	-	12,000
Profit for the year 2006 (before payment of dividend of the year 2006)	-	1,00,000
Revenue Profit from Z Ltd.	-	45,000
	<u>78,000</u>	<u>1,57,000</u>
Share of X Ltd. (5/6)	65,000	1,30,833
Share of Minority Shareholders' Interest (1/6)	<u>13,000</u>	<u>26,167</u>

Note: This problem has been solved by following 'direct approach'.

Question 2.

The following are the Balance sheets (as at 31.3.2006) of A Ltd. and B Ltd.:

Liabilities	A Ltd. Rs.	B. Ltd. Rs.	Assets	A Ltd. Rs.	B. Ltd. Rs.
Share Capital:			Fixed Assets	50,00,000	30,00,000
Equity Shares of Rs.10 each	36,00,000	18,00,000	Investments	5,00,000	5,00,000
10% Preference shares of Rs.100 each	12,00,000	-	Current Assets		
			Stock	18,00,000	12,00,000
12% Preference shares of Rs.100 each	-	6,00,000	Debtors	15,00,000	12,00,000
			Bills receivable	50,000	10,000
			Cash at Bank	1,50,000	90,000
Reserve and Surplus:					
Statutory Reserve	1,00,000	1,00,000			
General Reserve	25,00,000	17,00,000			

Secured Loan

15% Debentures	5,00,000	-
12% Debentures	-	5,00,000

Current Liabilities

Sundry creditors	10,80,000	12,80,000		
Bills payable	<u>20,000</u>	<u>20,000</u>		
	<u>90,00,000</u>	<u>60,00,000</u>	<u>90,00,000</u>	<u>60,00,000</u>

Contingent liabilities for bills receivable discounted Rs.20,000.

(A) The following additional information is provided to you:

	A Ltd.	B Ltd.
	Rs.	Rs.
Profit before Interest and Tax	14,75,000	7,80,000
Rate of Income-tax	40%	40%
Preference dividend	1,20,000	72,000
Equity dividend	3,60,000	2,70,000
Balance profit transferred to Reserve account.		

- (B) The equity shares of both the companies are quoted on the Mumbai Stock Exchange. Both the companies are carrying on similar manufacturing operations.
- (C) A Ltd proposes to absorb business of B Ltd. as on 31.3.2006. The agreed terms for absorption are:
- 12% Preference shareholders of B Ltd. will receive 10% Preference shares of A Ltd. sufficient to increase their present income by 20%.
 - The Equity shareholders of B Ltd. will receive equity shares of A Ltd. on the following terms:
 - The Equity shares of B Ltd. will be valued by applying to the earnings per share of B Ltd. 60 per cent of price earnings ratio of A Ltd. based on the results of 2005-06 of both the Companies.
 - The market price of Equity shares of A Ltd. is Rs.40 per share.
 - The number of shares to be issued to Equity shareholders of B Ltd. will be based on the 80% of market price.
 - In addition to Equity shares, 10% Preference shares of A Ltd. will be issued to the equity shareholders of B Ltd. to make up for the loss in income arising from the above exchange of shares based on the dividends for the year 2005-2006.

- (iii) 12% Debentureholders of B Ltd. are to be paid at 8% premium by 15% debentures in A Ltd. issued at a discount of 10%.
- (iv) Rs.16,000 is to be paid by A Ltd. to B Ltd. for liquidation expenses. Sundry Creditors of B Ltd. include Rs.20,000 due to A Ltd. Bills receivable discounted by A Ltd. were all accepted by B Ltd.
- (v) Fixed assets of both the companies are to be revalued at 20% above book value. Stock in trade is taken over at 10%; less than their book value.
- (vi) Statutory reserve has to be maintained for two more years.
- (vii) For the next two years no increase in the rate of equity dividend is anticipated.
- (viii) Liquidation expense is to be considered as part of purchase consideration.

You are required to:

- (i) Find out the purchase consideration.
- (ii) Give journal entries in the books of A Ltd.
- (iii) Give the Balance Sheet as at 31.3.2006 after absorption. (16 Marks)

Answer

- (i) Computation of Purchase Consideration Rs.
For Preference Shareholders

Present Income of Preference Shareholders of B Ltd.	72,000
Add : Required 20% increase	<u>14,400</u>
	<u>86,400</u>

10% Preference Shares to be issued of Rs. 8,64,000 (86,400/10x 100)

For Equity Shareholders

Valuation of Equity Shares of B Ltd. =

Number of shares x Value of one share (i.e. EPS of B Ltd. x P/E ratio of A Ltd. x 60/100)

$$= 1,80,000 \times \left(\text{Rs.} 2 \times 20 \times \frac{60}{100} \right) = 1,80,000 \times 24 = \text{Rs.} 43,20,000$$

Issue of Equity Shares

No. of Equity Shares to be issued at 80% of Market Price i.e.

80% of Rs.40 = Rs.32

$$\frac{43,20,000}{32} = 1,35,000 \text{ shares}$$

$$\text{Equity Share Capital} = 1,35,000 \times \text{Rs.} 10 = \text{Rs.} 13,50,000$$

Securities Premium = 1,35,000 x Rs. 22 =	<u>Rs.29,70,000</u>	
	<u>Rs.43,20,000</u>	
Issue of Preference Shares		Rs.
Present Equity Dividend		2,70,000
Less: Expected Equity Dividend from A Ltd.		
(13,50,000 x $\frac{10}{100}$)		<u>1,35,000</u>
Loss in income		<u>1,35,000</u>
10% Preference Shares to be issued of Rs. 13,50,000 (1,35,000/10x 100)		
Purchase Consideration		
Preference Shares Capital [Rs.8,64,000 + Rs.13,50,000]	22,14,000	
Equity Share Capital (1,35,000 shares of Rs.10 each at Rs.32 per share)	43,20,000	
Liquidation Expenses (in cash)		<u>16,000</u>
		<u>65,50,000</u>

(ii)

Journal Entries in the Books of A Ltd.

Particulars	Dr.(Rs).	Cr. (Rs.)
1. Fixed Assets A/c	Dr. 10,00,000	
To Revaluation Reserve		10,00,000
(Being Revaluation of Fixed assets at 20% above book value)		
2. Business Purchase A/c	Dr. 65,50,000	
To Liquidator of B Ltd.		65,50,000
(Being purchase consideration payable for the business taken over from B Ltd.)		
3. Fixed Assets A/c	Dr. 36,00,000	
Investment A/c	Dr. 5,00,000	
Stock A/c	Dr. 10,80,000	
Debtors A/c	Dr. 12,00,000	
Bills Receivable A/c	Dr. 10,000	
Cash at Bank A/c	Dr. 90,000	
Goodwill A/c (Balancing figure)	Dr. 19,10,000	

	To 12% Debentures in B Ltd.		5,40,000
	To Creditors		12,80,000
	To Bills Payable		20,000
	To Business Purchase A/c		65,50,000
	(Being incorporation of different assets and liabilities of B Ltd. taken over at agreed values and balance debited to goodwill account)		
4.	Liquidator of B Ltd.	Dr.	65,50,000
	To Equity Share Capital A/c		13,50,000
	To Securities Premium A/c		29,70,000
	To Preference Share Capital A/c		22,14,000
	To Bank A/c		16,000
	(Being discharge of consideration for B Ltd's business)		
5.	12% Debentures in B Ltd.	Dr.	5,40,000
	Discount on issue of Debentures	Dr.	60,000
	To 15% Debentures		6,00,000
	(Being allotment of 15% Debentures to debenture holders at a discount of 10% to discharge liability of B Ltd. debentures)		
6.	Sundry Creditors A/c	Dr.	20,000
	To Sundry Debtors A/c		20,000
	(Being cancellation of Mutual owing)		
7.	Amalgamation Adjustment A/c	Dr.	1,00,000
	To Statutory Reserve A/c		1,00,000
	(Being statutory reserve account is maintained under statutory requirements)		
8.	Securities Premium A/c	Dr.	60,000
	To Discount on issue of Debentures A/c		60,000
	(Being discount on issue of Debentures written off out of securities premium)		

(iii) Balance Sheet of A Ltd (after absorption of B Ltd.)
as on 31.3.2006

Liabilities	Amount Rs.	Assets	Amount Rs.
Share Capital:		Fixed Assets:	
4,95,000 Equity Shares of Rs. 10 each fully paid (1,35,000 shares have been allotted as fully paid up for consideration other than cash)	49,50,000	Goodwill	19,10,000
10% Preference Shares of Rs.100 each fully paid	34,14,000	Other Fixed Assets (60,00,000+36,00,000)	96,00,000
Reserve & Surplus:		Investment (5,00,000+5,00,000)	10,00,000
Statutory Reserve	2,00,000	Current Assets:	
Revaluation Reserve	10,00,000	Stock	(18,00,000+10,80,000) 28,80,000
General Reserve	25,00,000	Debtors	26,80,000
Securities Premium	29,10,000	(15,00,000+12,00,000- 20,000)	
Secured Loan:		Bills Receivable	60,000
15% Debentures (5,00,000 + 6,00,000)	11,00,000	(50,000+10,000)	
Current Liabilities and		Cash at Bank	2,24,000
Provisions:		(1,50,000 + 90,000- 16,000)	
Creditors		Amalgamation Adjustment A/c	1,00,000
(10,80,000+12,80,000-20,000)	23,40,000		
Bills Payable (20,000 + 20,000)	40,000		
	<u>1,84,54,000</u>		<u>1,84,54,000</u>

Note: No footnote will appear for contingent liability as it has been converted into actual liability after absorption of B Ltd.

Working Notes:

1. Calculation of EPS & P/E ratio

	A Ltd. Rs.	B Ltd. Rs.
Profit before Interest and Tax	14,75,000	7,80,000
Less: Interest on debentures	<u>75,000</u>	<u>60,000</u>
Profit before tax	14,00,000	7,20,000
Less: Tax @ 40%	<u>5,60,000</u>	<u>2,88,000</u>

	8,40,000	4,32,000
Less: Preference Dividend	<u>1,20,000</u>	<u>72,000</u>
Earnings available for equity shareholders	<u>7,20,000</u>	<u>3,60,000</u>
Number of shares	3,60,000 shares	1,80,000 shares
EPS (Earnings/ No. of shares)	2	2
Market Price	Rs.40	Not given
P/E ratio	40/2 = 20	N.A.

2. Computation of Goodwill/Capital Reserve on absorption:

			Rs.
Purchase Consideration			65,50,000
Fixed Assets taken over	30,00,000		
Add: Increase by 20%	<u>6,00,000</u>	36,00,000	
Investments		5,00,000	
Current Assets:			
Stock	12,00,000		
Less: Reduction in value by 10%	<u>1,20,000</u>		
	10,80,000		
Debtors	12,00,000		
B/R	10,000		
Cash at Bank	<u>90,000</u>	<u>23,80,000</u>	
		64,80,000	
Less: Outside Liabilities:			
12% Debentures at premium	5,40,000		
Sundry Creditors	12,80,000		
Bills Payable	<u>20,000</u>	<u>18,40,000</u>	<u>46,40,000</u>
Goodwill			<u>19,10,000</u>

Question 3

The following is the Balance Sheet (as at 31st December, 2006) of Sun Ltd.:

Liabilities		Assets	
	Rs.		Rs.
Share Capital:		Fixed Assets:	
80,000 Equity shares of Rs.10 each fully paid up	8,00,000	Goodwill	1,00,000
50,000 Equity shares of Rs.10 each Rs.8 paid up	4,00,000	Plant and Machinery	8,00,000

36,000 Equity shares of Rs.5 each fully paid up	1,80,000	Land and Building	10,00,000
30,000 Equity shares of Rs.5 each Rs.4 paid-up	1,20,000	Furniture and Fixtures	1,00,000
3,000 10% Preference shares of Rs.100 each fully paid	3,00,000	Vehicles	2,00,000
Reserve and Surplus:		Investments	3,00,000
General reserve	1,40,000	Current Assets:	
Profit and Loss account	2,10,000	Stock	2,10,000
Secured Loan: 12% Debenture	2,00,000	Debtors	1,95,000
Unsecured Loan: 15% Term loan	1,50,000	Prepaid Expenses	40,000
Deposits	1,00,000	Advances	45,000
Current Liabilities:		Cash and Bank balance	2,00,000
Bank Loan	50,000	Preliminary Expenses	10,000
Creditors	1,50,000		
Outstanding expenses	20,000		
Provision for tax	2,00,000		
Proposed Dividend:			
Equity	1,50,000		
Preference	30,000		
	<u>32,00,000</u>		<u>32,00,000</u>

Additional Information:

- (1) In 2004 a new machinery costing Rs.50,000 was purchased, but wrongly charged to revenue (no rectification has yet been made for the same).
- (2) Stock is overvalued by Rs.10,000 in 2005. Debtors are to be reduced by Rs.5,000 in 2006, some old furniture (Book value Rs.10,000) was disposed of for Rs.6,000.
- (3) Fixed assets are worth 5 per cent more than their actual book value. Depreciation on appreciated value of Fixed assets except machinery is not to be considered for valuation of goodwill.
- (4) Of the investment 20 per cent is trading and the balance is non-trading. All trade investments are to be valued at 20 per cent below cost. Trade investment were purchased on 1st January, 2006. 50 percent of the non-trade investments were acquired on 1st January, 2005 and the rest on 1st January, 2004. A uniform rate of dividend of 10 percent is earned on all investments.
- (5) Expected increase in expenditure without commensurate increase in selling price is Rs.20,000.

(6) Research and Development expenses anticipated in future Rs.30,000 per annum.

(7) In a similar business a normal return on capital employed is 10%.

(8) Profit (after tax) are as follows:

In 2004 – Rs.2,10,000, in 2005 – Rs.1,90,000 and in 2006 – Rs.2,00,000.

(9) Current income tax rate is 50%, expected income tax rate will be 40%.

From the above, ascertain the ex-dividend and cum-dividend intrinsic value for different categories of Equity shares. For this purpose goodwill may be taken as 3 years purchase of super profits. Depreciation is charged on machinery @ 10% on reducing system.

(16 Marks)

Answer

Computation of Value of Shares:

	Rs.
Value of Net Assets (As computed for Goodwill)	21,02,073
Value of Goodwill [Refer W.N.3]	11,406
Non-trade investments	<u>2,40,000</u>
	23,53,479
Less: Preference Share Capital	3,00,000
Proposed Dividend of Preference shares	30,000
Proposed Dividend of Equity shares	<u>1,50,000</u>
	<u>4,80,000</u>
Net Assets available for Equity Shareholders	<u>18,73,479</u>

Computation of Number of Equivalent Equity Shares:

Equity shares	No. of Equivalent Shares
80,000 shares+ 50,000 shares = 1,30,000 shares of Rs.10 each	$1,30,000 \times \frac{10}{10}$ 1,30,000
36,000 shares+ 30,000 shares = 66,000 shares of Rs.5 each	$66,000 \times \frac{5}{10}$ <u>33,000</u>
Total Equivalent Equity Shares of Rs.10 each	<u>1,63,000</u>

Calculation of Ex-Dividend intrinsic value of different categories of Equity Shares of Sun Ltd.

Net Assets available to deemed fully paid-up Equity Shareholders

= Net Assets as computed above + Notional Cash from partly paid-up shares

=Rs.18,73,479 + (50,000 x 2 + 30,000x1)

= Rs.18,73,479 + 1,00,000 + 30,000 = Rs.20,03,479

Computation of Ex-Dividend value per Equity Share

$$(i) \text{ Value of Rs.10 fully paid Equity Share} = \frac{20,03,479}{1,63,000} = \text{Rs.12.29 per share (approx.)}$$

$$(ii) \text{ Value of Rs.8 paid-up Equity Share} = 12.29 - 2 = \text{Rs.10.29 per share (approx.)}$$

$$(iii) \text{ Value of Rs.5 fully paid-up Equity Share} = 12.29 \times \frac{5}{10} = \text{Rs.6.15 per share (approx.)}$$

$$(iv) \text{ Value of Rs.4 paid-up Equity Share} = 6.15 - 1 = \text{Rs.5.15 per share (approx.)}$$

Calculation of Cum-Dividend intrinsic value of different categories of Equity Shares of Sun Ltd.

$$\begin{aligned} \text{Value of Net Assets (including proposed dividend on equity shares)} &= \text{Rs.18,73,479} + 1,50,000 \\ &= \text{Rs.20,23,479} \end{aligned}$$

Net assets (including dividend) available to deemed fully paid-up Equity Shareholders

= Net Assets as computed above + Notional Cash from partly paid-up shares

$$= \text{Rs.20,23,479} + (50,000 \times 2 + 30,000 \times 1)$$

$$= \text{Rs.20,23,479} + 1,00,000 + 30,000 = \text{Rs.21,53,479}$$

Computation of Cum-Dividend value per share*

$$(i) \text{ Value of Rs.10 fully paid Equity Share} = \frac{21,53,479}{1,63,000} = \text{Rs.13.21 per share (approx.)}$$

$$(ii) \text{ Value of Rs.8 paid-up Equity Share} = 13.21 - 2 = \text{Rs.11.21 per share (approx.)}$$

$$(iii) \text{ Value of Rs.5 fully paid-up Equity Share} = 13.21 \times \frac{5}{10} = \text{Rs.6.605 per share (approx.)}$$

$$(iv) \text{ Value of Rs.4 paid-up Equity Share} = 6.605 - 1 = \text{Rs.5.605 per share (approx.)}$$

Working Notes:

1. Calculation of Average Capital Employed

Rs.

Fixed Assets:

Plant and Machinery (including Rs.36,450 for a Machine charged in 2004)	8,36,450
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Land and Building	10,00,000
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Furniture & Fixtures (1,00,000-4,000)	96,000
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* **Note:** Candidates can also arrive at the cum-dividend value of shares by calculating the percentage of proposed dividend of equity shares to paid-up capital and adding that percentage of paid-up value of each share to ex-dividend value of equity shares.

Vehicles		<u>2,00,000</u>
		21,32,450
Add: Appreciation @ 5%		<u>1,06,623</u>
		22,39,073
Trade Investment $(3,00,000 \times \frac{20}{100}) \times \frac{80}{100}$		48,000
Current Assets:		
Stock		2,10,000
Debtors (1,95,000-5,000)		1,90,000
Prepaid Expenses		40,000
Advances		45,000
Cash & Bank Balance		<u>2,00,000</u>
		29,72,073
Less: Outside Liabilities:		
12% Debentures	2,00,000	
15% Term Loan	1,50,000	
Deposits	1,00,000	
Bank Loan	50,000	
Creditors	1,50,000	
Outstanding Expenses	20,000	
Provision for Tax	<u>2,00,000</u>	<u>8,70,000</u>
Capital employed at the end of the year i.e. Net Assets		21,02,073
Less: $\frac{1}{2}$ of the current year's Accounting Profit after Tax:		
Profit before Tax	3,80,950	
Less: Tax 40%* of Rs.3,80,950	<u>1,52,380</u>	
	<u>2,28,570</u>	
50% of Rs.2,28,570		<u>1,14,285</u>
Average capital employed		<u>19,87,788</u>

* Future tax rate has been considered.

2. Future Maintainable Profits

Statement of Average Profit			
Particulars	2004 Rs.	2005 Rs.	2006 Rs.
Profit after Tax	<u>2,10,000</u>	<u>1,90,000</u>	<u>2,00,000</u>
Profit before Tax (PAT x $\frac{1}{0.50}$)	4,20,000	3,80,000	4,00,000
Add: Capital expenditure charged to revenue	50,000	-	-
Less: Depreciation of the Machinery	(5,000)	(4,500)	(4,050)
Dividend on Non-Trade Investments	(12,000)	(24,000)	(24,000)
Over-valuation of closing stock	-	(10,000)	-
Add: Overvaluation of opening stock	-	-	10,000
Add: Loss on sale of furniture (Presumed to be extra ordinary items)	-	-	4,000
Less: Provision for debtors			(5,000)
	<u>4,53,000</u>	<u>3,41,500</u>	<u>3,80,950</u>
Total profit for the three years			<u>11,75,450</u>
Average Profit = $\frac{\text{Rs. } 11,75,450}{3}$			3,91,817
Less: Depreciation @ 10% on increase in the value of machinery			
$8,36,450 \times \frac{5}{100} \times \frac{10}{100} = \text{Rs. } 41,823 \times \frac{10}{100}$ i.e.,		4,182	
Expected increase in expenditure		20,000	
Annual R & D Expenses anticipated in future		<u>30,000</u>	<u>54,182</u>
Future Maintainable profit before tax			3,37,635
Less: Tax @ 40% of Rs.3,37,635			<u>1,35,054</u>
Future Maintainable Profit After Tax			<u>2,02,581</u>
3. Computation of Goodwill		Rs.	
Future Maintainable Profit After Tax		2,02,581	
Less: Normal Profit (10% of Rs.19,87,788)		<u>1,98,779</u>	
Super Profit		<u>3,802</u>	
Value of Goodwill = Super Profit x No. of years' purchase			
= Rs.3,802 x 3		<u>11,406</u>	

Question 4

- (a) A buyer buys a stock option of New Light Company Limited on 30th August, 2006 with a strike price of Rs.150 per unit to be expired on September 30, 2006. The premium is Rs.10 per unit and the market lot is of 100. The margin to be paid is Rs.60 per unit.

Show, how the transactions will appear in the books of the seller, when:

- (i) The option is settled by delivery of the Asset, and
 (ii) The option is settled in cash and the Index price is Rs.160 per unit.
- (b) When the general price index, was 100, Expert Ltd. purchased fixed assets of Rs.2 crore and it had also permanent working capital of Rs.80 lakhs. The entire amount required for purchase of the fixed assets and permanent working capital was raised by way of 12% redeemable preference share capital. Expert Ltd. wants to maintain its physical capital.

On 31st March, 2006, the company had reserves of Rs.3.50 crores. The general price index on that day was 200. The written down value of fixed assets was Rs.20 lakhs and they were sold for Rs.3.00 crores. The proceeds were utilized for redemption of the Preference Shares.

On the same day (31st March, 2006), the Company purchased a new factory for Rs.20 crores. The ratio of permanent working capital to cost of assets is to be maintained at 0.4:1.

The company raised the additional funds required for the purpose by issue of equity shares:

- (1) Calculate the amount of equity capital raised, and
 (2) Show the balance Sheet as at 1.4.2006. (8+8 = 16 Marks)

Answer

- (a) In the Books of Seller

			Dr. Amount Rs.	Cr. Amount Rs.
At the time of inception:				
30 th August	Equity Stock Option Margin A/c (100 x Rs.60)	Dr.	6,000	
	To Bank A/c			6,000
	(Being the initial Margin paid on option)			
	Bank A/c (100 x Rs.10)	Dr.	1,000	
	To Equity Stock Option Premium A/c			1,000
	(Being the premium on option collected)			

At the time of final settlement:

Bank A/c	Dr.	6,000	
To Equity Stock Option Margin A/c			6,000
(Being margin on equity stock option received back on exercise/expiry of option).			

(i) Option is settled by delivery of asset

30 th September Bank A/c	Dr.	15,000	
To Equity Shares of New Light Ltd A/c			15,000
(Being shares delivered on exercise of option)			

Equity Stock Option Premium A/c	Dr.	1,000	
To Profit & Loss A/c			1,000
(Being premium on option recognized as income)			

(ii) Option is settled in cash

30 th September Profit & Loss A/c [(160 – 150) x 100]	Dr.	1,000	
To Bank A/c			1,000
(Being difference in index price and strike price i.e. loss on exercise of option paid in cash)			

Equity Stock Option Premium A/c	Dr.	1,000	
To Profit & Loss A/c			1,000
(Being premium on option recognized as income)			

(b) (1) Computation of amount of equity share capital raised

	Rs. in crores
Requirement for purchase of new factory	20.00
Requirement for permanent working capital (20x .4)	<u>8.00</u>
	28.00
Less: Existing working capital(Refer Working Note 3)	<u>6.30</u>
Amount raised through equity capital	<u>21.70</u>

(2) Balance Sheet of Expert Ltd. as on 1st April, 2006

	(Rs. in crores)		(Rs. in crores)
Liabilities	Rs.	Assets	Rs.
Equity Share Capital	21.70	Fixed Assets	20
Reserves and Surplus (Working Note 3)	<u>6.30</u>	Working Capital	8.00
	<u>28.00</u>		<u>28.00</u>

Working Notes:

1.	Physical capital as on 31 st March, 2006	Rs. in crores
	Fixed Assets	2.00
	Working Capital	<u>0.80</u>
	Financed by 12% Redeemable Preference Share Capital	<u>2.80</u>

On the basis of general price index on 31st March, 2006,
physical capital has been worked out as follows:

$$2.80 \times \frac{200}{100} = 5.6 \text{ crores}$$

2.	Working Capital as on 31 st March, 2006	Rs. in crores
	Preference Share Capital	2.80
	Reserves	<u>3.50</u>
		6.30
	Less: Written Down Value of Fixed Assets	<u>0.20</u>
		<u>6.10</u>

The computation shows that the actual working capital
which is available with the company was more than the
minimum physical capital required to be maintained.

3.	Position as on 31 st March, 2006	Rs. in crores
	(after sale of fixed assets and redemption of preference shares)	
	Assets	
	Fixed Assets	-
	Working Capital [6.10 + 3.0 – 2.80]	<u>6.30</u>
		<u>6.30</u>

Liabilities	
Preference Share Capital	-
Reserves	3.50
Profit on sale of Fixed Assets (3.00 – 0.20)	<u>2.80</u>
	<u>6.30</u>

Question 5

- (a) During the course of the last three years, a company owning and operating Helicopters lost four Helicopters. The company Accountant felt that after the crash, the maintenance provision created in respect of the respective helicopters was no longer required, and proposed to write back to the Profit and Loss account as a prior period item.

Is the Company's proposed accounting treatment correct? Discuss.

- (b) Mr. 'X' as a contractor has just entered into a contract with a local municipal body for building a flyover. As per the contract terms, 'X' will receive an additional Rs.2 crore if the construction of the flyover were to be finished within a period of two years of the commencement of the contract. Mr. X wants to recognize this revenue since in the past he has been able to meet similar targets very easily.

Is X correct in his proposal? Discuss.

- (c) A Company is in the process of setting up a production line for manufacturing a new product. Based on trial runs conducted by the company, it was noticed that the production lines output was not of the desired quality. However, company has taken a decision to manufacture and sell the sub-standard product over the next one year due to the huge investment involved.

In the background of the relevant accounting standard, advise the company on the cut-off date for capitalization of the project cost.

- (d) A Company has an inter-segment transfer pricing policy of charging at cost less 10%. The market prices are generally 25% above cost. Is the policy adopted by the company correct? (4+4+4+4 = 16 Marks)

Answer

- (a) The balance amount of maintenance provision written back to profit and loss account, no longer required due to crash of the helicopters, is not a prior period item because there was no error in the preparation of previous periods' financial statements. The term 'prior period items', as defined in AS 5 (revised) "Net Profit or Loss for the Period, Prior Period Items and Changes In Accounting Policies", refer only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. As per paragraph 8 of AS 5, extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit

or loss can be perceived. The amount so written-back (If material) should be disclosed as an extraordinary item as per AS 5.

- (b) According to para 14 of AS 7 (Revised) 'Construction Contracts', incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when: (i) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and (ii) the amount of the incentive payment can be measured reliably. In the given problem, the contract has not even begun and hence the contractor (Mr. X) should not recognize any revenue of this contract.
- (c) As per provisions of AS 10 'Accounting for Fixed Assets', expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalized as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production i.e., production intended for sale or captive consumption, is not capitalized and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period. In the present case, the company did stop production even if the output was not of the desired quality, and continued the sub-standard production due to huge investment involved in the project. Capitalization should cease at the end of the trial run, since the cut-off date would be the date when the trial run was completed.
- (d) AS 17 'Segment Reporting' requires that inter-segment transfers should be measured on the basis that the enterprise actually used to price these transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements. Hence, the enterprise can have its own policy for pricing inter-segment transfers and hence, inter-segment transfers may be based on cost, below cost or market price. However, whichever policy is followed, the same should be disclosed and applied consistently. Therefore, in the given case inter-segment transfer pricing policy adopted by the company is correct if, followed consistently.

Question 6

Write short notes on any five of the following:

- (a) Capital adequacy requirements of merchant bankers.
- (b) Interest rate swaps.
- (c) Major issues in environmental accounting.
- (d) Impairment of asset and its application to inventory.
- (e) Treatment of borrowing costs.
- (f) Accounting for investment by a holding company in subsidiaries. (4x5= 20 Marks)

Answer

- (a) Capital adequacy requirements have been specified by SEBI under the SEBI (Merchant Bankers) Registration, 1992.

Registration 7 specifies that the requirement of capital adequacy shall not be less than the net worth of the person making the application for grant of registration.

The specified net worth in this connection will be computed as under:

	Minimum requirement
Category I: Merchant bankers who carry on activity of the issue management, which will inter alia, consist of preparation of prospectus and other information relating to the issue, determining the financial structure, tie-up of financiers and final allotment and refund of subscriptions and act as advisor, consultant, manager, underwriter, portfolio manager etc.	Rs. 5 crores
Category II – Merchant bankers who act as advisor, consultant, co-manager, underwriter, portfolio manager	Rs.50 lakhs
Category III – Merchant bankers who act as underwriter, adviser, consultant to the issue.	Rs.20 lakhs
Category IV – Merchant bankers who act only as an advisor or consultant to the issue.	Nil

For the purposes of the regulation, a merchant banker has been defined as any person engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities is as manager, consultant, advisory or rendering corporate advising more in relation to issue management.

- (b) Interest rate swap can be defined as a financial contract between two parties (called counter parties) to exchange on a particular date in the future, one series of cash flows (fixed interest) for another series of cash flows (variable or floating interest) in the same currency on the same principal (an agreed amount called notional principal) for an agreed period of time. The contract will specify the interest rates, the benchmark rate to be followed, the notional principal amount for the transaction, etc. Interest rates are of two types, fixed interest rates and floating rates which vary according to changes in a standard benchmark interest rate. An investor holding a security which pays a floating interest rate is exposed to interest rate risk. The investor can manage this risk by entering into an interest rate swap.
- (c) Major accounting issues involved in environmental accounting can be explained as follows:
- (i) Distinction between environmental expenditure and normal business expenditure: Many new machines may incorporate state-of-the-art environmental technology and accordingly, a portion of such capital costs and also the running and maintenance

expenditure may be treated as environment related expenditure. It is necessary to frame guidelines indicating whether the reporting entity should properly allocate the capital and revenue expenditures between environmental expenditure and normal business expenditure.

- (ii) Capitalization of environmental expenditures vis-a-vis expensing them during the current accounting period: Environmental protection costs relating to prior periods and current period are generally very high and if expensed in one year as and when a reporting entity is persuaded to follow environmental accounting, the adverse impact in EPS is a major concern. Accordingly many Western Corporations prefer to capitalize environment costs instead of immediate expensing and adopt an amortization policy extending up to 10 years. Although this accounting practice has no theoretical support and rather contradicts the well established accounting concept of "prudence", it is considered as a practical solution to off-load burden of accumulated environmental costs without abruptly disturbing the cash flows attributable to the lenders, Government and finally to the shareholders. However, recognition of environmental costs should not necessarily be restricted to the expenses accrued in view of the applicable environmental laws. It should be guided by ethical consideration.
- (iii) Recognition of environment related contingent liabilities: Environmental contingent liabilities are a matter of increasing concern throughout the world. Recognizing a liability of hazardous waste remediation frequently depends on the ability to estimate remediation costs reasonably.

In fact, identification and measurement of contingent liabilities are highly debatable accounting aspects. The United Nations Conference on Environment and Development (UNCEAD) papers raise the basic question why environmental contingencies should not be merged with other business contingencies. There is an urgent need for tightening the reporting rules on contingencies incorporating specific requirements for disclosure of environmental contingencies along with other contingencies.

- (d) The objective of AS 28 'Impairment of Assets' is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Statement requires the enterprise to recognize an impairment loss. This standard should be applied in accounting for the impairment of all assets, other than (i) inventories (AS 2, Valuation of Inventories); (ii) assets arising from construction contracts (AS 7, Accounting for Construction Contracts); (iii) financial assets, including investments that are included in the scope of AS 13, Accounting for Investments; and (iv) deferred tax assets (AS 22, Accounting for Taxes on Income). AS 28 does not apply to inventories, assets arising from construction contracts, deferred tax assets or investments because other accounting standards applicable to

these assets already contain specific requirements for recognizing and measuring the impairment related to these assets.

- (e) According to AS 16, borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds. Borrowing costs may include: (i) interest and commitment charges on bank borrowings and other short-term and long-term borrowings; (ii) amortization of discounts or premiums relating to borrowings; (iii) amortization of ancillary costs incurred in connection with the arrangement of borrowings; (iv) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and (v) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset* should be capitalized as part of the cost of that asset. Other borrowing costs should be recognized as an expense in the period in which they are incurred. The capitalization of borrowing costs as part of the cost of a qualifying asset should commence when the conditions specified in AS 16 are satisfied.
- (f) Investments by a holding company in the shares of its subsidiary company are normally considered as long term investments. Indian holding companies show investment in subsidiary just like any other investment and generally classify it as trade investment. As per AS 13 'Accounting for Investments', investments are classified as long term and current investments. A current investment is an investment that by its nature is readily realizable and is intended to be held for more than one year from the date of acquisition. A long term investment is one that is not a current one.

Costs of investment include besides acquisition charges, expenses such as brokerage, fees and duties. If an investment is acquired wholly or partly by an issue of shares or other securities, the acquisition cost is determined by taking the fair value of the shares/securities issued. If an investment were to be acquired in exchange – part or whole – for another asset, the acquisition cost of the investment is determined with reference to the value of the other asset exchanged. Dividends received out of incomes earned by a subsidiary before the acquisition of the shares by the holding company and not treated as income but treated as recovery of cost of the assets (investment made in the subsidiary). The carrying cost for current investment is the lower of cost or fair/market value whereas investment in the shares of the subsidiary (treated as long term) are carried normally at cost.

* A qualifying asset is an asset that necessarily takes a substantial period of time¹ to get ready for its intended use or sale.

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

Question No. 1 is compulsory. Answer any four from the rest.
Figures in the margin indicate marks allotted to each question.
Working notes should form part of the answer.

Question 1

- (a) XYZ Ltd. is considering a project for which the following estimates are available:

	Rs.
Initial Cost of the project	10,00,000
Sales price/unit	60
Cost/unit	40
Sales volumes	
Year 1	20000 units
Year 2	30000 units
Year 3	30000 units

Discount rate 10% p.a.

You are required to measure the sensitivity of the project in relation to each of the following parameters:

- (a) Sales Price/unit
- (b) Unit cost
- (c) Sales volume
- (d) Initial outlay and
- (e) Project lifetime

Taxation may be ignored. (16 Marks)

- (b) Write short notes on the role of Financial Advisor in a Public Sector undertaking.

(4 Marks)

Answer

- (a) Calculation of NPV:-

$$\begin{aligned}\text{NPV} &= -10,00,000 + \frac{20,000 \times 20}{1.1} + \frac{30,000 \times 20}{1.21} + \frac{30,000 \times 20}{1.331} \\ &= -10,00,000 + 3,63,636 + 4,95,868 + 4,50,789 \\ &= 13,10,293 - 10,00,000\end{aligned}$$

$$= \text{Rs.} 3,10,293/-$$

Measurement of sensitivity is as follows:

(a) Sales Price:-

Let the sale price/Unit be S so that the project would break even with 0 NPV.

$$\therefore 10,00,000 = \frac{20,000 \times (S - 40)}{1.1} + \frac{30,000 \times (S - 40)}{1.21} + \frac{30,000(S - 40)}{1.331}$$

$$= S - 40 = 10,00,000/65,512$$

$$= \text{Rs.} 15.26$$

$$= S = \text{Rs.} 55.26 \text{ which represents a fall of } (60 - 55.26)/60$$

$$\text{Or } 0.079 \text{ or } 7.9\%$$

Alternative Method

$$\frac{10,00,000 \times 20}{13,10,293} = \text{Rs.} 15.26$$

$$S = \text{Rs.} 40 + \text{Rs.} 15.26$$

$$= \text{Rs.} 55.26$$

(b) Unit Cost:-

If sales price = Rs. 60 the cost price required to give a margin of Rs.15.26 is (Rs.60 – Rs.15.26) or Rs.44.74 which would represent a rise of 11.85% i.e.,

$$\left(\frac{44.74 - 40}{40} \times 100 \right)$$

(c) Sales volume:-

The requisite percentage fall is:-

$$3,10,293/13,10,293 \times 100 = 23.68\%$$

(d) Since PV of inflows remains at Rs.13,10,293 the initial outlay must also be the same.

$$\therefore \text{Percentage rise} = 3,10,293/10,00,000 \times 100 = 31.03\%.$$

(e) Present value for 1st two years.

$$= - 10,00,000 + 4,00,000 \times 0.909 + 6,00,000 \times 0.826$$

$$= - 10,00,000 + 3,63,600 + 4,95,600$$

$$= - 10,00,000 + 8,59,200$$

$$= - 1,40,800$$

$\therefore$ The project needs to run for some part of the third year so that the present value of return is Rs.1,40,800. Let us consider that fraction of the year be x.

$$\therefore 6,00,000 \times (1.1)^{2+x} = 1,40,800$$

Putting $x = 0.2$ in above equation the present value of the return is Rs.97,301.

Putting $x = 0.3$ the present value becomes Rs.1,44,578.

By interpolating we get $X = 0.292$

Thus if the project run for 2.292 years then break even would be achieved.

Note: The above calculation may also be made as follows:

$$(i) = 30,000 \text{ units} \times \text{Rs.}20 \times .751 = \text{Rs.}4,50,600$$

$$(ii) \text{ Per day Production in (Rs.) assuming a year of 360 days} = \frac{\text{Rs.}4,50,600}{360} = \text{Rs.}1,252$$

$$(iii) \text{ Days needed to recover Rs.}1,40,800 = \frac{\text{Rs.}1,40,800}{\text{Rs.}1,252} = 112$$

Thus, if the project runs for 2 years and 112 days then break even would be achieved.

(b) Role of Financial Advisor in PSUs: The Financial Advisor occupies an important position in all public sector undertakings. He functions as the principal advisor to the chief executive of the enterprise on all financial matters. The committee on public sector undertakings has specified the following functions and responsibilities of a financial adviser:

- (i) Determination of financial needs of the firm and the ways these needs are to be met.
- (ii) Formulation of a programme to provide most effective cost-profit volume relationship.
- (iii) Analysis of financial results of all operations and recommendations concerning future operations.
- (iv) Examination of feasibility studies and detailed project reports from the point of view of overall economic viability of the project.
- (v) Conduct of special studies with a view to reduce costs and improve efficiency and profitability.

Question 2

(a) XYZ Ltd. a US firm will need £ 3,00,000 in 180 days. In this connection, the following information is available:

Spot rate 1 £ = \$ 2.00

180 days forward rate of £ as of today = \$1.96

Interest rates are as follows:

	U.K.	US
180 days deposit rate	4.5%	5%
180 days borrowing rate	5%	5.5%

A call option on £ that expires in 180 days has an exercise price of \$ 1.97 and a premium of \$ 0.04.

XYZ Ltd. has forecasted the spot rates 180 days hence as below:

Future rate	Probability
\$ 1.91	25%
\$ 1.95	60%
\$ 2.05	15%

Which of the following strategies would be most preferable to XYZ Ltd.?

- (a) a forward contract
- (b) a money market hedge
- (c) an option contract
- (d) no hedging

Show calculations in each case.

- (b) Expected returns on two stocks for particular market returns are given in the following table:

Market Return	Aggressive	Defensive
7%	4%	9%
25%	40%	18%

You are required to calculate:

- (a) The Betas of the two stocks.
 - (b) Expected return of each stock, if the market return is equally likely to be 7% or 25%.
 - (c) The Security Market Line (SML), if the risk free rate is 7.5% and market return is equally likely to be 7% or 25%.
 - (d) The Alphas of the two stocks.
- (c) Explain briefly the advantages of investing in mutual funds. (8+8+4= 20 Marks)

Answer

- (a) (a) Forward contract: Dollar needed in 180 days = £3,00,000 x \$ 1.96 = \$5,88,000/-

- (b) Money market hedge: - Borrow \$, convert to £, invest £, repay \$ loan in 180 days

Amount in £ to be invested = $3,00,000/1.045 = £ 287,081$

Amount of \$ needed to convert into £ = $2,87,081 \times 2 = \$ 5,74,162$

Interest and principal on \$ loan after 180 days = $\$5,74,162 \times 1.055$
 = \$ 6,05,741

- (c) Call option:

Expected Spot rate in 180 days	Prem./ unit	Exercise Option	Total price per unit	Total price for £3,00,000 xi	Prob. Pi	pixi
1.91	0.04	No	1.95	5,85,000	0.25	1,46,250
1.95	0.04	No	1.99	5,97,000	0.60	3,58,200
2.05	0.04	Yes	2.01	6,03,000	0.15	90,450
						<u>5,94,900</u>

- (d) No hedge option:

Expected Future spot rate	Dollar needed Xi	Prob. Pi	Pi xi
1.91	5,73,000	0.25	1,43,250
1.95	5,85,000	0.60	3,51,000
2.05	6,15,000	0.15	92,250
			<u>5,86,500</u>

The probability distribution of outcomes for no hedge strategy appears to be most preferable because least number of \$ are needed under this option to arrange £3,00,000.

- (b) (a) The Betas of two stocks:

Aggressive stock - $40\% - 4\%/25\% - 7\% = 2$

Defensive stock - $18\% - 9\%/25\% - 7\% = 0.50$

- (b) Expected returns of the two stocks:-

Aggressive stock - $0.5 \times 4\% + 0.5 \times 40\% = 22\%$

Defensive stock - $0.5 \times 9\% + 0.5 \times 18\% = 13.5\%$

- (c) Expected return of market portfolio = $0.5 \times 7\% + 0.5 \times 25\% = 16\%$

∴ Market risk prem. = $16\% - 7.5\% = 8.5\%$

∴ SML is, required return = $7.5\% + \beta_i 8.5\%$

- (d) Alpha for stock A = $0.22 - (0.075 + 2 \times 0.085) = -2.5\%$
 Alpha for stock B = $0.135 - (0.075 + 0.5 \times 0.085) = 1.75\%$

(c) The advantages of investing in a Mutual Fund are:

1. Professional Management: Investors avail the services of experienced and skilled professionals who are backed by a dedicated investment research team which analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme.
2. Diversification: Mutual Funds invest in a number of companies across a broad cross-section of industries and sectors. Investors achieve this diversification through a Mutual Fund with far less money and risk than one can do on his own.
3. Convenient Administration: Investing in a Mutual Fund reduces paper work and helps investors to avoid many problems such as bad deliveries, delayed payments and unnecessary follow up with brokers and companies.
4. Return Potential: Over a medium to long term, Mutual Fund has the potential to provide a higher return as they invest in a diversified basket of selected securities.
5. Low Costs: Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.
6. Liquidity: In open ended schemes investors can get their money back promptly at net asset value related prices from the Mutual Fund itself. With close-ended schemes, investors can sell their units on a stock exchange at the prevailing market price or avail of the facility of direct repurchase at NAV related prices which some close ended and interval schemes offer periodically.
7. Transparency: Investors get regular information on the value of their investment in addition to disclosure on the specific investments made by scheme, the proportion invested in each class of assets and the fund manager's investment strategy and outlook.

Question 3

(a) AFC Ltd. wishes to acquire BCD Ltd. The shares issued by the two companies are 10,00,000 and 5,00,000 respectively:

- (i) Calculate the increase in the total value of BCD Ltd. resulting from the acquisition on the basis of the following conditions:

Current expected growth rate of BCD Ltd.	7%
Expected growth rate under control of AFC Ltd., (without any additional capital investment and without any change in risk of operations)	8%
Current Market price per share of AFC Ltd.	Rs. 100

Current Market price per share of BCD Ltd. Rs. 20

Current Dividend per share of BCD Ltd. Re. 0.60

- (ii) On the basis of aforesaid conditions calculate the gain or loss to shareholders of both the companies, if AFC Ltd. were to offer one of its share for every four shares of BCD Ltd.
- (iii) Calculate the gain to the shareholders of both the Companies, if AFC Ltd. pays Rs.22 for each share of BCD Ltd., assuming the P/E Ratio of AFC Ltd. does not change after the merger. EPS of AFC Ltd. is Rs.8 and that of BCD is Rs.2.50. It is assumed that AFC Ltd. invests its cash to earn 10%.
- (b) AMK Ltd. an Indian based company has subsidiaries in U.S. and U.K.

Forecasts of surplus funds for the next 30 days from two subsidiaries are as below:

U.S. \$12.5 million

U.K. £ 6 million

Following exchange rate informations are obtained:

	\$/Rs.	£/Rs.
Spot	0.0215	0.0149
30 days forward	0.0217	0.0150

Annual borrowing/deposit rates (Simple) are available.

Rs. 6.4%/6.2%

\$ 1.6%/1.5%

£ 3.9%/3.7%

The Indian operation is forecasting a cash deficit of Rs.500 million.

It is assumed that interest rates are based on a year of 360 days.

- (i) Calculate the cash balance at the end of 30 days period in Rs. for each company under each of the following scenarios ignoring transaction costs and taxes:
- (a) Each company invests/finances its own cash balances/deficits in local currency independently.
- (b) Cash balances are pooled immediately in India and the net balances are invested/borrowed for the 30 days period.
- (ii) Which method do you think is preferable from the parent company's point of view?
- (c) A money market instrument with face value of Rs.100 and discount yield of 6% will mature in 45 days. You are required to calculate:
- (i) Current price of the instrument.

(ii) Bond equivalent yield

(iii) Effective annual return.

(8+8+4= 20 Marks)

Answer

(a) (i) For BCD Ltd., before acquisition

The cost of capital of BCD Ltd. may be calculated by using the following formula:

$$\frac{\text{Dividend}}{\text{Price}} + \text{Growth\%}$$

Cost of Capital i.e., $K_e = (0.60/20) + 0.07 = 0.10$ After acquisition g (i.e. growth) becomes 0.08Therefore, price per share after acquisition = $0.60/(0.10-0.08) = \text{Rs.}30$ The increase in value therefore is = $\text{Rs.}(30-20) \times 5,00,000 = \text{Rs.}50,00,000/-$ (ii) To share holders of BCD Ltd. the immediate gain is $\text{Rs.}100 - \text{Rs.}20 \times 4 = \text{Rs.}20$ per share

The gain can be higher if price of shares of AFC Ltd. rise following merger which they should undertake.

To AFC Ltd. shareholders	(Rs. (In lakhs))
Value of Company now	1,000
Value of BCD Ltd.	<u>150</u>
	1,150
No. of shares	11.25

 $\therefore$ Value per share $1150/11.25 = \text{Rs.}102.22$ Gain to shareholders of BCD Ltd. = $\text{Rs.}102.22 - \text{Rs.}(4 \times 20) = \text{Rs.}22.22$ Gain to shareholders of AFC Ltd. = $\text{Rs.}102.22 - \text{Rs.}100.00 = \text{Rs.}2.22$

(iii) Gain to shareholders of AFC Ltd:-

Earnings of BCD Ltd. $(5,00,000 \times 2.50) =$	<u>Rs.12,50,000/-</u>
Less: Loss of earning in cash	<u>Rs.11,00,000/-</u>
$(5,00,000/- \times 22 \times 0.10)$	
Net Earning	Rs.1,50,000/-
Number of shares	10,00,000
Net increase in earning per share	0.15

P/E ratio of AFC Ltd. = $100/8 = 12.50$

Therefore, Gain per share of shareholders of AFC Ltd.

= $0.15 \times 12.50 = \text{Rs.}1.88$ Gain to the shareholders of BCD Ltd. $\text{Rs.} (22-20) = \text{Rs.}2/-$ per share

(b)

Figures in 000's

(a) Cash Balances:

Acting independently

	<u>Capital</u>	<u>Interest</u>	<u>Rs. in 30 days</u>
India	-5,00,000	-2,666.67	-5,02,667
U.S.	12,500	15.63	5,76,757
U.K.	6,000	18.50	4,01,233
			<u>4,75,323</u>

(b) Cash Balances:-

Immediate Cash pooling

	Rs.
India	– 5,00,000
U.S. $\frac{12,500}{0.0215} =$	5,81,395
U.K. $\frac{6,000}{0.0149} =$	4,02,685
	<u>4,84,080</u>

Immediate cash pooling is preferable as it maximizes interest earnings

Note: If the company decides to invest pooled amount of Rs.4,84,080/- @ 6.2% p.a. for 30 days an interest of Rs.2,501/- will accrue.

(c) (i) Current price of the Bond = $100 \times [1 - \{45/360\} \times 0.06]$

= Rs.99.25

Alternatively, the current price of bond may also be calculated as follows:

$$\frac{D}{100 - D} \times \frac{360}{45} = 0.06$$

$$\frac{D}{100 - D} = 0.06 \times \frac{45}{360}$$

$$\frac{D}{100 - D} = 0.06 \times \frac{1}{8}$$

$$8D = 6 - 0.06D$$

$$8.06D = 6$$

$$D = \frac{6}{8.06} = 0.7444$$

Current price of the bond = Face value – D

$$= \text{Rs.}100 - 0.7444 = \text{Rs.}99.2556$$

$$(ii) \text{ Bond equivalent yield} = \frac{100 - 99.25}{99.25} \times \frac{360}{45} = 6.045\% \text{ P.A.}$$

$$(iii) \text{ Effective annual return} = \left[1 + (0.06045/8)^8 \right] - 1$$

$$= 6.045\% \text{ P.A..}$$

Note: If a year of 365 days is considered the Bond equivalent yield and Effective annual return works out to 6.129% P.A.

Question 4

- (a) ABC Co. is considering a new sales strategy that will be valid for the next 4 years. They want to know the value of the new strategy. Following information relating to the year which has just ended, is available:

Income Statement	Rs.
Sales	20,000
Gross margin (20%)	4,000
Administration, Selling & distribution expense (10%)	2,000
PBT	2,000
Tax (30%)	600
PAT	1,400
Balance Sheet Information	
Fixed Assets	8,000
Current Assets	4,000
Equity	12,000

If it adopts the new strategy, sales will grow at the rate of 20% per year for three years. The gross margin ratio, Assets turnover ratio, the Capital structure and the income tax rate will remain unchanged.

Depreciation would be at 10% of net fixed assets at the beginning of the year.

The Company's target rate of return is 15%.

Determine the incremental value due to adoption of the strategy.

- (b) Discuss the major sources available to an Indian Corporate for raising foreign currency finances.
- (c) (i) What are Stock futures?
 (ii) What are the opportunities offered by Stock futures?
 (iii) How are Stock futures settled?

(8+8+4= 20 Marks)

Answer

(a)

Projected Balance Sheet

	Year 1	Year 2	Year 3	Year 4
Fixed Assets (40%) of Sales	9,600	11,520	13,824	13,824
Current Assets (20%) of Sales	4,800	5,760	6,912	6,912
Total Assets	14,400	17,280	20,736	20,736
Equity	14,400	17,280	20,736	20,736

Projected Cash Flows:-

	Year 1	Year 2	Year 3	Year 4
Sales	24,000	28,800	34,560	34,560
PBT (10%) of sale	2,400	2,880	3,456	3,456
PAT (70%)	1,680	2,016	2,419.20	2,419.20
Depreciation	800	960	1,152	1,382
Addition to Fixed Assets	2,400	2,880	3,456	1,382
Increase in Current Assets	800	960	1,152	-
Operating cash flow	(720)	(864)	(1,036.80)	2,419.20

Present value of Projected Cash Flows:-

Cash Flows	PV at 15%	PV
-720	0.870	-626.40
-864	0.756	-653.18
-1,036.80	0.658	<u>-682.21</u>
		-1,961.79

Residual Value - $2419.20/0.15 = 16,128$

Present value of Residual value = $16128/(1.15)^3$
 = $16128/1.521 = 10603.55$
 Total shareholders value = $10,603.55 - 1,961.79 = 8,641.76$
 Pre strategy value = $1,400 / 0.15 = 9,333.33$
 $\therefore$ Value of strategy = $8,641.76 - 9,333.33 = - 691.57$

Conclusion: The strategy is not financially viable

(b) The major sources are:-

Foreign currency term loan from Financial Institutions.

Export credit schemes.

External commercial borrowings.

Euro issues

Issues in foreign domestic markets.

They are discussed here below:-

1. Foreign currency term loan from Financial Institutions:- Financial Institutions provide foreign currency term loan for meeting the foreign currency expenditures towards import of plant, machinery, and equipment and also towards payment of foreign technical know how fees.
2. Export Credit Schemes:- Export credit agencies have been established by the government of major industrialized countries for financing exports of capital goods and related technical services. These agencies follow certain consensus guidelines for supporting exports under a convention known as the Berne Union. As per these guidelines, the interest rate applicable for export credits to Indian companies for various maturities are regulated. Two kinds of export credit are provided i.e., buyer's and supplier's credit.

Buyer's Credit:- Under this arrangement, credit is provided directly to the Indian buyer for purchase of capital goods and/or technical service from the overseas exporter.

Supplier's Credit:- This is a credit provided to the overseas exporters so that they can make available medium-term finance to Indian importers.
3. External commercial borrowings: Subject to certain terms and conditions, the Government of India permits Indian firms to resort to external commercial borrowings for the import of plant and machinery. Corporates are allowed to raise up to a stipulated amount from the global markets through the automatic route. Companies wanting to raise more than the stipulated amount have to get an approval of the MOF. ECBs include bank loans, supplier's and buyer's credit, fixed and floating rate bonds and borrowing from private sector windows of Multilateral Financial Institution such as International Finance Corporation.
4. Euro Issues: The two principal mechanisms used by Indian companies are Depository Receipts mechanism and Euro convertible Issues. The former represents indirectly equity investment while the latter is debt with an option to convert it into equity.
5. Issues in foreign domestic markets: Indian firms can also issue bonds and Equities in the domestic capital market of a foreign country. In recent year, Indian companies like Infosys Technologies and ICICI have successfully tapped the US equity market by issuing American Depository Receipts(ADRs). Like GDRs, ADRs

represent claim on a specific number of shares. The principal difference between the two is that the GDRs are issued in the euro market whereas ADRs are issued in the U.S. domestic capital market.

- (c) (i) Stock future is a financial derivative product where the underlying asset is an individual stock. It is also called equity future. This derivative product enables one to buy or sell the underlying Stock on a future date at a price decided by the market forces today.
- (ii) Stock futures offer a variety of usage to the investors. Some of the key usages are mentioned below:
Investors can take long-term view on the underlying stock using stock futures.
 - (a) Stock futures offer high leverage. This means that one can take large position with less capital. For example, paying 20% initial margin one can take position for 100%, i.e., 5 times the cash outflow.
 - (b) Futures may look over-priced or under-priced compared to the spot price and can offer opportunities to arbitrage and earn riskless profit.
 - (c) When used efficiently, single-stock futures can be effective risk management tool. For instance, an investor with position in cash segment can minimize either market risk or price risk of the underlying stock by taking reverse position in an appropriate futures contract.
- (iii) Up to March 31, 2002, stock futures were settled in cash. The final settlement price is the closing price of the underlying stock. From April 2002, stock futures are settled by delivery, i.e., by merging derivatives position into cash segment.

Question 5

- (a) A Company is planning to acquire a machine costing Rs.5,00,000. Effective life of the machine is 5 years. The Company is considering two options. One is to purchase the machine by lease and the other is to borrow Rs.5,00,000 from its bankers at 10% interest p.a. The Principal amount of loan will be paid in 5 equal instalments to be paid annually. The machine will be sold at Rs.50,000 at the end of 5th year. Following further informations are given:
 - (a) Principal, interest, lease rentals are payable on the last day of each year.
 - (b) The machine will be fully depreciated over its effective life.
 - (c) Tax rate is 30% and after tax.. Cost of Capital is 8%.

Compute the lease rentals payable which will make the firm indifferent to the loan option.

(b) The following information are supplied to you:

	Rs.
Total Earnings	2,00,000
No. of equity shares (of Rs.100 each)	20,000
Dividend paid	1,50,000
Price/Earning ratio	12.5

- (i) Ascertain whether the company is the following an optimal dividend policy.
 (ii) Find out what should be the P/E ratio at which the dividend policy will have no effect on the value of the share.
 (iii) Will your decision change, if the P/E ratio is 8 instead of 12.5? (12+8 = 20 Marks)

Answer

(a) Borrowing option:

Annual Instalment = Rs.50,00,000/- / 5 = Rs.1,00,000/-

Annual depreciation = Rs.50,00,000/- / 5 = Rs.1,00,000/-

Computation of net cash outflow:

Year	Principal	Interest	Total	Tax Saving Depn. & Interest	Net cash Outflow	PV @ 8%	Total PV
1	1,00,000	50,000	1,50,000	45,000	1,05,000	0.926	97,230
2	1,00,000	40,000	1,40,000	42,000	98,000	0.857	93,986
3	1,00,000	30,000	1,30,000	39,000	91,000	0.794	72,254
4	1,00,000	20,000	1,20,000	36,000	84,000	0.735	61,740
5	1,00,000	10,000	1,10,000	33,000	77,000	0.681	52,437
							<u>3,67,647</u>
Less: Present value of Inflows at the end of 5 th year (Rs.50,000/- x 0.7) or Rs.35,000 x 0.681 =							<u>23,835</u>
PV of Net Cash outflows							<u>Rs.3,43,812</u>

Calculation of lease rentals:

Therefore, Required Annual after tax outflow = 3,43,812/3.993 = Rs.86,104/-.

Therefore, Annual lease rental = 86,104/0.70 = Rs.1,23,006/-

- (b) (i) The EPS of the firm is Rs.10 (i.e., Rs.2,00,000/20,000). The P/E Ratio is given at 12.5 and the cost of capital, k_e , may be taken at the inverse of P/E ratio. Therefore, k_e is 8 (i.e., $1/12.5$). The firm is distributing total dividends of Rs.1,50,000 among 20,000 shares, giving a dividend per share of Rs.7.50. the value of the share as per Walter's model may be found as follows:

$$\begin{aligned}
 P &= \frac{D}{K_e} + \frac{(r/K_e)(E-D)}{K_e} \\
 &= \frac{7.50}{.08} + \frac{(.10/.08)(10-7.5)}{.08} \\
 &= \text{Rs.132.81}
 \end{aligned}$$

The firm has a dividend payout of 75% (i.e., Rs.1,50,000) out of total earnings of Rs.2,00,000. since, the rate of return of the firm, r , is 10% and it is more than the k_e of 8%, therefore, by distributing 75% of earnings, the firm is not following an optimal dividend policy. The optimal dividend policy for the firm would be to pay zero dividend and in such a situation, the market price would be

$$\begin{aligned}
 P &= \frac{D}{k_e} + \frac{(r/K_e)(E-D)}{K_e} \\
 &= \frac{0}{.08} + \frac{(.10/.80)(10-0)}{.08} \\
 &= \text{Rs.156.25}
 \end{aligned}$$

So, theoretically the market price of the share can be increased by adopting a zero payout.

- (ii) The P/E ratio at which the dividend policy will have no effect on the value of the share is such at which the k_e would be equal to the rate of return, r , of the firm. The K_e would be 10% ($=r$) at the P/E ratio of 10. Therefore, at the P/E ratio of 10, the dividend policy would have no effect on the value of the share.
- (iii) If the P/E is 8 instead of 12.5, then the k_e which is the inverse of P/E ratio, would be 12.5 and in such a situation $k_e > r$ and the market price, as per Walter's model would be

$$\begin{aligned}
 P &= \frac{D}{K_e} + \frac{(r/K_e)(E-D)}{K_e} \\
 &= \frac{7.50}{.125} + \frac{(.1/.125)(10-7.5)}{.125} \\
 &= \text{Rs.76}
 \end{aligned}$$

Question 6

- (a) The historical rates of return of two securities over the past ten years are given. Calculate the Covariance and the Correlation coefficient of the two securities:

Years:	1	2	3	4	5	6	7	8	9	10
Security 1: (Return per cent)	12	8	7	14	16	15	18	20	16	22
Security 2: (Return per cent)	20	22	24	18	15	20	24	25	22	20

- (b) Write brief notes on Leveraged Buyouts (LBOs).
- (c) Find the current market price of a bond having face value Rs.1,00,000 redeemable after 6 year maturity with YTM at 16% payable annually and duration 4.3202 years. Given $1.16^6 = 2.4364$. (10+4+6= 20 Marks)

Answer

- (a) Calculation of Covariance

Year	R_1	Deviation ($R_1 - \bar{R}_1$)	R_2 ($R_2 - \bar{R}_2$)	Deviation	Product of deviations
1	12	-2.8	20	-1	2.8
2	8	-6.8	22	1	-6.8
3	7	-7.8	24	3	-23.4
4	14	-0.8	18	-3	2.4
5	16	1.2	15	-6	-7.2
6	15	0.2	20	-1	-0.2
7	18	3.2	24	3	9.6
8	20	5.2	25	4	20.8
9	16	1.2	22	1	1.2
10	22	7.2	20	-1	-7.2
$\bar{R}_1 = \frac{148}{10} = 14.8$ $\bar{R}_2 = \frac{210}{10} = 21$					-8.00

$$\text{Covariance} = \frac{\sum_{i=1}^N [R_1 - \bar{R}_1][R_2 - \bar{R}_2]}{N}$$

$$= -8/10 = -0.8$$

For calculation of correlation, the standard deviation of the two securities are also required.

Calculation of Standard Deviation

Year	R ₁	R ₁ ²	R ₂	R ₂ ²
1	12	144	20	400
2	8	64	22	484
3	7	49	24	576
4	14	196	18	324
5	16	256	15	225
6	15	225	20	400
7	18	324	24	576
8	20	400	25	625
9	16	256	22	484
10	22	484	20	400
	148	2398	210	4494

Standard deviation of security 1:

$$\begin{aligned}\sigma_1 &= \sqrt{\frac{N \sum R_1^2 - (\sum R_1)^2}{N^2}} \\ &= \sqrt{\frac{(10 \times 2398) - (148)^2}{10 \times 10}} = \sqrt{\frac{23980 - 21904}{100}} \\ &= \sqrt{20.76} = 4.56\end{aligned}$$

Standard deviation of security 2:

$$\begin{aligned}\sigma_2 &= \sqrt{\frac{N \sum R_2^2 - (\sum R_2)^2}{N^2}} \\ &= \sqrt{\frac{(10 \times 4494) - (210)^2}{10 \times 10}} = \sqrt{\frac{44940 - 44100}{100}} \\ &= \sqrt{\frac{840}{100}} = \sqrt{8.4} = 2.90\end{aligned}$$

Correlation Coefficient

$$r_{12} = \frac{\text{Cov}}{\sigma_1 \sigma_2}$$

$$= \frac{-0.8}{4.56 \times 2.90} = \frac{-0.8}{13.22}$$

$$= -0.0605$$

(b) Leveraged Buyouts (LBOs)

- (1) A popular technique that was widely used during the 1980s to make acquisition is the leveraged buyouts, which involves the use of a large amount of debt to purchase a firm.
- (2) While some leveraged buyouts involve a company in its entirety, most involve a business unit of a company. After the buyout, the company invariably becomes a Private Company.
- (3) A large part of the borrowing is secured by the firms assets, and the lenders, because of a high risk, take a portion of the firms equity. Junk bonds have been routinely used to raise amounts of debt needed to finance the LBO transaction.
- (4) The success of the entire operation depends on their ability to improve the performance of the unit, contain its business risk, exercise cost controls and liquidate disposable assets. If they fail to do so, the high fixed financial costs can jeopardize the venture.
- (5) An attractive candidate for acquisition through leveraged buyout should possess three basic attributes:
 - (a) It must have a good position in its industry with a solid profit history and reasonable expectations of growth.
 - (b) The firm should have a relatively low level of debt and a high level of bankable assets that can be used as loan collateral.
 - (c) It must have a stable and predictable cash flows that are adequate to meet interest and principal payment on the debt and provide adequate working capital.

Of course, a willingness on the part of existing ownership and management to sell the company on a leveraged basis is also needed.

(c) Duration $4.3202 = (1.16/0.16) - [1.16 + 6(c-0.16)] / (c[(1.16)^6 - 1] + 0.16)$

$$4.3202 = \frac{1.16}{0.16} - \frac{1.16 + 6(c-0.16)}{c[(1.16)^6 - 1] + 0.16}$$

$$\frac{1.16 + 6c - 0.96}{1.4364c + 0.16} = 2.9298$$

$$0.2 + 6c = 4.20836472c + 0.468768$$

$$1.79163528c = 0.268768$$

$$C = 0.150012679$$

$$\therefore c = 0.15$$

Where c = Coupon rate

Therefore, current price = Rs.(1,00,000/- x 0.15 x 3.685 + 1,00,000/- x 0.410)

= Rs.96,275/-.

PAPER – 3 : ADVANCED AUDITING

Answer Question Nos. 1 and 2 and any four from the rest.

Question 1

As an auditor, how would you deal with the following?

- (a) L Private Ltd., which has outstanding loan of Rs. 50 lakhs from Financial Institution defaulted in repayment thereof to the extent of 50%. The company holds that it being a private limited company, the Companies Auditors Report Order (CARO) is not applicable. (5 Marks)
- (b) In the audit of ABC Private Limited, auditor came across cases of payments to Directors, whereby, expenses of a personal nature were re-imbursed. (5 Marks)
- (c) The management of a limited company states that proposed dividend does not represent a liability and hence no provision need to be made-Comment. (4 Marks)
- (d) ABC Limited to whom CARO is applicable made a public issue of 7% debentures of Rs. 3 crores, redeemable after 5 years and used the proceeds of issue for payment of Sundry creditors and other Current liabilities to the tune of 3 crores. (4 Marks)

Answer

- (a) Applicability of CARO to a Private Ltd. Co.: A Private Ltd. Co., in order to be exempt from the applicability of CARO must satisfy all the following conditions cumulatively :
 - (i) its paid-up capital and reserves are Rs. 50 lacs or less;
 - (ii) it has no outstanding loan exceeding Rs. 25 lacs from any bank or financial institutions; and
 - (iii) its turnover does not exceed Rs. 5 crores during the financial year.Since condition (ii), above, is violated, the Order is applicable to L Pvt. Ltd.
The period and amount of default be reported by the auditor as per para 4(xi) of the CARO.
- (b) Reimbursement of personal expense of Director: All payments to Directors as remuneration or perquisites whether in the case of a public or private company are required to be authorised both in accordance with the Companies Act and Articles of Association of the company. Articles may provide that such remuneration require sanction of the shareholders either by ordinary or special resolution while in some cases it may require only approval of Directors. If the terms of appointment of a Director include payment of expenses of a personal nature, then such expenses can be incurred by the company; otherwise, no such expense can be incurred or reimbursed by the company. In the instant case the auditor has to ensure that the above is complied with, without which, if such expenses are paid, he has to disclose the fact in his report, as also in the accounts. In this regard attention is invited to section 227 (1A) (e) of the Companies Act

wherein auditor has to inquire into whether personal expenses have been charged to revenue.

- (c) Provision for proposed dividend: As per the ICAI's Guidance Note, proposed dividend does not represent a liability, nor does it amount to a provision, pending the approval of the share holders in the general meeting.

Though the format given in schedule VI requires proposed dividend to be shown under 'Current Liabilities and Provisions', it does not mean in fact that the proposed dividend becomes a liability or is necessarily a provision. Part 1 of Schedule VI that prescribes the form of balance sheet requires " proposed dividend" to be shown under 'Provisions' and paragraph 3(xiv) of Part II of the same Schedule requires specific disclosure of the proposed dividend.

It is recommended, that if no appropriation is made, shareholders' attention should be drawn to such fact and the amount should be quantified. The fact that provision for proposed dividend has not been made should be disclosed by means of a note in the accounts. The auditor should refer to the note in his report and make his report subject thereto.

- (d) End use of issue proceeds of a public issue: Para 4(xx) of CARO deals with end use of issue proceeds of a public issue. Public issue may relate to equity shares, preference shares, debentures and other securities. The auditor is expected to verify and report whether the end use of moneys raised by way of public issue have been properly disclosed in the financial statements.

The auditor must see whether the terms of issue of debentures contain any specific purpose/project for which the funds raised will be utilized.

If the terms of issue of debentures is for liquidating sundry creditors and other current liabilities, it would be in order for the company to do so. Auditor should verify that the amount of end use of money disclosed in the financial statements by the management is adequate and is not significantly different from the proposed and actual use. If either end use is not for the purpose for which a public issue is made or the disclosure is not adequate, the auditor should state the fact in his report.

Question 2

Comment on the following with reference to the Chartered Accountants Act, 1949 and schedules thereto:

- (a) A chartered accountant in practice created his own website in attractive format and colours and circulated the information contained in the website through E-mail. (5 Marks)
- (b) A chartered accountant in practice takes up the appointment as managing director of a public limited company. (4 Marks)
- (c) S. a practicing chartered accountant gives power of attorney to an employee chartered accountant to sign reports and financial statements, on his behalf. (5 Marks)

- (d) A is the auditor of Z Ltd., which has a turnover of Rs. 200 crore. The audit fee for the year is fixed at Rs. 50 lakhs. During the year, the company offers A an assignment of management consultancy within the meaning of Section 2(2)(iv) of the CA Act, 1949 for a remuneration of Rs. 1 crore. A seeks your advice on accepting the assignment. (4 Marks)

Answer

- (a) Creation of own website by a chartered accountant/firm of chartered accountants : The guidelines approved by the Council of the Institute of Chartered Accountants of India permits creation of own website by a chartered accountant in his or his firm name and no standard format or restriction on colours is there. The chartered accountant or firm, as per the guidelines, should ensure that none of the information contained in the website be circulated on their own or through E-mail or by any other mode except on a specific "Pull" request.

Since in the given case, the chartered accountant circulated the information contained in the website through E-mail, he is guilty of misconduct under clause 6 of Part I of the First Schedule to the Chartered Accountants Act, i.e., a chartered accountant in practice is deemed to be guilty of professional misconduct if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means.

- (b) Appointment of a CA in practice as MD of a Public Limited Company: Under clause 11 of Part I of First Schedule to the Chartered Accountants Act, a chartered accountant in practice is deemed to be guilty of professional misconduct, if he engages in any business or occupation other than the profession of chartered accountants, unless permitted by the council so to engage.

However, nothing contained in clause 11 shall disentitle a chartered accountant from being a director of a company, unless he or any of his partners is interested in such company as an auditor.

Regulation 190A, states a member in practice cannot engage himself in any business or occupation other than that of a chartered accountant except when permitted by the council. As per Appendix 10 of CA Regulations, 1988, a CA in practice may hold the office of a Managing Director a Whole Time Director of a body corporate, provided that the member and/or his relatives do not hold substantial interest in such concern, after obtaining the specific and prior approval of the Council.

He should seek prior approval of the council otherwise he would be held guilty of misconduct.

- (c) Power of signing reports and financial statements: Under clause 13 of Part I of First Schedule to the Chartered Accountants Act a CA in practice is deemed to be guilty of professional misconduct if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

This clause read in conjunction with Section 26 of the CA Act 1949 stipulates that no person other than the member of the institute shall sign any document on behalf of a CA in practice or a firm of CA's in his or its professional capacity.

The term 'Financial Statement' for this purpose would cover an examination of the accounts or financial statements given under a statutory enactment or otherwise. Accordingly S is guilty of professional misconduct under clause 13 of part I of First Schedule and also under clause (1) of Part II of Second Schedule for contravening Section 26.

- (d) Appointment as a statutory auditor of a PSUs'/Govt company(ies)/listed company(ies) and other public company(ies) : In exercise of the powers conferred by clause (ii) of part II of the Second Schedule to the CA Act, 1949, the Council of ICAI specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct if he accepts the appointment as a statutory auditor of a PSUs'/Govt company(ies)/listed company(ies) and other public company(ies) having a turnover of Rs. 50 crores or more in a year and accepts any other work(s) or assignment(s) or service(s) in regard to same undertaking(s) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking. In view of the above position it would be a misconduct on A's part if he accepts the management consultancy assignment for a fee of Rs. 1 crore.

Question 3

- (a) State the items contained in the SEBI's check list for auditors in respect of contract notes issued by a Stock Broker. (8 Marks)
- (b) What are the advantages that accrue to the stockholders of a company because of a Cost audit? (8 Marks)

Answer

- (a) SEBI's check list for auditors in respect of contract notes issued by a Stock Broker:
- (1) Members should issue Contract Notes to his clients for all trades executed by him on their behalf.
 - (2) The member should stamp his order sheets/records and the order time should be reflected in the Contract Note along with the time of execution of order.
 - (3) The Contract Notes should bear SEBI Registration number of the member. It should be pre printed and issued within 24 hours of trade execution. Appropriate stamps should be affixed on the contract Note. Duplicate copies of the contract note should be maintained.
 - (4) The Contract Note should be signed by the member or his constituted attorney.
 - (5) Contract note issued to the clients should show the brokerage separately.
 - (6) In case the broker acts as a principal, the Contract Note should be in Form B.

- (7) Consent of the client should be taken for any trade done by the broker while acting as a principal.
- (8) Brokerage should be within the limits prescribed by the exchange.
- (b) Advantages of Cost Audit : Cost Audit will be advantageous to the stockholders in the following manner :
 - (1) To Management:
 - (i) Reliability of data for price fixing, control and decision making.
 - (ii) Waste control and consequently cost reduction.
 - (iii) Through the system of budgetary control and standard costing, cost control is established.
 - (iv) Proper valuation of closing stock, work in progress.
 - (2) To Society:
 - (i) Cost Audit is often introduced for the purpose of price fixation. Customers are saved from exploitation through proper costing of products and services.
 - (ii) Since price increase by some industries is not allowed without proper justification as to increase in cost of production, inflation through price hikes can be controlled and consumers can maintain their standard of living.
 - (3) To Shareholders: Cost Audit ensures that proper records are kept as to purchases and utilization of materials and expenses incurred on wages etc. It also makes sure that the valuation of closing stock and work-in-progress is on a fair basis. The shareholders are assured about the calculation of the profitability and thus return on their investments.
 - (4) To Government:
 - (i) In a cost plus contract, price fixation is properly calculated.
 - (ii) Price ceiling for essential commodities and thus undue profiteering is checked.
 - (iii) Able to monitor inefficient units
 - (iv) Decision support on Government protection to certain industries.
 - (v) Settlement of trade disputes.

Cost audit and consequent management action can create a healthy competition among the various units in an Industry. This imposes an automatic check on inflation.

Question 4

- (a) State the procedure to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company. (10 Marks)
- (b) How would you verify "Acceptances, Endorsements and other obligations" appearing in the Balance Sheet of a bank ? (6 Marks)

Answer

- (a) Procedure to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company : Equity securities and derivative instruments that are traded in active markets, shall be measured at fair value as at the Balance Sheet date. Fair value will be the lowest of the last quoted closing price of the stock exchanges where the securities are listed. The insurance company shall assess on each Balance Sheet date whether any impairment of listed security/derivative instruments has occurred.

An active market shall mean a market, where the securities traded are homogeneous, availability of willing buyers and sellers is normal and the prices are publicly available.

Unrealized gains/losses arising due to changes in fair value of listed equity shares and derivative instruments shall be taken to equity under the head 'Fair Value Change Account'. The 'profit' on sale of investments' or 'loss on sale of investments', as the case may be, shall include accumulated changes in the fair value previously recognized in equity under the heading Fair Value Change Account in respect of particular security and being recycled to profit and loss account on actual sale of that listed security.

Any credit balance in Fair Value Change Account will not be available for distribution as dividends. Also any debit balance in such an account shall be reduced from profits/free reserves while declaring dividends.

At every Balance Sheet date, impairment loss should be recognized as an expense to the extent of the difference between the re-measured fair value of the security and its acquisition cost as reduced by any previous impairment loss already recognized. Any reversal of impairment loss earlier recognized as an expense, should be recognized in the Revenue/Profit & Loss Account.

Unlisted and other than actively traded equity securities and derivative instruments will be measured at historical costs. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of investments over its carrying amount. The increased carrying amount of the investments due to reversal of the provision shall not exceed the historical cost.

- (b) Acceptances, Endorsements and Other Obligations: This item includes the following balances:

(a) letters of credit opened by the bank on behalf of its customers and

(b) bills drawn by the bank's customers and accepted/endorsed by the bank.

Letters of credit: Evaluate the adequacy of the internal controls over LC Forms e.g. custody, maintenance of records, periodical verification, reconciliation etc.

Verify the balance of LC from the Register maintained by the bank to ascertain the amount of LC and payments made under them.

Examine the guarantees of the customers, copies of the LC issued & security obtained for issuing LC.

In respect of other acceptances and endorsements the following procedure may be adopted.

- (i) Examine the arrangements made by the bank with its customers.
- (ii) Test check the amounts of bills with the register maintained by the bank.
- (iii) Verify whether such bills are marked off in the register on payment at maturity.

Letters of comfort: Where letters of comfort has been issued,, verify whether the bank has incurred a potential financial obligation under such a letter. If an obligation has been cast under letters of comfort, ensure that the amount has also been shown as contingent liability in the Balance Sheet.

Question 5

- (a) Outline the contents of a due diligence report. (8 Marks)
- (b) Enumerate some of the key functions of the Energy Auditor. (8 Marks)

Answer

- (a) Contents of a Due Diligence Report : The Contents of a due diligence report vary with individual cases but the following can be illustrative headings:
 - (i) Executive summary.
 - (ii) Introduction.
 - (iii) Background of target.
 - (iv) Objective of due diligence.
 - (v) Terms of reference and scope of verification.
 - (vi) Brief history of the company.
 - (vii) Summary on capital structure and group structure of company.
 - (viii) Shareholding pattern.
 - (ix) Observations on the review.
 - (x) Assessment of Management structure.
 - (xi) Assessment of financial liabilities.
 - (xii) Assessment of valuation of assets.
 - (xiii) Comments on properties, terms of leases, lien and encumbrances.
 - (xiv) Assessment of operating results.
 - (xv) Assessment of taxation and statutory liabilities.
 - (xvi) Assessment of possible liabilities on account of litigation.

- (xvii) Assessment of net worth.
 - (xviii) Any liabilities not provided for in the books.
 - (xix) SWOT analysis comments on future projections.
 - (xx) Status on charges, liens, mortgages and assets of the company.
 - (xxi) Ways and means to cover unforeseen contingent liabilities.
 - (xxii) Aspects to be taken care of before/after merger.
 - (xxiii) Interlocking investments and financial obligations with group/associate companies amounts receivable subject to litigation.
- (b) Key functions of the Energy Auditor: Following are some of the key functions of the Energy Auditor:
- (i) Quantify energy costs and quantities.
 - (ii) Correlate trends of production or activity to energy costs.
 - (iii) Devise energy database formats to ensure they depict the correct picture –by department, consumer, product, etc.
 - (iv) Advise and check the compliance of the organization for policy and regulation aspects.
 - (v) Highlight areas that need attention for detailed investigation.
 - (vi) Conduct preliminary and detailed energy audits which should include the following:
 - (a) Data collection and analysis
 - (b) Measurements, mass and energy balances.
 - (c) Reviewing energy procurement practices.
 - (d) Identification of energy efficiency projects and techno-economic evaluation.
 - (e) Establishing action plan including energy saving targets, staffing requirements, implementation time requirements, procurement issues, details and cost estimates.
 - (f) Recommendation on goal setting for energy saving, record keeping, reporting and energy accounting, organization requirements, communications and public relations.

Question 6

As a chartered accountants firm draft an engagement letter to the Board of Directors for the compilation of financial statements of XYZ Ltd. as at 31.3.2007. (16 Marks)

Answer

Engagement letter to the Board of Directors for the compilation of financial statements of XYZ Ltd. as at 31.3.2007:

To

The Board of Directors

XYZ Ltd.

.....

You have vide your letter datedrequested that we compile the Balance Sheet of XYZ. Ltd. as at 31.3.2007 and the related Profit and Loss account for the year ended on that date.

We are pleased to confirm our acceptance and understanding of the engagement by means of this letter. As no audit or review engagement procedures would be carried out, no opinion on the financial statements will be expressed. Further, our engagement cannot be relied upon to disclose whether frauds or defalcations, or illegal acts exist. However, we will inform you of any such matters which might come to our attention in the course of the engagement.

As Management, you are responsible for :

- (a) The accuracy and completeness of the information supplied to us, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.
- (b) Preparation and presentation of the financial statements of the entity, in accordance with the applicable laws and regulations, if any.
- (c) Safeguarding the assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.
- (d) Ensuring that the activities of the entity are carried on in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.

You will confirm that events and transactions are recorded in accordance with the applicable accounting standard(s), issued by the Institute of Chartered Accountants of India and other recognized accounting principles and practices and inform us of any departures therefrom.

As part of our normal procedures, we may request you to provide written confirmations of any information or explanations given to us orally during the course of our work.

We understand that the intended use and distribution of the information we have compiled is(specify purpose)

We look forward to full co-operation with your staff and we trust that they will make available to us whatever records, documents and other information requested in connection with our engagement.

Our fees will be billed as the work progresses.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our compilation of your financial statements.

XYZ & Co.
Chartered Accountants
S/d

Question 7

- (a) A company wants to amend its accounts after the completion of the audit and adoption of the Accounts by the Board, but before circulation to the shareholders. It requires its statutory auditor to report on the amended accounts. State the steps the statutory audit should adopt in such a situation. (8 Marks)
- (b) K Ltd., requires you to organize a Management audit program. Briefly state a plan of action. (8 Marks)

Answer

- (a) Amendment of accounts after the completion of the audit and adoption of the Accounts by the Board before circulation to the shareholders: This pertains to the manner in which the statutory auditor should report upon amended accounts. The Companies Act does not contemplate the revision of accounts and a further report by the statutory auditor on the amended accounts. At the same time, it is entirely within the competence of the Board of Directors to amend the accounts and resubmit the same to statutory auditors for report before the accounts are placed before the annual General Meeting. The report issued by the statutory auditor on such amended accounts will be in substitution of the report issued before the amendment. Unless all copies of the original accounts and reports are returned to the auditor, such substitution is not possible.

The guidance on Auditor's report on revised accounts of companies before circulation to shareholders recommends that members, when called upon to issue a report on amended accounts for the same period due to amendments to the accounts, should ensure all copies of the original accounts and reports are returned to him, adequate disclosure about the revision of accounts already reported, appears as a specific note on the amended accounts. If the Statutory auditor is satisfied about the adequacy of disclosure, there may not be any need for him to refer to the revision of balance sheet and/or the profit and loss account in his report otherwise he has to refer to the revision in his report.

- (b) Organizing a Management Audit for K Ltd.: The key requirement for a successful Management audit program would be the approval and support of the top management to initiate. Accordingly the following shall be the matters that should be considered while organizing the Management Audit of K. Ltd.
 - (i) Devising a statement of policy : In consultation with the top Management, a policy statement on Management should be issued. The policy should ideally cover the scope, objective, the authority of the management audit function. In short the policy should be drafted to become a charter of Management Audit .
 - (ii) Location of audit function within the organization: The hierarchical status of the Management auditor and his team should be clearly defined.
 - (iii) Allocation of personnel : The Management audit team should comprise of personnel who have adequate experience on all the facets of the organization, Ideally it should comprise of technical audit team.

- (iv) Staff Training : In order to maintain qualitative standards, adequate and continuous training should be offered to the Management audit team.
- (v) Time and other aspects : While planning management audit adequate consideration should be given to time & cost involved in conducting the audit.
- (vi) Frequency of audit : Depending on the pace of change that happens in that industry, the frequency of the Management audit should be determined. This can be fixed in consultation with the top Management.

Question 8

Write short notes on any four of the following:

- (a) Analytical procedures in planning an audit
- (b) Public Accounts Committee
- (c) Method of accounting in Form No. 3CD of Tax Audit
- (d) Contents of Audit report of Mutual Fund
- (e) Eight situations of external confirmations
- (f) Factors to consider in determining the use of Computer Assisted Audit Techniques (CAATs). (4 x 4 = 16 Marks)

Answer

- (a) Analytical procedures in planning an audit: In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures.

Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, the square feet of selling space, volume of goods produced and similar information.
- (b) Public Accounts Committee: The parliament as well as each state legislative sets up a public accounts committee to scrutinize the appropriation accounts and the report of the auditors thereon. The committee also examines financial statements (together with the auditors' report thereon) of the State Corporation and other autonomous and semi-autonomous bodies (except Government companies and those public undertakings which assigned to the committee on public undertakings).
- (c) Method of accounting in Form No. 3CD of Tax Audit: Clause 11 of Form No. 3CD of the tax audit requires to state method of accounting employed in the previous year. It also requires to state change in method of accounting vis-à-vis the preceding year. If so, details of change and the effect on the profit or loss are to be stated. Also details of deviation thereof if any, from accounting standards prescribed under section 145 and the effect thereof on the profit or loss are stated.

Section 145 provide that method of accounting be either cash or mercantile. Hybrid system is not permitted.

- (d) Audit report of mutual fund: It comprises the following:
 - (i) The auditor has obtained all information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of the audit.
 - (ii) The balance sheet and the revenue account give a fair and true view of the scheme, state of affairs and surplus or deficit in the fund for accounting period to which the balance sheet or, as the case may be, the revenue account relates.
 - (iii) The statement of account has been prepared in accordance with accounting policies and standards as specified in the ninth schedule.
- (e) Eight situations of external confirmations:
 - (i) Bank balances from bankers.
 - (ii) Accounts receivable balances.
 - (iii) Accounts payable balances.
 - (iv) Stocks held by third parties.
 - (v) Property title deeds held by third parties.
 - (vi) Investments purchased but delivery not taken.
 - (vii) Loans from lenders.
 - (viii) Long outstanding share application money.
- (f) Factors to consider in determining the use of Computer Assisted Audit Techniques:
 - (i) The IT knowledge, expertise and experience of the audit team.
 - (ii) The availability of CAATs and suitable computer facilities and data.
 - (iii) The impracticability of manual tests due to complex processing needed.
 - (iv) Effectiveness and efficiency in evaluating evidence involving large population.
 - (v) Time constraints.

The above is in consonance with the guidance note on Computer Assisted Audit Techniques.

PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE

Question Nos. 1,2, and 3 are compulsory. Answer any four from the rest of the questions

Question 1

Answer any two of the following:

- (a) A Company wants to include the following clause in its Articles of Association:
- “Each director shall be entitled to be paid out of the funds of the company for attending meetings of the Board or a committee thereof including adjourned meetings such sum as sitting fees as shall be determined from time to time by the Directors, but not exceeding a sum of Rs. 30,000 for each such meeting to be attended by the Director.”
- You are required to advise the Company as to the validity of such a clause and the correct legal position. (5 Marks)
- (b) Describe the provisions of the Securities Contracts (Regulation) Act, 1956 regarding the powers of the Central Government to supersede the Governing Body of a recognized Stock Exchange and the consequences of such supersession. (5 Marks)
- (c) SEBI is of the opinion that in the interest of investors, it is desirable to amend the rules of RSP Stock Exchange prohibiting the appointment of the broker-member as President of the Stock Exchange. Explain briefly with reference to the provisions of Securities Contracts (Regulation) Act, 1956, whether it is possible for SEBI to amend the rules of the Stock Exchange, if the Stock Exchange does not change the rules. (5 Marks)

Answer

- (a) The payment of sitting fee to a Director is governed by the provisions of Section 310 of the Companies Act, 1956 read with Rule 10B of the Companies (Central Government's) general Rules and Forms 1956. According to the said provisions, a Company with a paid up share capital and free reserves of Rs. 10 crores and above or a turnover of Rs. 50 crores and above can pay to its director by way of sitting fee for each meeting of the board of directors or a committee thereof an amount not exceeding Rs. 20,000/- and in case of other company the limit has been set at Rs. 10,000/-.

In view of the above legal provisions, the company cannot have a clause in its Articles of Association which exceeds the limit prescribed by law. The Company is advised to check whether the aggregate of its paid up capital and free reserves exceeds Rs. 10 crores or whether its turnover exceeds Rs. 50 crores and accordingly it can have a clause in its Articles of Association. In case the company keeps the clause as given in the question, it shall be ultra vires the Companies Act, 1956, as section 9 states that any provision contained in Memorandum of Association, Articles of Association, Agreements or Resolutions to the extent it is repugnant to the provisions of the Companies Act, 1956, shall be void.

- (b) In accordance with the provisions of Section 11 of the Securities Contracts (Regulation) Act, 1956, where the Central Government is of opinion that the governing body of any recognized stock exchange should be superseded, then notwithstanding anything contained in any other law for the time being in force, the Central Government may serve on the governing body a written notice that the Central Government is considering the supersession of the governing body for the reasons specified in the notice. After giving an opportunity to the governing body of such Stock Exchange to be heard in the matter, the Central Government may, by notification in the Official Gazette, declare the governing body of such Stock Exchange to be superseded.

The Central Government may appoint any person or persons to exercise and perform all the powers and duties of the governing body. If more than one person is so appointed, one of them may be the Chairman and another as the Vice-chairman. Such person shall hold office for such period as may be specified in the Notification and the Central Government may vary such period by way of another Notification.

On the publication of the notification in the Official Gazette, following are the consequences:

- (i) the members of the governing body of such Stock Exchange ceases to hold office as such members on and from the date of notification.
 - (ii) The person or persons appointed by the Central Government may exercise and perform all the powers and duties of the governing body which has been so superseded.
 - (iii) The property of the Stock Exchange as deemed necessary and so specified in writing by such person or persons to carry on the business of Stock Exchange shall vest in such person or persons.
- (c) In accordance with the provisions of section 8 of Securities Contracts (Regulation) Act, 1956, The Central Government is empowered to issue written order directing all or any of the recognized stock exchange to make any rules or to amend any rules already made within two months from the date of the order in respect of matters specified in section 3(2) of the said Act. One of the matters specified in the said section 3(2) is the governing body of stock exchange, its constitution and powers of management and the manner in which its business is to be transacted. Hence, the Central Government is empowered to direct the stock exchange in respect of prohibition on broker-member being appointed as President of the stock exchange. According to notification issued by Central Government under section 29A of the said Act, this power is also exercisable by SEBI.

If any recognized stock exchange fails or neglects to comply with any order made by SEBI within two months, SEBI may itself make the rules or amend the rules made by stock exchange either in the form proposed in the order or with such modification thereof as may be agreed to between SEBI and the stock exchange. The amended rules are required to be notified in the Gazette of India and in the Gazette of the State where the principal office of the stock exchange is situated. After such publication, the rules shall be valid as if the same were made or amended by the recognized stock exchange itself.

Accordingly of the above provisions of Securities Contracts (Regulation) Act, 1956, SEBI can issue directions to RSP Stock Exchange to amend the rules and if the said stock exchange does not comply with the above, SEBI can amend the rules on its own.

Question 2

Answer any two of the following:

- (a) (i) Tomco Ltd. A vehicles manufacturing company situate at Pune, Maharastra has received an order from a transport company in Italy for supply of 100 Trucks on lease. You are required to state, how the said Tomco Ltd. can accept such an order.

(3 Marks)

- (ii) Forex Dealers Ltd. Is an Authorised Person within the meaning of Foreign Exchange Management Act, 1999. Reserve Bank of India issued certain directions to the said Authorised person to file certain returns which it failed to file. You are required to state the penal provisions to which the said Authorised Person has exposed itself.

(4 Marks)

- (b) (i) Mr. Sekhar resided in India for a period of 150 days in India during the financial year 2006-07 and thereafter went abroad. He came back to India on 1st April, 2007 as an employee of a business organization. What would be his residential status during the financial year 2007-2008?

(3 Marks)

- (ii) Mr. Atul, an Indian National desires to obtain foreign exchange for the following purposes:

- (a) Remittance of US Dollar 10,000 for payment for goods purchased from a party situated in Nepal.
- (b) US Dollar 10,000 for remitting as commission to his agent in USA for sale of commercial plot situated near Bangalore, consideration in respect of which was received by Mr. Atul by way of foreign currency inward remittance amounting to US Dollar 1,00,000.

Advise him, if he can get the Foreign Exchange and under what conditions.

(4 Marks)

- (c) (i) Hon'ble Justice Mr. HCJ, a retired High Court Judge, attained the Age 61 years on 31st December, 2004. The Central Government appointed him as the Chairperson of the Competition Commission of India with effect from 1st January, 2005. You are required to state, with reference to the provisions of the Competition Act, 2002, the term for which he may be appointed as Chairperson of the Competition Commission of India. Whether he can be reappointed as such and till when he can remain as Chairperson of the Competition Commission of India ?

(3 Marks)

- (ii) After ceasing to be a member of the Competition Commission of India with effect from 31st March, 2007, Mr. MKP was offered the post of Executive Director with

appropriate remuneration and perquisites in the following organizations with effect from 1st April, 2007:

- (a) HLL Ltd. a private sector public limited company, whose case was disposed off by the Competition Commission under the provisions of the Competition Act, 2002 in the month of February, 2007.
- (b) Life Insurance Corporation of India.

You are required to state with relevant provisions of the Competition Act, 2002, the option available to Mr. MKP in respect of accepting the offers. (4 Marks)

Answer

- (a) (i) Under provisions of section 7 of the Foreign Exchange Management Act, 1999 certain rules have been made governing export of goods and services. Regulation 14-A of the Foreign Exchange Management (Export of Goods and Services) Regulations, 2000 prescribes that no person shall, except with prior permission of the Reserve Bank of India, take or send out by land, sea or air any goods from India to any place outside India on lease or hire or under any arrangement or in any other manner other than sale or disposal of such goods.

Accordingly if Tomco Ltd. wants to accept the order for dispatching 100 trucks to Italy on lease, it has to take prior permission of the Reserve Bank of India.

- (ii) In accordance with the provisions of the Foreign Exchange Management Act, 1999 as contained in section 11(3), stated that where any authorized person contravenes any direction given by the Reserve Bank of India under the said Act or fails to file any return as directed by the Reserve Bank of India, the Reserve Bank of India may, after giving reasonable opportunity of being heard, impose on Authorised Person a penalty which may extend to ten thousand rupees and in the case of continuing contraventions with an additional penalty which may extend to two thousand rupees for every day during which such contravention continues.

Since as per the facts given in the question, the Authroised person, namely, Forex Dealers Ltd., has failed to file the return as directed by the Reserve Bank of India, according to the above provisions if has exposed itself to a penalty which may extend to Rs. 10,000 and in the case of continuing contraventions in the nature of failure to file the return, with an additional penalty which may extend to Rs. 2,000 for every day during which such contravention continues.

- (b) (i) In accordance with the provisions of Section 2(v) of the Foreign Exchange Management Act, 1999, as contained in section 2(v) a person in order to qualify for the purpose of being treated as a "Person Resident in India" in any financial year, must reside in India for a period of ore than 182 days during the preceding financial year. In the given case, Mr. Sekhar has resided in India for a period of only 150 days, i.e., less than 182 days, during the financial year 2006-2007. Hence he cannot be considered as a "Person Resident in India" during the financial year 2007-2008 irrespective of the purpose or duration of his stay.

- (ii) In accordance with the provisions the Foreign Exchange Management Act, 1999 as contained in Section 5, certain Rules have been made for drawal of Foreign Exchange for Current Account transactions. As per these Rules, drawal Foreign Exchange for some of the Current Account transactions is prohibited. As regards some other Current Account transactions, Foreign Exchange can be drawn with prior permission of the Central Government while in case of some Current Account transactions, prior permission of Reserve Bank of India is required.
- (a) In respect of item (a), i.e., remittance to Nepal, such remittance is prohibited and the same is included in First Schedule to be Foreign Exchange Management (Current Account Transactions) Rules, 2000. Hence, Mr. Atul cannot withdraw Foreign Exchange for this purpose.
- (b) The type of payment as envisaged in item (b) is covered under Third Schedule to the Foreign Exchange Management (Current Account Transactions) Rules 2000 and for withdrawing foreign Exchange exceeding 5% (five percent) of the inward remittance as commission to agent abroad for sale of commercial plot in India, Mr. Atul will require the prior permission of the Reserve Bank of India.
- (c) (i) According to Section 10(1) of the Competition Act, 2002, the Chairperson and every other Member shall hold office as such for a term of five years from the date on which he enters upon his office and shall be eligible for re-appointment.

Provided that no Chairperson or other Member shall hold office as such after he has attained, -

- (a) in the case of the Chairperson, the age of sixty-seven years;
- (b) in the case of any other Member, the age of sixty-five years.

Based on the above provisions of the Competition Act, 2002, it can be concluded that Hon'ble retired Justice Mr. HCJ can be appointed as the Chairperson of the Competition Commission of India by the Central Government initially for a period of five years and he can also be re-appointed after his initial term of five years is over. But since he shall be attaining the age of 67 years as on 31st December, 2010, he will have to step down from the post on his attaining the age of 67 years.

- (ii) In accordance with the provisions of the Competition Act, 2002 as contained in Section 12, the Chairperson and other Members shall not, for a period of one year from the date on which they ceased to hold office, accept any employment in, or connected with the management or administration of, any enterprise which has been a party to a proceeding before the Commission under this Act:

Provided that nothing contained in this section shall apply to any employment under the Central Government or a State Government or local authority or in any statutory authority or any corporation established by or under any Central, State or Provincial Act or a Government company as declined in section 617 of the Companies Act, 1956 (1 of 1956).

Based on the above provisions of the Competition Act, 2002, Mr. MKP will not be able to accept the offer of HLL Ltd. for one year from the date of his cessation as a member of the Competition Commission since in a case of the said company, it was a party to the proceedings before the Commission.

However, since Life Insurance Corporation of India is a Corporation established under the Central Act, the above restriction does not apply and Mr. MKP can accept the offer to join as the Executive Director of the said corporation with effect from 1st April, 2007.

Question 3

Answer any two of the following:

- (a) As on 31st December, 2006, following information and figures are noticed from the Annual Accounts for the year ended 31st March, 2006 of CAS Ltd., a Company listed with the Stock Exchange, Mumbai:
- (i) Authorised Share Capital Rs. 20.22 Crores comprising of 2 Crore Equity Shares of Rs. 10 each.
 - (ii) Paid up Share Capital Rs. 9.00 Crores comprising of 80 lac Equity Shares of Rs. 10 each fully paid up and 20 lac Equity Shares of Rs. 10 each called and paid upto Rs. 5 each. The total paid up capital is paid up in cash.
 - (iii) Securities Premium Account Rs. 20.00 Crores.
 - (iv) 5 lac Full Convertible Debentures of Rs. 100 each. These debentures are due for conversion on 31st March, 2007 in full into fully paid Equity Shares of Rs. 10 each in the ratio of one Debenture : two Equity Shares.
 - (v) General Reserve Rs. 30.00 crores.
 - (vi) Fixed Assets Revaluation Reserve Rs. 10.00 crores.
 - (vii) Outstanding Liabilities in respect of Bonus to Employees & workers Rs. 25.00 lacs.
 - (viii) Outstanding Liabilities in respect of Interest payable on Public Deposits comprising of Fixed Deposits from general public Rs. 15.00 lacs.

Following other information is gathered from the books of account and other records of the said Company for the period upto 31st December, 2006:

- (a) The partly paid shares were made fully paid prior to 30th June, 2006.
- (b) Bonus to employees and workers was paid on 15th September, 2006.
- (c) Interest on Public Deposits was outstanding on 31st December, 2006.

The Directors of CAS Ltd. Wants to issue Bonus Shares on or after 1st April, 2007 in ratio of 1:1. Advise the Directors on the matter with reference to the guidelines issued by Securities and Exchange Board of India on Bonus Issue. (8 Marks)

- (b) Securities and Exchange Board of India (SEBI) has issued certain guidelines in respect of fixation of exit price through “Book Building” process for the shares to be bought back

by the listed companies, who want to voluntarily delist their shares from the stock exchanges. You are required to state the salient features of the said "Book Building" process. (8 Marks)

- (c) (i) What is the effect of proviso ? Does it qualify the main provisions of an Enactment?
 (ii) Does an explanation added to a section widen the ambit of a section ? Support your answer with an example from the Companies Act, 1956.
 (iii) What do you understand by the term 'Preamble" and how does it help in interpretation of a statute ? (8 Marks)

Answer

- (a) According to Guidelines issued by Securities & Exchange Board of India on Bonus Issue, a listed Company proposing to issue bonus shares has to comply with the following:
- (i) Pending the conversion of Fully Convertible Debentures (FCDs) / Partly Convertible Debentures (PCDs), the Company cannot issue shares by way or bonus unless similar benefit is extended to the holders of FCDs / PCDs through reservation of shares and the shares so reserved may be issued at the time of conversion of FCDs / PCDs on the same terms on which the bonus issues were made.
 - (ii) The bonus issue is made out of free reserve built out of genuine profits or securities premium collected in cash only.
 - (iii) Fixed Assets Revaluation Reserves are not capitalized for the purpose of bonus issue.
 - (iv) The bonus issue is not made in lieu of dividend.
 - (v) The bonus issue can be made only after any partly paid shares are made fully paid.
 - (vi) The Company should not have defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption.
 - (vii) The Company should have sufficient reasons to believe that it has not defaulted in respect of the payment of statutory dues like contribution to P.F., Gratuity and bonus to employees etc.
 - (viii) The Board of Directors' proposal to make bonus issue is implemented within six months from the date of approval by the Board of Directors and the same can not be revoked.
 - (ix) The bonus issue must be permitted by the Articles of Association and if the Articles of Association does not contain such a clause, then first the same should be suitably amended.
 - (x) If Authorised Capital is not sufficient to accommodate the post bonus issue paid up capital, the capital clause of the Memorandum of Association should be suitably amended.

- (xi) A compliance certificate by the Company duly countersigned by the statutory auditor or company secretary in practice is to be submitted to SEBI.

Based on the abovementioned guidelines of SEBI, the Board of Directors is advised as follows:

- (a) Check the Articles of Association whether it allows the issue of bonus shares. If not, the Articles of Association should be amended to include the relevant clause.
 - (b) The Paid up Share Capital of the Company as on 31st March, 2006 was Rs. 9.00 Crores and after the partly paid shares were made fully paid, the paid up share capital became Rs. 10.00 Crores. Moreover, after the conversion of 5 lac FCDs, the paid up capital will increase by 10 lac shares of Rs. 10/- each, that means the paid up capital shall become 11.00 Cores as on 31st March, 2007. The Directors want to make bonus issue in the ratio of 1:1. Therefore, the post bonus issue paid up capital shall become Rs. 22.00 crores. But the Authorised Share Capital is only Rs. 20.00 Crores, hence, the Directors are required to take steps to increase the authorized capital to at least Rs. 22.00 crores.
 - (c) The Company is having sufficient amount in General Reserve and Securities Premium Account and the Directors can use from Any/both of these accounts for bonus issue. But they should not utilize any amount from the Fixed Assets Revaluation reserve.
 - (d) Since the Bonus to employees and workers have been paid within the time allowed by the Payment of Bonus Act, the requirement of the SEBI Guidelines have been fulfilled.
 - (e) The default in paying the interest on fixed deposits should be rectified by paying the necessary amount as provided in the Companies (Acceptance of Deposit Rules) 1975.
 - (f) The Directors should pass necessary resolution in the meeting of Board of Directors and take further steps to issue the bonus shares within six months from the passing of such resolution.
 - (g) After the issue of bonus shares, the company should forward a compliance certificate duly counter signed by its statutory auditor or a company secretary in practice to SEBI.
- (b) Any promoter of a company which desires to delist from the stock exchange shall determine an exit price for delisting of securities in accordance with book building process. The Book Building process starts after a floor price is fixed by the management. The Book Building process for this purpose is as follows:
1. The book building process shall be made through an electronically linked transparent facility.

2. The number of bidding centres shall not be less than thirty, including all stock exchange centres and there shall be at least one electronically linked computer terminal at all bidding centres.
3. The promoter shall deposit in an escrow account, 100% of the estimated amount of consideration calculated on the basis of the floor price indicated and the number of securities required to be acquired. The provisions of clause 10 of the Securities and Exchange Board of India (Buyback of Securities) Regulations, 1998 shall be applicable mutatis mutandis to such escrow accounts.
4. The offer of buy shall remain open to the security holders to a minimum period of three days. The security holders shall have a right to revise their bids before the closing of the bidding.
5. The promoter or acquirer shall appoint 'trading members' for placing bids on the on-line electronic system.
6. Investors may approach trading members for placing offers on the on-line electronic system.
7. The security holders desirous of availing the exit opportunity shall deposit the shares offered with the trading members prior to placement of orders. Alternatively they may mark a pledge for the same to the trading member. The trading members in turn may place these securities as margin with the exchanges/clearing corporations.
8. The offers placed in the system shall have an audit trail in the form of confirmations which gives broker ID details with time stamp and unique order number.
9. The final offer price shall be determined as the price at which the maximum number of shares has been offered. The acquirer shall have the choice to accept the price. If the price is accepted then the acquirer shall be required to accept all offers up to and including the final price but may not have to accept higher priced offers. An illustration is given below:

Offer quantity (No. of shares)`	Offer price (Rs. Per share)	Remarks
5000	120	Floor price
8200	125	-----
15000	130	Final price as quantity offered is maximum
27000	135	-----
500	140	-----

10. If final price is accepted the acquirer shall have to accept offers up to and including the final price i.e. 28200 shares at the final price of Rs. 130/-.

11. At the end of the book build period the merchant banker to the book building exercise shall announce in the press and to the concerned exchanges at the final price and the acceptance (or not) of the price by the acquirer.
 12. The acquirer shall make the requisite funds available with the exchange/clearing corporation on the final settlement day (which shall be three days from the end of the book build period). The trading members shall correspondingly make the shares available. On the settlement day the funds and securities shall be paid out in a process akin to secondary market settlement.
 13. The entire exercise shall only be available for demat shares. For holders of physical certificates the acquirer shall keep the offer open for a period of 15 days from the final settlement day for the shareholders to lodge the certificate(s) specified by the merchant banker.
- (c) (i) Normally a Proviso is added to a section of an Act to except something or qualify something stated in that particular section to which it is added. A proviso should not be, ordinarily, interpreted as a general rule. A proviso to a particular section carves out an exception to the main provision to which it has been enacted as a Proviso and to no other provision. [Ram Narian Sons Ltd. Vs. Commissioner of Sales Tax AIR (1955) S.C. 765]
- (ii) Sometimes an explanation is added to a section of an Act for the purpose of explaining the main provisions contained in that section. If there is some ambiguity in the provisions of the main section, the explanation is inserted to harmonise and clear up and ambiguity in the main section. Something may added to or something may be excluded from the main provision by insertion of an explanation. But the explanation should not be construed to widen the ambit of the section.
- For example, Section 294AA of the Companies Act, 1956 gives power to the Central Government to prohibit the appointment of Sole Selling Agents of a company in certain cases. An explanation has been added to that section which states that an "appointment" includes "re-appointment". By inclusion of this explanation, the legislature has only clarified the main provisions of that section and has not widened the ambit of the powers of the Central Government.
- (iii) The "Preamble" expresses the scope, object and purpose of the Act. It may recite the ground and the cause making a statue and the evil, which is sought to be remedied by it. It is a part of the statute and can legitimately be used for construing it. However, it does not over-ride the plain provisions of the Act, but if the wording of the statute gives rise to the doubts as to its proper construction, e.g., where the words or phrase have more than one meaning and a doubt arises as to which of the two meanings is intended in the Act, then the Preamble can and ought to be referred to in order to arrive at the proper construction.

Question 4

- (a) (i) Mr. MTP was appointed as a director at the Annual General Meeting of a limited company held on 30th September, 2005 and he carried on his duties and functions

as a director. In the month of August, 2006, it was found out that there were certain irregularities in his appointment and on 31st August, 2006, his appointment was declared invalid. But Mr. MTP continued to act as director even after 31st August, 2006. You are required to state, with reference to the provisions of the Companies Act, 1956, whether the acts done by Mr. MTP are valid and binding upon the company ?

- (ii) In course of administration of the affairs of a limited company, Chairman of its Board of Directors came across a matter, which required the approval by say of a board resolution. In the prevailing circumstances, it is not possible to convene and hold a Board Meeting. The Chairman approaches you to advise him of the way and the relevant procedure to obtain such approval without holding the Board Meeting. You are required to advise him on the matter as per the provisions of the Companies Act, 1956. (8 Marks)
- (b) The management of ATP Ltd., a company listed with The Stock Exchange, Mumbai wants to appoint Mr. BDF as a Director of a Company at the Annual General Meeting of the Company to be held on 24th May, 2007. It may be noted that Mr. BDF is not a retiring Director. The Management seeks your guidance regarding the procedure to be adopted for the purpose. You are required to state the procedure to be followed for giving effect to such proposal and formalities to be observed after appointment of Mr. BDF as Director, by the management of ATP Ltd., as per the provisions of the Companies Act, 1956. (8 Marks)

Answer

- (a) (i) In accordance with the provision of the Companies Act, 1956 as contained in section 290, acts done by a person as a director shall be valid, notwithstanding that it may afterwards be discovered that his appointment was invalid by reason of any defect or disqualification or had terminated by virtue of any provision contained in this Act or in the articles:
- The Proviso to section 290 further provides that nothing in this section shall be deemed to give validity to acts done by a director after his appointment has been shown to the company to be invalid or to have terminated.
- In view of the provision of section 290 of the Companies Act, 1956, the acts done by Mr. MTP prior to 31st August, 2006 are to be treated as valid and binding on the Company.
- However in view of the Proviso to the said section 290, the acts done by Mr. MTP after 31st August, 2006 shall be deemed to be invalid and not binding upon the Company.
- (ii) As per the provisions of the Companies Act, 1956, several Board Resolutions are required in course of carrying on the affairs of a limited company. But it may sometimes so happen that a Board Meeting can not be held. To meet such eventualities, the Companies Act, 1956 contains the solution in section 289. According to this section, the board resolution can be passed by way of circulation.

It may however be noted that the matter listed in the provisions of section 292 and other sections requiring passing of resolution at the board meetings only can not be passed by way of circulation and can be passed only at the Board Meeting. The Chairman of the company is advised that the approval in the form of a Board Resolution may be obtained by way of passing the relevant resolution by circulation if the matter is not covered by the barring sections of the said Act.

The procedure to be adopted for the purpose shall be as follows:’

- (i) Send the draft of the resolution in duplicate together with the necessary papers, if any, to all the directors then in India. It is to be ensured that the number of such directors is not less than the directors required to form the quorum for a Board meeting.
 - (ii) Send the draft of the resolution in duplicate together with the necessary papers, if any, to all other directors at their usual address in India.
 - (iii) Obtain one copy of the draft resolution duly signed by the directors, whether approving the resolution or disapproving the same. It may be noted that the resolution shall be deemed to be passed by the Board if all the directors then in India or majority of all directors as are entitled to vote on the matter approve the resolution by signing one copy and returning the same to the company.
 - (iv) The resolution passed by circulation shall be placed before the next Board Meeting for confirmation.
 - (v) The resolution shall be recorded in the minutes of the next Board Meeting.
- (b) The directors of a company are appointed by the shareholders at the general meeting. Though the retiring directors are normally re-appointed, it may sometimes become necessary to appoint a person other than the retiring director as director. The shareholders also have a right to propose the appointment of a person as a director. This power may be exercised in order to increase the strength of the Board or to permit the shareholders to exercise this important right available to them.

In the case of private company which is not a subsidiary of a public company, the provisions given below are not applicable and the appointment shall be in accordance with the Articles of Association.

Procedure to be adopted:

1. A person, other than the retiring director, shall be eligible for appointment to the office of director only if he or some other member intending to propose him has, at least 14 days before the meeting, left at the office of the company a special notice in writing under his hand signifying his candidature for the office of director along with a deposit of Rs. 500 as required under section 257 of the Companies Act, 1956.
2. On receipt of the special notice, information should be sent to all the members of the company not less than 7 days before the meeting. Alternatively, an advertisement may be issued regarding the candidature or intention not less than 7

days before the meeting in at least in two newspapers circulating in the place where the registered office of the company is situated both in English and in the local language.

3. The resolution for the appointment should be move before the annual general meeting and an ordinary resolution should be passed for this purpose. If the resolution is not passed, no further action needs to be taken in this regard.
4. In case the resolution is passed, the deposit money is Rs. 500 should be refunded to the person who made the payment.
5. In the case of a listed company, copy of the minutes of the meeting and intimation regarding the appointment should be sent to each of the stock exchanges in which the securities are listed.
6. Within 30 days of the appointment, a return in Form No. 32 should be filed electronically, with the Registrar of Companies together with the prescribed filing fee.
7. The Company and the director has to complete the formalities as prescribed under Companies (Director Identification Number) Rules, 2006.
8. A genial notice of disclosure of interest in Form No. 24AA indicated the names of bodies corporate of which he is a director or member (holding more than 2% of paid-up capital) or firms in which eh is a partner should be obtained. The said disclosures should be placed before the Board and a resolution taking the notice on record should be passed. The notice shall expire at the end of the financial year but may be renewed by giving a fresh Form No. 24AA in the last month of the financial year in which it would otherwise expire.
9. Articles of Association should be check and in case it provides for acquiring of qualification shares, the same should be acquired within two months of appointment, if the new appointee does not hold the same.
10. Particulars regarding directors should be entered in the Register of Directors and the Register of Directors' Shareholdings.

Question 5

- (a) A majority of the Board of Directors of M/s Bulk Drugs Ltd. have reasons to believe that some of the business activities carried on in the name of the company and prima facie against the interest of the company and its members. They want the matter to be referred to Central Government in the form of an application for appointment of an Inspector to reach to the bottom of the matter and unveil and truth. In this connection you are required to:
- (i) State the steps required to be taken with reference to the provisions of the Companies Act, 1956.
 - (ii) Draft an application to be made to the Central Government. (8 Marks)

- (b) (i) Mr. SDR, a shareholder in M/s JKP Ltd. Holding ten equity shares of Rs. 10 each fully paid up wants to give a special notice to the company for removal of a Mr. EDM, a director of M/s JKP Ltd. without stating any reasons in the notice. You are required to state as per the provisions of the Companies Act, 1956 and / or any decided case law whether Mr. SDR is entitled to do so ?
- (ii) Would your answer be different, if Mr. EDM was a director appointed by the Central Government under Section 408 of the Companies Act, 1956 ?
- (iii) State the relevant provisions of the Companies Act, 1956 in case of an appropriate special notice is received by the company for removal of any director. (7 Marks)

Answer

- (a) The case stated in the question relates to the provisions of Section 237 of the Companies Act, 1956 dealing with appointment of Inspectors to investigate the affairs of a company and to report thereon.

Clause (a) of the section 237 provides that Central Government shall appoint one or more person as Inspectors to investigate the affairs of a company if the company by way of a special resolution or the court by an order declares that the affairs of the company should be investigated.

Clause (b) of the said section further states that the Central Government may appoint an Inspector if in the opinion of the Company Law Board (Now Tribunal), there are circumstances suggesting that:

- (i) the business of the company is being conducted with intent to defraud the creditors, members or any other person.
- (ii) the person concerned in the formation of the company or the management of its affairs have been guilty of fraud, misfeasance or misconduct towards the company or its members.
- (iii) the members have not been given all the information with respect to its affairs.

In view of the above stated legal provisions, M/s Bulk Drugs Ltd. have following options to get the company's affairs investigated by an inspector appointed by Central Government under the said Section 237:

- (i) To get a special resolution passed in a general meeting and apply to the Central Government.
- (ii) To approach the court with a petition requesting it to direct the Central Government for the desired purpose.
- (iii) To approach the Company Law Board (now Tribunal) with a petition requesting it to express its opinion on the affairs of the company and then bringing to the notice of the Central Government.

It may, however, be noted that while in first two options, the Central Government is bound to act as per provisions of the said section 237 but it has discretionary powers in the case of the third option.

DRAFT APPLICATION

BULK DRUGS LTD.

(Address)

Dated _____

To,

The Secretary,
Department of Company Affairs,
(Address)
New Delhi

Sir,

At an Extra-ordinary General Meeting of the shareholders of the company held on _____ date _____ at the registered office of the company, the members have unanimously passed the following Special Resolution:

"RESOLVED that the Central Government be approached to appoint an Inspector pursuant to the provisions of section 237 of the Companies Act, 1956 to carry out an investigation whether the following activities carried out in the name of the company are or are not in the interest of the company or its members:

1. Granting of interest-free loans to certain parties.
2. Purchase of Raw Materials without complying with the procedure laid down by the Drug Controller."

"Resolved further that Mr. _____, the Secretary of the Company be and is hereby authorized to do needful in the matter."

It is, therefore, prayed that the Central Government be please to appoint, pursuant to section 237 of the Companies Act, 1956, an inspector to investigate the affairs of the Company regarding the matters mentioned in the Special Resolution quoted above and communicate its decision to the company.

The Challan evidencing the payment of prescribed fee as per Companies (Fees on Application) Rules, 1999 and other papers & documents as required by rules are enclosed.

Yours faithfully,

For BULK DRUGS LTD.
Secretary

- (b) (i) The problems as stated in the question is governed by the provisions of section 284 of the Companies Act, 1956. Sub-Section (2) of the said section stated that a special notice is required of any resolution to remove a director. The section states that a special notice is required of any resolution to remove a director. The section does not put any condition in respect of the number of members or their shareholding and furnishing any reason therefore. Accordingly the Karnataka High Court in the case of Karnataka Bank Ltd. Vs. A.B. Datar & Other reported at [1994] 79 Comp. Cases 417 held that there is no requirement with regard to the number of members of their shareholding and even one member is entitled to give special notice for removal of director, The Court also held that there is no need to give any reason for removal of a director in the resolution proposed to be moved. Hence Mr. SDR holding only ten equity shares can alone give a special notice for removal of Mr. EDM from the office of director of M/s. JK Ltd.
- (ii) According to section 284 (1) of the Companies Act, 1956, the provisions relating to removal of directors are not applicable to the directors appointed by the Central Government under section 408 of the said Act. Hence, in case Mr. EDM was a director appointed by the Central Government under the said section 408, Mr. SDR would not be entitled to give any special notice under section 284 for removal of director.
- (iii) On receipt of notice of a resolution to remove a director, the relevant provisions of the Companies Act, 1956 in this regard are as follows:
- (a) The Company has to forward a copy of the notice to the concerned director, [Sec 284(3)].
 - (b) The concerned director, whether he is a member of the company or not, shall be entitled to be heard on the resolution at the meeting. [Sec 284(3)].
 - (c) In case the concerned director makes any representation in writing of reasonable length and requests the company to notify the same to the members of the company, the fact of receiving the representation should be stated in the notice of the meeting and a copy should be circulated to all the members of the company. [Sec. 284 (4)]
 - (d) In case the representation received by the company is too late for inclusion in the notice or if there is an omission of the part of the company, the same should be read out at the meeting. [Sec 284 (4)]
 - (e) The company or the person who claims to be aggrieved may make an application to the Central Government seeking exemption from circulation or reading out the representation if the rights are sought to be abused to secure needless publicity for defamatory matter and the Central Government may pass an order granting such exemption. [Proviso to Sec 284 (4)].
 - (f) The Central Government may also order the company's costs on the application to be paid in whole or in part by the director concerned notwithstanding that he is not a party to it. [Proviso to Sec 284 (4)].

- (g) The Board of Directors is not entitled to appoint a person as a Director if he has been removed from his office under the provision of section 284 of the Companies Act, 1956. [proviso to Sec 284 (6)]

Question 6

- (a) (i) Define the expression "Accounting Standards" within the meaning of Companies Act, 1956.
- (ii) XYZ Limited did not prepare its Balance Sheet as at 31st March, 2007 and the Profit and Loss Account for the year ended on that date in conformity with some of the mandatory Accounting Standards issued by the Institute of Chartered Accountants of India. You are required to state with reference to the provisions of the Companies Act, 1956, the responsibilities of directors and statutory auditor of the company in this regard. (8 Marks)
- (b) (i) A two year old Producer Company registered under Section 581C of the Companies Act, 1956 wants to donate some amount. The Chief Executive of the producer Company has approached you to advise him as to how and for what purposes the donation can be made by such company. Also state the monetary restrictions, if any, laid down in the Companies Act, 1956 on making donations by a Producer Company. You are informed that as per the profit and loss account of the Producer Company for its last account year the profit was Rs. 20.00 lacs.
- (ii) State the powers and functions of the Board of Directors of a Producer Company as enumerated in the Companies Act, 1956. (7 marks)

Answer

- (a) (i) As per sub-section (3c) of Section 211 of the Companies Act, 1956, the expression "accounting standards" means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949 as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under sub-section (1) of section 210 of the said Act.
- Proviso to the above sub-section further states that the standards of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the accounting standards until the accounting standards are prescribed by the Central Government under this sub-section.
- (ii) Sub-Section (3A) of the said section states that every profit and loss account and balance sheet of the company shall comply with the accounting standards.
- (a) the deviation from the accounting standards;
- (b) the reasons for such deviation; and
- (c) the financial effect, if any, arising due to such deviation.

Accordingly to sections 211 (7) and (8) read with section 209 (6) of the Companies Act, 1956 following persons are responsible for complying with the above requirements:

- (a) the managing director or manager of the company, if any,
- (b) all officers and employees of the company, and
- (c) if the company does not have a managing director or manager, then every director of the company.

In view of the above provisions of the Companies Act, 1956, the managing director/directors have a responsibility to ensure that in case of non-compliance of any mandatory Accounting Standard, proper disclosure is made in the profit & loss account and the balance sheet.

Moreover, the board of directors is also required under section 217 of the companies Act, 1956 to include a Directors Responsibility Statement indicating therein that in the preparation of the annual accounts the applicable accounting standards have been followed along with proper explanation relating to material departures.

Responsibilities of auditors:

As per section 227(3) (d) of the Companies Act, 1956, the statutory auditor's responsibility is to state in his report, whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section 211 of the Companies Act, 1956.

- (i) As per provisions of section 581-ZH of the Companies, Act, 1956, a Producer Company may, by special resolution, make donation or subscription to any institution or individual for the following purposes-
 - (a) For promoting the social and economic welfare of Producer Members of producers of general public; or
 - (b) For promoting the mutual assistance principles

Thus as per the above stated provisions of the Companies Act, 1956, a Producer Company may make a donation by passing a special resolution and for the above mentioned purposed.

The 1st proviso to the said section 581-ZH lays down the monetary limit for making the donation by Producer Company. According to the said proviso the aggregate amount of all such donation and subscription in any financial year shall not exceed three per cent of the net profit of the Producer Company in the financial year immediately proceeding the financial year in which the donation or subscription was made.

Since the net profit of the Producer Company as per its last profit & loss account was Rs. 20.00 lacs, it can make a total donation of Rs. 60,000/- in this year being three percent thereof.

- (ii) Sub-section (3) of section 581-R of the Companies Act, 1956 states that all the powers specified in sub-section (1) and (2) shall be exercised by the Board, by means of resolution passed at its meeting on behalf of the Producer Company.

Sub-section (1) of the said section states that subject to the provisions of this Act and articles, the Board of directors of a Producer Company shall exercise all such powers and to do all such acts and things, as that company is authorized so to do.

Sub-section (2) of the said section states that such powers of the Board of Directors of a Producer Company May include all or any of the following matters, Namely:-

- (a) determination of the dividends payable;
- (b) determination of the quantum of withheld price and recommend patronage to be approved at general meeting;
- (c) admission of new Members;
- (d) pursue and formulate the organizational policy, objectives, establish specific long-term and annual objectives, and approve corporate strategies and financial plans;
- (e) appointment of a Chief Executive and such other officers of the Producer Company, as may be specified in the articles;
- (f) exercise superintendence, direction and control over Chief Executive and other officers appointed by it;
- (g) cause proper books of account to be maintained; prepare annual accounts to be placed before the annual general meeting with the auditor's report and the replies on qualifications, if any, made by the auditors.
- (h) acquisition or disposal of property of the Producer Company in its ordinary course of business;
- (i) investment of the funds of the Producer Company in its ordinary course of its business;
- (j) sanction any loan or advance, in connection with the business activities of the Producer Company to any Member, not being a director or his relative;
- (k) take such other measures or do such other acts as may be required in the discharge of its functions or exercise of its powers

Question 7

- (a) 60% shares of Indo-French Ltd. are held by French Group and balance by an Indian Group. As per articles of association of the company both groups had equal managerial powers. The relationship between the two groups soured and the operations of the

company reached a deadlock. The Indian Group approached the Company Law Tribunal (Company Law Board till Company Law Tribunal becomes functional, referred to as CLB hereinafter) for action against the French Group for oppression. Based on these facts, you are required to decide, with reference to the provisions of the Companies Act, 1956 and/or the decided case laws, the following issues:

- (i) Whether the contention of oppression against the French Group by the Indian Group is tenable ?
- (ii) What are the powers of the CLB in this regard ? (8 Marks)
- (b) State the provisions of the Companies Act, 1956 in respect of appointment of Auditor in the following cases:
 - (i) A Government Company within the meaning of Section 617 of the Companies Act, 1956.
 - (ii) A public limited company at whose annual general meeting hold on 30th November, 2006 in respect its accounting year ended on 30th June, 2006, the auditor was appointed to hold office as such till the conclusion of its next annual general meeting, but whose auditor has resigned on 15th March, 2007.
 - (iii) A company whose shareholders include the following:
 - (a) Bank of Baroda (a nationalized bank) holding 12% of the Subscribed capital in the Company.
 - (b) National Insurance Co. Ltd. (carrying on general insurance business) holding 10% of the Subscribed capital in the Company.
 - (c) Maharashtra State Financial Corporation (a public financial institution) holding 8% of the Subscribed capital in the Company. (7 Marks)

Answer

- (a) (i) Section 397 of the Companies Act, 1956 deals with the remedy in a situation when the affairs of the company are being conducted in a manner oppressive to a shareholder or shareholders. This means that some of the shareholders must be in such a position that they can be oppressed by other shareholders or the management. In the present case as given in the question, both the Indian Group and the French Group are equally strong and none is able to oppress the other. The situation stated in the question is a deadlock but it can not be termed as oppression. Since it is not a case of winding up of the company, the relief under the said section 397 is not available to the Indian Group. [Gnanasambandam v. Tamilnad Transporters (Coimbatore) p. Ltd. (1971) 41 Comp. Cas. 26] In view of the position discussed, the contention of the Indian Group is not tenable.
- (ii) The powers of the Company Law Tribunal (Company Law Board till National Company Law Tribunal becomes functional) referred to as CLB hereinafter) under the provisions of section 397 of the Companies Act 1956, are discretionary in character. Apart from the general powers envisaged therein, the CLB under section

402 (b) of the said Act, may order the purchase of the shares of one group by the other group. In the case of *Yashovardhan Saboo Vs. Groz Beckert Saboo Ltd.* 1933 1 Comp. L.J. 20, the presiding officer ordered the foreign group to buy out the shares of the minority group at the fair price with deadlock and the matters are not sorted out by any other means, an order for winding up of the company may also be made under the just and equitable clause, [*Kishan Kumar Ahuja Vs. Suresh Kumar Ahuja*]. Thus, if the Indian Group of the French Group fail to buy out the shares of the other group, the CLB may order the winding up of the company.

- (b) (i) The appointment and re-appointment of auditor in the case of a Government Company is governed by the provisions of section 619 of the Companies Act, 1956. The said section states that the auditor of a Government on the advice of Comptroller and Auditor General of India. The provision for appointment of auditor by Central Government of the advice of Comptroller and Auditor General of India has been amended by the Companies (Amendment) Act, 2000 with effect from 13.12.2000.
- (ii) The situation as stated in the question is covered by the provisions of section 224 (6) of the Companies Act, 1956. Clause (A) of the said section states that the Board of Directors may fill nay casual vacancy in the office of an auditor, but proviso thereto states that were such vacancy is caused by the resignation of an auditor, the vacancy shall only be filled by the company in general meeting. Hence, in the case of registration by the auditor, the company is required to convene and hold a general meeting and appoint the auditor thereat.
- (iii) The case of appointment of auditor of a company who's 25% or more of the Subscribed capital is held by Government, financial institution, nationalized banks. General insurance companies are governed by the provisions of section 224A of the Companies Act, 1956. According to the provision of the said section in the case of a company in which not less than twenty-five per cent of the subscribed share capital is held, whether singly or in any combination, by-
 - (a) a public financial institution or a Government Company or Central Government or any state Government, or
 - (b) any financial or other institution established by any Provincial or State Act which a State Government holds not less than fifty-one per cent of the subscribed share capital, or
 - (c) a nationalized bank or an insurance company carrying on general insurance business,

the appointment or re-appointment at each annual general meeting of an auditor or auditors or auditors shall be made by a special resolution.

In view of the above provisions of the companies Act, 1956, since the combined holding of the nationalized bank, general insurance company and the financial institution covered by the said provisions is 30% which exceeds the limit of 25% of

the subscribed capital of the company, the company has to appoint its auditors in the Annual general Meeting by passing a special resolution.

Question 8

- (a) MNC Ltd., a company, whose paid up capital was Rs. 4.00 Crores, has issued rights shares in the ratio of 1:1. The said company is listed with Mumbai Stock Exchange. Whether the company is required to appoint any Audit Committee and if yes, draft a suitable Board Resolution to appoint an Audit committee covering the aspects as provided in the Companies Act, 1956 and the listing Agreement with the Stock Exchange. In case the company is not required to appoint any Audit Committee, state the provisions of the Companies Act, 1956 in respect of appointment of Audit Committee by a Company. (8 Marks)
- (b) An allegation was leveled against PQR Ltd. that the funds of the company are misused. Mr. Z, one of the Directors of the company wants to inspect the books of account of the company in order to ascertain whether the allegation was true. But since Mr. Z does not have the knowledge of accounting, he appoints Mr. A, his friend and a practicing Chartered Accountant to go through the books of account of the company on his behalf. The company seeks your advice as to whether Mr. A may be allowed to inspect the books of account of the company on behalf of Mr. Z. You are required to give your advice to the company on behalf of Mr. Z. You are required to give your advice to the company keeping in view the provisions of the Companies Act, 1956.
- What would be your advice if Mr. Z would have been a shareholder only and not a Director of the company ? (7 Marks)

Answer

- (a) As per provision of section 292A of the Companies Act, 1956, a public company having a paid up capital of Rs. 5.00 Crores or more is required to have an Audit Committee. Since, after the rights issue by MNC Ltd. its paid up capital has increased to Rs. 8.00 Crores, it is required to appoint an Audit Committee.

The relevant Board Resolution for appointment of an Audit Committee is as follows:

Resolved that pursuant to the provision contained in section 292A of the companies Act 1956 and clause 49 of Listing Agreement with the Mumbai Stock Exchange, an Audit Committee of the Company be and is hereby constituted as under:

1. Mr. A -- An Independent Director.
2. Mr. B -- An Independent Director
3. Mr. C -- Director nominated by IDBI
4. Mr. D -- An Independent Director
5. Mr. FD -- Financial Executive
6. Mr. MD -- Managing Director

Further resolved that the Chairman of the Committee, who shall be an independent Director, be elected by the members from amongst themselves.

Further resolved that the quorum for a meeting of the Audit Committee shall be 1/3rd of the total number of members or two directors (other than the Managing Director), whichever is higher.

Further resolved that the Audit Committee shall comply with the following:

- (1) The Audit Committee shall have meetings periodically as it may deem fit with at least three meeting in a year, viz., one meeting before finalization of annual accounts and one every six months.
- (2) The Audit Committee shall invite such of the executives (and particularly the head of the finance function) to be present at the meeting of the Committee whenever required by it.
- (3) The finance Director, head of internal audit and the auditors of the company shall attend and participate at the meeting without right to vote.

Further resolved that the audit Committee shall have the authority to investigate into nay matter that may be prescribed under the said section 292A of the Companies Act, 1956 and the matters as mentioned in the Listing Agreements entered into between the Company and the Mumbai Stock Exchange and all the matters as may be referred to it by the Board from time to time and for this purpose the Audit Committee shall have full access to information contained in the records of the Company and external professional advice, if necessary.

Further resolved that the Audit committee shall conduct discussions with the auditors periodically about internal control system, the scope of audit including the observations of the auditors.

Further resolved that the Audit Committee shall review the quarterly and annual financial statements and submit the same to the Board with its recommendations, if any.

Further resolved that the recommendations made by the Audit Committee on any matter relating to financial management including the audit report shall be binding on the Board. However, where such recommendations are not accepted by the Board, the reasons for the same shall be recorded in the minutes of the Board meeting or communicated to the shareholders.

Further resolved that the Audit Committee have the minutes of its meetings drawn and approved by the Chairman of the Committee and the same be circulated to the members of the Board within thirty days from the date of such meeting.

Further resolved that the Company Secretary of the Company shall be the Secretary to the Audit Committee.

Further resolved that the Chairman of the Audit Committee shall attend the annual general meeting of the Company to provide any clarifications on matters relating to audit as may be required by the members of the company.

Further resolved that the Board's Report/Annual Report to the members of the Company shall include the particulars of the constitution of the Audit Committee.

- (b) Section 209 (4) of the Companies Act 1956 provides that the books of account and other books and papers shall be open to inspection by any director during the business hours.

The right of inspection given by this sub-section is not so restricted that it can only be exercised personally by the director in *Vakharia Vs Supreme General Film Exchange CO. Ltd* it was held that a director is entitled to take inspection of accounts personally or through an agent provided that there is no reasonable objection to the person chosen and the agent undertakes not to utilize the information obtained by him for any purpose other than the purpose of his principal.

As the right of inspection is a statutory right given under this sub-section, a director who is prevented from or refused inspection may enforce his right through court.

As such, Mr. Z being the director, can appoint Mr., A to inspect the Books of accounts of the company.

In case Mr. Z is the member of the company

As per the provisions of the Act the board shall from time to time determine whether and to what extent and at what times and places and under what conditions or regulation, the accounts and books of the company, or any of them, shall be open to inspection of members not being directors. No member (Not being a director) shall have any right to inspection any account or books or document of the company except as conferred by law or authorized by the board or by the company in general meeting.

In case Mr. Z is a member of the company, he shall be able to inspect the books of account only if he is given such a right by ordinary resolution of the members or if authorized by the board. But even in such case Mr. Z would have to exercise the right personally and not through a proxy i.e. he can himself inspect the books but cannot ask Mr. A to inspect the books in his behalf.

Question 9

- (a) Following information is available from the audited Balance Sheet as at 31st March, 2007 of ASK Ltd.:

Capital & Liabilities	Rs.	Assets	Rs.
Share Capital:		Fixed Assets:	
Equity Share Capital		Goodwill	10,00,000
(5,00,000 shares of Rs. 10 each fully paid up in cash)		Land & Buildings	75,00,000
		Plant & Machinery	1,50,00,000
	50,00,000	Furniture & Other	
Less: Calls in arrear	50,000	Assets	2,50,000
	49,50,000	Investments:	

Less: Calls in arrear	15,00,000	Equity Shares in wholly owned Subsidiary Company -	
Share Application Money	10,00,000		
Reserves & Surplus:			
Securities Premium	15,00,000	KMC Ltd.	12,50,000
Capital Redemption Reserve	12,00,000	Equity Shares representing 90% of MTC Ltd.	
Fixed Assets Revaluation Reserve	10,50,000	Share Capital of MTC Ltd.	4,50,000
General Reserve	40,00,000	Debentures in SKT Ltd.	
Profit and loss Account	22,00,000	SKT Ltd.	12,00,000
Dividend Equalisation Reserve	6,00,000	Preference Shares in HUT Ltd.	5,00,000
Secured Loans:			
Cash credit facility from Bank	1,00,00,000	Capital account balance in Partnership Firm - BKP & Co.	8,00,000
		Current Assets:	
Fixed Deposits (From general public maturing after 31.02.2007)	20,00,000	Stock and Book Debts	14,00,000
Current Liabilities & Provisions:		Cash & Bank Balances	1,00,000
Current Liabilities	12,50,000	Loans & Advances:	
Provision for Taxation	10,00,000	Inter-corporate Deposits	25,00,000
		Business Advances	14,00,000
	<u>3,33,50,000</u>		<u>3,33,50,000</u>

The directors of the company want to make further investments stated below by taking a decision in the meeting of Board of Directors without seeking approval of the shareholders :

	Rs.
(a) Loan to KMC Ltd.	25,00,000
(b) Loan to MTC Ltd.	15,00,000
(c) Purchase of further debentures in SKT Ltd.	8,00,000
(d) Purchase of shares from the open market in Glaxo Ltd.	15,00,000

You are required to state, with reference to the relevant provisions of the Companies Act, 1956, whether the directors can do so and mention the relevant calculations. (10 Marks)

- (b) X Ltd. and Y Ltd. are two listed companies engaged in the business of telecommunication. The companies are not making profits and as such their share's market prices have gone down. A substantial portion of their share capital is held by Central Government as well as some Public Financial Corporations. In order to increase the share value, the Central Government wants to amalgamate the aforesaid two companies into a single company.

Examine the powers of Central Government to amalgamate the two companies in public interest as per the provisions of the Companies Act, 1956. (5 Marks)

Answer

- (a) According to the provisions of section 372A of the Companies Act, 1956, a public company and private company, which is a subsidiary of the public company shall not, directly or indirectly:

- (a) make any loan to any other body corporate.
- (b) give any guarantee, or provide security, in connection with a loan made by any person to, or to any other person, by any body corporate; and
- (c) acquire, by way of subscription, purchase or otherwise the securities of any other body corporate.

exceeding 60% of its Paid up Share Capital and free reserves or 100% of its free reserves, whichever is more without prior authorization by way of a special resolution passed in a general meeting.

In order to arrive at the conclusion whether the directors of ASK Ltd. can make the proposed investments without seeking approval from the shareholders, the amount upto which they can invest has to be arrived at. In the given case, the Paid up Share Capital and free reserves are as follows:

Paid up Share Capital

Equity Share Capital (500,000 shares of Rs. 10/- each fully paid up in cash)	Rs. 5,000,000/-
Less: Calls in arrear	Rs. 50,000/-
	Rs. 4,950,000/-
Preference Share Capital	Rs. 1,500,000/-
Total of Paid up Share Capital	Rs. 6,450,000/-
Free Reserves:	Rs. 1,500,000/-
	Rs. 4,000,000/-
	Rs. 2,200,000/-
	Rs. 600,000/-
Total Free Reserves	Rs. 8,300,000/-
Total of paid up share capital and Free Reserves:	Rs. 14,750,000/-

As per explanation to the said section, "Free Reserves" means those reserves which, as per the latest, audited balance sheet of the company, are free for distribution as dividend and shall include balance to the credit of the securities premium account but shall not include share application money.

Accordingly, for the purpose of calculating the amount of Free Reserves, the amounts lying in the accounts of Share Application Money and reserves not available for distribution as dividend being Capital Redemption Reserves, Fixed Assets Revaluation Reserve and Sinking Fund Reserve are excluded.

Ceiling limit for investments:

60% of Paid up Share Capital and free reserves (i.e., 60% of Rs. 14,750,000/-)	Rs. 88,50,000
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100% of Free Reserves (i.e., 100% of Rs. 83,00,000/-)	Rs. 83,00,000
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Since 60% of Paid up Share Capital and free reserves is Rs. 88,50,000/- which is higher than 100% of Free Reserves, the directors of ASK Ltd. can advance loans and make investments in other bodies corporate upto a total limit of Rs. 88,50,000/- without obtaining prior approval from the shareholders.

For arriving at a decision for further investments, the extent of present investment is to be determined and the directors can make further loans and investments upto the residual amount.

The present investments and loans of ASK Ltd. calculated as per the provisions of section 372A of the Companies Act, 1956 are as follows:

Equity Shares in wholly owned 'Subsidiary Company – KMC Ltd.

(not to be counted since as per provisos of Section 372(8)(e), investments in wholly owned subsidiary company is outside the purview of this section)

Equity Shares representing 90% of share capital of MTC Ltd.	Rs. 4,50,000/-
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Debentures in SKT Ltd.	Rs. 12,00,000/-
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Preference shares in HUT Ltd.	Rs. 5,00,000/-
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Inter-corporate Deposits	Rs. 25,00,000/-
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Total investments of ASK Ltd. within the meaning of Section 372A	Rs. 46,50,000/-
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Limit upto which directors can make investments as calculated above	Rs. 88,50,000/-
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Less existing investments	Rs. 46,50,000/-
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further investments which directors can make without shareholders' special resolution	Rs. 42,00,000/-
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Proposed additional investments within the meaning of section 372 is to be calculated as follows:

(a) Loan to KMC Ltd.	--
(Not to be counted since as per provisions of section 372 (8)(c) Loan to Wholly owned subsidiary company is outside the purview of this section)	
(b) Loan to MTC Ltd.	Rs 15,00,000/-
(c) Purchase of further debentures in SKT Ltd.	Rs 8,00,000/-
(d) Purchase of share from the open market in Glaxo Ltd.	<u>Rs 15,00,000/-</u>
	<u>38,00,000/-</u>

Since the proposed additional investment is within the amount permissible as calculated above, the directors, by passing a unanimous resolution in a Board Meeting, can make the proposed additional investment. Since the total investments do not exceed the limit as calculated above, the directors are not required to obtain the approval of shareholder. In absence of any term loan from any public financial institution, the question of their permission does not arise. Moreover, the fixed deposits from public are not yet due for repayment and hence there is no default on this account. In the light of above, it can be concluded that the directors can make the proposed investments.

- (b) According to section 396 (1) of the Companies Act 1956 where the Central Government is satisfied that it is essential in public interest that two public limited companies should amalgamate the said Government may, by order notified in the Official Gazette, provide for the amalgamation of the said two companies into a single company with such constitution, with such property, powers, rights, interests, authorities and privileges and with such liabilities, duties and obligations as may be specified in the order. This power of Central Government is notwithstanding anything contained in section 394 and 395 of the Act that deal with amalgamation and reconstruction of companies. The Central Government has also the power to pass and provide for any consequential, incidental and supplementary provisions in connection with the amalgamation including the continuation by or against the transferee company of any legal proceedings pending by or against the transferor company. Any member or creditor who is aggrieved by the order of the amalgamation resulting in any financial loss is entitled to compensation, which will be assessed by such authority as, may be prescribed. Any person aggrieved by the order of compensation can file an appeal to the Company Law Board (now tribunal) within 30 days of the publication of the order of compensation. Any order passed by the central government under this section can be made only where the draft copy thereof is sent to both the companies who have right to make an appeal and the same has been either disposed of or no appeal has been filed within the time provided thereof. The Central Government has duty to make such modifications in the light of any suggestions and objections received. All copies of the orders made under this section shall be laid before both the houses of parliament as soon as the same has been made.

SUMMARY OF EXAMINERS' COMMENTS ON THE PERFORMANCE OF CANDIDATES

PAPER – 1 : ADVANCED ACCOUNTING

General Comments

The performance of the candidates has not been satisfactory. The answers of the candidates showed lack of knowledge and understanding of the subject, particularly the accounting standards and guidance notes. The candidates are advised to brush up their skills regarding practical problems based on application of accounting standards. A thorough practice and lots of reading of the subject is required to maintain the level of knowledge expected from the students of Final Level.

Specific Comments

Question 1. The performance of the candidates was not up to the mark. Most of the candidates erred in analysis of profits of the subsidiary companies between pre and post acquisition which resulted in wrong calculation of cost of control, minority shareholders' interest, consolidated profit and loss account and consequently, the consolidated balance sheet. Some of them were confused about the treatment for payment of dividend.

Question 2. Majority of the candidates computed the EPS, PE ratios and the number of preference shares to be issued to the equity shareholders for loss of dividend but could not arrive at the correct value of equity shares of B Ltd. Some of them could not compute purchase consideration and goodwill correctly. Few candidates failed to give the required journal entries relating to issue of debentures, liquidation expenses and statutory reserve.

Question 3. The candidates have performed badly in this question. The candidates erred in the calculating average capital employed and future maintainable profit and consequently, could not compute goodwill and intrinsic value of shares.

Question 4.(a) Most of the candidates answered this question on the basis of assumptions without applying Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options.

(b) The performance of the candidates was very poor and only a few candidates could correctly work out the amount of equity capital raised.

Question 5. By and large the performance of the candidates was satisfactory. However, some candidates could not apply the relevant provisions of the accounting standards in the required manner. Even if the conclusions were correct in most of the cases, reasoning was not accurate.

Question 6. In general, answers of the candidates to this theory question were not brief, concise and to the point. Most of the candidates could not write about interest rate swaps. Few candidates discussed the environmental issues rather than issues involved in environmental accounting. In part (d) of the question, they could not discuss impairment of assets without reference to its application to inventory. Some of the candidates did not appreciate part (f) of the question and wrote about the treatment of investments in preparing the consolidated balance sheet.

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

General Comments

- (i) The conceptual clarity of candidates is not adequate.
- (ii) Candidates presentation in general was poor.
- (iii) The candidates did not seem to follow the requirements of the question paper.
- (iii) Many candidates failed to give working notes.
- (iv) Candidates did not commence the answers to the questions on a fresh page.
- (v) Some of the candidates did not mention the question Nos. Moreover, questions having different parts were answered at different places.

Specific Comments

Question 1.(a) Most of the candidates could not measure the sensitivity of the project properly in relation to various parameters given in the question.

(b) Most of candidates answered this question by writing general concepts of Financial Management rather than focusing on role of Financial Advisor in Public Sector Undertakings (PSUs).

Question 2.(a) Candidates failed to calculate various strategies for Foreign Exchange Risk Management.

(b) Most of the candidates calculated Beta properly but they failed to calculate Security Market Line (SML) and Alphas of the two stocks.

(c) Most of the candidates answered this question properly.

Question 3.(a) Performance of students was not found to be satisfactory in all parts of this question. Some of them gave partially correct answer and very few could give completely correct solution.

(b) Many candidates used borrowing rate instead of depositing rate and vice-a-versa. Some of the candidates solved some parts of this question properly, however, they could not conclude properly.

(c) Some of the candidates solved first part of the question properly. They could not however solve the second and third part of the question.

Question 4.(a) In this part, candidates could not prepare the projected balance sheet, projected cash flows and the present value of projected cash flows.

(b) This part was discussed properly.

(c) This part was also properly attempted by the candidates.

Question 5.(a) Most of the candidates solved this question based on lease finance properly. But following are the common mistakes committed by them:

Many candidates deducted salvage value while calculating depreciation, while the question

says that the machine will be fully depreciated.

Many candidates solved the question on the basis of equated annual installments while question clearly says that the principal amount of loan will be paid in 5 equal instalments to be paid annually.

Many candidates did not consider the capital gain on sale of the machine.

(b) Performance of candidates on this question was average.

Question 6.(a) Most of the candidates applied proper formulas for solving this question but they committed silly mistakes while doing the calculations.

(b) Most of the candidates attempted this question but hardly some could give proper answer for this question. They wrongly explained the Concept, Leveraged Buyouts (LBOs').

(c) This question was based on duration of bonds, hardly a few candidates could solve this question.

PAPER – 3 : ADVANCED AUDITING

General Comment

The overall performance of the candidates was not upto the mark expected at CA Final level. The answers of the candidates showed lack of knowledge of the subject. It was also observed that candidates have written unnecessary and irrelevant texts to enlarge the length of answers. Candidates should understand that every question has clear cut answers and there is no scope for imagination and needless extra flow of words.

Specific Comments

Question 1. (a) This part of the question was answered reasonably well by majority of the candidates. However, quite a good number of candidates failed to highlight the remaining requirements i.e. with reference to paid up capital & reserve exceeding Rs. fifty lakhs and turnover exceeding Rs. Five crores.

(b) This part of the question was answered reasonably well by majority of the candidates. However, most of the candidates failed to refer to the provisions of section 227 (1A) (e) of the Companies Act, 1956 and consequent inquiry by the auditor about the charging of said expenses to the revenue.

(c) This part of the question was answered satisfactorily by almost all the candidates.

(d) Candidates in general were unaware that the terms of issue of debentures were to be looked into to find out for what purpose the funds were raised and whether the end use was actually for different purpose.

Question 2. (a) Most of the candidates answered correctly.

(b) Fairly well done, though some have not understood that permission can be granted by the Council in this case.

(c) Most of the candidates answered this part of the question correctly. Few candidates had

wrongly stated that there is no professional misconduct in giving power of attorney to an employee chartered accountant to sign reports and financial statements.

(d) Most of the students were unaware about the fact that statutory auditors of PSUs/Govt. Companies/Listed Companies and Public Companies having a turnover of Rs. 50 crores or more in a year cannot accept any other work where that fee exceeds the statutory audit fees of the same organization/undertaking.

Question 3. (a) Candidates generally attempted this question on correct lines.

(b) This part of the question was answered quite satisfactorily by majority of the candidates.

Question 4. (a) Very few candidates attempted this question and those who did attempt, did not know the answer fully.

(b) Very few candidates attempted this question and those who did attempt, did not know what items were covered under Acceptances, Endorsements and other obligations. Therefore candidates could not say what procedure needed to be followed.

Question 5. (a) Most of the Candidates attempted this question on correct lines.

(b) Candidates attempted this question quite satisfactorily.

Question 6. (a) Many candidates have not understood the difference between assignment for compilation work and audit work and hence have lost marks for the entire question. Even those who did understand have not covered all the major points.

Question 7. (a) This part of the question was answered satisfactorily by majority of the candidates.

(b) Candidates did not know how to answer this question as their conception was not clear about what a Management Audit was all about and naturally therefore they did not know how to organise such an audit.

Question 8. (a) Fairly well attempted by majority of the candidates.

(b) Very few have answered this question correctly.

(c) Though many have described the methods of accounting, the comments on the details of change and the effect on the profit and loss account, have not been given clearly.

(d) Very few have answered correctly

(e) Fairly well attempted.

(f) Fairly well attempted.

PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE

General Comments

The performance in general was 'average'. The level of knowledge as expected at the final level was lacking. Instead of writing generalized answers, candidates need to improve their presentation of answers in accordance with the relevant provisions of law.

Specific Comments

Question 1. The overall performance to the all the sub-parts of the question was moderate. In respect of sub-part (c) of the question relating to powers of SEBI to amend rules of the stock exchange, candidates did not affirmatively wrote that SEBI has the power under section 29A of the SCRA, 1956 to amend the rules of its own if concerned stock exchange does not do so.

Question 2. Questions relating to the FEMA, 1999 and the Competition Act, 2002 was not answered well by many of the candidates. Candidates were not adequately prepared and did not have the grasp of the relevant provisions.

Question 3. Candidates did not pay much attention to the SEBI (DIP) Guidelines, 2000 and as a result the performance was not upto the mark.

Question 4. Candidates were not able to segregate the legal liability of directors before and after their appointment were declared invalid. The provisions of section 290 of the Companies Act, 1956 was not referred. Also the procedure to adopted for passing a Board Resolution in the form of circulation by resolution was not in proper order.

Question 5. The performance was unsatisfactory. Candidates did not have a clear idea of the operational scope of section 237 dealing with appointment of inspectors to investigate the affairs of a company. The drafting of application under the said section was also not proper. In respect of problem oriented question relating to removal of director under section 284 of the Companies Act, 1956, answers were satisfactory.

Question 6. Most of the candidates did not write the definition of Accounting Standards as per section 211(3C) of the Companies Act, 1956. The answers to other parts of the question relating to responsibilities of directors and statutory auditors for non-conformity of financial statements with some of the mandatory Accounting Standards of the ICAI were vague.

Question 7. The powers of the CLB in regard to section 402 of the Companies Act, 1956 in case of oppression was not explained correctly.

Question 8. The performance to the question on Audit Committee under section 292A of the Companies Act, 1956 was poor. Most of the candidates did not draft Board's Resolution to appoint an audit committee properly. The problem oriented question on section 209 was also not solved by many of the candidates.

Question 9. Very few candidates were able to solve the problem on Inter Corporate Loans and Investments under section 372A of the Companies Act, 1956. The powers of the Central Government to amalgamate two companies in public interest under section 396 was not referred in most of the answers.



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			<u>640</u>	<u>440</u>
				145
				145
PROFESSIONAL COMPETENCE COURSE (PCC)				
Group I				
	Advanced Accounting Vol. I & Vol. II		500	500
	Auditing and Assurance Vol.I		175	175
	Auditing and Assurance Standards & Guidance Note (English) Vol.II		100	
	Law, Ethics and Communication		275	275
			<u>1050</u>	<u>950</u>
				215
				215
Group II				
	Cost Accounting & Financial Management		300	300
	Taxation		200	200
	Information Technology		150	150
	Strategic Management		100	100
			<u>750</u>	<u>750</u>
				180
				180
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				395
				395
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	Financial Reporting		600	
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	<u>1020</u>		<u>225</u>	
Both Groups	2600		540	
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Mathematics and Statistics	100	75		
Economics	100	100		
Business Communication	50	75		
Organisation and Management	<u>100</u>	<u>75</u>		
	<u>500</u>	<u>400</u>	135	120
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Auditing Vol. I & Vol. II	150	125		
Business and Corporate Laws	<u>100</u>	<u>125</u>		
	<u>500</u>	<u>400</u>	165	105
Group II				
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Income-Tax and Central Sales Tax	100	100		
Information Technology	<u>150</u>	<u>150</u>		
	<u>400</u>	<u>400</u>	120	135
Both Groups	<u>900</u>	<u>800</u>	235	200
FINAL COURSE				
Group I				
Advanced Accounting	150	225		
Management Accounting & Financial Analysis	200	275		
Advanced Auditing	300	350		
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3. Advanced Auditing (May 2000 to November 2006)	60		40	
4. Corporate Laws and Secretarial Practice (May 2000 to November 2006)	60		40	
5. Cost Management (May 1996 to May 2006)	70		40	
6. Management Information and Control Systems (May 1996 to November 2006)	60		40	
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PAPER – 5 : COST MANAGEMENT

Question No. 1 is compulsory.

Answer any four questions from the rest.

Working notes should form part of the answer.

Question 1

- (a) A company produces a product X, using raw materials A and B. The standard mix of A and B is 1 : 1 and the standard loss is 10% of input.

You are required to compute the missing information indicated by “?” based on the data given below:

	A	B	Total
Standard price of raw material (Rs./kg.)	24	30	
Actual input (kg.)	?	70	
Actual output (kg.)			?
Actual price Rs./kg.	30	?	
Standard input quantity (kg.)	?	?	
Yield variance (sub usage)	?	?	270(A)
Mix variance	?	?	?
Usage variance	?	?	?
Price variance	?	?	?
Cost variance	0	?	1300(A)

- (b) The initial allocation of a transportation problem, alongwith the unit cost of transportation from each origin to destination is given below. You are required to arrive at the minimum transportation cost by the Vogel's Approximation method and check for optimality.

(Hint : Candidates may consider $u_1 = 0$ at Row 1 for initial cell evaluation)

Requirement

11	2	8	6	2	4	18
9	9	12	9	6		10
7	6	3	7	7		8
9	3	5	6	11		4
<u>Availability</u>						
12	8	8	8	4		40

- (c) How does the JIT approach help in improving an organisation's profitability?

(14 + 6 + 4 = 24 Marks)

Answer

- (a) Computation of Yield Variance for 'A' and 'B'

$$\begin{array}{l} \text{DM yield} \\ \text{variance} \\ \text{for 'A'} \end{array} = \left[\begin{array}{l} \text{Std qty of} \\ \text{all DM} \\ \text{allowed} \\ \text{for actual} \\ \text{output} \end{array} - \begin{array}{l} \text{Actual} \\ \text{total qty} \\ \text{of all DM} \\ \text{used} \end{array} \right] \times \begin{array}{l} \text{Std} \\ \text{Mix} \\ \text{\%age} \\ \text{of 'A'} \end{array} \times \text{Std price of 'A'}$$

$$= [SQ_A - RSQ_A] \times \text{Std price of 'A'}$$

Where RSQ_A = Revised Standard Quantity of 'A' = (Actual total qty of all DM used) $\times$ Std Mix %age of 'A' and

SQ_A = Standard Quantity of DM 'A' for Actual Production = Standard quantity of all DM allowed for actual output $\times$ Std Mix %age of 'A'

$$\begin{array}{l} \text{DM yield} \\ \text{variance} \\ \text{for 'B'} \end{array} = \left[\begin{array}{l} \text{Std qty of} \\ \text{all DM} \\ \text{allowed} \\ \text{for actual} \\ \text{output} \end{array} - \begin{array}{l} \text{Actual} \\ \text{total qty} \\ \text{of all DM} \\ \text{used} \end{array} \right] \times \begin{array}{l} \text{Std} \\ \text{Mix} \\ \text{\%age} \\ \text{of 'B'} \end{array} \times \text{Std price of 'B'}$$

$$= [SQ_B - RSQ_B] \times \text{Std price of 'B'}$$

Where RSQ_B = Revised Standard Quantity of 'B' = (Actual total qty of all DM used) $\times$ Standard Mix %age of 'B' and

SQ_B = Standard quantity of DM 'B' for Actual Production = Standard quantity of all DM allowed for actual output $\times$ Standard Mix %age of 'B'

Since Standard Mix %age is the same for both 'A' and 'B' (1:1) we have,

Total Yield variance for 'A' and 'B' = $T \times (\text{Std price of 'A'} + \text{Std price of 'B'})$

Where $T = (\text{Std qty of all DM allowed for actual output} - \text{Actual total qty of all DM used}) \times 0.5$

As Total Yield variance for 'A' and 'B' is given as – Rs 270, we have

$$- \text{Rs } 270 = T \times \text{Rs } 24 + T \times \text{Rs } 30$$

$$\text{Or } T = -5$$

Hence Yield Variance for 'A' = $-5 \times 24 = -\text{Rs } 120$ and

Yield variance for 'B' = $-5 \times 30 = -\text{Rs } 150$.

Also

$$(SQ_A - RSQ_A) \times 24 = -120 \text{ or } SQ_A - RSQ_A = -5$$

Similarly

$$(SQ_B - RSQ_B) \times 30 = -150 \text{ or } SQ_B - RSQ_B = -5$$

Alternative 1

Let total actual quantity consumed; X kg.

Then, Quantity of A = X – 70

$RSQ = \frac{X}{2}$ of A & $\frac{X}{2}$ of B. (Since the Mix ratio is 1:1)

The Standard input for both 'A' and 'B' will be $0.5X - 5$

Since Cost Variance for 'A' is given to be nil, we have,

$$(SP_A \times SQ_A) - (AQ_A \times AP_A) = 0$$

$$\text{i.e. } 24 \times (0.5X - 5) - (X - 70) \times 30 = 0$$

or X = 110 Kgs

Therefore Actual Input for 'A' = 110 – 70 = 40 Kgs

Also, Standard Input for 'A' and 'B' will be $\left(\frac{110}{2} - 5\right) = 50$ Kgs. Using this quantity in the

Cost Variance of 'B', the actual price per kg of 'B' (AP_B) will be ,

$$50 \times 30 - 70 \times AP_B = -1,300$$

Or $AP_B = \text{Rs } 40$.

Alternative 2

Let the standard input of 'A' = X kg. Therefore, the total standard input for 'A' + 'B' = 2X

Actual input = (2X + 10) Kgs. $\therefore$ Actual input for 'A' = (2X + 10 – 70) = (2X – 60) Kgs

Forming the equation for nil cost variance of 'A'.

$$\text{Rs. } 24 \times X - \text{Rs. } 30 \times (2X - 60) = 0$$

Or X = 50 Kgs. Using this quantity in the Cost Variance of 'B', the actual price per kg. of 'B' (AP_B) will be ,

$$50 \times 30 - 70 \times AP_B = -1,300$$

Or $AP_B = \text{Rs. } 40$.

Alternative 3

Let the actual input of 'A' = X

Then the total actual input = $(X + 70)$. Therefore, RSQ of 'A' and 'B' each = $0.5X + 35$ and Standard Input of 'A' and 'B' each = $0.5X + 30$.

Forming the equation for nil cost variance of 'A', we have,

$$24 \times (0.5X + 30) - 30 \times X = 0$$

Or $X = 40$ Kgs.

$\therefore$ Standard Input will be 50 Kgs. Using this, quantity in the Cost Variance of 'B', the actual price per kg. of 'B' (AP_B) will be,

$$50 \times 30 - 70 \times AP_B = -1,300$$

Or $AP_B = \text{Rs. } 40$.

Substituting various values for quantity and price, we get the following table.

	(1)	(2)	(3)	(4)
	Std. Price $\times$ SQ	Std. Price $\times$ RSQ	Std. Price $\times$ Actual Qty.	Actual Price $\times$ Actual Qty.
A	$24 \times 50 = 1200$	$24 \times 55 = 1320$	$24 \times 40 = 960$	$30 \times 40 = 1200$
B	$30 \times 50 = 1500$	$30 \times 55 = 1650$	$30 \times 70 = 2100$	$40 \times 70 = 2800$
	<u>2700</u>	<u>2970</u>	<u>3060</u>	<u>4000</u>

	(1) – (2)	(2) – (3)	(1) – (3)	(3) – (4)	(1) – (4)
	Yld variance	Mix variance	Usage variance	Price variance	Cost variance
A	$1200 - 1320 = 120(A)$	$1320 - 960 = 360(F)$	$1200 - 960 = 240(F)$	$960 - 1200 = 240(A)$	$1200 - 1200 = 0$
B	$1500 - 1650 = 150(A)$	$1650 - 2100 = 450(A)$	$1500 - 2100 = 600(A)$	$2100 - 2800 = 700(A)$	$1500 - 2800 = 1300(A)$
	<u>270A)</u>	<u>90A)</u>	<u>360A)</u>	<u>940A)</u>	<u>1300A)</u>

Actual Output = 90 Kgs.

(Actual output and standard output are always equal numerically in any material variance analysis)

Standard output = Standard input – Standard loss or $100 - 10 = 90$ Kgs.

- (b) The concept tested in this problem is Degeneracy with respect to the transportation problem. Total of rows and columns = $(4 + 5) = 9$. Hence, the number of allocations = $9 - 1 = 8$. As the actual number of allocation is 7, a 'zero' allocation is called for. To resolve this, an independent cell with least cost should be chosen. R4C2 has the least

cost (cost = 3), but this is not independent. The next least cost cell R4C3 (cost = 5) is independent.

	9 C1	2 C2	5 C3	6 C4	2 C5	Total
0R1	11	2	8	6	2	18
0R2	9	9	12	9	6	10
-2R3	7	6	3	7	7	8
0R4	9	3	5	6	11	4
Total	12	8	8	8	4	40

Forming Equations through allocated cells

Basic equation	Setting R1 = 0 other values
$R1 + C2 = 2$	Setting R1 = 0, C2 = 2
$R1 + C4 = 6$	C4 = 6
$R1 + C5 = 2$	C5 = 2
$R2 + C1 = 9$	R2 = 0
$R3 + C3 = 3$	R3 = -2
$R4 + C1 = 9$	C1 = 9
$R4 + C3 = 5$	C3 = 5
$R4 + C4 = 6$	R4 = 0

Evaluate unallocated cells

$R1C1 = 11 - 0 - 9 = 2$	$R3C1 = 7 + 2 - 9 = 0$
$R1C3 = 8 - 0 - 5 = 3$	$R3C2 = 6 + 2 - 2 = 6$
$R2C2 = 9 - 0 - 2 = 7$	$R3C4 = 7 + 2 - 6 = 7$
$R2C3 = 12 - 0 - 5 = 7$	$R3C5 = 7 + 2 - 2 = 7$
$R2C4 = 9 - 0 - 6 = 3$	$R4C2 = 3 - 0 - 2 = 1$
$R2C5 = 6 - 0 - 2 = 4$	$R4C5 = 11 - 0 - 2 = 9$

Since all the evaluation is 0 or +ve, the optimal solution is obtained.

Optimal cost = $(8 \times 2) + (6 \times 6) + (4 \times 2) + (10 \times 9) + (8 \times 3) + (2 \times 9) + (0 \times 5) + (2 \times 6) = 16 + 36 + 8 + 90 + 24 + 18 + 10 + 12 = \text{Rs. } 204.$

Note: As regards allocation of the zero values, the solution to the above problem is also obtained by allocating the zero value in other independent cells such as R1C3, R2C2, R2C3, R3C1, R3C2, R3C4, R3C5. In such situation there will be one more iteration.

- (c) JIT approach helps in the reduction of costs/increase in prices as follows:
- (i) Immediate detection of defective goods being manufactured so that early correction is ensured with least scrapping.
 - (ii) Eliminates/reduces WIP between machines within working cell.
 - (iii) OH costs in the form of rentals for inventory, insurance, maintenance costs etc. are reduced.
 - (iv) Higher product quality ensured by the JIT approach leads to higher premium in the selling price.
 - (v) Detection of problem areas due to better pdn/scrap reporting/labour tracing and inventory accuracy lead to reduction in costs by improvement.

Question 2

- (a) A company has produced 1,500 units against a budgeted quantity of 2,000 units. Actual sales were 1,300 units. The company's policy is to value stocks at standard absorption cost.

Other data are:

Direct material	Rs. 100 per unit
Direct labour	Rs. 100 per unit at normal efficiency
Variable OH	Rs. 50 per unit
Fixed OH at budgeted capacity	Rs. 1,00,000
Variable selling OH	Rs. 26,000
Budgeted fixed selling OH	Rs. 30,000
Actual fixed selling OH	Rs. 25,000
Selling price	Rs. 400 per unit

There was no opening stock.

- (i) Present the profitability statement under absorption costing system.
- (ii) Assuming actual labour was 25% below normal efficiency and that 100 units of production had to be scrapped after complete manufacture, compute the actual profit or loss.
- (iii) Reconcile the profits under (i) and (ii) above.

- (b) What is product life cycle costing? What are the costs that you would include in product life cycle cost?
- (c) The following information of a company is available for the year 2006:

	Rs.
Sales	40,000
Raw materials	20,000
Direct wages	6,000
Variable and fixed OH	10,000
Profit	4,000
Units sold	200 Nos.

In the year 2007, wages rate will increase by 50% and fixed cost will decrease by Rs. 600. If 300 units are sold in 2007, the total fixed and variable OH will be 11,400. How many units should be sold in 2007, so that the same amount of profit per unit as in year 2006 may be earned?
(11 + 4 + 4 = 19 Marks)

Answer

(a) Profitability under absorption costing system		Actual profit and loss account	
Particulars	Rs. 000's	Particulars	Rs. 000's
Sales (1,300×400)	520	Sales (1,300×400)	520
Absorption costs		Closing Stock (100×300)	30
Opening Stock	Nil	Total	550
Cost of production		Cost	
1,500 units × 300	450	Direct materials (1,500×100)	150
Less: Closing stock (200×300)	60	Direct labour (1,500×100/75%)	200
Net Absorption costs	390	Variable overhead (1,500×50)	75
Add: Under-absorption (500×50)	25	Fixed manufacturing overhead	100
Total absorption costs	415	Fixed Selling overhead	25
Gross profit	105	Variable selling overhead	26
Less: Selling overhead variable	26	Total costs	576
Selling overhead fixed	25		
Profit/(loss)	54	Profit / (Loss)	(26)

Working Notes:

	Rs.		Units
Absorption cost per unit		Budgeted capacity	2,000
Direct materials	100	Production	1,500
Direct labour	100	Under-absorption	500
Variable overhead	50	Sales	1,300
Fixed Overhead (1,00,000 / 2,000)	<u>50</u>	Closing stock	200
Total	<u>300</u>		

Reconciliation

	Rs. 000's
Profit under absorption costing	54
Less: Labour inefficiency**	(50)
Less: Value of units scrapped	(30)
Actual profit / (loss)	(26)

** (1,500 × (133 1/3 – 100))

Note: In case budgeted fixed selling overheads are considered while arriving at absorption profit a saving of Rs. 5,000 shall need to be identified as part of reconciliation.

- (b) Product life cycle costing traces costs and revenues of each product over several calendar periods throughout their entire life cycle.

The costs are included in different stages of the product life cycle.

Development phase – R & D cost / Design cost.

Introduction phase – Promotional cost / Capacity costs.

Growth phase / Maturity – Manufacturing cost / Distribution costs / Product support cost.

Decline / Replacement phase – Plants reused / sold / scrapped / related costs.

(c) Particulars (Data per unit)	2006	2007
	Rs.	Rs.
Selling price (40,000 / 200)		200
Raw materials (20,000 / 200)		100
Direct wages (6,000 / 200)	30	(30 × 150%) 45
Variable overhead		20
Total variable cost		165
Contribution		35

Profit per unit (4,000 /200)		20
Net contribution per unit to cover fixed overheads		15
Fixed overheads	6,000	5,400
No. of units		5,400/15 = 360 units

Working Notes:

No. of units sold	200	300
Total variable and fixed overheads	10,000	11,400 + 600 = 12,000
Differential cost in 2007		100 units Rs. 2,000
Variable overhead per unit		2,000 / 100 = 20
Total variable cost	4,000	6,000
Total fixed cost	6,000	(6,000 – 600) 5,400

Question 3

(a) A company had planned its operations as follows:

Activity	Duration (days)
1–2	7
2–4	8
1–3	8
3–4	6
1–4	6
2–5	16
4–7	19
3–6	24
5–7	9
6–8	7
7–8	8

- (i) Draw the network and find the critical paths.
- (ii) After 15 days of working, the following progress is noted:
 - (a) Activities 1–2, 1–3 and 1–4 completed as per original schedule.
 - (b) Activity 2–4 is in progress and will be completed in 4 more days.
 - (c) Activity 3–6 is in progress and will need 17 more days to complete.

- (d) The staff at activity 3–6 are specialised. They are directed to complete 3–6 and undertake an activity 6–7, which will require 7 days. This rearrangement arose due to a modification in a specialisation.
- (e) Activity 6–8 will be completed in 4 days instead of the originally planned 7 days.
- (f) There is no change in the other activities.

Update the network diagram after 15 days of start of work based on the assumption given above. Indicate the revised critical paths along with their duration.

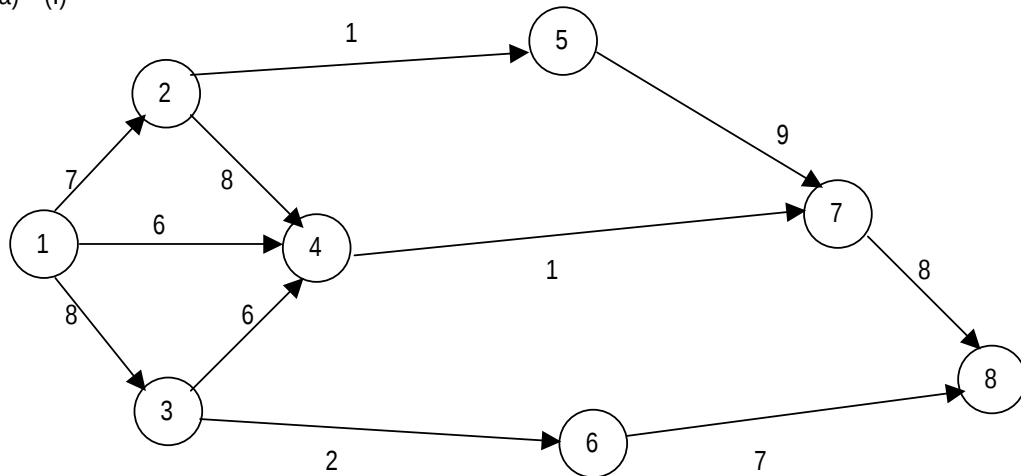
(b) Explain briefly the major components of a balanced score card.

(c) Describe the process of zero-base budgeting.

(11 + 4 + 4 = 19 Marks)

Answer

(a) (i)



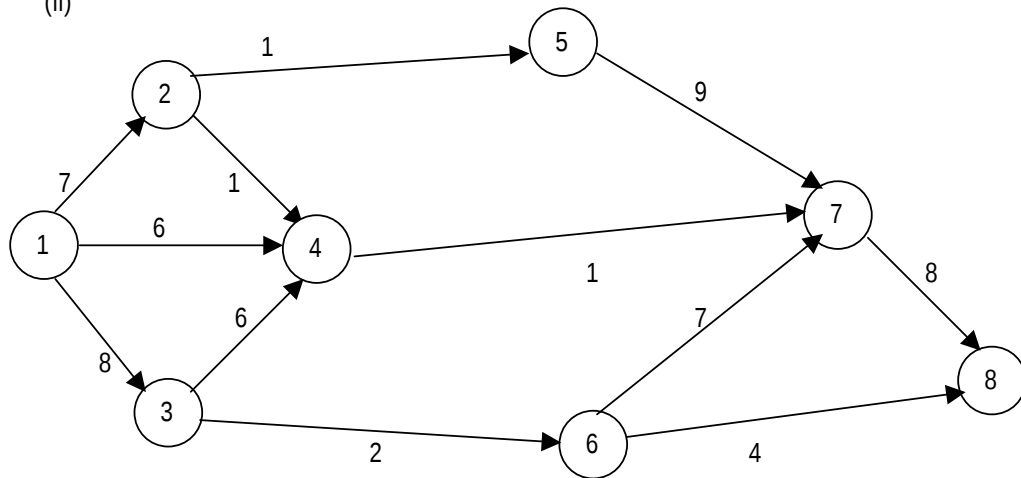
Paths	Duration
1 – 2 – 5 – 7 – 8	$7 + 16 + 9 + 8 = 40$
1 – 2 – 4 – 7 – 8	$7 + 8 + 19 + 8 = 42$
1 – 4 – 7 – 8	$6 + 19 + 8 = 33$
1 – 3 – 4 – 7 – 8	$8 + 6 + 19 + 8 = 41$
1 – 3 – 6 – 8	$8 + 24 + 7 = 39$

Critical path 1 – 2 – 4 – 7 – 8 = 42 days.

Revised Duration of activities 2 – 4 and 3 – 6 after 15 days for update.

Activity	Preceding Activity	Date of completion	Revised Duration
2 – 4	1 – 2	$15 + 4 = 19$ days	$19 - 7 = 12$ days
3 – 6	1 – 3	$15 + 17 = 32$ days	$32 - 8 = 24$ days
6 – 7 (new activity)	3 – 6		7 days
6 – 8	3 – 6		4 days

(ii)



Paths	Duration
1 – 2 – 5 – 7 – 8	$7 + 16 + 9 + 8 = 40$
1 – 2 – 4 – 7 – 8	$7 + 12 + 19 + 8 = 46$
1 – 4 – 7 – 8	$6 + 19 + 8 = 33$
1 – 3 – 4 – 7 – 8	$8 + 6 + 19 + 8 = 41$
1 – 3 – 6 – 7 – 8	$8 + 24 + 7 + 8 = 47$
1 – 3 – 6 – 8	$8 + 24 + 4 = 36$

Critical path = 1 – 3 – 6 – 7 – 8 = 47 days.

- (b) An ideal Balanced score card combines financial measures of past performance with measures of the firm's drivers of future performance. The following perspectives are evaluated:
- (i) Customer perspective – Measures of price / delivery / quality / support.
 - (ii) Internal perspective – Measures of efficiency / sales penetration and new product introduction.

- (iii) Innovation and learning perspective – Measures of technology / cost leadership.
- (iv) Financial perspective – Sales / Cost of sales / Return on capital employed etc.
- (c) The zero Base Budgeting involves the following steps:
 - (i) Corporate objectives should be established and laid down in details.
 - (ii) Decide about the techniques of ZBB to be applied.
 - (iii) Identify those areas where decisions are required to be taken.
 - (iv) Develop decision programmes and rank them in order of preferences.
 - (v) Preparation of budget, that is translating decision packages into practicable units/items and allocating financial resources.

Question 4

- (a) A gear manufacturing company makes two types of gears – A and B. Both gears are processed on 3 machines, Hobbing M/c, Shaping M/c and Grinding M/c. The time required by each gear and total time available per week on each M/c is as follows:

Machine	Gear (A) (Hours)	Gear (B) (Hours)	Available Hours
Hobbing M/c	3	3	36
Shaping M/c	5	2	60
Grinding M/c	2	6	60
Other data:			
Selling price (Rs.)	820	960	
Variable cost (Rs.)	780	900	

Determine the optimum production plan and the maximum contribution for the next week by simplex method. The initial table is given below:

			C _j	40	60	0	0	0
			Qty.					
C _j	Variable		X ₁	X ₂	X ₃	X ₄	X ₅	
0	X ₃	36	3	3	1	0	0	
0	X ₄	60	5	2	0	1	0	
0	X ₅	60	2	6	0	0	1	

- (b) What are the essential requirements for successful implementation of TQM?
- (c) A company makes 1,500 units of a product for which the profitability statement is given below:

		Rs.
Sales		1,20,000
Direct materials	30,000	
Direct labour	36,000	
Variable OH	<u>15,000</u>	
Subtotal variable cost		81,000
Fixed cost		<u>16,800</u>
Total cost		<u>97,800</u>
Profit		<u>22,200</u>

After the first 500 units of production, the company has to pay a premium of Rs. 6 per unit towards overtime labour. The premium so paid has been included in the direct labour cost of Rs. 36,000 given above.

You are required to compute the Break-even point.

(7 + 6 + 6 = 19 Marks)

Answer

(a)

Table 1

		C_j Qty	40	60	0	0	0	Ratio	
c_j	Variable		X_1	X_2	X_3	X_4	X_5		
0	X_3	36	3	3	1	0	0	12	
0	X_4	60	5	2	0	1	0	30	
0	X_5	60	2	6	0	0	1	10	←
	Z_j	0	0	0	0	0	0		
	$Z_j - C_j$		-40	-60	0	0	0		

Table 2

		C_j Qty	40	60	0	0	0	Ratio	
c_j	Variable		X_1	X_2	X_3	X_4	X_5		
0	X_3	6	2	0	1	0	$-\frac{1}{2}$	3	←
0	X_4	40	$\frac{13}{3}$	0	0	1	$-\frac{1}{3}$	$\frac{120}{13}$	

60	X_2	10	$\square$	1	0	0	1/6	30	
	Z_j	600	20	60	0	0	10		
	$Z_j - C_j$		-20	0	0	0	10		



Table 3

		C_j	40	60	0	0	0
	Qty						
C_j	Variable		X_1	X_2	X_3	X_4	X_5
40	X_1	3	1	0	$\frac{1}{2}$	0	$-\frac{1}{4}$
0	X_4	27	0	0	$-\frac{13}{6}$	1	$\frac{3}{4}$
60	X_2	9	0	1	$-\frac{1}{6}$	0	$\frac{1}{4}$
	Z_j	660	40	60	10	0	5
	$Z_j - C_j$		0	0	10	0	5

Since all $Z_j - C_j$ are positive or zero, this is the optimum solution with. $X_1 = 40$ and $X_2 = 60$ and optimum $Z = 660$.

Note : Alternatively, $C_j - Z_j$ may be used whereby maximum positive value may be considered.

- (b) Commitment: Quality improvement must be everyone's job. Clear commitment from the top management, steps necessary to provide an environment for changing attitudes and breaking down barriers to quality improvement must be provided. Support and training for this must be extended.

Culture: Proper training must be given to effect changes in culture and attitude.

Continuous Improvement: Recognition of room for improvement continually as a process, and not merely a one-off programme.

Cooperation: Must be ensured by involving employees by resorting to mutually agreeable improvement strategies and associated performance measures.

Customer Focus: Perfect service with zero defectives with satisfaction to end user whether external customer or internal customer.

Control: Documentation, procedures and awareness of current practices ensure checking deviation from the intended course of implementation.

(c)

Data / Unit	1 – 500	501 – 1,500
	Rs.	Rs.
Sales (1,20,000 / 1,500)	80	80
Direct material (20,000 / 1,000)	20	20
Direct labour	20	26
Variable overheads 15,000 / 1,500	10	10
Contribution	30	24
No. of units	500	
Total contribution	15,000	
Fixed costs	16,800	
Shortfall	1,800	
No. of units required above 500 to recover shortfall		$1,800 / 24 = 75$
Break even point		$(500 + 75) = 575$ units

Let X be the Direct Labour per unit upto 500 units.

Total Direct Labour $500X + 1,000(X + 6) = 36,000$

$$1,500X + 6,000 = 36,000$$

$$X = 20.$$

Therefore, up to 500 units the Direct Labour is Rs. 20. After 500 units it is Rs. 26.

Question 5

- (a) A research project, to date, has cost a company Rs. 2,50,000 and is under review. It is anticipated that, should the project be allowed to proceed, it will be completed in about one year and can be sold for Rs. 4,00,000. The following additional information is available:
- Materials have just been received for Rs. 60,000. These are extremely toxic, and if not used in the project, have to be disposed of by special means at Rs. 15,000.
 - Labour: Rs. 75,000. The men are highly skilled. If they are released from the Research Project, they may be transferred to the Works Department of the company and consequently the sales could increase by Rs. 1,50,000. The accountant estimates that the prime cost of those sales would be Rs. 1,00,000 and the overhead absorbed (all fixed) would amount to Rs. 25,000.
 - Research staff: Rs. 1,60,000. A decision has already been taken that this will be the last major piece of research undertaken and consequently, when work on the

project ceases, the staff involved will be made redundant. Redundancy and severance pay have been estimated at Rs. 25,000.

(iv) Share of General Building Expenses : Rs. 35,000.

The Managing Director is not sure what is included in this amount, but the accounts staff charge similar amounts each year to each department.

You are required to advise whether the project should be allowed to proceed and explain the reasons for the treatment of each of the amounts above in your analysis.

- (b) Discuss with examples, the basic costing methods to assign costs to services.
 (c) Discuss the application of the learning curve. (10 + 5 + 4 = 19 Marks)

Answer

(a) Research Project

Particulars	Relevancy	Reason	Amount (Rs. '000s)
Project cost till date	Not relevant	Sunk cost	–
Sale price of the project	Relevant	Incremental revenue/opportunity gain	400
Cost of materials received	Not relevant	Sunk cost	–
Cost of disposal of materials	Relevant	Avoidable/opportunity cost	15
Cost of labour	Not relevant	Common costs	–
Contribution lost on the alternative use	Relevant	Opportunity cost [Sales – (Prime cost – labour)]	(125)
Absorbed Fixed overheads	Not relevant	Sunk cost	–
Cost of Research Staff	Relevant	Incremental / out of pocket	(160)
Redundancy and severance pay	Not relevant	Common costs	–
Share of General Building expenses	Not relevant	Sunk costs	–
Total incremental inflow if the project is proceeded with			<u>130</u>

Decision: Better to continue the project.

- (b) (i) (i) Job costing method: The cost of a particular service is obtained by assigning costs to a distinct identifiable service.
 e.g. Job Costing method is used in service sectors – like Accounting Firm, Advertisement campaign.
 (ii) Process Costing method: Cost of a service is obtained by assigning costs to masses of similar unit and then computing cost / unit on an average basis.

e.g. Retail banking, postal delivery, credit card etc.

(iii) Hybrid method: Combination of both (i) & (ii) above.

- (c) Application of Learning curve: Learning curve helps to analyse cost-volume profit relationships during familiarisation phase of product or process to arrive at cost estimates.

It helps in budgeting and profit planning.

It helps in pricing and consequent decision making – e.g. acceptance of an order, negotiations in establishing contract prices etc. with the advantage of the knowledge of decreasing unit cost.

It helps in setting standards in the learning phase.

Question 6

- (a) Hardware Ltd. Manufactures computer hardware products in different divisions which operate as profit centres. Printer Division makes and sells printers. The Printer Division's budgeted income statement, based on a sales volume of 15,000 units is given below. The Printer Division's Manager believes that sales can be increased by 2,400 units, if the selling price is reduced by Rs. 20 per unit from the present price of Rs. 400 per unit, and that, for this additional volume, no additional fixed costs will be incurred.

Printer Division presently uses a component purchased from an outside supplier at Rs. 70 per unit. A similar component is being produced by the Components Division of Hardware Ltd. And sold outside at a price of Rs. 100 per unit. Components Division can make this component for the Printer Division with a small modification in the specification, which would mean a reduction in the Direct Material cost for the Components Division by Rs. 1.5 per unit. Further, the Component Division will not incur variable selling cost on units transferred to the Printer Division. The Printer Division's Manager has offered the Component Division's Manager a price of Rs. 50 per unit of the component.

Component Division has the capacity to produce 75,000 units, of which only 64,000 can be absorbed by the outside market.

The current budgeted income statement for Components Division is based on a volume of 64,000 units considering all of it as sold outside.

	Printer Division	Component Division
	Rs. '000	Rs. '000
Sales revenue	<u>6,000</u>	<u>6,400</u>
Manufacturing cost:		
Component	1,050	—
Other direct materials, direct labour		
And variable OH	1,680	1,920

Fixed OH	<u>480</u>	<u>704</u>
Total manufacturing cost	<u>3,210</u>	<u>2,624</u>
Gross margin	2,790	3,776
Variable marketing costs	270	384
Fixed marketing and Admn. OH	<u>855</u>	<u>704</u>
Non-manufacturing cost	<u>1,125</u>	<u>1,088</u>
Operating profit	<u>1,665</u>	<u>2,688</u>

- (i) Should the Printer Division reduce the price by Rs. 20 per unit even if it is not able to procure the components from the Component Division at Rs. 50 per unit?
- (ii) Without prejudice to your answer to part (i) above, assume that Printer Division needs 17,400 units and that, either it takes all its requirements from Component Division or all of it from outside source. Should the Component Division be willing to supply the Printer Division at Rs. 50 per unit?
- (iii) Without prejudice to your answer to part (i) above, assume that Printer Division needs 17,400 units. Would it be in the best interest of Hardware Ltd. for the Components Division to supply the components to the Printer Division at Rs. 50?

Support each of your conclusions with appropriate calculations.

- (b) What are the practical applications of Linear programming? (12 + 7 = 19 Marks)

Answer

(a)

Particulars	Printer Division			Components Division	
	Existing price	Reduction in selling price	If component is purchased internally	Existing	If transfer is effected
Selling price	400	380	380	100	50
Component cost	70	70	50		
Other direct materials, labour and Variable overhead	112	112	112	30	28.50
Variable marketing cost	18	18	18	6	
Contribution	200	180	200	64	21.50

Volume units	15,000	17,400	17,400	64,000	17,400
Total contribution ('000)	3,000	3,132	3,480	4,096	374.10
Volume lost in the market					6,400 units
Contribution lost					$6,400 \times 64 = 409.60$

- (i) Yes, Printer Division should institute the Rs. 20 price reduction on its printer units because net income would increase by Rs. 1,32,000 (Rs. 31,32,000 – Rs. 30,00,000).

Alternatively by incremental approach the net increase can be computed as follows:

	Rs.
Contribution margin of sales increase (Rs. 180 × 2,400)	4,32,000
Loss in contribution margin on original volume arising from decrease in selling price (15,000 × Rs. 20)	3,00,000
Increase in operating profit	1,32,000

- (ii) No, the Component Division should not sell all 17,400 units to Printer Division for Rs. 50. If the Component Division does sell all 17,400 units to Printer, Component Division will only be able to sell 57,600 units to outside customers instead of 64,000 units due to the capacity restrictions. This would decrease Component Division's profit before taxes by Rs. 35,500. Supporting calculations are as follows:

	Rs.
Contribution from sales to printer (Rs. 21.50 × 17,400)	3,74,100
Loss in contribution from loss of sales to outsiders (Rs. 64 × 6,400)	<u>4,09,600</u>
Decrease in operating profit	<u>35,500</u>

- (iii) Yes, it would be in the best interest of Hardware Ltd. for the Component Division to sell the units to the Printer division at Rs. 50 each. The net advantage to the Hardware Ltd. is Rs. 3,12,500 as shown below. The net Advantage is the result of the cost savings from purchasing the Component unit internally and the contribution margin lost from 6,400 units that the Component Division otherwise would sell to outsiders.

	Total Company Rs. '000s
Incremental contribution – if the component is transferred within (Rs. '000) (3,480 – 3,132)	348.00
Contribution to the Component Division	374.10
Total incremental contribution	722.10
Less: Contribution lost by the Component Division	409.60
Net contribution gain	312.50

(b) Linear programming can be used to find optional solutions under constraints.

In production:

- pdt. mix under capacity constraints to minimise costs/maximise profits along with marginal costing.
- Inventory management to minimise holding cost, warehousing / transporting from factories to warehouses etc.

Sensitivity Analysis: By providing a range of feasible solutions to decide on discounts on selling price, decisions to make or buy.

Blending: Optional blending of raw materials under supply constraints.

Finance: Portfolio management, interest/receivables management.

Advertisement mix: In advertising campaign – analogous to pdn. management and pdt. mix.

Assignment of personnel to jobs and resource allocation problems.

However, the validity will depend on the manager's ability to establish a proper linear relationship among variables considered.

PAPER – 6 : MANAGEMENT INFORMATION AND CONTROL SYSTEMS

Question No. 1 is compulsory.

Answer any four questions from remaining six questions.

Question 1

- (a) Briefly describe the techniques used to preserve audit trails in a Computer Based Information system.
- (b) Briefly outline the contents of Information Security policy.
- (c) What are CASE tools? Discuss briefly its three categories.
- (d) Various software packages serve as aids in analysis of program logic. Explain briefly.

(5 + 5 + 5 + 5 = 20 Marks)

Answer

- (a) The following are examples of techniques used to preserve audit trails in a CBIS.
 - (i) Transaction Logs: Every transaction successfully processed by the system should be recorded on a transaction log, which serves as a journal. There are two reasons for creating a transaction log. First, the transaction log is a permanent record of transactions. Second, not all of the records in the validated transaction file may be successfully processed. Some of these records may fail tests in the subsequent processing stages. A transaction log should contain only successful transaction-those that have changed account balances. Unsuccessful transactions should be placed in an error file. The transaction log and error files combined should account for all the transactions in the batch. The validated transaction file may then be scratched with no loss of data.
 - (ii) Transaction Listings: The system should produce a (hard-copy) transaction listing of all successful transactions. These listings should go to the appropriate users to facilitate reconciliation with input.
 - (iii) Log of Automatic Transactions: Some transactions are triggered internally by the system. An example of this is when inventory drops below a preset reorder point, and the system automatically processes a purchase order. To maintain an audit trail of these activities, all internally generated transactions must be placed in a transaction log.
 - (iv) Listing of Automatic Transactions: To maintain control over automatic transaction processed by the system, the responsible end user should receive a details listing of all internally generated transactions.
 - (v) Unique Transaction Identifies: Each transaction processed by the system must be uniquely identified with a transaction number. This is the only practical means of tracing a particular transaction through a database of thousands or even millions of records. In systems that use physical source documents, the unique number printed on the documents can be transcribed during data input and used for this

purpose. In real-time systems, which do not use source documents, each transaction should be assigned a unique number by the system.

- (vi) Error Listing: A listing of all error records should go to the appropriate user to support error correction and resubmission.

(Students are required to discuss any five points)

- (b) The Information Security policy should describe:

- The importance of Information security to the organization;
- A statement from the chief executive officer in support of the goals and principles of effective information security;
- Specific statements indicating minimum standards and compliance requirements for specific areas;
- Assets classification;
- Data Security;
- Personnel security;
- Physical, logical and environmental security;
- Communications security;
- Legal, regulatory and contractual requirements;
- System development and maintenance life cycle requirements;
- Business continuity planning;
- Security awareness, training and education;
- Security breach detection and reporting requirements; and violation enforcement provisions;
- Definitions of responsibilities and accountabilities for information security with appropriate separation of duties;
- Particular information system or issue specific areas; and Reporting responsibilities and procedures.

- (c) CASE stands for "Computer Aided Software Engineering". CASE tools are automated software tools. CASE encompasses computer based procedures, techniques and tools which can be used to develop, maintain and re-engineer software. CASE technology allows different types of tools to be assessed and compared. It also provides a conceptual basis of understanding.

The three categories of CASE tools are:

1. Tools that support individual process tasks such as checking the consistency of a design, compiling a program, comparing test results and so on.

2. Work benches to support process phases such as specification, design etc. They consist of sets of tools with variable degree of integration.
 3. Environments support for all or part of software process. Includes several different workbenches which are integrated in some way.
- (d) The following software packages serve as aids in program analysis:
- Automated flowcharting programs, which interpret program source code and generate a corresponding program flowchart.
 - Automated decision table programs, which generate a decision table representing the program logic.
 - Scanning routines, which search a program for occurrences of a specified variable name or other character combinations.
 - Mapping programs, which identify unexecuted program code. This software could have uncovered the program code that is developed by the unscrupulous programmer who have inserted to erase all computer files when he was terminated
 - Program tracing, which sequentially prints all application program steps (line numbers or paragraph names) executed during a program run. This list is intermingled with regular output so that the auditors can observe the precise sequence of events that unfold during program execution. Program tracing helps auditors to detect unauthorized program instructions, incorrect logic paths, and unexecuted program code.

Question 2

- (a) State and briefly explain the various stages of developing an inhouse program.
- (b) How will you establish and implement Critical Success Factors (CSFs) and Key Performance Indicators (KPIs) in an organization for achieving the benefits of implementation of ERP? (10 + 10 = 20 Marks)

Answer

- (a) An In-house development of programs commonly involves the following six stages:
 - (i) Program Analysis: In this state, the programmer ascertains the input, processing and output required for a particular application. The programmer then determines whether the proposed application can be programmed at all. It is not unlikely that the proposal is shelved for modifications on technical grounds.
 - (ii) Program design: In this stage the programmer develops the general organization of the program as it relates to the main functions to be performed. Out of several other tools available to him input, output, file layouts and flowcharts are quite useful at this stage. These are provided to the programmer by the systems analyst.
 - (iii) Program Coding: The logic of the program outlined in the flowchart is converted into program statements or instructions at this stage. For each language, there are specific rules concerning format and syntax. There are special sheets for writing

the program instructions in each language. The format of these sheets facilitates writing error-free programs. The programmers broadly pursue three objectives: simplicity, efficient utilization of storage and least processing time. Future changes and development of the programs should be kept in mind.

- (iv) Debug the program: The process of debugging a program refers to correcting the language syntax and diagnostic errors so that the program compiles cleanly. A clean compile means that the program can be successfully converted from the source code written by the program into machine language instructions. Debugging consists of four steps:

- (a) Inputting the source program to the compiler,
- (b) Letting the compiler find errors in the program,
- (c) Correcting lines of codes that are in error; and
- (d) Resubmitting the corrected source program as input to the compiler.

These are followed by use of structured walkthroughs, testing of the program and review of the program code for adherence to standards.

- (v) Program documentation: The writing of narrative procedures and instructions for people who will use software is done throughout the program life cycle. The procedures and instructions should be reviewed and approved by the authorized persons. The documentation should be prepared in such a way that the user can clearly understand the instruction given in Program documentation.
 - (vi) Program maintenance: The requirements of business data processing applications are subject to continual change. This calls for modification of the various programs. There are usually separate categories of programmers called maintenance programmers who are entrusted with this task.
- (b) Effective use of ERP is a direct result of steps taken at the time of implementation toward preparing the organization. Change integration has to be necessarily embedded in the task list for any ERP implementation. The main tool for this is the process of communication in all forms-written, oral, workshops, meetings and follow up activities. The process should start quite early by educating all layers of the management on the particular ERP product, its relevant functionality, limitations and benefits.

Also at the start of the project, the Critical Success Factors (CSFs) for the company as whole should be listed. These should be drilled down to CSFs for respective departments like Finance, Marketing, Purchase, Stores, Production, Quality, Maintenance and HRD or Personnel. From these CSFs, performance measures required to address these CSFs should be culled out. The numeric figures against these performance measures can be classified as the Key Performance Indicators (KPIs). The process of firming up the above is usually done through workshops. This has to be completed before the processes to be configured on the ERP are drawn up. The important end users should be involved in evolving the process keeping ERP in mind. The KPIs derived from organisational goals and CSFs should be kept in mind.

The post implementation tasks are:

- Develop the new job descriptions and organization structure to suit the post ERP scenario.
- Determine the skill gap between existing jobs and envisioned jobs.
- Assessing training requirements, and create and implement a training plan.
- Develop and amend HR, financial and operational policies to suit the future ERP environment.
- Develop a plan for workforce logistic adjustment.

Then the major task is to monitor KPIs and take correct business decisions to improve them. Hence, the immediate task is to set attainable goals. Certain KPIs, though existing in the system, are better monitored and controlled after ERP System attains maturity. There will be resistance to change, but the management should be strong to continue implementation.

Question 3

- (a) What is Share accounting system? Describe briefly the input, outputs and processing steps involved in this system.
- (b) "Decision support systems are widely used as part of an Organisation's Accounting Information system". Give examples to support this statement. (10 + 10 = 20 Marks)

Answer

- (a) Share is an investment option used by many persons. A person may purchase shares either from the company (at the time of a public or a rights issue) or from the share market. A share accounting system, needs to maintain an updated list of shareholders. For each shareholder, the main information held is the name and address, names of joint holders (if any), the number of shares held, and the identification of the certificates through which these shares are held.

When a person purchases shares from a share holder, a share transfer form along with the certificates is sent by the buyer to the company for incorporating the transfer. The system records a change in ownership for the shares from the seller to the buyer. Periodically, the company declares a dividend. Dividend warrants (cheques) need to be mailed on a particular day to the various shareholders who hold shares. Calculation of income tax to be deducted at source is also done before the printing and mailing dividend warrants.

Other facilities usually provided in share accounting system are:

- Bank mandate facility, where the shareholder's dividend warrant is sent to a bank account at the shareholder's request.
- Splitting of share certificates, where a single certificate containing a large number of shares is replaced with a number of certificates containing a smaller number of shares.

- Consolidation of shares, where many certificates belonging to a single shareholder are combined into one share certificate.
- Mailing annual reports and invitations to various meetings.

Main Inputs in a share accounting systems are:

- Shareholding data from a fresh issue-this is usually supplied by the issue agency on electronic media.
- Share transfer request.
- Split request.
- Consolidation request.
- Request for bank mandate.
- Tax exemption forms.
- Request for duplicate certificates.
- Request for duplicate dividend warrants.
- Change in shareholder's address.

Main Processing in a share accounting systems are:

- Updating shareholders master file.
- Recording the transfer of shares.
- Handling splitting, consolidation and duplicate requests and printing new certificates.
- Calculation of dividend and income tax to be deducted.

Main Outputs in a share accounting systems are:

- Transferred share certificates.
- New share certificates in case of consolidations, splitting and duplicates.
- Dividend warrants and counterfoils.
- Statement of Tax deductions.

(b) Decision Support Systems are widely used as part of an organisation's AIS. The complexity and nature of decision support systems vary from organization to organization. Many are developed in-house using either a general type of decision support program or a spreadsheet program to solve specific problems. Below are the examples of DSS in Accounting includes:

- Cost Accounting System: The health care industry is well-known for its cost complexity. Managing cost in this industry requires controlling costs of supplies, expensive machinery, technology, and a variety of personnel. Cost Accounting applications help health care organisations calculate product costs for individual

procedures or services. Decision support systems can accumulate these product costs to calculate total costs per patient. Combining cost accounting DSS and Productivity system applications allows managers to measure the effectiveness of specific operating processes to improve its management decision-making.

- **Capital Budgeting System:** Companies require new tools to evaluate high-technology investment decisions. Decision makers need to supplement analytical techniques with decision support tools that consider some benefits of new technology. One decision support system designed to support decisions about investments in automated manufacturing technology that is AutoMan, which allows decision makers to consider financial, non-financial, quantitative, and qualitative factors in their decision-making processes. Using this decision support system, accountants, managers, and engineers identify and prioritize these factors. They can then evaluate up to seven investment alternatives at once.
- **Budget Variance Analysis System:** Financial institutions rely heavily on their budgeting systems for controlling costs and evaluating managerial performance. DSS allows comptrollers to graph, view, analyse, and annotate budget variances, as well as create additional one-and five year budget projections using the forecasting tools provided in the system. The decision support system thus helps the comptrollers create and control budgets for the cost-center managers reporting to them.
- **General Decision Support System:** These types of decision support systems are a decision-maker's tools that are used to input the data and answer questions about a specific problem domain to make use of this type of decision support system. An example is a program called Expert Choice. This program supports a variety of problems requiring decisions. The user works interactively with the computer to develop a hierarchical model of the decision problem. The decision support system then asks the users to compare decision variables with each other. Expert Choice analyses investment judgments and presents the decision maker with the best alternative.

Question 4

- (a) What is system manual? What information is included in it?
- (b) What are five control objectives of an Operating system?
- (c) What steps can be taken to detect computer fraud? (10 + 5 + 5 = 20 Marks)

Answer

- (a) A system manual or job specification manual is an output of the system design that describes the task to be performed by the system with complete layouts and flow charts. It contains:
 - (i) **General description of the existing system:** It describes the general structure of the existing system from top management to the bottom management.

- (ii) Flow of the existing system: It describes the input, processing and output of the data to be flow at various levels of organisation's structure.
 - (iii) Outputs of the existing system: The documents produced by existing system are listed and briefly described, including distribution of copies.
 - (iv) General description of the new system: Its purpose and functions and also major differences from the existing system are stated together with a brief justification for the changes.
 - (v) Flow of the new system: This shows the flow of the system from and to the computer operation and within the computer department.
 - (vi) Output Layouts: It describes the user interface or layouts for the user that is used for better communication in near future.
 - (vii) Output distribution: The output distribution is summarized to show what each department will receive as a part of the proposed system.
 - (viii) Input layouts: The inputs to the new system are described as well as a complete layouts of the input documents, input disks or tapes are described.
 - (ix) Input responsibility: The source of each input document is indicated as also the user department responsible for each item on the input documents.
 - (x) Macro Logic: The overall logic of the internal flows will be briefly described by the systems analyst, wherever useful.
 - (xi) Files to be maintained: The specifications will contain a listing of the tape, disk or other permanent record files to be maintained, and the items of information to be included in each file.
 - (xii) List of programs: A list of programs to be written shall be a part of the systems specifications.
 - (xiii) Timing estimates: A summary of approximate computer timing is provided by the system analyst.
 - (xiv) Controls: This shall include type of controls, and the method in which it will be operated.
 - (xv) Audit trail: A separate section of the systems specifications shows the audit trail for all financial information. It indicates the methods with which errors and defalcation will be prevented or eliminated.
 - (xvi) Glossary of terms used.
- (b) Five Control Objectives of an operating system are:
- (i) The operating system must protect itself from users: User applications must not be able to gain control of, or damage in any way, the operating system, thus causing it to cease running or destroy data.

- (ii) The operating system must protect users from each other: One user must not be able to access, destroy, or corrupt the data or programs of another user.
 - (iii) The operating system must protect users from themselves: A user's application may consist of several modules stored in separate memory locations, each with its own data. One module must not be allowed to destroy or corrupt another module.
 - (iv) The operating system must be protected from itself: The operating system is also made up of individual modules. No module should be allowed to destroy or corrupt another module.
 - (v) The operating system must be protected from its environment: In the event of a power failure or other disaster, the operating system should be able to achieve a controlled termination of activities from which it can later recover.
- (c) The following steps can be taken to detect computer fraud:
- (i) Conduct Frequent Audit: To conduct periodic external and internal audits as well as specific network security audits is the way to detect the computer fraud. Auditors regularly test system controls and periodically browse data files looking for suspicious activities. However, care must be exercised to make sure that employees' privacy rights are not violated.
 - (ii) Use a Computer Security Officer: Most frauds are not detected by internal or external auditors. The security officer should be independent of the information system function and can monitor the system and disseminate information about improper system uses and their consequences.
 - (iii) Use Computer Consultants: Outside computer consultants or in-house teams to test and evaluate their security procedures and that is closely evaluated, and corresponding protective measures are implemented.
 - (iv) Monitor System Activities: All system transactions and activities should be recorded in a log. The log should indicate who accessed what data, when, and from which terminal. These logs should be reviewed frequently to monitor system activity and trace any problems to their source. There are a number of risk analysis and management software packages that can review computer systems and networks. These systems evaluate security measures already in place and test for weaknesses and vulnerabilities. A series of reports is then generated that explain the weaknesses found and suggest improvements.
 - (v) Use Fraud Detection Software: People who commit fraud tend to follow certain patterns and leave behind telltale clues, such as things that do not make sense. Software has been developed to search out these fraud symptoms.

Question 5

- (a) What is prototyping approaches to systems development? Describe its advantages and disadvantages also.

- (b) Describe some of the powers of controller under section 89 to make regulations consistent with Information Technology Act, 2000.
- (c) What is Transaction processing cycle? Discuss briefly four common cycles of a business activity. (10 + 5 + 5 = 20 Marks)

Answer

- (a) Prototyping approaches: Prototyping technique is used to develop smaller systems such as decision support systems, management information systems and expert systems. The goal of prototyping approach is to develop a small or pilot version called a prototype of part or all of a system. A prototype is a usable system or system component that is built quickly and at a lesser cost, and with the intention of being modifying or replacing it by a full scale and fully operational system. Finally, when a prototype is developed that satisfies all user requirements, either it is refined and turned into the final system or it is scrapped. If it is scrapped, the knowledge gained from building the prototype is develop the real system.

Prototyping can be viewed as a series of four steps:

Step 1: Identify Information System Requirements: In traditional approach, the system requirements have to be identified before the development process start. However, under prototype, the process of determining them can be less formal and time-consuming than when performing traditional systems analysis.

Step 2: Develop the Initial Prototype: In this step, the designers create an initial base model-for example, using fourth-general programming languages or CASE tools. The main goal of this stage is 'rapid development' and 'low cost'.

Step 3: Test and Revise: After finishing the initial prototype, the designers first demonstrate the model to users for experiment. At the outset, users must be told that the prototype is incomplete and requires subsequent modifications based on their feedback. Thus, the designers ask users to record their likes and dislikes about the system and recommend changes. Using this feedback, the design team modifies the prototype as necessary and then resubmits the revised model to system user for reevaluation. Thus interactive process of modification and reevaluation continues until the users are satisfied-commonly, through four to six interactions.

Step 4: Obtain User Signoff of the Approved Prototype: At the end of Step 3, users formally approve the final version of the prototype, which commits them to the current design and establishes a contractual obligation about what the system will, and will not do or provide.

Advantages of Prototyping

1. Prototyping requires intensive involvement by the system users. Therefore, it typically results in a better definition of the users' needs and requirements than does the traditional system development approach.

2. A very short time period (e.g., a week) is normally required to develop and start experimenting with a prototype. This short time period allows system users to immediately evaluate proposed system changes.
3. Since system users experiment with each version of the prototype through an interactive process, errors are hopefully detected and eliminated early in the developmental process. As a result, the information system ultimately implemented should be more reliable and less costly to develop than when the traditional systems development approach is employed.

Disadvantages of Prototyping

1. Prototyping can only be successful if the system users are willing to devote significant time in experimenting with the prototype and provide the system developers with change suggestions.
 2. The interactive process of prototyping causes the prototype to be experimented with quite extensively. Because of this, the system developers are frequently tempted to minimize the testing and documentation process of the ultimately approved information system. Inadequate testing can make the approved system error-prone, and inadequate documentation make this system difficult to maintain.
 3. Prototyping may cause behavioral problems with system users. These problems include dissatisfaction by users if system developers are unable to meet all user demands for improvements as well as dissatisfaction and impatience by user when they have to go through too many interactions of the prototype.
- (b) The controller has been given the following powers under Section 89 to make regulations consistent with the Information Technology Act, 2000:
- The particulars relating to maintenance of data base containing the disclosure record of every Certifying Authority
 - The conditions and restrictions subject to which the Controller may recognize any foreign Certifying Authority
 - The terms and conditions subject to which a license may be granted
 - Other standards to be observed by a Certifying Authority
 - The manner in which the Certifying Authority may make the disclosure Under Section 34
 - The particulars of statement to be submitted along with an application for the issue of a Digital Signature Certificate
 - The manner in which the subscriber should communicate the compromise of private key to the Certifying Authority.
- (c) A Transaction Processing Cycle organizes transactions by an organization's business processes. The nature and types of transaction processing cycles vary, depending on the information needs of a specific organization. Most business organizations have in

common, transactions that may be grouped according to four common cycles of business activity. These common Cycles are:

- Revenue Cycle: Events related to the distribution of goods and services to other entities and the collection of related payments.
- Expenditure Cycle: Events related to the acquisition of good and services from other entities and the settlement of related obligations.
- Production Cycle: Events related to the transformation of resources into goods and services.
- Finance Cycle: Events related to the acquisition and management of capital funds including cash.

Question 6

- (a) Describe various steps that should be taken for successful installation of the equipment during the implementation phase.
- (b) What are control techniques that are essential for the security of the client/server environment?
- (c) Differentiate between open and closed systems. (10 + 5 + 5 = 20 Marks)

Answer

- (a) Following steps should be taken for successful installation of the equipment:

1. Site preparation: An appropriate location must be found to provide an operating environment for the equipment that will meet the vendor's temperature, humidity and dust control specifications. It is very important to lay down proper procedures for acquiring and planning space layout in the systems implementation. A bad layout cannot only drastically reduce the productivity of the data processing department but also that of the entire organization as a whole. If the system is micro computer, little layout and site preparation work is needed. However, the electric lines should be checked to ensure that they are free of static or power fluctuation. It will be better to install a 'clean' line that is not shared by other equipments. In case of mini computer, or a mainframe, the Project Manager should prepare a rough layout, make cost estimates and get budget approved from the management. Layout planning must be done well in advance in order to permit acquisition for long lead-time items like air-conditioning equipments, etc. The following factors should be taken into consideration for space planning:

- Space occupied by the equipments
- Space occupied by the people, and
- Movement of equipment and people.

The site-layout should allow ample space for moving the equipment in and setting it for normal operation. Vendors will provide clearance requirement for performing services and maintenance and for air circulation. These requirements must be

strictly adhered to otherwise warranties may become void and maintenance discontinued until specifications are met. Carpets etc, should be avoided whenever possible in the computer room since they can create static charge which can cause the introduction of errors in the data or, in some case, accidental erase of data. Highly waxed floors produce the same effect. It is best to have the site preparation completed prior to the delivery of the equipment, since vendors are reluctant to deliver equipment when construction work is still in progress.

2. Equipment installation: The equipment must be physically installed by the manufacturer, connected to the power source and wired to communication lines, if required.
 3. Equipment check out: The equipment must be turned on for testing under normal operating conditions. Not only the routine 'diagnostic test' should be run by the vendor, but also the implementation team should devise and run extensive tests of its own to ensure that equipments are in proper working condition.
- (b) In Client/Server environment the security issue is the prime consideration at all access point that is known. The number of routes exist to access the application data on client/server, which should be examined and checked. To increase the security, the following control techniques are used:
- Access to data and application is secured by disabling the floppy disk drive.
 - Diskless workstation prevents unauthorized access.
 - Unauthorised users may be prevented from overriding login scripts and access by securing automatic boot or startup batch files.
 - Network monitoring can be done to know about the client so that it will be helpful for later investigation, if it is monitored properly.
 - Data encryption techniques are used to protect data from unauthorized access.
 - Authentication system can be provided to a client, so that they can enter into system, only by entering login name and password.
 - Smart cards can be used. It uses intelligent hand held devices and encryption techniques to decipher random codes provided by client-server based operating systems.
 - Application controls may be used and users will be limited to access only those functions in the system that are required to perform their duties.
- (c) A Closed System is self-contained and does not interact or make exchange across its boundaries with its environment. Closed systems do not get the feed back they need from the external environment and tend to deteriorate. A Closed Systems one that has only controlled and well defined input and output. Participant in a closed system become closed to external feed back without fully being aware of it. Some of the examples of closed systems are manufacturing systems, computer programs etc.

Open System actively interact with other systems and establish exchange relationship. They exchange information, material or energy with the environment including random and undefined inputs. Open systems tend to have form and structure to allow them to adapt to changes in their external environment for survival and growth. Organisations are considered to be relatively open systems.

Question 7

Write short notes on the following:

- (a) Data dictionary
- (b) System maintenance
- (c) Holistic protection
- (d) Snapshot technique. (4 × 5 = 20 Marks)

Answer

- (a) Data Dictionary: A data dictionary is a computer file that contains descriptive information about data items in the files of a business information System. Each computer record of a data dictionary contains information about a single data item used in a business information system. This information may include:
 - (i) Codes describing the data items length, data type and range.
 - (ii) The identity of the source documents used to create the data item.
 - (iii) The names of computer files that store the data item.
 - (iv) The names of the computer program that modify the data item.
 - (v) The identity of the computer program or individuals permitted to access the data item for the purpose of file maintenance, upkeep, or inquiry.
 - (vi) The identity of the computer programs or individuals not permitted to access the data file.

As new data fields are added to the record structure of a business file, information about each new data item is used to create a new computer record in the data dictionary. The data dictionary is updated to indicate the data items that are added /created. When data fields are deleted from the structure of the file records, their corresponding records in the data dictionary are dropped.

- (b) Systems Maintenance: Most information systems require at least some modification after development. The need for modification arises from a failure to anticipate all requirements during system design and / or from changing organisational requirements. The changing organizational requirements continue to impact most information systems as long as they are in operation. Consequently periodic systems maintenance is required for most of the information systems. Systems maintenance includes adding new data elements, modifying reports, adding new reports and changing calculations.

Maintenance can be categorised in the following two ways:

- (1) Scheduled maintenance is anticipated and can be planned for. For example the implementation of a new inventory coding scheme can be planned in advance.
- (2) Rescue maintenance refers to previously undetected malfunctions that were not anticipated but require immediate solution. A system that is properly developed and tested should have few occasions of rescue maintenance.

More and more systems are developed, a greater portion of systems analyst and programmer time is spent on maintenance which is a continuous exercise.

- (c) Holistic Protection: Protection must be done holistically and give the organization the appropriate level of security at a cost that is acceptable to the business. One must plan for the unexpected and unknown, expect the worst events to happen, and recover from these events if and when they occur, as though nothing ever happened. Such events cannot be planned, and they always seem to happen at the most inopportune times.
- (d) Snapshot Technique: It examines the way transactions are processed. Selected transactions are marked with a special code that triggers the snapshot process. Audit modules in the program, records these transactions and their master file records before and after processing. Snapshot data are recorded in a special file and reviewed by the auditor to verify that all processing steps have been properly executed.

The Suggested Answers for Paper 7: Direct Taxes are based on the provisions applicable for A.Y. 2007-08, which is the assessment year relevant for May, 2007 examinations.

PAPER – 7 : DIRECT TAXES

Answer all questions

Question 1

M/s. HIG, a firm, consisting of three partners namely, H, I and G, carried on the business of purchase and sale of television sets in wholesale and manufacture and sale of pens under a deed of partnership executed on 1.4.2002. H, I and G were partners in their individual capacity. The deed of partnership provided for payment of salary amounting to Rs.1,25,000 each to H and G, who were the working partners. A new deed of partnership was executed on 1.10.2006 which, apart from providing for payment of salary to the two working partners as mentioned in the deed of partnership executed on 1.4.2002, for the first time provided for payment of simple interest @ 12% per annum on the balances standing to the credit of the Capital accounts of partners from 1.4.2006. The firm was dissolved on 31.3.2007 and the Capital assets of the firm were distributed among the partners on 20.4.2007. The net profit of the firm for the year ending 31.3.2007 after payment of salary to the working partners and debit/credit of the following items to the Profit and Loss Account was Rs.1,50,000:

- (i) Interest amounting to Rs.1,00,000 paid to the partners on the balances standing to the credit of their capital accounts from 1.4.2006 to 31.3.2007.
- (ii) Interest amounting to Rs.50,000 paid to the partners on the balances standing to the credit of their Current accounts from 1.4.2006 to 31.3.2007.
- (iii) Interest amounting to Rs.20,000 paid to the Hindu undivided family of partner H @ 18% per annum.
- (iv) Payment of Rs.25,000 towards purchase of television sets made by crossed cheque on 1.11.2006.
- (v) Rs.30,000 being the value of gold jewellery received as gift from a manufacturer for achieving sales target.
- (vi) Depreciation amounting to Rs.15,000 on motor car bought and used exclusively for business purposes, but not registered in the name of the firm.
- (vii) Depreciation under section 32(1)(ii) amounting to Rs.37,500 of new machinery bought and installed for manufacture of pens on 1.11.2006 at a cost of Rs.5,00,000. There was no increase in the installed capacity as a result of the installation of the new machinery.
- (viii) Interest amounting to Rs.25,000 received from bank on fixed deposits made out of surplus funds.

The firm furnishes the following information relating to it:

- (a) Closing stock-in-trade was valued at Rs.60,000 as per the method of lower of cost or market rate consistently followed by it. The market value of the closing stock-in-trade was Rs.65,000.

- (b) Brought forward business loss relating to the assessment year 2006-07 was Rs.50,000.
- (c) The fair market value of the capital assets as on 31.3.2007 was Rs.20,00,000 and the cost of their acquisition was Rs.15,00,000.

Compute the total income of M/s. HIG for the assessment year 2007-08.

You are required to furnish explanations for the treatment of the various items given above.

(16 Marks)

Answer

Computation of total income of M/s.HIG for the A.Y. 2007-08

Particulars	Rs.	Rs.
Net profit as per profit & loss account		1,50,000
Add: Interest to partners on capital accounts for the period from 1.4.2006 to 30.9.2006	50,000	
Interest to partners on current accounts from 1.4.2006 to 31.3.2007	50,000	
20% of Rs.25,000 paid towards purchase of television sets	5,000	
Difference on account of valuation of closing stock-in-trade at market value	5,000	
Salary paid to working partners considered separately	2,50,000	
		<u>3,60,000</u>
		5,10,000
Less: Additional depreciation on new machinery		50,000
		<u>4,60,000</u>
Less: Interest received from bank on fixed deposits considered separately		25,000
Book profit		<u>4,35,000</u>
Less: Salary to working partners -		
On first Rs.75,000 book profit @ 90%	67,500	
On next Rs.75,000 book profit @ 60%	45,000	
On balance Rs.2,85,000 book profit @ 40%	1,14,000	
		<u>2,26,500</u>
		2,08,500
Less: Business loss relating to assessment year 2006-07 set off		50,000
Income from business		<u>1,58,500</u>
Income from other sources		
Interest received from bank on fixed deposits		25,000
Total Income		<u>1,83,500</u>

Explanation for the treatment of various items

- (i) Interest to partners authorised by the partnership deed will be allowed as deduction only for the period beginning with the date of the partnership deed and not for any earlier period as per section 40(b)(iv). Therefore, interest paid to the partners on the balances standing to the credit of their capital accounts from 1.10.2006 alone is eligible for deduction, since the partnership deed was executed only on 1.10.2006. Interest for the period prior to 1.10.2006 is not allowed.
- (ii) The partnership deed of 1.10.2006 provided for payment of interest on balances in capital accounts of partners only. As such, the interest paid on the balances standing to the credit of the current accounts of partners is not allowable under section 40(b). The Kerala High Court has, in *Novel Distributing Enterprises v. DCIT & Anr.* (2001) 251 ITR 704 (Ker), on identical facts, held that interest paid to the partners on their current account balances is not allowable.
- (iii) Since H is a partner in his individual capacity, interest paid to the Hindu Undivided Family of partner H does not attract disallowance under section 40(b)(iv).
- (iv) Section 40A(3) has been amended by the Taxation Laws (Amendment) Act, 2006 with effect from 13.7.2006 to provide that expenditure, in respect of which payment exceeding Rs.20,000 has been made otherwise than by an account payee cheque / account payee bank draft, will attract disallowance at 20% thereof. Since the firm has made payment of Rs.25,000 towards purchase of television sets after 13.7.2006 by a crossed cheque and not by an account payee cheque, 20% of such expenditure would be disallowed.
- (v) Gold jewellery valued at Rs.30,000 received as gift from a manufacturer for achieving sales target is taxable under section 28(iv), being a benefit arising from business.
- (vi) Depreciation on motor car bought and used exclusively for the purposes of business is allowable though not registered in the name of the firm in view of the ratio of the decision of the Supreme Court in *Mysore Minerals Ltd. v. CIT* (1999) 239 ITR 775.
- (vii) The firm is entitled to additional depreciation@ 20% under section 32(1)(iia) in respect of the new machinery installed for manufacture of pens. Since the new machinery is put to use for less than 180 days during the relevant previous year, the additional depreciation is restricted to 50% of the prescribed rate of 20% i.e. it is restricted to 10%.
- (viii) Interest received from bank on fixed deposits made out of surplus funds is assessable under the head 'Income from other sources'. Hence, it is not taken into account for the purpose of computing book-profit.
- (ix) The Supreme Court has, in *A.L.A Firm v. CIT* (1991) 189 ITR 285, held that the closing stock has to be valued at market rate in the case of a dissolved firm. As such, the closing stock-in-trade of the firm has to be valued at the market rate.
- (x) Net profit shown in the profit and loss account computed in the manner laid down in Chapter IV-D as increased by the aggregate amount of the remuneration paid or payable to all the partners constitutes book profit as per Explanation 3 to section 40(b). Carry forward and set off of business loss is covered under Chapter VI. Hence, brought

forward business loss relating to the assessment year 2006-07 is not considered for calculation of book-profit.

- (xi) Section 45(4) is not applicable to the firm for the assessment year 2007-08, since though the dissolution of the firm took place on 31.3.2007, there was no transfer by way of distribution of capital assets during the relevant previous year. The distribution of the capital assets took place on 20.4.2007. The capital gains will be assessable in the assessment year 2008-09.

Question 2

- (a) Examine whether the following items of expenditure incurred/payments made by a company in the course of its business during the year ending 31.3.2007 are liable to fringe benefit tax for the assessment year 2007-08:
- (i) Reimbursement to employees of expenditure on food and beverages consumed by them in the office.
 - (ii) Sales commission paid to agents.
 - (iii) Advance towards travelling expenses to be incurred during April 2007.
 - (iv) Distribution of free samples of medicines to hospitals.
 - (v) Get-together of employees on Diwali and on Republic Day.
 - (vi) Contribution to approved superannuation fund in respect of two employees A and B amounting to Rs.90,000 and Rs.20,000 respectively. (6 Marks)
- (b) Discuss the taxability or otherwise of the following gifts received by M, an individual, during the financial year 2006-07:
- (i) Rs.24,000 each from his four friends on the occasion of his birthday.
 - (ii) Wrist watch valued at Rs.60,000 from his friend. (3 Marks)
- (c) T, an individual, filed his return of income for the assessment year 2006-07 on 15.6.2006 declaring a total income of Rs.1,20,000. He later discovered that he had not claimed a particular deduction amounting to Rs.2,10,000 while computing his business income in the said return. He filed a revised return on 3.1.2007 declaring a total loss of Rs.90,000. The Assessing Officer proposes to disallow the claim of T for carry forward of the business loss amounting to Rs.90,000 for the reason that the revised return declaring loss for the first time was filed beyond the time prescribed under section 139(3). Examine the validity of the proposed action of the Assessing Officer. (3 Marks)

Answer

- (a) (i) Yes, it is liable to fringe benefit tax, since only expenditure incurred on food or beverages procured by the employer for providing to his employees in an office or factory is exempt from fringe benefit tax.
- (ii) No, it is not liable to fringe benefit tax, since brokerage and selling commission paid to selling agents are in the nature of ordinary selling expenses and do not constitute

expenditure for the purposes of sales promotion including publicity. Therefore, the sales commission paid to agents is not liable to fringe benefit tax.

- (iii) No, it is not liable to fringe benefit tax. Fringe benefit tax is payable in the year in which the expenditure is incurred. Therefore, payment of advance towards expenditure to be incurred in the future will not attract fringe benefit tax. Hence, fringe benefit tax will not be payable on the advance paid towards travelling expenses to be incurred during April 2007.
 - (iv) Yes, it is liable to fringe benefit tax. Only expenditure on distribution of free samples of medicines or of medical equipment to doctors has been excluded from "sales promotion including publicity" and is consequently, exempt from levy of fringe benefit tax. Therefore, the expenditure on distribution of free samples of medicines to persons other than doctors like hospitals, nursing homes etc. will be liable to fringe benefit tax.
 - (v) The expenditure on meeting/get-together of employees and their family members on the occasion of any festival like 'Navratri', 'Diwali' etc., is expenditure on festival celebrations and, is therefore, liable to fringe benefit tax. However, such expenditure on celebration of Independence Day and Republic Day will not be liable to fringe benefit tax as they are not festivals as normally understood. Hence, while expenditure incurred on get-together of employees on Diwali is liable to fringe benefit tax, such expenditure incurred on Republic Day is not liable to fringe benefit tax.
 - (vi) No, it is not liable to fringe benefit tax. Under section 115WB(1)(c) read with section 115WC(1)(b), any contribution by the employer to an approved superannuation fund for employees in excess of Rs.1,00,000 in respect of each employee will be considered as a fringe benefit and would be liable to fringe benefit tax. In the instant case, contribution to such fund in respect of each of the two employees is less than Rs.1,00,000. Hence, the contribution made to the said fund in respect of both the employees A & B is not liable to fringe benefit tax.
- (b) (i) Section 56(2)(vi) inserted by the Taxation Laws (Amendment) Act, 2006 provides that where any sum of money is received without consideration by an individual or a Hindu undivided family from any person or persons on or after 1.4.2006 exceeding Rs.50,000 in the aggregate in any previous year, the whole of the aggregate value of such sum will be liable to tax. In the instant case, M has received Rs.24,000 from each of his four friends. The aggregate amount of gifts received works out to Rs.96,000. As such, the entire amount of Rs.96,000 is taxable under the head "Income from other sources".
- (ii) A plain reading of section 56(2)(vi) indicates that only sums of money received towards gift fall within its purview. Gifts in kind are not liable to tax thereunder. The gift of wrist watch valued at Rs.60,000 received by M from his friend is, therefore, not taxable.

- (c) T has filed his original return of income for the assessment year 2006-07 within the due date specified in section 139(1). Section 139(5) empowers an assessee, who discovers any omission or wrong statement in the return filed by him under section 139(1), to file a revised return before the expiry of one year from the end of the relevant assessment year or before the completion of the assessment, whichever is earlier. T, having discovered an omission to claim a particular deduction in the return filed by him under section 139(1), has filed a revised return within the time prescribed under section 139(5). A revised return has the effect of replacing the original return and relates back to the date of the original return. Thus, where a return was filed under section 139(1) declaring income and later it was revised declaring a loss, the loss shall be allowed to be carried forward as the revised return shall substitute the original return which was filed within time. There is no bar on filing a revised return showing loss for the first time. Therefore, the proposed action of the Assessing Officer to deny the benefit of carry forward of business loss to T is not valid in law.

Question 3

- (a) V, an individual, owned three residential houses which were let out. Besides, he and his four brothers co-owned a residential house in equal shares. He sold one residential house owned by him during the previous year relevant to the assessment year 2007-08. Within a month from the date of such sale, the four brothers executed a release deed in respect of their shares in the co-owned residential house in favour of V for a monetary consideration. V utilised the entire long-term capital gain arising out of the sale of the residential house for payment of the said consideration to his four brothers. V is not using the house, in respect of which his brothers executed a release deed, for his own residential purposes, but has let it out to another person, who is using it for his residential purposes. Is V eligible for exemption under section 54 of the Income-tax Act, 1961 for the assessment year 2007-08 in respect of the long-term capital gain arising from the sale of his residential house, which he utilised for acquiring the shares of his brothers in the co-owned residential house? Will the ownership of two more houses by him on the date of sale of the residential house and non-use of the new house for his own residential purposes disentitle him to exemption? (6 Marks)
- (b) ABC Ltd. took on sub-lease a building from J, an individual, with effect from 1.9.2006 on a rent of Rs.10,000 per month. It also took on hire machinery from J with effect from 1.10.2006 on hire charges of Rs.9,000 per month. ABC Ltd. entered into two separate agreements with J for sub-lease of building and hiring of machinery. The rent of building and hire charges of machinery for the financial year 2006-07 amounting to Rs.70,000 and Rs.54,000 respectively were credited by ABC Ltd. to the account of J in its books of account on 31.3.2007. Examine the obligation of ABC Ltd. to deduct tax at source in respect of the rent and hire charges. (4 Marks)
- (c) P, an individual, borrowed Rs.20,00,000 for repair and reconstruction of his self-occupied house property and paid interest of Rs.1,60,000 thereon during the year ending 31.3.2007. What is the amount of interest allowable as a deduction under section 24 for the assessment year 2007-08? (3 Marks)

Answer

- (a) The long-term capital gain arising on sale of residential house would be exempt under section 54 if it is utilized, inter alia, for purchase of a new residential house within one year before or two years after the date of transfer. Release by the other co-owners of their share in co-owned property in favour of V would amount to "purchase" by V for the purpose of claiming exemption under section 54 [CIT v. T.N. Aravinda Reddy (1979) 120 ITR 46 (SC)]. Since such purchase is within the stipulated time of two years, V is eligible for exemption under section 54. As V has utilised the entire long-term capital gain arising out of the sale of the residential house for payment of consideration to the other co-owners who have released their share in his favour, he can claim full exemption under section 54.

The ownership of two more houses on the date of sale of the residential house by V will not disentitle him from claiming the exemption under section 54. Such restriction is contained only in section 54F and not in section 54. Further, there is no requirement in section 54 that the new house should be used by the assessee for his own residence. The condition stipulated is that the new house should be utilised for residential purposes. This requirement would be satisfied even when the new house is let out for residential purposes.

- (b) Section 194-I dealing with deduction of tax at source from payment of rent has been amended by the Taxation Laws (Amendment) Act, 2006 with effect from 13.7.2006. The scope of the section has also been extended to include within its ambit, rent for machinery, plant and equipment. Tax is required to be deducted at source from payment of rent, by whatever name called, under any lease, sub-lease, tenancy or any other agreement or arrangement for the use of, inter alia, building and machinery, irrespective of whether such assets are owned or not by the payee. The limit of Rs.1,20,000 for tax deduction at source will apply to the aggregate rent of all the assets. Even if two separate agreements are entered into, one for sub-lease of building and the other for hiring of machinery, rent and hire charges under the two agreements have to be aggregated for the purpose of application of the threshold limit of Rs.1,20,000. Therefore, ABC Ltd. has to deduct tax at source under section 194-I @ 15% as increased by education cess of 2% in respect of the rent and hire charges aggregating to Rs.1,24,000 credited to the account of J, the payee.
- (c) Section 24(b) provides that where the self-occupied house property has been acquired, constructed, repaired, renewed or reconstructed with borrowed capital, deduction towards interest payable thereon shall not exceed Rs.30,000. Therefore, only Rs.30,000 would be allowed as deduction on account of interest on loan borrowed for repair and reconstruction of self-occupied house property. The higher limit of Rs.1,50,000 in respect of interest on loan borrowed on or after 1.4.99 would be available only where such loan is borrowed for acquisition or construction of self-occupied property and not for repair or reconstruction of such property.

Question 4

- (a) The following trusts claim that anonymous donations received by them during the financial year 2006-07 are not liable to tax under section 115BBC:
- (i) A charitable trust referred to in section 11 which applied the entire amount of anonymous donations for purposes of the trust during the relevant financial year.
 - (ii) A trust established wholly for religious purposes which applied 75% of the amount of anonymous donations for the purposes of the objects of the trust during the relevant financial year.

Examine the validity of the claim made by the trusts. (4 Marks)

- (b) PQR Co-operative Bank, a co-operative society, having its area of operation confined to Gubbi Taluk and the principal object of which is to provide for long-term credit for agricultural and rural development activities, has received the following amounts during the year ending 31.3.2007 :
- (i) Interest amounting to Rs.1,00,000 from its members on loans advanced to them.
 - (ii) Interest amounting to Rs.1,50,000 on deposits with other co-operative societies.
 - (iii) Rent amounting to Rs.2,00,000 from letting out its godowns for storage of commodities.

PQR Co-operative Bank seeks your advice in the matter of taxability of the above amounts and the eligibility for deduction, if any, in respect thereof for the assessment year 2007-08. (5 Marks)

- (c) MNO Ltd. is a company in which the public are not substantially interested. K is a shareholder of the company holding 15% of the equity shares. The accumulated profits of the company as on 31.3.2006 amounted to Rs.10,00,000. The company lent Rs.1,00,000 to K by an account payee bank draft on 1.10.2006. The loan was not connected with the business of the company. K repaid the loan to the company by an account payee bank draft on 30.3.2007. Examine the effect of the borrowal and repayment of the loan by K on the computation of his total income for the assessment year 2007-08. (3 Marks)

Answer

- (a) (i) Section 115BBC(1) provides for levy of tax @ 30% on anonymous donation received by, inter alia, charitable trusts or institutions referred to in section 11. Further, section 13(7) provides that the exemption provisions contained in sections 11 and 12 shall not be applicable in respect of any anonymous donation liable to tax under section 115BBC. As such, application of the anonymous donations received by the charitable trust for charitable purposes does not confer any exemption from tax. Therefore, the claim for non-taxability under section 115BBC of anonymous donations received by the charitable trust is not valid in law.
- (ii) Section 115BBC(2) provides that the provisions contained in section 115BBC(1) relating to the taxability of anonymous donations are not applicable to any trust or institution created or established wholly for religious purposes. As such, the trust

established wholly for religious purposes is not liable to be taxed in respect of the anonymous donations received by it. The application or non-application of such anonymous donation for the purposes of trust during the relevant financial year is not germane to the issue of taxability under section 115BBC.

- (b) Sub-clause (viiia) has been inserted in section 2(24) by the Finance Act, 2006 to include within the scope of definition of income, the profits and gains of any business of banking (including providing credit facilities) carried on by a co-operative society with its members. Hence, the interest of Rs.1,00,000 received by PQR Co-operative Bank on loans advanced to its members constitutes its income.

Further, interest received amounting to Rs.1,50,000 on deposits with other co-operative societies and rent amounting to Rs.2,00,000 received from letting out its godowns for storage of commodities also constitute the income of the co-operative bank.

Sub-section (4) inserted in section 80P by the Finance Act, 2006 with effect from the assessment year 2007-08 provides that section 80P shall not apply to any co-operative bank other than a primary agricultural credit society or a primary co-operative agricultural and rural development bank. Explanation to section 80P(4) defines a primary co-operative agricultural and rural development bank to mean a society having its area of operation confined to a taluk and the principal object of which is to provide for long-term credit for agricultural and rural development activities. PQR Co-operative Bank is a primary co-operative agricultural and rural development bank as defined in the said Explanation since it is a co-operative society having its area of operation confined to Gubbi Taluk and its principal object is to provide long-term credit for agricultural and rural development activities. Therefore, it is eligible for deduction under section 80P.

Interest of Rs.1,00,000 received by the bank on loans advanced to its members is eligible for deduction in full under section 80P(2)(a)(i).

Interest of Rs.1,50,000 received by the bank from deposits with other co-operative societies qualifies for deduction in full under section 80P(2)(d).

Rent of Rs.2,00,000 received by the bank from letting out its godowns for storage of commodities is eligible for deduction in full under section 80P(2)(e).

- (c) As per section 2(22)(e), any payment by a company, in which the public are not substantially interested, by way of advance or loan to a shareholder, being a person who is the beneficial owner of shares holding not less than 10% of the voting power, shall be treated as dividend to the extent to which the company possesses accumulated profits.

In the instant case, MNO Ltd. is a company in which the public are not substantially interested. The company has accumulated profits of Rs.10,00,000 on 31.3.2006. The loan given by the company to K was not in the course of its business. K holds more than 10% of the equity shares in the company. Therefore, assuming that K has voting power equivalent to his shareholding, section 2(22)(e) comes into play and the sum of Rs.1,00,000, representing the amount lent by the company to K, is includible as dividend in the total income of K for the assessment year 2007-08.

Under section 2(22)(e), the liability arises the moment the loan is borrowed by the shareholder and it is immaterial whether the loan is repaid before the end of the accounting year or not. Therefore, the repayment of loan by K to the company on 30.3.2007 will not affect the taxability of the sum of Rs.1,00,000 as dividend in his hands.

Question 5

- (a) XYZ Ltd. incurred expenditure amounting to Rs.3,00,000 in connection with the issue of rights shares and Rs.2,00,000 in connection with the issue of bonus shares during the year ending 31.3.2007. The company seeks your opinion in the matter of eligibility for deduction of the expenditure incurred from its business profits for the assessment year 2007-08. (4 Marks)
- (b) X, an individual, has got his books of account for the year ending 31.3.2007 audited under section 44AB. His total income for the assessment year 2007-08 is Rs.1,90,000. He desires to know if he can furnish his return of income for the assessment year 2007-08 through a Tax Return Preparer. (3 Marks)
- (c) Mr. Q, a non-resident, operates an aircraft between Singapore and Chennai. He received the following amounts in the course of the business of operation of aircraft during the year ending 31.3.2007:
- (i) Rs.2 crores in India on account of carriage of passengers from Chennai.
 - (ii) Rs.1 crore in India on account of carriage of goods from Chennai.
 - (iii) Rs.3 crores in India on account of carriage of passengers from Singapore.
 - (iv) Rs.1 crore in Singapore on account of carriage of passengers from Chennai.
- The total expenditure incurred by Mr. Q for the purposes of the business during the year ending 31.3.2007 was Rs.6.75 crores.
- Compute the income of Mr. Q chargeable to tax in India under the head "Profits and gains of business or profession" for the assessment year 2007-08. (4 Marks)
- (d) JKL Ltd. filed its return of loss for the assessment year 2006-07 on 10.1.2007 beyond the time prescribed under section 139(3) declaring a total loss of Rs.15,00,000. It approaches you for advice regarding the course of action to be taken to secure the benefit of carry forward of the business loss for set off against future profits. Advise the company suitably in the matter. (2 Marks)

Answer

- (a) The Supreme Court has, in *Brooke Bond India Ltd. v. CIT* (1997) 225 ITR 798 (SC), held that expenditure incurred by a company in connection with issue of shares with a view to increase its share capital is directly related to the expansion of its capital base and, therefore, constitutes a capital expenditure. The issue of rights shares results in expansion of the capital base of XYZ Ltd. Hence, expenditure of Rs.3,00,000 incurred by the company in connection with the issue of rights shares is a capital expenditure and is not allowable as a business expenditure.

On the other hand, the issue of bonus shares does not result in inflow of fresh funds or increase in the capital employed. It is merely capitalization of reserves. The issue of bonus shares does not expand the capital base of the company. The total funds available with the company and its capital structure will remain the same on issue of bonus shares. The Supreme Court, in CIT v. General Insurance Corporation (2006) 286 ITR 232, considered this effect of issue of bonus shares and ruled that expenditure incurred in connection with the issue of bonus shares was allowable as a revenue expenditure. In view of the decision of the Supreme Court, XYZ Ltd. will be eligible for deduction of the expenditure amounting to Rs.2,00,000 incurred in connection with the issue of bonus shares from its business profits for the assessment year 2007-08.

- (b) Section 139B inserted by the Finance Act, 2006 with effect from 1.6.2006 provides for the scheme for submission of returns of income through Tax Return Preparers. It empowers the Central Board of Direct Taxes (CBDT) to frame a scheme for the purpose of enabling any specified class or classes of persons to prepare and furnish their returns of income through Tax Return Preparers. Specified class or classes of persons have been defined to mean any person, other than a company or a person whose accounts are required to be audited under section 44AB or under any other existing law, who is required to furnish a return of income under the Act. Thus, companies and persons whose accounts are liable for tax audit under section 44AB do not fall within the definition of 'specified class or classes of persons' and consequently, cannot furnish their returns of income through Tax Return Preparers. In the instant case, the books of account of X for the year ending 31.3.2007 have been audited under section 44AB. As such, he cannot furnish his return of income for the assessment year 2007-08 through a Tax Return Preparer.
- (c) Section 44BBA incorporates special provisions for computing profits and gains of the business of operation of aircraft in the case of non-residents. Section 44BBA starts with a non-obstante clause. Therefore, section 44BBA overrides the provisions contained in sections 28 to 43A. As such, the business income of Mr. Q is required to be computed in accordance with the provisions of section 44BBA.

Under section 44BBA(1), a sum equal to 5% of the aggregate of the amounts specified in sub-section (2) is deemed to be the profits and gains chargeable to tax under the head "Profits and gains of business or profession". Sub-section (2) specifies the following amounts -

- (a) the amount paid or payable, whether in or out of India, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods from any place in India; and
- (b) the amount received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods from any place outside India.

Keeping in view the provisions of section 44BBA, the income of Mr. Q chargeable to tax in India under the head "Profits and gains of business or profession" is worked out hereunder -

	Rs.
Amount received in India on account of carriage of passengers from Chennai	2,00,00,000
Amount received in India on account of carriage of goods from Chennai	1,00,00,000
Amount received in India on account of carriage of passengers from Singapore	3,00,00,000
Amount received in Singapore on account of carriage of passengers from Chennai	1,00,00,000
	7,00,00,000

Income from business under section 44BBA at 5% of Rs.7,00,00,000 is Rs.35,00,000, which is the income of Mr.Q chargeable to tax in India under the head "Profits and gains of business or profession" for the A.Y.2007-08.

- (d) JKL Ltd. is advised to file an application under section 119(2)(b) with the Central Board of Direct Taxes(CBDT) seeking a direction to the concerned Assessing Officer to allow its claim for carry forward of business loss. The Karnataka High Court has, in Associated Electro Ceramics v. Chairman, CBDT (1993) 201 ITR 501, held that the Board has the power to condone the delay, in cases having claim of carry forward of losses, in exercise of its power under section 119(2)(b). Further, Circular No.8 of 16.5.2001 clarifies that the CBDT has the power under section 119(2)(b) to condone the delay in filing a return of loss having a claim of carry forward of losses.

Question 6

- (a) State briefly the provisions relating to furnishing of annual information return under the Income-tax Act, 1961. What are the consequences of not furnishing the annual information return? (7 Marks)
- (b) S, an individual, carried on the business of purchase and sale of agricultural commodities like paddy, wheat, etc. He borrowed loans from Punjab State Financial Corporation and State Bank of India and has not paid interest as detailed hereunder:

	Rs.
(i) Punjab State Financial Corporation (Previous years 2004-05, 2005-06 & 2006-07)	36,00,000
(ii) State Bank of India (Previous years 2005-06 & 2006-07)	72,00,000
	1,08,00,000

Both Punjab State Financial Corporation and State Bank of India, while restructuring the loan facilities of S during the year ended 31.3.2007, converted the above interest payable by S to them as loan repayable in 36 equal instalments. During the year ended 31.3.2007, S paid six instalments to Punjab State Financial Corporation and five

instalments to State Bank of India. S claimed the entire interest of Rs.1,08,00,000 as an expenditure while computing the income from business of purchase and sale of agricultural commodities. Discuss whether his claim is valid and if not, what is the amount of interest, if any, allowable. (4 Marks)

- (c) R, an individual, filed his return of income for the assessment year 2006-07 on 15.6.2006. He later discovered that he had not claimed deduction under section 80-C in the said return. He claimed the said deduction through a letter addressed to the Assessing Officer. The Assessing Officer completed the assessment without allowing the deduction claimed by R. Is the Assessing Officer justified in doing so? (2 Marks)

Answer

- (a) Section 285BA provides that any assessee, who enters into any financial transaction, as may be prescribed, with any other person, shall furnish, within the prescribed time, an annual information return in such form and manner, as may be prescribed, in respect of such financial transactions entered into by him during any previous year.

Sub-section (1) casts responsibility on an assessee or the prescribed person in the case of an office of Government or certain other authorities, who are responsible for registering or maintaining books of account or other documents containing a record of any specified financial transaction, to furnish an annual information return.

Such annual information return should be furnished to the prescribed income-tax authority or such other authority or agency as may be prescribed in respect of –

- (i) such transactions registered or recorded by him during any financial year beginning on or after 1st April, 2004, and
- (ii) information relating to which is relevant and required for the purposes of this Act

The annual information return has to be furnished within the prescribed time after the end of such financial year in such form and manner (including on a floppy, diskette, magnetic cartridge tape, CD-ROM or any computer readable media) as may be prescribed.

“Specified financial transaction” includes the following transactions, which may be prescribed by the CBDT –

- (i) a transaction of purchase, sale or exchange of goods or property or right or interest in a property, or
- (ii) a transaction for rendering any service, or
- (iii) a transaction under a works contract, or
- (iv) a transaction by way of an investment made or an expenditure incurred, or
- (v) a transaction for taking or accepting any loan or deposit

The CBDT may prescribe different values for different transactions in respect of different persons, having regard to the nature of such transactions. The value or the aggregate value of such transactions during a financial year so prescribed referred to above should not be less than fifty thousand rupees.

Section 271FA provides a penalty for not furnishing a return as required under section 285BA(1). Penalty of Rs.100 is attracted for every day during which failure continues, if a person who is required to furnish an annual information return fails to furnish such return within the time prescribed.

- (b) Section 43B allows deduction only on “payment” basis in respect of certain expenditure specified therein, irrespective of the method of accounting followed by the assessee. Such expenditure would be allowed as deduction in the previous year in which the liability to pay such sum was incurred only if the payment is made on or before the due date for filing the return of income under section 139(1). If the payment is made after the stipulated due date, deduction can be claimed only in the year of actual payment. Such specified expenditure include, inter alia,
- (1) interest on loan or borrowing from any public financial institution or a State financial corporation or a State industrial investment corporation; and
 - (2) interest on any loan or advances from a scheduled bank.

A clarification has been given by way of insertion of Explanations 3C and 3D in section 43B by the Finance Act, 2006. These Explanations clarify that if any sum payable by the assessee as interest on any such loan or borrowing or advance is converted into a loan or borrowing or advance, the interest so converted and not “actually paid” shall not be deemed as actual payment, and hence would not be allowed as deduction. The clarificatory explanations reiterate the rationale that conversion of interest into a loan or borrowing or advance does not amount to actual payment. Therefore, Rs.1,08,00,000, being the aggregate of interest on loan (from a State Financial Corporation and a scheduled bank) converted into loan will not be allowed as deduction. Consequently, the claim of S is not valid.

The manner in which the converted interest will be allowed as deduction has been clarified in Circular No.7/2006 dated 17th July, 2006. The unpaid interest, whenever actually paid to the bank or financial institution, will be in the nature of revenue expenditure deserving deduction in the computation of income. Therefore, irrespective of the nomenclature, the deduction will be allowed in the previous year in which the converted interest is actually paid.

Hence, the repayment of Rs.16,00,000 during the A.Y. 2007-08, as detailed hereunder, will be allowed as deduction while computing the business income of S.

Particulars	Rs.
Paid to Punjab State Financial Corporation (36,00,000 x 6/36)	6,00,000
Paid to State Bank of India (72,00,000 x 5/36)	10,00,000
	16,00,000

- (c) The Supreme Court has, in Goetze (India) Ltd. v. CIT (2006) 284 ITR 323, ruled that the assessing authority has no power to entertain a claim for deduction made after filing of the return of income otherwise than by way of a revised return. In the instant case, R

has claimed the deduction under section 80C, which he omitted to claim in the original return of income, through a letter addressed to the Assessing Officer and not by filing a revised return under section 139(5). In view of the decision of the Supreme Court cited above, the Assessing Officer was justified in completing the assessment without allowing the deduction under section 80C.

Question 7

- (a) The directors of a private company are personally liable to pay the income tax due from the company. Discuss. (4 Marks)
- (b) GP Ltd. was incorporated on 31.12.2005 for manufacture of tyres and tubes for motor vehicles. The manufacturing unit was set up on 30.4.2006. The company commenced its manufacturing operations on 1.5.2006. The total cost of the plant and machinery installed in the unit is Rs.100 crores. The said plant and machinery included second hand plant and machinery bought for Rs.10 crores and new plant and machinery for scientific research relating to the business of the assessee acquired at a cost of Rs.10 crores.
- Compute the amount of depreciation allowable under section 32 of the Income-tax Act, 1961 in respect of the assessment year 2007-08. Furnish explanations in support of your computation. (4 Marks)
- (c) The Assessing Officer lodged a complaint against M/s. KLM, a firm, under section 276CC of the Income-tax Act, 1961 for failure to furnish its return of income for the assessment year 2005-06 within the prescribed time. The tax payable on the assessed income, as reduced by the advance tax paid and tax deducted at source, was Rs.60,000. The appeal filed by the firm against the order of assessment was allowed by the Commissioner (Appeals). The Assessing Officer passed an order giving effect to the order of the Commissioner (Appeals). The tax payable by the firm as per the said order of the Assessing Officer was Rs.1,000. The Assessing Officer has accepted the order of the Commissioner (Appeals) and has not preferred an appeal against it to the Income Tax Appellate Tribunal. The firm desires to know of the maintainability of the prosecution proceedings in the facts and circumstances of the case. (3 Marks)

Answer

- (a) Section 179 contains the provisions relating to the liability of directors of a private company in liquidation in respect of tax due from the company. Where any tax due from a private company in respect of income of any previous year or from any other company in respect of any income of any previous year during which such other company was a private company cannot be recovered, then, every person who was a director of such company at any time during the relevant previous year shall be jointly and severally liable for the payment of such tax. However, the director shall not be so liable if he proves that the non-recovery cannot be attributed to any gross neglect, misfeasance or breach of duty on his part in relation to the affairs of the company.

Where a private company is converted into a public company and the tax assessed in respect of income of any previous year during which such company was a private

company cannot be recovered from the company, then such tax dues shall be recovered from every person who was a director during the relevant previous year.

- (b) Computation of depreciation allowable for the A.Y. 2007-08 in the hands of GP Ltd.

Particulars	Rs. in crores	
Total cost of plant and machinery	100.00	
Less: Used for Scientific Research (Note 1)	<u>10.00</u>	
	<u>90.00</u>	
Normal Depreciation at 15% on Rs.90 crores		13.50
Additional Depreciation:		
Cost of plant and machinery	100.00	
Less: Second hand plant and machinery (Note 2)	10.00	
Plant and machinery used for scientific research, the whole of the actual cost of which is allowable as deduction under section 35(2)(ia) (Note 2)	<u>10.00</u>	<u>20.00</u>
		80.00
Additional Depreciation at 20%		<u>16.00</u>
Depreciation allowable for A.Y.2007-08		<u>29.50</u>

Notes:

- As per section 35(2)(iv), no depreciation shall be allowed in respect of plant and machinery purchased for scientific research relating to assessee's business, since deduction is allowable under section 35 in respect of such capital expenditure.
- As per section 32(1)(iia), additional depreciation is allowable in the case of any new machinery or plant acquired and installed after 31.3.2005 by an assessee engaged in the business of manufacture or production of any article or thing, at the rate of 20% of the actual cost of such machinery or plant.

However, additional depreciation shall not be allowed in respect of, inter alia, –

- any machinery or plant which, before its installation by the assessee, was used either within or outside India by any other person;
- any machinery or plant, the whole of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income chargeable under the head "Profit and gains of business or profession" of any one previous year.

In view of the above provisions, additional depreciation cannot be claimed in respect of -

- (i) Second hand plant and machinery; and
 - (ii) New plant and machinery purchased for scientific research relating to assessee's business in respect of which the whole of the capital expenditure can be claimed as deduction under section 35(1)(iv) read with section 35(2)(ia).
- (c) Section 276CC provides for prosecution for willful failure to furnish a return of income within the prescribed time. However, prosecution proceedings will not be attracted if the tax payable by the assessee on the total income determined on regular assessment, as reduced by the advance tax, if any, paid and any tax deducted at source, does not exceed Rs.3,000. Even though the tax liability of the firm as per the original order of assessment exceeded Rs.3,000, however, as a result of the order of the Commissioner (Appeals), it got reduced to Rs.1,000, which is, less than Rs.3,000. Therefore, since the tax liability of the firm on final assessment was determined at Rs.1,000, the prosecution proceedings are not maintainable. In *Guru Nanak Enterprises v. ITO* (2005) 279 ITR 30, where the facts were similar, the Supreme Court held that prosecution was unwarranted

Question 8

- (a) S gifted Rs.2,00,000 to his wife on 10.4.2006. His wife bought gold jewellery on 31.1.2007 out of the said sum of Rs.2,00,000. The fair market value of the gold jewellery as on 31.3.2007 was Rs.2,50,000. S claims that since his wife has not held on 31.3.2007 the sum of Rs.2,00,000 which he gifted to her, no amount is includible in his net wealth for the assessment year 2007-08. Examine the claim of S. (3 Marks)
- (b) Wealth tax is not payable by an assessee in respect of any property held under trust or other legal obligation for any public purpose of a charitable or religious nature in India. Do you agree with the statement? (2 Marks)
- (c) Compute the net wealth of UMV Ltd. (carrying on the business of running cars on hire and also dealing in jewellery) which furnishes the following particulars of its assets and liabilities as on 31.3.2007:

	(Rs. in crores)	(Rs. in crores)
	Book value	If valued as per Schedule III
Assets		
(i) Fixed Assets:		
Plant & Machinery	10	15
Factory Building	25	10
Urban land (450 sq. meters)	40	100
Motor cars	5	10
(ii) Investments		
Jewellery	15	30
Plot of land in Mumbai (480 sq. meters)	10	50

	Equity shares in subsidiary companies	20	25
(iii)	Current assets :		
	Inventories (Jewellery)	150	150
	Sundry Debtors	10	10
	Cash and bank balances		
	(includes cash balance of Rs.1,00,000)	5	5
	Liabilities		
(i)	Current Liabilities	40	40
(ii)	Loans secured on Fixed Assets (Urban land)	30	30

(5 Marks)

Answer

- (a) Section 4(1)(a) of the Wealth-tax Act, 1957 provides that the value of assets which are transferred, directly or indirectly, otherwise than for adequate consideration or in connection with an agreement to live apart, by a husband to his wife or vice versa, are to be clubbed in the hands of the transferor, whether the assets are held in the form in which they were transferred or otherwise. The Supreme Court has, in CWT v. Kishan Lal Bubna (1993) 204 ITR 600, held that where the assessee transfers money and the transferee utilises that money to acquire an asset, it is the value of that asset on the valuation date which is relevant for the purposes of computing the net wealth of the assessee. Where what is transferred by the assessee is an asset and the transferee disposes of the asset and acquires with the consideration received another asset, it is the value of that acquired asset on the valuation date which is relevant for the purposes of computing the net wealth of the assessee. In view of this legal position, the claim of S is not valid. The value of gold jewellery as per Schedule III on the valuation date 31.3.2007 is includible in the net wealth of S for A.Y.2007-08. Therefore, Rs.2,50,000, being the fair market value of gold jewellery as on 31.3.2007 is includible in the net-wealth of S under section 4(1)(a).
- (b) The statement is valid. This exemption is provided in section 5(i). However, wealth-tax is payable in respect of the following properties:
- Any property held under any trust or other legal obligation forming part of any business, other than the business referred to in section 11(4A)(a) or section 11(4A)(b) of the Income-tax Act, 1961 in respect of which separate books of accounts are maintained; or
 - Any property forming part of a business carried on by an institution, fund or trust referred to in section 10(23B) or 10(23C) of the Income-tax Act, 1961.

(c) Computation of Net Wealth of UVM Limited as on the valuation date 31.03.2007

Particulars	Reasons	Value (Rs. in crores)
Assets:		
(i) Fixed Assets:		
Plant & Machinery	Not an asset u/s 2(ea)	Nil
Factory building	Commercial property. Hence, not an asset u/s 2(ea)	Nil
Urban land (450 sq. meters)	It is an asset u/s 2(ea) - Refer Note 2	100
Motor cars	Used for running on hire. Hence, not an asset u/s 2(ea) – Refer Note 3	Nil
(ii) Investments:		
Jewellery	Not stock-in-trade. Hence, an asset u/s 2(ea)	30
Plot of land in Mumbai	An asset u/s 2(ea). Refer Note 2	50
Equity shares in subsidiary companies	Not an asset u/s 2(ea)	Nil
(iii) Current assets:		
Inventories (Jewellery)	Stock-in-trade. Hence, not an asset u/s 2(ea)	Nil
Sundry Debtors	Not an asset u/s 2(ea)	Nil
Cash and bank balances (includes cash balance of Rs.1,00,000)	Bank balance – not an asset under section 2(ea). Cash in hand – recorded in books – hence, not an asset under section 2(ea).	Nil
Value of assets as per Schedule III of the Wealth-tax Act, 1957(A)		<u>180</u>
Liabilities:		
(i) Current Liabilities	Not incurred in relation to an asset under section 2(ea). Hence, not eligible for deduction.	Nil
(ii) Loans secured on Fixed Assets (Urban land)	Assuming that the loan is taken for purchase of urban land, which is included in the net wealth, it is eligible for deduction.	30
Liabilities eligible for deduction (B)		<u>30</u>
Net wealth [(A) – (B)]		150

Notes:

1. The value of any asset other than cash shall be its value as on the valuation date determined in the manner laid down in Schedule III.
2. Plot of land not exceeding 500 sq. meters is exempt only in the case of an individual or HUF and not in the case of a company.
3. It is assumed that all the motor cars are used in the business of running on hire.

The suggested answers for Indirect Taxes (Paper 8) are based on the provisions as amended by the Finance Act, 2006 and Notifications/Circulars issued up to 31.10.2006 which are relevant for May 2007 examinations.

PAPER – 8 : INDIRECT TAXES

Question Nos. 1, 6 and 9 are compulsory. In addition thereto, answer any two questions from Part “A” and one question from Part “B”.

PART – A

Question 1

- (a) Briefly explain any two of the following with reference to the provisions of the Central Excise Act, 1944:
- (i) Adjudicating Authority
 - (ii) Central Excise Officer
 - (iii) Duty paid under protest (2 x 2 = 4 Marks)
- (b) What is the period of validity of registration certificate granted by the Appropriate Excise Authority? (2 Marks)
- (c) Discuss the validity or otherwise of the following statements, with reasons:
- (i) Inputs cleared as such to a job worker on 01.10.2006 were not returned in 180 days (assessable value being Rs.20,000, excise duty @ 16.32%). 50% of the inputs were received on 1.4.2007. In this situation, no cenvat will be allowed in the year ending on 31.3.2007.
 - (ii) Captive consumption of excisable goods should always be valued on the basis of sale price of similar goods manufactured by others. (2 x 3 = 6 Marks)
- (d) State the offences under Rule 25(1) of the Central Excise Rules, 2002. (4 Marks)
- (e) A2Z & Co., manufactured shikai powder. They purchased shikai seeds crushed them and sold the same. The assessee did not pay excise duty on such powder contending that such powder was not excisable goods. However, the Central Excise Department treated the said goods as excisable goods by classifying them under the chapter heading “3305.99 – Cosmetic or toilet – preparations, essential oil etc. – preparations for use on the hair – other”. Discuss the validity of the contention of the assessee. (4 Marks)

Answer

- (a) (i) As per section 2(a) of the Central Excise Act, 1944, adjudicating authority means any authority competent to pass any order or decision under this Act, but does not include the Central Board of Excise and Customs constituted under the Central Boards of Revenue Act, 1963, Commissioner of Central Excise (Appeals) or Appellate Tribunal.
- (ii) As per section 2(b) of the Central Excise Act, 1944, Central Excise Officer means

the Chief Commissioner of Central Excise, Commissioner of Central Excise, Commissioner of Central Excise (Appeals), Additional Commissioner of Central Excise, Joint Commissioner of Central Excise, Assistant Commissioner of Central Excise or Deputy Commissioner of Central Excise or any other officer of the Central Excise Department or any person (including an officer of the State Government) invested by the Central Board of Excise and Customs constituted under the Central Boards of Revenue Act, 1963 with any of the powers of a Central Excise Officer under the Act.

- (iii) Sometimes it happens that the classification and assessable value of goods determined by the excise authorities are not agreeable to or acceptable to the assessee. In such cases, the assessee can file an appeal and in the meanwhile he can pay duty under protest if no stay is obtained from Appellate Authorities.

The assessee shall inform the Superintendent or Inspector of Central Excise in writing giving reasons for paying duty under protest and obtain a dated acknowledgement. The assessee shall mark invoices or monthly/quarterly return indicating the goods on which duty is paid 'under protest'.

- (b) Once registration certificate is granted, it has a permanent status unless it is suspended or revoked by the appropriate authority in accordance with law or is surrendered by the person or company concerned. If the person who applies for registration with the department is an individual, then the certificate ceases to be valid in the event of the death of the said individual. In the case of limited company, death of a director does not affect the status of registration, since registration is issued to the body corporate recognizing the same as a legal person. In the case of partnership firms also, normally, no difficulty arises with regard to succession, since the surviving partners continue either in the same name or with the change of name of the business.
- (c) (i) True. Rule 4(5)(a) of the CENVAT Credit Rules, 2004 inter alia provides that CENVAT credit is allowed on the inputs or capital goods sent to the job worker for further processing, testing repair etc. if the same are received back in the factory of the manufacturer within 180 days of their being sent. If the inputs or capital goods are not received back within the said period, the manufacturer is required to pay an amount equal to the CENVAT credit attributable to such inputs or capital goods. However, the manufacturer can subsequently avail of the CENVAT credit again (which was debited when the said goods were not received) when the inputs or capital goods are received back.

In the given case, the inputs are received back on 01.04.2007 viz., after the expiry of 180 days of their being sent to the job worker. Therefore, the credit of Rs.3264 (Rs.20,000 x 16.32%) allowed earlier will have to be reversed.

However, credit of Rs.1632 (50% of Rs.3264) can be taken again on 01.04.07 since 50% of the inputs sent to the job worker are received back on 01.04.07, though the same cannot be shown in the CENVAT records made for financial year 2006-2007.

- (ii) False. It is incorrect to state that captive consumption of excisable goods should

always be valued on the basis of sale price of similar goods manufactured by others.

As per Rule 8 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 where the excisable goods are not sold by the assessee but are used for consumption by him or on his behalf in the production or manufacture of other articles, then such captively consumed goods have to be valued at 110% of the cost of production or manufacture of such goods. CBE&C has clarified that such cost of production or manufacture should be computed in accordance with the Cost Accounting Standard - 4 issued by the Institute of Cost and Works Accountants of India.

- (d) Subject to the provisions of section 11AC of the Central Excise Act, 1944, following offences have been prescribed under rule 25(1) of the Central Excise Rules, 2002:
- (a) removal of any excisable goods in contravention of any of the provisions of these rules or the notifications issued under these rules; or
 - (b) non accounting of any excisable goods produced or manufactured or stored; or
 - (c) manufacture, production or storage of any excisable goods without having applied for the registration certificate required under section 6 of the Act; or
 - (d) contravention of any of the provisions of these rules or the notifications issued under these rules with intent to evade payment of duty.

If any producer, manufacturer, registered person of a warehouse or a registered dealer commits any of the above-mentioned offences then, he shall be liable to the penalty as prescribed and such goods shall be liable to confiscation.

- (e) The facts of the given case are similar to the case of *Mayil Mark Nilayam v. Superintendent of Central Excise, Madras* 2001 (127) E.L.T. 659 (Mad.). In this case, the High Court has held that Seeakkai is not an excisable commodity as it does not fall under the ambit of 'other' items grouped under Heading 3305.99 of the Central Excise Tariff. Seeakkai is a natural product, which is crushed into powder for removing oil stains and is also used for taking oil bath. Seeakkai means 'soap pod wattle' and is clearly distinct from soapnut powder or soapnut. It is neither a detergent or scouring powder nor does it have any application to the oil or to the hair.

Hence, the contention of the assessee is correct.

Note: Heading No.3305.99 now reads as 3305 90 90 in view of the new eight digit Central Excise Tariff being introduced with effect from 28.02.2005.

Question 2

- (a) M/s P Ltd. manufactured concentrates of non-alcoholic beverages and sold it to various bottlers. The bottlers after processing the concentrates bottled the outcome and sold the same. Under the agreement between P Ltd. and the bottlers, P Ltd. was required to advertise the finished products. Subsequently, the bottlers formed S Ltd. to work as a centralized agency for the advertisement of the finished products. The shareholders as

well as the directors of S Ltd. were the representatives of the bottlers.

Determine whether or not the expenses of advertisement incurred by S Ltd. to advertise aerated products manufactured by the third party i.e. bottlers, is includible in the assessable cost of concentrate manufactured by P Ltd. (4 Marks)

- (b) Examine the validity of the following statements:
- (i) Purchased a plant for Rs.1,16,320 cum-duty price on 12.12.2006 and received the plant in the factory on 5.4.2007. Excise duty rate 16.32%. Cenvat allowed will only be Rs.8,160 for the year ended 31.3.2007.
 - (ii) An assessee purchased inputs weighing 400 tons. The duty paid on inputs was Rs.4,000. During transit, 20 tons of the inputs were destroyed. The destroyed quantity of inputs does not qualify to be 'inputs' within the meaning of the Cenvat Credit Rules, 2004. (2 x 2 = 4 Marks)
- (c) Explain the non-applicability of 'transaction value' with reference to section 4 of the Central Excise Act, 1944. (5 Marks)
- (d) What are "exempted goods" under the Cenvat Credit Rules, 2004? (2 Marks)

Answer

- (a) The facts of the given case are similar to the case of CCEx. Mumbai v. Parle International Ltd. 2006 (198) ELT 486 (SC). In this case, the Apex Court has held that advertisement expenses incurred by the centralized agency to advertise aerated products manufactured by third party bottlers would not be includible in the assessable value of concentrates manufactured by the assessee, as only the advertisement and sales expenses incurred for the goods under assessment (here concentrate) could be added to the assessable value.

Thus, in this case the advertisement expenditure incurred by S Ltd. to advertise aerated products manufactured by the third party i.e. bottlers would not be includible in the assessable value of the concentrates manufactured by P Ltd.

- (b) (i) Cum-duty price of plant is Rs.1,16,320

Therefore, duty component = $1,16,320 \times (16.32/116.32) = \text{Rs.}16,320$

As per rule 4(2) of the CENVAT Credit Rules, 2004, out of the total credit of Rs.16,320 available on the plant, credit not exceeding up to 50% can be taken in the first year of acquisition and the balance in the subsequent years. Further, credit in respect of duty paid on capital goods can be taken only on receipt of the capital goods in the factory of the manufacturer.

Hence, in the given case, credit of Rs.8,160 (50% of Rs.16,320) in respect of duty paid on plant can be taken only on or after 05.04.2007. Accordingly, the same cannot be taken in the financial year 2006-2007.

- (ii) As per rule 2(k) of the CENVAT Credit Rules, 2004 inputs should be used in or in relation to production or manufacture of excisable goods. In the given case, 20 tons

of the inputs are destroyed in transit. Thus, they could not be used in or in relation to manufacture of excisable goods. Hence, they do not qualify to be 'inputs' within the meaning of CENVAT Credit Rules, 2004.

Therefore, the CENVAT credit admissible to the assessee will be Rs.3800/ only

$$\left[4000 - \left(\frac{4000 \times 20}{400} \right) \right]$$

- (c) The concept of 'transaction value' is applicable only in the circumstances where:
- (a) there is a sale of goods;
 - (b) the goods are sold for delivery at the time and place of removal;
 - (c) the assessee and the buyer of the goods are not related; and
 - (d) the price is the sole consideration for the sale.

In cases where any of the above-mentioned requirements are missing, the concept of 'transaction value' does not apply and the assessable value is determined on the basis of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 notified under section 4(1)(b) of the Central Excise Act, 1944.

- (d) Rule 2(d) of the CENVAT Credit Rules, 2004 defines 'exempted goods' as goods which are exempt from the whole of the duty of excise thereon and includes goods which are chargeable to 'NIL' rate of duty.

Question 3

- (a) The appellants were the manufacturers of rubber products. Some of the defective goods were returned by the buyers and the appellants took Cenvat credit of the duty originally paid under Rule 16 of the Central Excise Rules, 2002. Defective goods were reprocessed, which however yielded only scrap and such scrap was cleared on payment of duty. Department claimed that Cenvat credit taken by the appellants should be reversed since reprocessing did not amount to 'manufacture' whereas appellants argued that the process cannot be anything other than 'manufacture' in as much as the defective goods returned by their buyers were put to normal process of manufacture.

Offer your comments to the appellants referring to the decided case law. (5 Marks)

- (b) What are the provisions regarding general exemption to SSI units? (5 Marks)
- (c) M/s P Ltd. used to label its products with a foreign brand and claimed exemption under a notification. The classification list was approved by the department after carrying out verifications and all returns were regularly filed. The invoice containing description of goods were also regularly approved by the department. The department denied the benefit of exemption to the assessee by invoking extended period of limitation under section 11A on the ground that it failed to declare the particulars regarding affixing of labels. Is the department justified? (5 Marks)

Answer

- (a) The facts of the given case are similar to the case of Sundaram Industries Ltd. v. CCE, Madurai 2006 (202) ELT 538 (Tri.-Chennai). In this case, the Tribunal relied on the case of Commissioner v. Tata SSL Ltd. 2005 (191) ELT 799 (Tri. Mumbai) wherein it was held that ".....what is ultimately cleared from the factory is scrap resulting out of further processing of rejected wire".

Thus, the Tribunal held that the "process" undergone by the defective/returned final product amounted to "manufacture" though it resulted in scrap. The Tribunal further elaborated that on this fact, rule 16 got attracted and it was open to the appellants to remove the scrap on payment of duty, after availing CENVAT credit on the defective/returned final product.

Thus, the contention of the appellants is correct.

- (b) The Government has given various concessions to small scale industries. The most important notification governing these concessions is Notification No. 8/2003 CE dated 01.03.2003. The provisions of the notification are:
- (i) A unit is entitled for SSI exemption only if its turnover in previous year does not exceed Rs.4 crore e.g. a unit whose turnover is more than Rs.4 crore in financial year 2005-06 will not be eligible for any SSI concession in financial year 2006-07. However, a unit whose turnover is less than Rs.4 crore in financial year 2005-06 will be eligible for SSI exemption in financial year 2006-07. SSI exemption is available in respect of the goods specified in the said notification.
 - (ii) For a unit entitled for SSI exemption, turnover up to Rs.100 lakhs is fully exempt if the unit does not avail of CENVAT credit on inputs. However, if the SSI unit avails of CENVAT credit on inputs, it has to pay normal duty on all clearances.
 - (iii) A unit availing SSI exemption can avail of CENVAT credit on capital goods but such credit can be utilized only after the turnover crosses Rs.100 lakhs.
 - (iv) The limit of Rs.100 lakh or Rs.4 crore is calculated by taking into account the clearances in respect of one manufacturer from one or more factories or from a factory by one or more manufacturers.
 - (v) SSI exemption is not available if the SSI unit uses a brand name of another person on its clearances.
- (c) The facts of the given case are similar to the case of Pahwa Chemicals Private Ltd. v. CCEx., Delhi 2005 (189) ELT 257 (SC) wherein the Apex Court has held that mere failure to declare the particulars does not amount to mis-declaration or willful suppression. Some positive act on the part of the assessee to establish either willful mis-declaration or willful suppression is must.

The Apex Court explained that there was no willful mis-declaration or willful suppression as all the facts were within the knowledge of the department and the assessee did not make the declaration on the belief that affixing of a label made no difference. Thus, the Apex Court held that since all the facts were within the knowledge of department, hence

extended period of limitation was not invokable.

Thus, in view of the abovementioned judgement, the department is not justified in invoking the extended period of limitation in the given case.

Question 4

- (a) Explain whether a person who is neither a producer nor a curer nor a manufacturer of excisable goods, but only stores such goods in a warehouse, can be called upon to pay the duties of excise on such goods? (3 Marks)
- (b) "The value of price support incentives received from the raw materials supplier should be included in the assessable value of the final products". Do you agree? Explain. (3 Marks)
- (c) Briefly explain the procedure to be adopted in respect of exported goods subsequently re-imported and returned to factory. (4 Marks)
- (d) Explain the concept of 'Provisional Assessment' under Rule 7 of the Central Excise Rules, 2002. (5 Marks)

Answer

- (a) As per rule 4(1) of the Central Excise Rules, 2002, every person who produces or manufactures any excisable goods, or who stores such goods in a warehouse, shall pay the duty leviable on such goods. No excisable goods, on which any duty is payable, shall be removed without payment of duty from any place, where they are produced or manufactured or from a warehouse, unless otherwise provided.

Thus, a warehouse keeper though not a producer or manufacturer or curer, shall be liable to pay duty of excise on the goods stored by him.

- (b) In the case of CCEx. v. Bisleri International Private Limited 2005 (186) ELT 257 (SC), the value of the price support incentives was held as not includible in the assessable value of the final product as
 - there was no flow back of any additional consideration from the buyers;
 - the price uniformity was maintained;
 - there was no evidence of any concession to any of the buyers or existence of any favoured buyers.

It is possible to take a view that if the conditions pointed out by the Apex Court are not satisfied, the value of the price support incentives would be includible in the assessable value of the final product.

- (c) Exported excisable goods, which are re-imported for carrying out repairs, reconditioning, refining, remaking or subject to any similar process, may be returned to the factory of manufacturer for carrying out the said processes and subsequent re-export.

Notification No. 42/2001-CE (NT) as amended prescribes the procedure in respect of exported goods subsequently re-imported and returned to the factory as under:

- (i) The manufacturer shall maintain separate account for return of such goods in the

daily stock account and shall make suitable entry in the said account after the goods are processed, repaired, reconditioned, refined or remade.

- (ii) Such re-import and re-export shall be governed by the provisions of the Customs Act, 1962.
 - (iii) Any waste or refuse arising as a result of the said processes shall be removed from the factory after the payment of appropriate duty or destroyed after informing the proper officer in writing at least 7 days in advance and after observing such conditions and procedure as may be specified by the Commissioner of Central Excise.
 - (iv) Thereafter, the duty payable on such waste or refuse may be remitted by the said Commissioner of Central Excise.
- (d) Rule 7 of the Central Excise Rules, 2002 contains the provisions in respect of provisional assessment. Provisional assessment can be requested by the assessee. Department itself cannot order provisional assessment.

An assessee can request for provisional assessment if he:

- (i) is unable to determine the value of the excisable goods or
- (ii) is unable to determine the applicable rate of duty.

In aforesaid cases, assessee may request Assistant/Deputy Commissioner in writing giving reasons for provisional assessment of duty. After such request, the Assistant/Deputy Commissioner may by order allow payment of duty on provisional basis. The Assistant/Deputy Commissioner shall also specify the rate or value at which duty will be provisionally paid. Payment of duty on provisional basis will be allowed subject to execution of bond for payment of differential duty.

The Assistant/Deputy Commissioner should pass the order for final assessment within 6 months from the date of order of provisional assessment. If after final assessment, any differential amount becomes payable, interest shall be payable from the first day of the month succeeding the month for which such amount is determined, till the date of payment thereof. However, if a refund arises consequent to the order of final assessment, interest shall be payable on such refund from the first day of the month succeeding the month for which such refund is determined, till the date of refund. The refund shall be subject to the provisions of unjust enrichment.

Question 5

- (a) Discuss the power of the Central Government to amend First and Second Schedules of the Central Excise Tariff. (3 Marks)
- (b) What would be the outcome, if retail price is not indicated or wrongly indicated at the time of removal? (3 Marks)
- (c) State the non-application of provisions of unjust enrichment under section 11B(2) of the Central Excise Act, 1944. (4 Marks)

- (d) State the powers of the Settlement Commission under section 32 of the Central Excise Act, 1944. (5 Marks)

Answer

- (a) Section 5 of the Central Excise Tariff Act, 1985 empowers the Central Government to amend the First and Second Schedules. It provides that where the Central Government is satisfied that it is necessary so to do in the public interest, it may, by notification in the Official Gazette, amend the First Schedule and the Second Schedule. However, such amendment shall not alter or affect in any manner the rates specified in the First Schedule and the Second Schedule in respect of goods at which duties of excise shall be leviable on the goods under the Central Excise Act, 1944. Such notifications shall be laid before each House of Parliament, while it is in session, for a total period of thirty days as soon as it is issued.
- (b) Section 4A(4) of the Central Excise Act, 1944 inter alia provides that where a manufacturer removes the excisable goods from the place of manufacture without declaring the retail sale price of such goods on the packages or declares a retail sale price which is not the retail sale price as required to be declared under the central excise provisions or any other law then, such goods shall be liable to confiscation. Further, the retail sale price of such goods shall be ascertained in the prescribed manner and duty shall be payable as per the retail price so determined.
- (c) As per proviso to section 11B(2) of the Central Excise Act, 1944, a refund of excise duty is not hit by the bar of unjust enrichment (i.e., the refund, instead of being credited to the Fund, is paid to the applicant) if the amount of excise duty is relatable to:
- (a) rebate of excise duty on excisable goods exported out of India (if export is on payment of duty)
 - (b) rebate of excise duty on excisable materials used in manufacture of goods exported out of India (if CENVAT credit has not been availed)
 - (c) refund of credit of duty paid on inputs in accordance with any rules or notifications
 - (d) unspent advance deposits lying in balance in the applicant's account current
 - (e) the excise duty paid by the manufacturer, if he had not passed on the incidence of such duty to any other person
 - (f) the excise duty borne by the buyer, if he had not passed on the incidence of such duty to any other person
 - (g) the excise duty borne by certain notified applicants
- (d) The powers of the Settlement Commission are briefed hereunder:
- (i) It has all the powers of a Central Excise Officer.
 - (ii) It can attach the property of an applicant during the pendency of proceedings, to protect revenue.
 - (iii) It can regulate its own procedure and decide the places where the bench will sit.

- (iv) It has the power to grant immunity from prosecution, penalty, fine and interest.
- (v) It has the power to reopen any proceedings within five years from the date of application, if for proper disposal of the case pending before it, an earlier case which was settled is required to be reopened.
- (vi) It has the power to send back a case to proper officer if the applicant has not cooperated with it.

Note: Section 32 of the Central Excise Act, 1944 contains the provisions relating to the constitution of the Customs and Excise Settlement Commission. The powers of the Settlement Commission are given in section 32G, section 32H, section 32I etc.

PART - B

Question 6

- (a) Explain briefly with reference to the provisions of the Customs Act, 1962 any two of the following:
 - (i) Conveyance
 - (ii) Dutiable goods
 - (iii) India (2 x 2 = 4 Marks)
- (b) State the situations in which the proper officer is authorized to issue show-cause notice under section 28 of the Customs Act, 1962 and also the time limit. (5 Marks)
- (c) The assessee M Ltd. entered into a joint venture with a foreign collaborator N for promotion and selling antennas, accessories and other communication equipments. The agreement between them indicates that N owned majority of equity shares in M Ltd. Technical services were provided by N to M Ltd. for various functions that were carried out in respect of manufacture of antenna system in India, for which technical services fee was paid to N by M Ltd. Based on the above facts, the department opined that both M Ltd. and N were related persons in terms of Rules 2(2)(i) and 2(2)(iv) of the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988 and that the technical fee paid by M Ltd. was includible in the assessable value of the imported components in terms of Rule 9(1)(c) of the Rules. Decide referring to decided case law. (5 Marks)
- (d) From the following particulars, calculate assessable value and total custom duty payable:
 - (i) Date of presentation of bill of entry : 20.6.2006 [Rate of BCD 25%; Exchange Rate : Rs.43.60 and rate notified by CBEC Rs.43.80].
 - (ii) Date of arrival of goods in India : 30.6.2006 [Rate of BCD 20%; Exchange Rate: Rs.43.90 and rate notified by CBEC Rs.44.00].
 - (iii) Rate of Additional Customs Duty : 16%.
 - (iv) CIF value 2,000 US Dollars; Air Freight 500 US Dollars, Insurance cost 100 US Dollars [Landing charges not ascertainable].

(v) Education cess applicable 2%.

(vi) Assume there is no special CVD.

(6 Marks)

Answer

- (a) (i) As per section 2(9) of the Customs Act, 1962, conveyance is defined to include vessel, an aircraft and a vehicle. As the Customs Act seeks to consolidate the laws relating to levy of duties on import and export of goods, it is necessary to cover all the modes of transport. Therefore, the Act uses the term "conveyance" with an inclusive definition covering all the 3 modes of transport i.e. water, air and land. The specific terms are vessel (by sea), aircraft (by air) and vehicle (by land).
- (ii) As per section 2(14) of the Customs Act, 1962, dutiable goods is defined to mean any goods which are chargeable to duty and on which duty has not been paid. In order to be dutiable, any article should be within the ambit of the word goods as defined under section 2(22) and should find a mention in the Custom tariff.
- (iii) As per section 2(27) of the Customs Act, 1962, India includes the territorial waters of India. Territorial waters of India extend to 12 nautical miles into sea from the appropriate base line. Goods are deemed to have been imported if the vessel enters the imaginary line on the sea at the 12th nautical mile i.e., if the vessel enters the territorial waters of India. India includes not only the surface of sea in the territorial waters but also the air space above and the ground at the bottom of the sea.
- (b) As per section 28 of the Customs Act, 1962, the proper officer is authorized to issue show cause notice in the following situations:
- (i) when duty has not been levied
 - (ii) when duty has been short-levied
 - (iii) when duty has been erroneously refunded
 - (iv) when interest payable has not been paid
 - (v) when interest payable has been part paid
 - (vi) when interest has been erroneously refunded

Time Limit for issue of show-cause notice

- (a) In case of any import made by an individual for his personal use or by the Government or by any educational, research or charitable institution or hospital – within one year from the relevant date
- (b) In any other case – within six months from the relevant date
- (c) In the case of collusion or any willful mis-statement or suppression of facts by the importer or the exporter or the agent or employee of the importer or exporter, the time period shall be extended to 5 years.

Note: Relevant date is defined in sub-section (3) of section 28 of the Customs Act, 1962.

- (c) The given case relates to the Supreme Court's decision in the case of CCus. v. Prodelin India (P) Ltd. (2006) 202 ELT 13 (SC). It was held by the Apex Court in this case that the technical fee paid by the assessee to the foreign collaborator for design, drawing, fabrication etc. was in respect of the manufacture of antenna system in India and not with regard to the imported parts of the antenna. Further, the Apex Court pointed out that the Department was not able to prove that the relationship between the assessee and the foreign collaborator had influenced the value of the imported goods. Therefore, this case indicates that the technical fee charged in respect of post importation activities should not be included in the assessable value of the imported goods under Rule 9(1)(c) of the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988.

Thus, in view of the above-mentioned decision, the technical fee paid by M Ltd. should not be included in the assessable value of the imported components.

(d)	CIF value	2000 US Dollars
	Less : Freight	500
	Insurance	<u>100</u> <u>600</u> US Dollars
	FOB Value	1400 US Dollars
	Add: Air Freight @ 20% of FOB Value	280
	Insurance (actual amount)	<u>100</u> <u>380</u> US Dollars
		1780 US Dollars
		Rs.
	Value @ 43.80/-	77964.00
	Add: 1% for landing charges	<u>779.64</u>
	Assessable Value	78743.64
	Basic Custom Duty @ 20% (a)	15,748.73
		94,492.37
	Additional Custom Duty (b)	15,421.15
	(@ 16% + 2% cess on 16% = 16.32% on Rs.94,492.37)	
	Total of Basic Duty + Additional Duty (c) = (a + b)	31,169.88
	Education Cess @ 2% on Rs.31,169.88 (d)	623.40
	Total Duty (c + d)	31,793.28

Notes:

- (i) Rate of exchange notified by CBEC on the date of presentation of bill of entry has been considered.
- (ii) Rate of duty as applicable on the date of the arrival of aircraft which is later than the date of submission of the bill of entry has been considered.

- (iii) Landing charges have been considered as per rule 9(2)(b) of the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988.

Question 7

- (a) After visiting USA, Mrs. & Mr. X brought to India a lap-top computer valued at Rs.80,000, personal effects valued at Rs.90,000 and a personal computer for Rs.52,000. What is the customs duty payable? (3 Marks)
- (b) Write a brief note on the following with reference to the Customs Act, 1962:
- (i) Remission of duty on imported goods lost
 - (ii) Pilfered goods (2 x 3 = 6 Marks)
- (c) State the requirements to be satisfied to accept 'transaction value' under rule 4(2) of the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988. (6 Marks)

Answer

- (a) As per the baggage provisions:
- (i) personal effects and one laptop are exempt from customs duty.
 - (ii) general free allowance is Rs.25,000
Hence, duty shall be payable on Rs.52,000 – Rs.25,000 = Rs.27,000.
 - (iii) Effective rate of duty for baggage = 35% + 2% education cess
Therefore, duty payable = Rs.9,450 + Rs.189
Total customs duty = Rs.9,639
- (b) (i) Remission of duty on imported goods lost
- Section 23(1) of the Customs Act, 1962 provides for remission of duty on imported goods lost (otherwise than as a result of pilferage) or destroyed, if such loss or destruction is at any time before clearance for home consumption. Such loss or destruction covers loss by leakage. Duty is payable under this section but it is remitted by Assistant/Deputy Commissioner of Customs if the importer is able to prove the loss or destruction. Thus, unless remitted, duty has to be paid and burden of proof is on the importer. Remission is at the discretion of Customs authorities. The provisions of this section are applicable for warehoused goods also.
- (ii) Pilfered goods
- Section 13 provides that if imported goods are pilfered after unloading thereof but before the proper officer has made an order for clearance for home consumption or deposit in a warehouse, no duty is payable on the goods, unless the pilfered goods are restored to importer. In such a case, duty on pilfered goods is payable by the Port authorities. Also, the importer does not have to prove pilferage. However, the loss must be only due to pilferage. Section 13 is not applicable for warehoused goods.

- (c) The transaction value can be accepted under rule 4(2) of the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988 when:
- (i) the sale is in the ordinary course of trade under fully competitive conditions [Rule 4(2)(a)];
 - (ii) the sale does not involve any abnormal discount or reduction from the ordinary competitive prices [Rule 4(2)(b)];
 - (iii) the sale does not involve special discounts limited to exclusive agents [Rule 4(2)(c)];
 - (iv) objective and quantifiable data exists with regard to adjustments required to be made, under the provisions of rule 9, to the transaction value [Rule 4(2)(d)];
 - (v) there are no restrictions as to the disposition or use of the goods by the buyer other than restrictions which —
 - (i) are imposed or required by law or by the public authorities in India; or
 - (ii) limit the geographical area in which the goods may be resold; or
 - (iii) do not substantially affect the value of the goods [Rule 4(2)(e)];
 - (vi) the sale or price is not subject to some condition or consideration for which a value cannot be determined in respect of the goods being valued [Rule 4(2)(f)];
 - (vii) no part of the proceeds of any subsequent resale, disposal or use of the goods by the buyer will accrue directly or indirectly to the seller, unless an appropriate adjustment can be made in accordance with the provisions of rule 9 of these rules [Rule 4(2)(g)]; and
 - (viii) the buyer and seller are not related [Rule 4(2)(h)].

Question 8

- (a) Enumerate the penalties in respect of improper exportation of goods under section 114 of the Customs Act. (3 Marks)
- (b) State the difference between transit and transshipment of goods under the provisions of the Customs Act. (4 Marks)
- (c) State the ingredients in the case of seizure under section 123 of the Customs Act. (4 Marks)
- (d) Explain the provisions under section 15 of the Customs Act for determining the rate of duty and tariff valuation of imported goods. (4 Marks)

Answer

- (a) Section 114 of the Customs Act, 1962 provides that any person who, in relation to any goods, does or omits to do any act which act or omission would render such goods liable to confiscation under section 113, or abets the doing or omission of such an act, shall be liable:

- (i) in the case of goods in respect of which any prohibition is in force under this Act or any other law for the time being in force, to a penalty not exceeding three times the value of the goods as declared by the exporter or the value as determined under this Act, whichever is the greater;
 - (ii) in the case of dutiable goods, other than prohibited goods, to a penalty not exceeding the duty sought to be evaded or five thousand rupees, whichever is the greater;
 - (iii) in the case of any other goods, to a penalty not exceeding the value of the goods, as declared by the exporter or the value as determined under this Act, whichever is the greater.
- (b) Differences between transit and transshipment has been summarized in the table hereunder:-

Transit	Transshipment
(i) Section 53 of the Customs Act, 1962 provides for transit of goods.	(i) Section 54 of the Customs Act, 1962 provides for transshipment of goods.
(ii) In case of transit of goods, goods are allowed to remain on the same conveyance.	(ii) In case of transshipment of goods, the conveyance changes i.e., the goods are unloaded from one conveyance and loaded in another conveyance.
(iii) In case of transit, the record already made in the ship's/aircraft's manifest continues. The imported goods are shown in the manifest as the same bottom cargo. Thus, there is continuity in the records and there is no chance of the control over such transit goods being lost.	(iii) In transshipment of goods, continuity in the records is not maintained as the goods are transferred to another conveyance.

- (c) There are four ingredients in section 123 of the Customs Act:
- (i) there should be seizure under the provisions of Customs Act;
 - (ii) seizure must have been from the possession of the person proceeded against or the one claiming ownership of the goods;
 - (iii) seizure must be in respect of goods for which section 123 applies;
 - (iv) seizure must be in the reasonable belief that the goods seized are smuggled.

Section 123 applies in case of gold and manufactures thereof, watches and other notified goods. In a case where all these four ingredients are established by the seizing authorities, the burden to prove that the seized goods are not smuggled goods lies on the

owner or possessor of the seized goods.

Note: The provisions relating to seizure are dealt in section 110 of the Customs Act, 1962. Therefore, this question may also be answered in light of the provisions of section 110. The provisions of section 110 dealing with seizure are as follows:

An Officer of Customs can seize any goods, if he has reason to believe that the same are liable to confiscation, under the Customs Act. The proper officer may also seize any document or things that may be relevant to any proceedings under the Customs Act. However, the person from whom these documents are seized is entitled to make copies of the same.

The person from whom the goods are seized is issued a show cause notice, usually within six months. If the notice is not issued within six months, the seized goods are returned to the person from whom they were seized. However, the Commissioner of Customs, on sufficient cause being shown, can extend the time period for issue of show cause notice, by a further period of six months.

If the seized goods are perishable or hazardous in nature or are prone to depreciate in value over time or there is constraint in storage space, the Government may notify such goods and the same can be disposed off before the conclusion of the proceedings.

- (d) Section 15 provides that the rate of duty and tariff valuation, if any, applicable to any imported goods, shall be the rate and valuation in force -
- (a) in the case of goods entered for home consumption under section 46, on the date on which a bill of entry in respect of such goods is presented under that section;
 - (b) in the case of goods cleared from a warehouse under section 68, on the date on which bill of entry for home consumption in respect of such goods is presented;
 - (c) in the case of any other goods, on the date of payment of duty;

However, if a bill of entry has been presented before the date of entry inwards of the vessel or the arrival of the aircraft by which the goods are imported, the bill of entry shall be deemed to have been presented on the date of such entry inwards or the arrival, as the case may be.

The provisions of section 15 do not apply to baggage and goods imported by post.

PART – C

Question 9

- (a) State whether in the following cases service tax is payable, with reasons:
- (i) Temporary transfer of any intellectual property right.
 - (ii) Canteens in office run by the canteen contractor providing service directly to employees/workmen.

- (iii) Business auxiliary service provided by commission agents in relation to sale of agricultural produce. (3 x 1 = 3 Marks)
- (b) M/s TCCL, providing management consultancy to its client, do not maintain any separate accounts and have paid Rs.1,00,000 as service tax and excise duty towards input services and input material/capital goods used by them. They have used the inputs for partially exempted and partially taxable services. They are now providing the output services for which current tax liability is Rs.1,40,000. How much credit out of Rs.1,00,000 can be availed by them for paying output service tax liability, if they do not maintain any separate accounts? (4 Marks)
- (c) Mr. AJAR, a Chartered Accountant, raised an invoice for Rs.28,060 (25,000 + 3,060 service tax) to a client on 20.1.2007. The client, however, has paid a lump-sum of Rs.26,000 on 28.4.2007 for full and final settlement.
- (i) How much service tax Mr. AJAR has to pay and when does this tax become due for payment?
- (ii) What will be his liability, if the client refuses to pay service tax and pays only Rs.25,000 in total? (4 Marks)
- (d) (i) The service provider is abroad. He renders service to a subsidiary of an Indian Company located abroad. Payment to him is done by holding Indian Company. Does this attract service tax?
- (ii) What do you understand by 'Centralised Registration'? (2 x 2 = 4 Marks)

Answer

- (a) (i) Section 65(55b) of the Finance Act, 1994 defines intellectual property service as:
- (a) transferring, temporarily; or
- (b) permitting the use or enjoyment of, any intellectual property right.
- Thus, temporary transfer of any intellectual property right (IPR) shall be subject to service tax.
- (ii) Section 65(76a) of the Finance Act, 1994 defines outdoor caterer as a caterer engaged in providing services in connection with catering at a place other than his own but including a place provided by way of tenancy or otherwise by the person receiving such services.
- Thus, if service is directly provided to employees/workmen, then the canteen will not come within the purview of the definition of the outdoor caterer as the place is not provided by the person receiving the service. Hence, this service would not be chargeable to service tax.
- (iii) Business auxiliary services provided by commission agents in relation to sale or purchase of agricultural produce is exempt from service tax vide Notification No. 13/2003 ST dated 20.06.03 as amended.

- (b) Rule 6(3) of the CENVAT Credit Rules, 2004 inter alia provides that where common input/input services are used for providing taxable as well as exempted services and separate accounts are not maintained, the output service provider shall utilize credit only up to 20% of the amount of service tax payable on taxable output service.

Therefore, M/s. TCCL can take full credit of Rs.1,00,000 but can utilize credit only upto 20% of the amount of service tax payable on taxable output service i.e.,:

$$20\% \text{ of Rs.1,40,000} = \text{Rs.28,000}$$

In this case, out of Rs.1,40,000 M/s. TCCL shall pay output service tax of Rs.1,12,000 in cash and balance Rs.28,000 shall be paid by utilizing CENVAT credit. Remaining credit available with M/s. TCCL shall be Rs.72,000 (i.e. Rs.1,00,000 - Rs. 28,000).

- (c) (i) The Department has clarified vide the Frequently Asked Questions issued by it that service tax is required to be paid only on the value/amount of taxable service received and not on the gross amount billed to the client. However, where the amount received is less than the gross amount charged/billed to the client, the assessee is required to amend the bills either by rectifying the existing bill or by issuing a revised bill and by properly endorsing such change in the billed amount.

Assuming that Mr.AJAR has amended the bill, amount of service tax payable shall be computed by back calculations. Effective rate of service tax is 12.24% (12% service tax + 2% education cess on service tax).

$$\begin{aligned} \text{Service tax and education cess payable} &= \frac{\text{Gross value} \times \text{Rate of tax}}{100 + \text{rate of tax}} \\ &= \frac{26000 \times 12.24}{100 + 12.24} \\ &= \frac{26000 \times 12.24}{112.24} \\ &= \text{Rs.2835} \end{aligned}$$

Such service tax should be paid along with the tax of 1st quarter of financial year 2007-08 by 5th of July, 2007.

- (ii) The Department has clarified vide the Frequently Asked Questions issued by it that where the assessee only receives the service charges and not the service tax payable thereon, the amount so realized from the client would be treated as gross amount inclusive of service tax. Accordingly, the value of taxable service and the service tax liability will be worked out by back calculations. Effective rate of service tax is 12.24% (12% service tax + 2% education cess on service tax).

$$\begin{aligned}\text{Service tax and education cess payable} &= \frac{\text{Gross value} \times \text{Rate of tax}}{100 + \text{rate of tax}} \\ &= \frac{25000 \times 12.24}{100 + 12.24} \\ &= \frac{25000 \times 12.24}{112.24} \\ &= \text{Rs.2726}\end{aligned}$$

- (d) (i) Section 64(1) of the Finance Act, 1994 provides that provisions of service tax law extend to whole of India except the State of Jammu & Kashmir. Service tax is paid by the person or firm or a company who provides the services. In this case, service tax will not be attracted as service provider is abroad and renders service outside India.
- (ii) Sometimes an assessee provides taxable service from more than one premises. Rule 4(2) of the Service Tax Rules, 1994 provides that in such cases, the assessee can obtain centralized registration at his option if:
- (a) he has centralized billing or centralized accounting in respect of such service, and
 - (b) such centralized billing or centralized accounting systems are located in one or more offices or premises.

The assessee can register such offices or premises where centralized accounting or centralized billing systems are located.

SUMMARY OF EXAMINERS' COMMENTS ON THE PERFORMANCE OF CANDIDATES

PAPER – 5 : COST MANAGEMENT

General Comments

The performance of the candidates in both theory and practical questions is short of what is expected of a CA Final student. Students are advised to understand clearly, the basic concepts underlying various techniques and tools used in both traditional and modern Cost Management. Such an understanding is necessary for correctly analysing practical questions and also for writing better theoretical answers.

Specific Comments

Question 1. (a) This was a practical question part from the area of Standard Costing. Students were required to calculate the missing information from other cost details given in the question. Most of the students were unable to identify the Yield Variances relating to raw material 'A' and 'B' and hence were unable to proceed further.

(b) This practical question part relating to Transportation was attempted well by most of the students. A few students wrongly evaluated the unallocated cells and hence got the answer wrong.

(c) This theory question part relating to the JIT approach was answered reasonably well by a majority of the students.

Question 2. (a) This practical question part required candidates to have a conceptual understanding of absorption costing. Many candidates were unable to find profits under absorption costing as well as actual profit and loss account and hence were unable to reconcile the two.

(b) This theory part was attempted reasonably well by most of the students.

(c) This practical question part required candidates to identify future sale quantum so that existing profits may be maintained. Many candidates were unable to bifurcate Fixed and Variable Overheads and hence got their answers wrong.

Question 3. (a) This was a practical question part from the area of CPM. Many candidates were unable to find the revised duration of Network and revised duration of activity (3-6).

(b) This theory question part required examinees to describe briefly the various components of a Balanced Scorecard. Many of the students identified the 'Perspectives' correctly but gave vague answers for the measures to be used.

(c) This theory question part required students to describe the process of Zero Based Budgeting. Many candidates explained the concept of ZBB but failed to elaborate upon the process.

Question 4. (a) This was a practical question part requiring candidates to determine the optimum production plan and the maximum contribution by using the simplex method. Most of the

students got the first table/iteration right but could not proceed on the desired lines subsequently.

(b) The answer to this theory question part was average.

(c) In this practical question part candidates are required to calculate the BEP from the give data. Answer to this part was satisfactory; however some students computed wrong labour cost and hence arrived at the wrong answer.

Question 5. (a) This question part required students to identify relevant and irrelevant costs from the given scenario. Examiners have reported a lack of knowledge of concepts because of which many students were unable to get the entire answer right.

(b & c) These theory question parts were attempted fairly well by most of the students.

Question 6. (a) This practical question part was attempted very poorly by most of the candidates. Examiners have noted that students lacked concepts relating to marginal costing /contribution analysis and hence were not able to arrive at correct decisions.

(b) This theory question part required students to write about the practical applications of Linear Programming. The answer to this part was average.

PAPER – 6 : MANAGEMENT INFORMATION AND CONTROL SYSTEMS

General Comments

The understanding of the question is necessary to give relevant answer that was not reflected in the Answer Sheet prepared by the students. Lack of adequate preparation and presentation of the answers were the part of the student as far as the student's knowledge is concerned. The students are required to take examination with more seriously and sincerity as to perform well. They also need to understand the importance of the subject in particular domain, in today's scenario.

Specific Comments

Question 1.(a) Most of the students attempted this question but the performance was not satisfactory. Understanding of the question and the description of the techniques are necessary to secure good marks that was not seen in the answers given by the students.

(b) Answered given by most of the students with an average performance. Lack of understanding of the security policy versus security techniques was the major problem of the students.

(c) Attempted by the majority of the students and performed well.

(d) Most of the students were confused with general software packages versus specific software packages used for various purposes. They were also misunderstood the meaning of the question. Hence, the performance was very poor.

Question 2.(a) Answered by the majority of the students and performed well.

(b) Most of the students answered wrongly. Students are required to understand the basic concepts of ERP system with CSF and KPI. Hence, the performance was very poor.

Question 3.(a) Not many of the students answered correctly. Some of the students were confused with the sharing accounting system and account sharing system in c/s networking system. Although the performance was average.

(b) Average number of the students answered correctly. Many of the students were not clear about the basic concept of DSS as well as its organizational structure. Hence, the performance was below average.

Question 4.(a) The answers are readily available in the course material but average number of students have given the answer correct. Although, the performance was satisfactory.

(b) Most of the students attempted the question and performed well.

(c) More than average number of students attempted this question nicely.

Question 5.(a) Answers by the majority of the students and performed well.

(b) Many of the students have answered wrongly. Some of the students did not know the powers of the controller under section 89 in Information Technology Act, 2000 which is readily available in the study material. Hence, the performance is very poor.

(c) Most of the students attempted this question nicely.

Question 6.(a) Answered given by most of the students with an average performance.

(b) Most of the students attempted this question and performed well. Although some of the students attempted the question with incorrect or vague answer without understanding the basic concepts of the question on Client / Server security.

(c) Good performance by the majority of the students.

Question 7.(a) Well answered by almost all the students and secured good marks.

(b) More than average number of students attempted this question nicely.

(c) Performance was not satisfactory. More than average number of students did not explain the Holistic Protection which is a part of Information security.

(d) Satisfactory performance by the majority of the students.

PAPER – 7 : DIRECT TAXES

General Comments

Overall performance of the candidates is not satisfactory. The candidates lack conceptual clarity. The explanations given by them and analysis of the facts were not up to the mark due to lack of understanding and clarity of the provisions of Income tax Act and Wealth tax Act. It has been noticed that when it comes to applying the law to the facts, most of the candidates have not been able to analyse and discuss the relevant provisions to support their conclusions.

Specific Comments

Question 1.(a) Most of the candidates have not understood the problem and failed to compute total income correctly. Some common mistakes are:

- (i) Most of the candidates were not aware of the provisions of the section 45(4). They have considered the capital gain on distribution of assets as arising on the date of dissolution of the firm instead of on the actual date of distribution of assets.
- (ii) Many candidates have considered the value of gold jewellery received as a gift for achieving sales target as a capital receipt instead of treating the same as a perquisite or benefit arising in the course of business chargeable as business income under section 28.
- (iii) Most of the candidates have not computed the additional depreciation on new plant and machinery.
- (iv) Many candidates were not aware that stock-in-trade has to be valued at market price in the case of a dissolved firm.
- (v) Majority of the candidates were not aware of the amendment made by the Taxation Laws (Amendment) Act, 2006 in section 40A(3), requiring payments in excess of Rs.20,000 to be made by an account payee cheque/account payee bank draft.
- (vi) Very few candidates have stated that the interest on current accounts of partners are not allowable in the absence of authorisation in the partnership deed.
- (vii) A number of candidates have treated purchase of television sets as capital expenditure without considering that the assessee firm was engaged in the business of television sets.
- (viii) Very few candidates could correctly compute the Book Profit of the firm.

Question 2.(a) Most of the candidates have showed lack of awareness of the clarifications given by the CBDT on the various issues arising out of FBT provisions vide Circular No. 8/2005. Some of the candidates have stated that reimbursement of expenditure on food & beverages in the office is not liable to FBT. Distribution of free samples to hospitals has been wrongly understood as distribution to doctors.

(b) Most of the candidates were not aware of the amendment made by the Taxation Laws (Amendment) Act, 2006 in section 56(2). They were not aware that if the aggregate value of gifts received from non-relatives during the year exceeds Rs. 50,000/-, the entire sum is taxable under section 56(2)(vi).

(c) Many candidates have failed to explain that the revised return filed under section 139(5) replaces the original return. They have wrongly concluded that the loss disclosed in the revised return cannot be carried forward.

Question 3.(a) Most of the candidates have confused the conditions of section 54 with that of section 54F. Many candidates were not aware that purchase of share of other co-owners is considered as purchase of residential property for the purpose of availing exemption under section 54.

(b) Candidates were not aware of the amendment made by the Taxation Laws (Amendment) Act, 2006 to the definition of 'rent' under section 194-I to include within its scope, rent for plant & machinery as well. They treated the hire charges of machinery as falling under the provisions of section 194C.

(c) Most of the candidates have not been able to understand the difference between construction and repair of house property and considered the limit of Rs.1,50,000 applicable for construction of residential house property for repairs and reconstruction also.

Question 4.(a) Most of the candidates have not understood the provisions of section 115BBC and treated the anonymous donations received and applied for charitable purposes under section 11 as non-taxable and anonymous donations received by trust wholly for religious purposes but not utilized fully as taxable under section 115BBC(1).

(b) Most of the candidates were not aware that the deduction under section 80P is still available to a primary co-operative agricultural and rural development bank.

(c) Most of the candidates have not understood the provisions of section 2(22)(e) and confused the same with the provisions of section 269SS and section 269T.

Question 5.(b) Most of the candidates have wrongly answered that only a Tax Return Preparer can file a return of the assessee whose accounts are audited under section 44AB.

(c) Many candidates were not aware of the presumptive tax provisions under section 44BBA relating to profit from the business of operation of aircraft by a non-resident. Some have applied different rates for presumptive taxation like 7.5% or 10%.

Question 6. (a) A number of candidates did not know the provisions relating to furnishing of annual information return and got confused with furnishing of return of income under section 139.

(b) This question pertains to conversion of interest into term loan vis-à-vis section 43B. Most of the candidates have not mentioned the relevant provisions of Explanations 3C & 3D inserted in section 43B by the Finance Act, 2006.

Question 7.(b) Most of the candidates were not aware of the rate of depreciation allowable under section 32 in respect of plant and machinery and have wrongly charged 20% or 25%. Further, most of them have not computed additional depreciation.

(c) Majority of the candidates were not aware of the provisions of section 276CC that prosecution proceedings were not maintainable unless the tax liability exceeds Rs. 3,000.

Question 8.(a) Some of the candidates have taken cost of jewellery as taxable instead of its fair market value.

(c) Many candidates were not able to identify the assets specified under section 2(ea) and apply the provisions of valuation of business assets. Some candidates have treated urban land as not taxable.

PAPER – 8 : INDIRECT TAXES

General comments

The overall performance of the candidates was unsatisfactory. It was observed that candidates lacked conceptual clarity. Thus, the explanations and analysis of the facts given by them were very poor. Very few candidates were able to cite the case laws while answering the questions. Majority of the candidates were not aware of the recent developments in the indirect tax laws. Many candidates got confused as to whether the question related to customs or central excise even though the questions were divided properly. It has been noticed that when it comes to applying law to the facts, most of the candidates are not able to analyse and discuss relevant points supporting the conclusion.

Specific comments

Question 1.(a) Many candidates were not aware of the difference between the Adjudicating Authority and the Central Excise Officer. They gave the same meaning for both the terms. Further, many of them did not explain as to who could not be an adjudicating authority.

(b) Some candidates wrongly explained the period of validity of registration as five years, one year, six months or even till the date of completion of any project.

(d) Many candidates were not able to explain the offences under rule 25(1) of the Central Excise Rules, 2002.

(e) A large number of the candidates wrongly concluded that the process was manufacture and the product i.e. shikai powder was an excisable goods chargeable to excise duty.

Question 2.(a) Only a handful of the candidates were able to cite the case law. Most of the candidates wrongly explained that since there was a nexus between the advertisement and the product manufactured by P Ltd., the cost of such advertisement should be included in the assessable value of the concentrates.

(b)(i) Most of the candidates failed to answer that CENVAT credit in respect of duty paid on capital goods can be taken only on receipt of the capital goods in the factory of the manufacturer.

(b)(ii) Many candidates wrongly mentioned that the destroyed goods qualify to be inputs within the meaning of CENVAT Credit Rules, 2004.

Question 3.(b) Very few candidates were aware of the provisions regarding general exemption to SSI units.

(c) In this question, candidates were required to comment on the departments' action of invoking the extended period of limitation. However, many candidates wrote about brand name etc. Their understanding of the concept of invocation of extended period was not up to the mark. Further, many candidates discussed the applicability of exemption instead of discussing whether the department was justified in invoking the extended limit.

Question 4.(b) Most of the candidates wrongly explained that the value of price support incentives received from raw material supplier should be included in the value of the final products.

(c) Candidates performed poorly in this question. They were required to explain the procedure to be adopted in respect of exported goods subsequently re-imported and returned to factory. However, they wrote irrelevant details about duty draw back etc.

(d) Most of the candidates failed to explain as to who can initiate provisional assessment and mentioned unnecessary details.

Question 5.(a) This question required the candidates to discuss the power of the Central Government to amend First Schedule and Second Schedule of the Central Excise Tariff. However, majority of the candidates discussed the emergency powers of the Central Government under section 3 of the Central Excise Tariff Act, 1985. They wrongly explained that the Central Government has the power to amend the schedules of the Central Excise Tariff only for amending the rate of duty.

(c) The concept of unjust enrichment and its exceptions were not known to many candidates.

(d) Some candidates, instead of explaining the powers of the Settlement Commission, wrongly explained the procedure to make an application to the Settlement Commission.

Question 6.(b) Many candidates failed to explain the situations in which the show cause notice can be issued under the Customs Act, 1962.

(d) Most of the candidates were not able to determine the correct assessable value of the imported goods. The difference between the CIF value and the FOB value was not clear to many candidates.

Question 7.(a) Majority of the candidates allowed Rs.50,000 (25,000 x 2) as deduction by wrongly pooling the general free allowance of the two individuals involved.

(c) Instead of explaining the conditions to be satisfied under rule 4(2) of the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988, many candidates discussed the provisions relating to value under section 14(1) of the Customs Act, 1962.

Question 8.(a) A large number of the candidates were not aware of the provisions relating to penalties in respect of improper exportation of goods under section 114 of the Customs Act, 1962.

(b) Very few candidates were able to correctly distinguish between transit and transshipment of goods.

(c) The performance in this question was very poor. Most of the candidates were ignorant about the ingredients in case of seizure under section 123 of the Customs Act, 1962.

Question 9.(b) Many candidates wrongly concluded that the entire amount of CENVAT credit of Rs.1,00,000 could be utilized for payment of output tax liability.

(c) Most of the candidates wrongly answered that Mr.AJAR would be required to pay the entire service tax of Rs. 3,060 irrespective of whether he is able to recover the same from the client or not.



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