

PAPER – 1 : ADVANCED ACCOUNTING

Answer all questions.

Working notes should form part of the answer.

Wherever necessary, suitable assumptions may be made by the candidates.

Question 1

Astha Ltd. acquired 80% of both classes of shares in Birat Ltd. on 1.4.2007. The draft Balance Sheets of two companies on 31st March, 2008 were as follows:

(Rs. in 000's)					
Liabilities	Astha Ltd.	Birat Ltd.	Assets	Astha Ltd.	Birat Ltd.
Share Capital:					
Equity shares of Rs.10 each, full paid up	3,000	600	Plant & machinery	2,060	600
14% Preference shares of Rs.100 each, fully paid up	-	400	Furniture & fixtures	600	540
General reserve	1,900	40	Investments		
			in equity shares of Birat Ltd.	1,920	-
Profit and loss account	1,600	720	in preference shares of Birat Ltd.	320	-
Creditors	300	320	Stock	680	404
			Debtors	560	316
			Cash at bank	<u>660</u>	<u>220</u>
	<u>6,800</u>	<u>2,080</u>		<u>6,800</u>	<u>2,080</u>

Note:

Contingent liability – Astha Ltd.: Claim for damages lodged by a contractor against the company pending in a law-suit – Rs.1,55,000.

Additional Information:

- General reserve balance of Birat Ltd. was the same as on 1.4.2007.
- The balance in Profit and Loss A/c of Birat Ltd. on 1.4.2007 was Rs.3,20,000, out of which dividend of 16% p.a. on the Equity capital of Rs.6,00,000 was paid for the year 2006-07.

- (iii) The dividend in respect of preference shares of Birat Ltd. for the year 2007-08 was still payable as on 31.3.2008.
- (iv) Astha Ltd. credited its Profit and Loss A/c for the dividend received by it from Birat Ltd. for the year 2006-07.
- (v) Sundry creditors of Astha Ltd. included an amount of Rs.1,20,000 for purchases from Birat Ltd., on which the later company made a loss of Rs.10,000.
- (vi) Half of the above goods were still with the closing stock of Astha Ltd. as at 31.3.2008.
- (vii) At the time of acquisition by Astha Ltd., while determining the price to be paid for the shares in Birat Ltd. it was considered that the value of plant and machinery was to be increased by 25% and that of furniture and fixtures reduced to 80%. There was no transaction of purchase or sale of these assets during the year. The directors wish to give effect to these revaluations in the consolidated balance sheet.
- (viii) The directors of Astha Ltd. are of opinion that disclosure of its contingent liability will seriously prejudice the company's position in dispute with the contractor.

Prepare consolidated balance sheet as at 31st March, 2008, assuming the rate of depreciation charged as 25% p.a. and 10% p.a. on plant and machinery and furniture and fixtures respectively. Workings should be part of the answer. (16 Marks)

Answer

Consolidated Balance Sheet of Astha Ltd. and its subsidiary Birat Ltd.

as at 31st March 2008

				(Rs. in '000s)
Liabilities	Amount	Assets	Amount	
Share capital:		Goodwill (W.N.5)	1,088.0	
3,00,000 Equity shares of		Plant and machinery		
Rs. 10 each fully paid up	3,000.0	Astha Ltd.	2,060.0	
Minority interest (W.N.4)	360.4	Birat Ltd. (W.N.7)	<u>750.0</u>	2,810.0
General reserves	1,900.0	Furniture and fixtures		
Profit and loss A/c (W.N.6)	1,894.6	Astha Ltd.	600.0	
Creditors		Birat Ltd. (W.N. 8)	<u>432.0</u>	1,032.0
Astha Ltd.	300.0	Stock		
Birat Ltd.	<u>320.0</u>	Astha Ltd.	680.0	
	620.0	Birat Ltd.	<u>404.0</u>	
Less: Mutual owings	<u>120.0</u>		1,084.0	
	500.0	Add: Unrealised loss	<u>5.0</u>	1,089.0

Debtors		
Astha Ltd.	560.0	
Birat Ltd.	<u>316.0</u>	
	876.0	
Less: Mutual owings	<u>120.0</u>	756.0
Cash at Bank		
Astha Ltd.	660.0	
Birat Ltd.	<u>220.0</u>	<u>880.0</u>
	<u>7,655.0</u>	<u>7,655.0</u>

Contingent liability: Claim against damages lodged by a contractor against Astha Ltd. is pending in a law suit Rs. 155 thousands (W.N. 9).

Working Notes:

- Calculation of capital profits (pre-acquisition) (Rs. in '000s)

General reserve balance as on 1-04-2007		40.0
Profit and loss account balance as on 1-04-2007	320.0	
Less: Dividend at 16% p.a. on Rs. 6,00,000 for the year 2006-07	<u>96.0</u>	<u>224.0</u>
		264.0
Add: Profit on revaluation of plant and machinery (W.N.7)		<u>200.0</u>
		464.0
Less: Loss on revaluation of furniture and fixtures (W.N.8)		<u>120.0</u>
		<u>344.0</u>
Share of Astha Ltd. (80%)		275.2
Share of Minority Interest (20%)		<u>68.8</u>

Calculation of revenue profits (post-acquisition) (Rs. in '000s)

Profits during the year 2007-08 (720.0 – 224.0)		496.0
Less: Preference dividend for the year 2007-08 @ 14% on Rs.4,00,000		<u>56.0</u>
		440.0
Less: Under charging of depreciation on plant and machinery due to upward revaluation (Rs.2,00,000 x 25%)		<u>50.0</u>
		390.0

Add: Overcharging of depreciation on furniture and fixtures due to downward revaluation (Rs.1,20,000 x 10%)		<u>12.0</u>
		<u>402.0</u>
Share of Astha Ltd. (80%)		321.6
Share of Minority Interest (20%)		<u>80.4</u>
3. Calculation of dividend on preference shares of Birat Ltd.	(Rs. in '000s)	
Dividend on preference shares (Rs. 4,00,000 x 14%)		<u>56.0</u>
Share of Astha Ltd. (80%)		44.8
Share of Minority Interest (20%)		<u>11.2</u>
		<u>56.0</u>
4. Calculation of Minority Interest	(Rs. in '000s)	
Equity share capital (20%)		120.0
Preference share capital (20%)		80.0
Share of capital profits (W.N. 1)		68.8
Share of Revenue profit (W.N.2)		80.4
Share of preference dividend (W.N.3)		<u>11.2</u>
		<u>360.4</u>
5. Calculation of Cost of Control - Goodwill	(Rs. in '000s)	
Investment by Astha Ltd. in		
Equity shares of Birat Ltd.	1,920.0	
Less: Dividend received for 2006-07 (600 x 80% 16%)	<u>76.8</u>	1,843.2
Preference shares		<u>320.0</u>
		2,163.2
Less: Paid up value of		
Equity shares (80%)	480.0	
Preference shares (80%)	320.0	
Share in Capital Profit (W.N. 1)	<u>275.2</u>	<u>1,075.2</u>
Goodwill		<u>1,088.0</u>

6. Calculation of Consolidated Profit and Loss A/c (Rs. in '000s)
- | | | |
|--|--|----------------|
| Balance in Profit and loss A/c of Astha Ltd. as on 1-04-2007 | | 1,600.0 |
| Add: Revenue profit from Birat Ltd (W.N. 2) | | 321.6 |
| Preference dividend of Birat Ltd. (W.N. 3) | | 44.8 |
| Share of unrealised loss on stock (Rs. 10,000 x 50%) | | <u>5.0</u> |
| | | 1,971.4 |
| Less: Dividend wrongly credited | | <u>76.8</u> |
| | | <u>1,894.6</u> |
7. Value of Plant and Machinery of Birat Ltd. (Rs. in '000s)
- | | | |
|--|-------------|----------------|
| Value as on 1.04.07 (600 x 100/75) | | 800.0 |
| Add: Appreciation on revaluation (25%) | | <u>200.0</u> |
| Revalued figure | | 1,000.00 |
| Less: Depreciation | | |
| Already charged (800-600) | 200.0 | |
| Due to upward revaluation (200 x 25%) | <u>50.0</u> | <u>(250.0)</u> |
| | | <u>750.0</u> |
8. Value of Furniture and Fixtures of Birat Ltd. (Rs. in '000s)
- | | | |
|---|---------------|-----------------|
| Value as on 1.4.2007 (540 x 100/90) | | 600.00 |
| Less: Diminution on revaluation (20%) | | <u>(120.00)</u> |
| Revalued Figure | | 480.0 |
| Less: Depreciation already charged (600 - 540) | 60.0 | |
| Less: Depreciation written back due to downward revaluation | | |
| (120 x 10%) | <u>(12.0)</u> | <u>(48.0)</u> |
| | | <u>432.0</u> |
9. Contingent liability:
- As per para 68 of AS 29, 'Provisions, Contingent Liabilities and Contingent Assets', "unless the possibility of any outflow in settlement is remote, an enterprise should disclose contingent liability at the balance sheet date along with a brief description of the nature of such contingent liability." Therefore, it would not be correct to ignore the contingent liability.

Question 2

T. Ltd. and V. Ltd. propose to amalgamate. Their balance sheets as at 31st March, 2008 were as follows:

Liabilities	T. Ltd. Rs.	V. Ltd. Rs.	Assets	T. Ltd. Rs.	V. Ltd. Rs.
Share capital:			Fixed assets		
Equity shares of Rs.10 each	15,00,000	6,00,000	Less: Depreciation	12,00,000	3,00,000
General reserve	6,00,000	60,000	Investments (face value of Rs.3 lakhs, 6% tax free G.P. notes)	3,00,000	-
Profit & Loss A/c	3,00,000	90,000	Stock	6,00,000	3,90,000
Creditors	3,00,000	1,50,000	Debtors	5,10,000	1,80,000
			Cash and bank balances	90,000	30,000
	<u>27,00,000</u>	<u>9,00,000</u>		<u>27,00,000</u>	<u>9,00,000</u>

Their net profits (after taxation) were as follows:

Year	T. Ltd.	V. Ltd.
2005-06	3,90,000	1,35,000
2006-07	3,75,000	1,20,000
2007-08	4,50,000	1,68,000

Normal trading profit may be considered as 15% on closing capital invested. Goodwill may be taken as 4 years' purchase of average super profits. The stock of T. Ltd. and V. Ltd. are to be taken at Rs.6,12,000 and Rs.4,26,000 respectively for the purpose of amalgamation. W. Ltd. is formed for the purpose of amalgamation of two companies.

- Suggest a scheme of capitalization of W. Ltd. and ratio of exchange of shares; and
- Draft the opening balance sheet of W. Ltd. (16 Marks)

Answer

- Scheme of capitalization of W. Ltd. and ratio of exchange of shares

Computation of Net Assets of amalgamating companies

	T. Ltd. Rs.	V. Ltd. Rs.
Goodwill (W.N.2)	3,19,200	1,21,200

Fixed Assets	12,00,000	3,00,000
6% investments (Non-trade)	3,00,000	-
Stock	6,12,000	4,26,000
Debtors	5,10,000	1,80,000
Cash and Bank Balances	<u>90,000</u>	<u>30,000</u>
	30,31,200	10,57,200
Less: Creditors	<u>3,00,000</u>	<u>1,50,000</u>
Net Assets	<u>27,31,200</u>	<u>9,07,200</u>
No. of Equity shares	1,50,000	60,000
Intrinsic value of a share	Rs. 18.208	Rs. 15.12
No of shares to be issued by W. Ltd to		
T. Ltd 1,50,000 x 18.208/10	2,73,120 shares	
V. Ltd 60,000 x 15.12/10		90,720 shares

In total 2,73,120 + 90,720 i.e. 3,63,840 shares will be issued by W. Ltd.

Ratio of exchange of shares will be as follows:

- Holders of 1,50,000 equity shares of T Ltd. will get 2,73,120 shares in W. Ltd.
- Similarly, holders of 60,000 equity shares of V Ltd. will get 90,720 shares in W. Ltd.

(b) Opening Balance Sheet of W. Ltd.

Liabilities	Rs.	Assets	Rs.
Share Capital:		Fixed Assets:	
3,63,840 Equity shares of Rs. 10 each	36,38,400	Goodwill (W.N.2) (3,19,200 + 1,21,200)	4,40,400
(Issued for consideration other than cash, pursuant to scheme of amalgamation)		Other fixed Assets (12,00,000+ 3,00,000)	15,00,000
Current Liabilities:		Investments in 6% Tax free G.P. Notes	3,00,000
Creditors	4,50,000	Current Assets:	
		Stock (6,12,000 + 4,26,000)	10,38,000
		Debtors (5,10,000 + 1,80,000)	6,90,000
		Cash and bank balance (90,000 + 30,000)	<u>1,20,000</u>
	<u>40,88,400</u>		<u>40,88,400</u>

Working Notes:

1. Calculation of closing trading capital employed on the basis of net assets

	T. Ltd.	V. Ltd.
	Rs.	Rs.
Fixed Assets	12,00,000	3,00,000
Stock	6,12,000	4,26,000
Debtors	5,10,000	1,80,000
Cash and Bank Balances	<u>90,000</u>	<u>30,000</u>
	24,12,000	9,36,000
Less: Creditors	<u>3,00,000</u>	<u>1,50,000</u>
Net Assets	<u>21,12,000</u>	<u>7,86,000</u>

2. Calculation of value of goodwill

(i) Average Trading Profit	T. Ltd.	V. Ltd.
	Rs.	Rs.
2005-06	3,90,000	1,35,000
2006-07	3,75,000	1,20,000
2007-08	<u>4,50,000</u>	<u>1,68,000</u>
Profit after tax	<u>12,15,000</u>	<u>4,23,000</u>
Profit before tax (40%)*	20,25,000	7,05,000
Add : Under valuation of closing stock	<u>12,000</u>	<u>36,000</u>
	<u>20,37,000</u>	<u>7,41,000</u>
Average of 3 years' profit before tax	6,79,000	2,47,000
Less: Income from non-trade investments (3,00,000 x 6%)	<u>18,000</u>	<u>-</u>
Average profit before tax	6,61,000	2,47,000
Less: 40% tax	<u>2,64,400</u>	<u>98,800</u>
Average profit after tax	<u>3,96,600</u>	<u>1,48,200</u>
(ii) Super Profits		
Average trading profit	3,96,600	1,48,200
Less: Normal Profit		

* Tax rate of 40% has been assumed. The candidates may assume some other tax rate and give the solution accordingly.

T. Ltd. Rs. 21,12,000 x 15%	3,16,800	
V. Ltd Rs. 7,86,000 x 15%	<u>79,800</u>	<u>1,17,900</u>
		<u>30,300</u>
(iii) Value of goodwill at 4 years' purchase of super profits	<u>3,19,200</u>	<u>1,21,200</u>

Question 3

- (a) ABC Ltd. grants 1,000 employees stock options on 1.4.2004 at Rs.40, when the market price is Rs.160. The vesting period is 2½ years and the maximum exercise period is one year. 300 unvested options lapse on 1.5.2006. 600 options are exercised on 30.6.2007. 100 vested options lapse at the end of the exercise period.

Pass Journal Entries giving suitable narrations.

- (b) From the following data, compute the 'Net Assets' value of each category of equity shares of Smith Ltd.:

Shareholders funds

- 10,000 'A' Equity shares of Rs.100 each, fully paid
- 10,000 'B' Equity shares of Rs.100 each, Rs.80 paid
- 10,000 'C' Equity shares of Rs.100 each, Rs.50 paid
- Retained Earnings Rs.9,00,000

(10+6 = 16 Marks)

Answer

- (a) Journal Entries in the Books of ABC Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31.3.2005	Employees compensation expenses account Dr.	48,000	
	To Employees stock option outstanding account		48,000
	(Being compensation expenses recognized in respect of the employees stock option i.e. 1,000 options granted to employees at a discount of Rs. 120 each, amortised on straight line basis over $2\frac{1}{2}$ years)		

	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at the end of the year)			
31.3.2006	Employees compensation expenses account	Dr.	48,000	
	To Employees stock option outstanding account			48,000
	(Being compensation expenses recognized in respect of the employee stock option i.e. 1,000 options granted to employees at a discount of Rs. 120 each, amortised on straight line basis over $2\frac{1}{2}$ years)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at the end of the year)			
31.3.2007	Employees stock option outstanding account (W.N.1)	Dr.	12,000	
	To General Reserve account (W.N.1)			12,000
	(Being excess of employees compensation expenses transferred to general reserve account)			
30.6.2007	Bank A/c (600 x Rs.40)	Dr.	24,000	
	Employee stock option outstanding account (600 x Rs.120)	Dr.	72,000	
	To Equity share capital account (600 x Rs. 10)			6,000
	To Securities premium account (600 x Rs.150)			90,000
	(Being 600 employees stock option exercised at an exercise price of Rs. 40 each)			

01.10.2007	Employee stock option outstanding account	Dr.	12,000	
	To General reserve account			12,000
	(Being Employees stock option outstanding A/c transferred to General Reserve A/c, on lapse of 100 options at the end of exercise of option period)			

Working Note:

On 31.3.2007, ABC Ltd. will examine its actual forfeitures and make necessary adjustments, if any to reflect expenses for the number of options, that have actually vested. 700 employees stock options have completed 2.5 years vesting period, the expense to be recognized during the year is in negative i.e.

	Rs.
No. of options actually vested (700 x Rs.120)	84,000
Less: Expenses recognized Rs.(48,000 + 48,000)	<u>96,000</u>
Excess expenses transferred to general reserve	<u>12,000</u>

(b) (i) Computation of Net assets

Worth of net assets is equal to shareholders' fund, i.e.

		Rs.
Paid up value of 'A' equity shares	10,000 x Rs.100	10,00,000
Paid up value of 'B' equity shares	10,000 x Rs. 80	8,00,000
Paid up value of 'C' equity shares	10,000 x Rs. 50	5,00,000
Retained earnings		<u>9,00,000</u>
Net assets		<u>32,00,000</u>

(ii) Net asset value of equity share of Rs.100 paid up

Notional calls of Rs. 20 and Rs.50 per share on 'B' and 'C' equity shares respectively will make all the 30,000 equity shares fully paid up at Rs. 100 each. In that case,

	Rs.
Net assets	32,00,000
Add: Notional calls (10,000 x Rs.20 + 10,000 x Rs.50)	<u>7,00,000</u>
	<u>39,00,000</u>

Value of each equity share of Rs.100 fully paid up = Rs. 39,00,000 / 30,000=Rs.130

(iii) Net asset values of each category of equity shares	Rs.
Value of 'A' equity shares of Rs. 100 fully paid up	130
Value of 'B' equity shares of Rs. 100 each, out of which Rs. 80 paid up (130-20)	110
Value of 'C' Equity shares of Rs.100 each, out of which Rs. 50 paid up (130-50)	80

Alternatively value of an equity share may also be calculated as follows:

Total paid-up capital	Rs.
'A' equity shares (10,000XRs.100)	10,00,000
'B' equity shares (10,000XRs. 80)	8,00,000
'C' equity shares (10,000XRs. 50)	<u>5,00,000</u>
	23,00,000
Retained earnings	<u>9,00,000</u>
Net assets value of all shares	<u>32,00,000</u>

$$\text{Value per rupee of paid up capital} = \frac{\text{Net assets value of all shares}}{\text{Paid up capital}} = \frac{32,00,000}{23,00,000} = \text{Rs.1.391}$$

Therefore,

Net assets value of Rs. 100 paid up share	Rs.1.391 x 100	Rs.139.10
Net assets value of Rs. 80 paid up share	Rs.1.391 x 80	Rs.111.28
Net assets value of Rs. 50 paid up share	Rs.1.391 x 50	Rs.69.55

Question 4

- (a) X Ltd. began construction of a new building on 1st January, 2007. It obtained Rs.1 lakh special loan to finance the construction of the building on 1st January, 2007 at an interest rate of 10%. The company's other outstanding two non-specific loans were:

Amount	Rate of Interest
Rs.5,00,000	11%
Rs.9,00,000	13%

The expenditure that were made on the building project were as follows:

	Rs.
January 2007	2,00,000
April 2007	2,50,000
July 2007	4,50,000
December 2007	1,20,000

Building was completed by 31st December, 2007. Following the principles prescribed in AS-16 'Borrowing Cost,' calculate the amount of interest to be capitalized and pass one Journal Entry for capitalizing the cost and borrowing cost in respect of the building.

- (b) From the following information of Steel India Ltd. for the year ended 31st March, 2008, prepare their Social Balance Sheet as on that date:

- A specialist has valued their human assets at Rs.828 lakhs.
- Their investments were classified as:

	(Rs. in lakhs)			
	Residential	Hospital	School	Welfare
Buildings	17.00	1.00	1.40	0.80
Equipments	2.80	1.00	1.00	-

- Water, electricity and gas supply systems totalled Rs.1 lakh.

- Their Net owned funds were Rs.26 lakhs. (10 + 6 = 16 Marks)

Answer

(a) (i)	Computation of average accumulated expenses	Rs.
	Rs. 2,00,000 x 12 / 12	= 2,00,000
	Rs. 2,50,000 x 9 / 12	= 1,87,500
	Rs. 4,50,000 x 6 / 12	= 2,25,000
	Rs. 1,20,000 x 1 / 12	= <u>10,000</u>
		<u>6,22,500</u>

- (ii) Calculation of average interest rate other than for specific borrowings

Amount of loan (in Rs.)	Rate of interest	Amount of interest (in Rs.)
5,00,000	11%	= 55,000
<u>9,00,000</u>	13%	= <u>1,17,000</u>
<u>14,00,000</u>		<u>1,72,000</u>
Weighted average rate of interest	=	
$(\frac{1,72,000}{14,00,000} \times 100)$		12.285% (approx)

(iii) Interest on average accumulated expenses

		Rs.
Specific borrowings (Rs. 1,00,000 X 10%)	=	10,000
Non-specific borrowings (Rs. 5,22,500* X 12.285%)	=	<u>64,189</u>
Amount of interest to be capitalized	=	<u>74,189</u>

(iv) Total expenses to be capitalized for building

	Rs.
Cost of building Rs.(2,00,000 + 2,50,000 + 4,50,000 + 1,20,000)	10,20,000
Add: Amount of interest to be capitalised	<u>74,189</u>
	<u>10,94,189</u>

(v) Journal Entry

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31.12.2007	Building account	Dr. 10,94,189	
	To Bank account		10,94,189
	(Being amount of cost of building and borrowing cost thereon capitalized)		

(b) Social Balance Sheet of Steel India Ltd.
as at 31.03.2008

(Rs. in lakhs)

Liabilities:

Organization Equity	26.00
Social Equity (Contribution by staff)	<u>828.00</u>
Total	<u>854.00</u>

Assets:

Social Capital Investment:

(a) Buildings

(i) Residential	17.00	
(ii) Hospital	1.00	
(iii) School	1.40	
(iv) Welfare	<u>0.80</u>	20.20

* (Rs. 6,22,500 – Rs. 1,00,000)

(b) Equipments		
(i) Residential	2.80	
(ii) Hospital	1.00	
(iii) School	<u>1.00</u>	4.80
(c) Water, Electricity and Gas supply systems		1.00
Human assets (as valued by the specialist)		<u>828.00</u>
Total		<u>854.00</u>

Question 5

- (a) U.K. International Ltd. is developing a new production process. During the financial year ending 31st March, 2007, the total expenditure incurred was Rs.50 lakhs. This process met the criteria for recognition as an intangible asset on 1st December, 2006. Expenditure incurred till this date was Rs.22 lakhs. Further expenditure incurred on the process for the financial year ending 31st March, 2008 was Rs.80 lakhs. As at 31st March, 2008, the recoverable amount of know-how embodied in the process is estimated to be Rs.72 lakhs. This includes estimates of future cash outflows as well as inflows.

You are required to calculate:

- Amount to be charged to Profit and Loss A/c for the year ending 31st March, 2007 and carrying value of intangible as on that date.
- Amount to be charged to Profit and Loss A/c and carrying value of intangible as on 31st March, 2008.

Ignore depreciation.

- Sky Hospital – a non-profit seeking entity receives medicines worth Rs.5,00,000 by way of donations from a donor. During the year its issues of all medicines totals Rs.16,00,000. The closing inventory of donated medicines is Rs.1,00,000. Show relevant summary Journal Entries in the books of the Hospital in respect of the above.
- Mini Ltd. took a factory premises on lease on 1.4.07 for Rs.2,00,000 per month. The lease is operating lease. During March, 2008, Mini Ltd. relocates its operation to a new factory building. The lease on the old factory premises continues to be live upto 31.12.2010. The lease cannot be cancelled and cannot be sub-let to another user. The auditor insists that lease rent of balance 33 months upto 31.12.2010 should be provided in the accounts for the year ending 31.3.2008. Mini Ltd. seeks your advice.

- (d) A Cosmetic articles producing company provides the following information:

	Cold Cream	Vanishing Cream
January, 2006 – September, 2006 per month	2,00,000	2,00,000
October, 2006 – December, 2006 per month	1,00,000	3,00,000
January, 2007- March, 2007 per month	0	4,00,000

The company has enforced a gradual change in product-line on the basis of an overall plan. The Board of Directors of the company has passed a resolution in March, 2006 to this effect. The company follows calendar year as its accounting year. Should this be treated as a discontinuing operation? Give reasons in support of your answer.

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

Answer

- (a) As per AS 26 'Intangible Assets'

- (i) For the year ending 31.03.2007

- (1) Carrying value of intangible as on 31.03.2007:

At the end of financial year 31st March 2007, the production process will be recognized (i.e. carrying amount) as an intangible asset at a cost of Rs. 28 lakhs (expenditure incurred since the date the recognition criteria were met, i.e., on 1st December 2006).

- (2) Expenditure to be charged to Profit and Loss account:

The Rs. 22 lakhs is recognized as an expense because the recognition criteria were not met until 1st December 2007. This expenditure will not form part of the cost of the production process recognized in the balance sheet.

- (ii) For the year ending 31.03.2008

- (1) Expenditure to be charged to Profit and Loss account:

	(Rs. in lakhs)
Carrying Amount as on 31.03.2007	28
Expenditure during 2007 – 2008	<u>80</u>
Total book cost	108
Recoverable Amount	<u>72</u>
Impairment loss	<u>36</u>

Rs. 36 lakhs to be charged to Profit and loss account for the year ending 31.03.2008.

(2) Carrying value of intangible as on 31.03.2008:

	(Rs. in lakhs)
Total Book Cost	108
Less: Impairment loss	<u>36</u>
Carrying amount as on 31.03.2008	<u>72</u>

(b) Journal Entries

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Inventory of Medicines (Donated) A/c	Dr. 5,00,000	
	To Operating Revenue A/c		5,00,000
	(Being receipt of donated medicines during the year)		
	Operating Expenses – Medicines A/c	Dr. 16,00,000	
	To Inventory of Medicines A/c (Donated)		4,00,000
	To Inventory of Medicines (Purchased)		12,00,000
	(Being consumption / issue of medicines during the year)		

- (c) In accordance with AS 29 'Provisions, Contingent Liabilities and Contingent Assets' and ASI 30 'Applicability of AS 29 to Onerous Contracts', if an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision. In the given case, the operating lease contract has become onerous* as the economic benefit of lease contract for next 33 months up to 31.12.2010 will be nil. However, the lessee, Mini Ltd., has to pay lease rent of Rs. 66,00,000 (i.e. 2,00,000 p.m. for next 33 months).

Therefore, provision on account of Rs.66,00,000 is to be provided in the accounts for the year ending 31.03.08. Hence auditor is right.

- (d) In response to the market forces, business enterprises often abandon products or even product lines and reduce the size of their work-force. These actions are not in themselves discontinuing operations unless they satisfy the definition criteria.

In the instant case the company has been gradually reducing operation in the product line of cold creams, simultaneously increasing operation in the product line of vanishing creams. The company was not disposing of any of its components. Phasing out a product line as undertaken by the company does not meet definition criteria in paragraph

* For a contract to qualify as an onerous contract, the unavoidable costs of meeting the obligation under the contract should exceed the economic benefits expected to be received under it.

3 of AS 24, namely, disposing of substantially in its entirety a component of the enterprise. Therefore, this change over is not a discontinuing operation.

Question 6

Answer the following questions:

- (a) What are the advantages of preparation of Value Added (VA) statements?
- (b) How are capital expenditures not represented by any specific or tangible assets dealt in financial statements?
- (c) One of the important factors generally considered for awarding shields and plaques in India for 'best presented accounts' is that the information presented in the accounts make useful disclosures.

What are actually looked into in this regard?

(6+5+5 = 16 Marks)

Answer

- (a) The various advantages of preparation of Value Added (VA) Statements are as under:
 - 1. Reporting on VA improves the attitude of employees towards their employing companies. This is because the VA statement reflects a broader view of the company's objectives and responsibilities.
 - 2. VA statement makes it easier for the company to introduce a productivity linked bonus scheme for employees based on VA. The employees may be given productivity bonus on the basis of VA / Payroll Ratio.
 - 3. VA based ratios (e.g. VA / Payroll, taxation / VA, VA / Sales etc.) are useful diagnostic and predictive tools. Trends in VA ratios, comparisons with other companies and international comparisons may be useful.
 - 4. VA provides a very good measure of the size and importance of a company. To use sales figure or capital employed figures as a basis for company's rankings can cause distortion. This is because sales may be inflated by large bought-in expenses or a capital-intensive company with a few employees may appear to be more important than a highly skilled labour-intensive company.
 - 5. VA statement links a company's financial accounts to national income. A company's VA indicates the company's contribution to national income.
 - 6. VA statement is built on the basic conceptual foundations which are currently accepted in balance sheets and income statements. Concepts such as going concern, matching, consistency and substance over form are equally applicable to VA statement.
- (b) Sometimes circumstances force a project to incur capital expenditure which is not represented by any specific or tangible assets. For example, a project may have to pay the cost of laying pipelines in order to facilitate the supply of its products or raw materials

to or from a sea port but the port trust or other similar authorities may insist that the pipelines belong to them even though the cost thereof is paid by the company. In such a case, the capital expenditure incurred by the project for the stated purpose would not be represented by any actual assets, since the pipeline would remain the property of the relevant port trust or other similar authorities even though the whole or a part of their cost may have been defrayed by the company in order to facilitate its business. In such cases the expenditure so incurred would have to be treated in the books of account as the capital expenditure.

There seems to be no valid objection to disclose the expenditure under the general heading of "Capital Expenditure" subject to two conditions. In the first place the description of the specific items on the balance sheet should be such as to indicate quite clearly that the capital expenditure is not represented by any assets owned by the company. In the second place the capital expenditure should be written off over the approximate period of its utility or over a relatively brief period not exceeding five years whichever is less.

In fact having regard to the nature of expenditure and purpose for which it is incurred, it would be more appropriate and realistic to classify such expenditure in the balance sheet under the heading of "Capital Expenditure" rather than either, write off the expenditure to revenue or classify the expenditure under the heading of "Miscellaneous Expenditure".

- (c) In order to ascertain whether the nature and quality of information presented in the accounts make useful disclosures, the following features are generally looked into:
1. Statement of changes in financial position.
 2. Sufficient details of revenues / expenses for financial analysis e.g. distinction between manufacturing cost, selling cost and administration cost.
 3. Use of vertical form as against the conventional T form; judicious use of schedules, use of sub-totals, manner of showing comparative figures, ease of getting at figures.
 4. To what extent additional financial information is provided to the readers through charts and graphs.
 5. Financial highlights and ratios including earnings per share.
 6. Inclusion of one or more bits of information like value added statement, break up of operations, organization chart, location of factories / branches, human resource accounting, inflation adjusted accounts, social accounts etc.

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

Question No. 1 is compulsory. Answer any four question from the rest.

Figures in the margin indicate marks allotted to each question.

Working notes should form part of the answer.

Question 1

- (a) DL Services is in the business of providing home Services like plumbing, sewerage line cleaning etc. There is a proposal before the company to purchase a mechanized sewerage cleaning line for a sum of Rs. 20 lacs. The life of the machine is 10 years. The present system of the company is to use manual labour for the job. You are provided the following information:

Cost of machine	Rs. 20 lacs
Depreciation	20% p.a. straight line
Operating cost	Rs. 5 lacs per annum
Present system	
Manual labour	200 persons
Cost of Manual labour	Rs. 10,000 (ten thousand) per person per annum

The company has an after tax cost of funds of 10% per annum. The applicable rate of tax inclusive of surcharge and cess is 35%.

Based on the above you are required to:

- State whether it is advisable to purchase the machine.
- Compute the savings/additional cost as applicable, if the machine is purchased.

(12 Marks)

- (b) P Ltd. invested on 1.4.2006 in Equity shares as below:

Company	Number of Shares	Cost (Rs.)
M Ltd.	1,000 (Rs. 100 each)	2,00,000
N Ltd.	500 (Rs. 10 each)	1,50,000

In September, 2006, M Ltd. paid 10% dividend and in October, 2006, N Ltd. paid 30% dividend.

On 31.3.2007, market price of shares of M Ltd. and N Ltd. were Rs. 220 and Rs. 290 respectively.

P Ltd. have been informed by their investment advisers that:

- Dividends from M Ltd. and N Ltd. for the year ending 31.3.2008 are likely to be 20% and 35% respectively.

(ii) Probabilities of market quotations on 31.3.2008 are:

Probability Factor	Price of share of M Ltd.	Price of share of N Ltd.
0.2	220	290
0.5	250	310
0.3	280	330

You are required to:

- (i) Calculate the average return from the portfolio for the year ended 31.3.2007.
- (ii) Calculate the expected average return from the portfolio for the year 2007 – 08.
- (iii) Advise P Ltd. of the comparative risk of two investments by calculating the Standard deviation in each case. (8 Marks)

Answer

(a) Present System

Cost per annum	
200 persons @ Rs.10,000 per annum	20,00,000
Cumulative Annuity factor at 10%	6.1446
Present value of cash outflow over a period of ten years at 10%	122,89,200
Tax benefit at 35% for 10 years	43,01,220
Net cost over ten years	79,87,980

If machine is purchased

Cost of Machine	20,00,000
Depreciation per annum	4,00,000
Annual cost of operation	5,00,000

Present value of operating cost for 10 years at 10%	30,72,300
Tax saving on operating cost at 35% for 10 years	10,75,305
Net operating cost	19,96,995
Annuity factor for 5 years at 10%	3.7908
Tax saving on depreciation at 35%	5,30,712

Summary

Outflow on machine	20,00,000
--------------------	-----------

Less: Tax saving on depreciation of Machine	-5,30,712
Add: Operating cost over 10 years	19,96,995
Total cost of machine over 10 years	34,66,283
Total saving	45,21,697

Since there is a saving of Rs.45.21 lacs it is advisable to purchase the machine.

Alternative Solution:

Calculation of Savings in operating cost if the mechanized cleaning line is purchased:

Annual Cost of the present system – cost of manual labour	Rs. lakhs
200 persons × Rs.10,000	20.00
Less: Operating cost with the new line	5.00
Annual Savings	15.00

Calculation of incremental cash in flows if the mechanized cleaning line is purchased:

Year 1 - 5

	Rs. lakhs
Annual Savings in operating cost (before tax)	15.00
Less: Annual depreciation @ 20% on cost	4.00
Taxable annual incremental income	11.00
Less: Tax @ 35%	3.85
After-tax annual incremental income	7.15
Add: Annual depreciation	4.00
Annual incremental cash-in-flow	11.15

Present Value Factor (of an Annuity for a period of 5 years @ 10%)	3.79
--	------

(Rs. Lakhs)

Present Value of 5-year annual incremental cash-in-flow	42.26
---	-------

Year 6 – 10

Annual Savings in operating cost (before tax)	15.00
Less: Tax @ 35%	5.25
After-tax annual incremental income/cash in flow	9.75

Present Value Factor (of an Annuity between year 6 and 10)	2.35
--	------

Present Value of cash-in-flow in years 6 to 10 (Rs. Lakhs) 22.91
(Salvage value presumed 'nil')

Rs. in lakhs

Calculation of Net Present Value:

Aggregate Present Value of Cash in flows in years 1 – 10

(42.26 + 22.91) 65.17

Less: Initial investment – cost of machine 20.00

NET PRESENT VALUE (+) 45.17

Conclusion: Since the NPV is positive, it is advisable to purchase the mechanized line.

(b) (i) Calculation of average return from portfolio for the year ended 31.03.2007

	Rs./Share	
	M Ltd.	N Ltd.
Dividend received during the year	10	3
Capital Gain/Loss to 31.03.2007		
Market Value	220	290
Cost of Investment	200	300
Gain (Loss)	20	(10)
Yield	30	(7)
Cost	200	300
% Return	15	(2.33)
Weight in the portfolio	57	43
Weighted average return $(0.57 \times 0.15) + (0.43 \times -0.0233)$ = 0.0755	7.55%	

(ii)

Expected average Return for 2007- 08

Expected Dividend 20 3.5

Capital Gain (Loss) to 31.03.2008

$(220 \times 0.2) + (250 \times 0.5) + (280 \times 0.3)$ [253-220] 33

$(290 \times 0.2) + (310 \times 0.5) + (330 \times 0.3)$ [312 – 290] 22

Yield 53 25.5

Market Value 220 290

% Return 24.09 8.79

Weighted Average (expected) Return $(0.57 \times 0.2409) +$
 $(0.43 \times 0.0879) =$ 17.51%

(iii) Calculation of Standard Deviation

	Expected Market Value	Expected Gain	Expected Dividend	Expected Yield	Devia- Tions	Square of Devia- tions	Proba- bility factor	Square of Devia- tions × probabi- lity
M Ltd.	220	-	20	20	-33	1089	0.2	217.80
	250	30	20	50	-3	9	0.5	4.50
	280	60	20	80	27	729	0.3	218.70
				SD 21				441.00
								=====
N Ltd	290	-	3.5	3.5	-22	484	0.2	96.80
	310	20	3.5	23.5	-2	4	0.5	2.00
	330	40	3.5	43.5	18	324	0.3	97.20
				SD 14				196.00
								=====

Share of M Ltd. is more risky as the SD is more than that of N Ltd.

Question 2

- (a) A company has a choice of investments between several different equity oriented mutual funds. The company has an amount of Rs.1 crore to invest. The details of the mutual funds are as follows:

Mutual Fund	Beta
A	1.6
B	1.0
C	0.9
D	2.0
E	0.6

Required:

- If the company invests 20% of its investment in the first two mutual funds and an equal amount in the mutual funds C, D and E, what is the beta of the portfolio?
- If the company invests 15% of its investment in C, 15% in A, 10% in E and the balance in equal amount in the other two mutual funds, what is the beta of the portfolio?
- If the expected return of market portfolio is 12% at a beta factor of 1.0, what will be the portfolios expected return in both the situations given above? (10 Marks)

(b) A holds the following portfolio:

Share/Bond	Beta	Initial Price Rs`	Dividends Rs.	Market Price at end of year Rs.
Epsilon Ltd.	0.8	25	2	50
Sigma Ltd.	0.7	35	2	60
Omega Ltd.	0.5	45	2	135
GOI Bonds	0.99	1,000	140	1,005

Calculate:

(i) The expected rate of return on his portfolio using Capital Asset Pricing Method (CAPM)

(ii) The average return of his portfolio.

Risk-free return is 14%.

(10 Marks)

Answer

With 20% investment in each MF Portfolio Beta is the weighted average of the Betas of various securities calculated as below:

(i)	Investment	BETA	Investment (Rs. Lacs)	Weighted Investment
	A	1.6	20	32
	B	1	20	20
	C	0.9	20	18
	D	2	20	40
	E	0.6	20	12
			100	122

Weighted BETA = 1.22

Expected Return = $1.22 \times 12 = 14.64\%$

(ii) With varied percentages of investments portfolio beta is calculated as follows:

	BETA	Investment (Rs. Lacs)	Weighted Investment
A	1.6	15	24
B	1	30	30
C	0.9	15	13.5
D	2	30	60

E	0.6	10	6
		100	133.5

Weighted BETA = 1.335

Expected Return – $1.335 \times 12 = 16.02\%$

- (iii) Expected return of the portfolio with pattern of investment as in case (i)
 $12\% \times 1.22$ i.e. 14.64%

With pattern of investment as in case (ii)

$12\% \times 1.335$ i.e., 16.02%.

- (b) (i) Expected rate of return

	Total Investments	Dividends	Capital Gains
Epsilon Ltd.	25	2	25
Sigma Ltd.	35	2	25
Omega Ltd.	45	2	90
GOI Bonds	<u>1,000</u>	<u>140</u>	<u>5</u>
	1,105	146	145
	=====	=====	=====

Expected Return on market portfolio = $\frac{146 + 145}{1105} = 26.33\%$

CAPM $E(R_p) = R_F + B [E(R_M) - R_F]$

					%age
Epsilon Ltd	$14 + 0.8$	$[26.33 - 14]$	=	$14 + 9.86$	= 23.86
Sigma Ltd.	$14 + 0.7$	$[26.33 - 14]$	=	$14 + 8.63$	= 22.63
Omega Ltd.	$14 + 0.5$	$[26.33 - 14]$	=	$14 + 6.17$	= 20.17
GOI Bonds	$14 + 0.99$	$[26.33 - 14]$	=	$14 + 12.21$	= 26.21

- (ii) Average Return of Portfolio

$$\frac{23.86 + 22.63 + 20.17 + 26.21}{4} = \frac{92.87}{4} = 23.22\%$$

OR

$$\frac{0.8 + 0.7 + 0.5 + 0.99}{4} = \frac{2.99}{4} = 0.7475$$

$$14 + 0.7475(26.33 - 14)$$

$$14 + 9.22 = 23.22\%$$

Question 3

- (a) The following is the Balance Sheet of a Private Limited Company as at 31st March, 2008.

Capital and Liabilities	Rs.	Property and Assets	Rs.
<u>Share capital:</u>	8,00,000	<u>Fixed Assets:</u>	
Authorized: 8,000 equity shares of Rs. 100 each		Cost 6,00,000	
		Less: Depreciation <u>2,00,000</u>	4,00,000
10,000 11% Cumulative Preference shares of Rs. 100 each.	<u>10,00,000</u>	<u>Current Assets:</u>	
		Stock in trade 2,00,000	
		Sundry debtors 4,00,000	
		Cash and bank balance <u>1,00,000</u>	7,00,000
Issued, subscribed and paid up:			
4,000 Equity shares of Rs. 100 each fully paid up	4,00,000		
Reserve	1,00,000		
15% Unsecured debentures	2,00,000		
Trade creditors and creditors for expenses	<u>4,00,000</u>		
	<u>Rs. 11,00,000</u>		<u>Rs. 11,00,000</u>

The company finds that a very profitable market exists for its products and with a little expansion; it could generate more sales at the present selling prices. The expansion calls for an investment of Rs. 8,00,000 in Fixed assets and Rs. 2,00,000 in Current assets. It is ascertained that the current annual profits in the region of Rs. 3,00,000 will be enhanced by 50% due to the expansion.

The debt-equity ratio applicable generally to the industry in which the Company is engaged is 2 : 1.

Please advise the management on the various methods available to it to meet the cost of financing the expansion, keeping in mind the interest of the equity shareholders.

(16 Marks)

- (b) Explain the difference between a Repo and a Reverse Repo transaction. (4 Marks)

Answer

(a)	Rs.	Rs.
Resources needed for expansion:		
Fixed assets	8,00,000	
Current assets	<u>2,00,000</u>	

	<u>10,00,000</u>	
Less: Resources available	<u>1,00,000</u>	9,00,000

The question asks for the interest of the equity shareholders to be kept in mind. Hence, EPS has to be the maximum in the circumstances.

The debt-equity ratio applicable to the industry is 2:1. The equity as on 31st March, 2008 is Rs.5,00,000 and the debt Rs.2,00,000. Some gearing is thus possible on the debt front.

It is also to be remembered that cost of servicing debt is an allowable set-off against profits while cost of servicing capital is not.

The various alternatives available are considered below:-

- (i) To raise the equity to the level authorized by the memorandum and to raise the balance by issue of preference capital.

Resources needed	9,00,000
Equity capital to the extent unissued to be issued at par	<u>4,00,000</u>
Balance needed	5,00,000
To be met by the issue of 5,000 11% cumulative preference share	<u>5,00,000</u>

EPS then will be $\text{Rs.}3,00,000 + \text{Rs.}1,50,000 - 55,000 \div 8,000$ viz. Rs.49.38

- (ii) To raise the entire requirements by issue of Preference Capital.

In this situation, EPS will be $\text{Rs.}4,50,000 - 99,000 = \frac{\text{Rs.}3,51,000}{4,000} = \text{Rs.}87.75$

- (iii) To raise the resources by part issue of equity and balance by way of 15% debentures.

Resources needed	Rs.9,00,000
Unissued capital	4,00,000
Issue of debentures	5,00,000

EPS in this case will be $\text{Rs.}4,50,000 - 75,000 = 3,75,000 \div 8,000 = \text{Rs.}46.88$

- (iv) The company's debt equity ratio is 0.4:1. The acceptable limit is 2:1. The company can therefore raise a debt, on the present level of equity base to the extent of Rs.10,00,000. The existing debt being Rs.2,00,000, balance of Rs.8,00,000 could be raised. Thus there will be a short cover of Rs.1,00,000. To use the debt cover to the fullest extent, the company can issue additional equity shares of 500 making the equity base of Rs.4,50,000.

Resources needed		9,00,000
Issue of new shares	50,000	
Issue of debt	<u>8,50,000</u>	<u>9,00,000</u>

The rate at which debt can be raised cannot be lower than what the company is paying to the debentureholders i.e., (15%). Assuming the cost of loan at 17%, the position of EPS will be as under:

New profits	4,50,000
Less: Interest on borrowings 17% on Rs.8,50,000	1,44,500
Profit available to equity holders	<u>Rs.3,05,500</u>
No. of equity shares	4,500
EPS	Rs.68 (rounded off)

A yet another method could be to issue the unissued equity shares assuming at a premium, say of 20% and for the balance raise preference share capital which is the least costly amongst the various alternatives.

Resources needed	Rs.9,00,000
Issue of 4000 equity shares at Rs.120 per share	4,80,000
Balance needed	<u>4,20,000</u>

Issue 4200 11% cum Preference shares at par. EPS in this situation will be
 $\text{Rs.}4,50,000 - \text{Rs.}46,200 = 4,03,800$

$$= \frac{4,03,800}{8,000}$$

$$= \text{Rs.}50.48$$

Tabled below are the various results.

$$\text{EPS at present } \frac{\text{Rs.}3,00,000}{\text{Rs.}4,000} = \text{Rs.}75$$

	(Rs.)
(i) By Combination of issue of equity and preference at par	49.38
(ii) By Raising preference shares only	87.75
(iii) By part issue of equity and part debentures	46.88
(iv) By Predominant resort to borrowings	68.00
(v) Issue of part equity at a premium and the balance preference shares	50.48

The suggested plan, per se, will be to meet the entire costs of expansion by issuing 11% cumulative preference shares.

- (b) Difference between a REPO and a REVERSE REPO Transaction: These are Money Market transactions entered into by players in the money market such as commercial banks, financial institutions, large players like Mutual Funds but are in restricted use because of reserve Bank of India policy guidelines. The word "REPO" is the abbreviation of a Repurchase Option. An agreement by which a borrower sells certain acceptable securities to a lender against funds received and agrees to reverse the transaction at an agreed future date is the essential feature of a REPO transaction. In essence it is a contract of lending and the difference between the prices of the securities on the two dates will represent the cost of funds which the borrower agrees to bear.

A single transaction as described above is a 'REPO' transaction when viewed from the point of view of the borrower-seller of securities; the same transaction when viewed from the point of view of the lender-buyer is understood as a 'REVERSE REPO'.

Hence, essentially, there is no difference between a 'REPO' and a 'REVERSE REPO' transaction excepting that the identification is from a different point of view.

The essential features of the Repo transaction are:

1. A financial institution places certain securities (presently restricted to Treasury Bills) with the buyer and borrows a certain amount of money.
2. On a given date specified in advance (between 14 days to 1 year) the entire transaction is reversed.
3. The difference between the purchase and sale price is the interest or gain to the buyer. Sometimes the seller may also gain from a transaction. This is when the buyer is in need of securities and initiates the transaction.

Question 4

- (a) Given below is the Balance Sheet of S Ltd. as on 31.3.2008 :

Liabilities	Rs. (in lakh)	Assets	Rs. (in lakh)
Share capital (share of Rs. 10)	100	Land and building	40
Reserves and surplus	40	Plant and machinery	80
Creditors	30	Investments	10
		Stock	20
		Debtors	15
		Cash at bank	5
	<u>170</u>		<u>170</u>

You are required to work out the value of the Company's, shares on the basis of Net Assets method and Profit-earning capacity (capitalization) method and arrive at the fair price of the shares, by considering the following information:

- (i) Profit for the current year Rs. 64 lakhs includes Rs. 4 lakhs extraordinary income and Rs. 1 lakh income from investments of surplus funds; such surplus funds are unlikely to recur.
- (ii) In subsequent years, additional advertisement expenses of Rs. 5 lakhs are expected to be incurred each year.
- (iii) Market value of Land and Building and Plant and Machinery have been ascertained at Rs. 96 lakhs and Rs. 100 lakhs respectively. This will entail additional depreciation of Rs. 6 lakhs each year.
- (iv) Effective Income-tax rate is 30%.
- (v) The capitalization rate applicable to similar businesses is 15%. (16 Marks)
- (b) Comment briefly on the social cost benefit analysis in relation to evaluation of an Industrial project. (4 Marks)

Answer

(a)	Rs. lakhs
Net Assets Method	
Assets: Land & Buildings	96
Plant & Machinery	100
Investments	10
Stocks	20
Debtors	15
Cash & Bank	<u>5</u>
Total Assets	246
Less: Creditors	<u>30</u>
Net Assets	216
	=====

Value per share

(a) Number of shares $\frac{1,00,00,000}{10} = 10,00,000$

(b) Net Assets Rs.2,16,00,000

$$\frac{\text{Rs.2,16,00,000}}{10,00,000} = \text{Rs.21.6}$$

Profit-earning Capacity Method

Profit before tax		64.00
Less: Extraordinary income	4.00	
Investment income (not likely to recur)	<u>1.00</u>	<u>5.00</u>
		59.00

Less: Additional expenses in forthcoming years

Advertisement	5.00	
Depreciation	<u>6.00</u>	<u>11.00</u>
Expected earnings before taxes		48.00
Less: Income-tax @ 30%		<u>14.40</u>
Future maintainable profits (after taxes)		33.60
		=====

Value of business 224

Capitalisation factor $\frac{33.60}{0.15} =$

Less: External Liabilities (creditors) 30
194
=====

Value per share

$$= \frac{1,94,00,000}{10,00,000} = \text{Rs. } 19.4$$

Fair Price of share Rs.

Value as per Net Assets Method 21.6

Value as per Profit earning capacity (Capitalisation) method 19.4

$$\text{Fair Price} = \frac{21.6 + 19.4}{2} = \frac{41}{2} = \text{Rs. } 20.5$$

- (b) Comments on Social Cost-Benefit Analysis of industrial projects: This refers to the moral responsibility of both PSU and private sector enterprises to undertake socially desirable projects – that is, the social contribution aspect needs to be kept in view.

Industrial capital investment projects are normally subjected to rigorous feasibility

analysis and cost benefit study from the point of view of the investors. Such projects, especially large ones often have a ripple effect on other sections of society, local environment, use of scarce national resources etc. Conventional cost-benefit analysis ignores or does not take into account or ignores the societal effect of such projects. Social Cost Benefit (SCB) is recommended and resorted to in such cases to bring under the scanner the social costs and benefits.

SCB sometimes changes the very outlook of a project as it brings elements of study which are unconventional yet very very relevant. In a study of a famous transportation project in the UK from a normal commercial angle, the project was to run an annual deficit of more than 2 million pounds. The evaluation was adjusted for a realistic fare structure which the users placed on the services provided which changed the picture completely and the project got justified. Large public sector/service projects especially in under-developed countries which would get rejected on simple commercial considerations will find justification if the social costs and benefits are considered.

SCB is also important for private corporations who have a moral responsibility to undertake socially desirable projects, use scarce natural resources in the best interests of society, generate employment and revenues to the national exchequer.

Indicators of the social contribution include

- (a) Employment potential criterion;
- (b) Capital output ratio – that is the output per unit of capital;
- (c) Value added per unit of capital;
- (d) Foreign exchange benefit ratio.

Question 5

- (a) M Ltd. belongs to a risk class for which the capitalization rate is 10%. It has 25,000 outstanding shares and the current market price is Rs. 100. It expects a net profit of Rs. 2,50,000 for the year and the Board is considering dividend of Rs. 5 per share.

M Ltd. requires to raise Rs. 5,00,000 for an approved investment expenditure. Show, how does the MM approach affect the value of M Ltd., if dividends are paid or not paid.

(8 Marks)

- (b) A company is considering hedging its foreign exchange risk. It has made a purchase on 1st. January, 2008 for which it has to make a payment of US \$ 50,000 on September 30, 2008. The present exchange rate is 1 US \$ = Rs. 40. It can purchase forward 1 US \$ at Rs. 39. The company will have to make a upfront premium of 2% of the forward amount purchased. The cost of funds to the company is 10% per annum and the rate of Corporate tax is 50%. Ignore taxation. Consider the following situations and compute the Profit/Loss the company will make if it hedges its foreign exchange risk:

(i) If the exchange rate on September 30, 2008 is Rs. 42 per US \$.

(ii) If the exchange rate on September 30, 2008 is Rs. 38 per US \$.

(8 Marks)

- (c) Briefly explain, what is 'refinancing', indicating any two institutions which offer this facility.
(4 Marks)

Answer

- (a) A When dividend is paid

- (a) Price per share at the end of year 1

$$100 = \frac{1}{1.10}(\text{Rs.}5 + P_1)$$

$$110 = \text{Rs.}5 + P_1$$

$$P_1 = 105$$

- (b) Amount required to be raised from issue of new shares

$$\text{Rs.}5,00,000 - (2,50,000 - 1,25,000)$$

$$\text{Rs.}5,00,000 - 1,25,000 = \text{Rs.}3,75,000$$

- (c) Number of additional shares to be issued

$$\frac{3,75,000}{105} = \frac{75,000}{21} \text{ shares or say 3572 shares}$$

- (d) Value of M Ltd.

$$(\text{Number of shares} \times \text{Expected Price per share})$$

$$\text{i.e., } (25,000 + 3,572) \times \text{Rs.}105 = \text{Rs.}30,00,060$$

- B When dividend is not paid

- (a) Price per share at the end of year 1

$$100 = \frac{P_1}{1.10}$$

$$P_1 = 110$$

- (b) Amount required to be raised from issue of new shares

$$\text{Rs.}5,00,000 - 2,50,000 = 2,50,000$$

- (c) Number of additional shares to be issued

$$\frac{2,50,000}{110} = \frac{25,000}{11} \text{ shares or say 2273 shares.}$$

- (d) Value of M Ltd.,
 $(25,000 + 2273) \times \text{Rs.}110$
 $= \text{Rs.}30,00,030$
 Whether dividend is paid or not, the value remains the same.

(b)	(Rs.)
Present Exchange Rate Rs.40 = 1 USD	
If company purchases USD 50000 forward premium is	
$50000 \times 39 \times 2\%$	39,000
Interest on Rs.39,000 for 9 months at 10%	2,925
Total hedging cost	41,925
If exchange rate is Rs.42	
Then gain $(\text{Rs.}42 - 39)$ for USD 50000	1,50,000
Less:Hedging cost	41,925
Net gain	1,08,075
 If USD = Rs.38	
Then loss $(39 - 38)$ for USD 50000	50,000
Add: Hedging Cost	41,925
Total Loss	91,925

- (c) REFINANCING: The term “refinancing” would refer to a process by which a lending institution reimburses and thus takes over the exposure or assistance provided by another financing institution to an industrial or business unit. For example, a nationalized bank may provide financial assistance to a number of small scale units and may get the amount reimbursed by Small Industries Development Bank of India (SIDBI).

Refinancing is a useful process by which a large lending institution which is not poised to do retail lending can do the activity through other banks/lending institutions which have infrastructure for and are focused on retail lending. It is a convenient tool for large public institutions with developmental or social goals to reach small needy borrowers.

In India, National Agricultural Bank for Reconstruction and Development (NABARD) has refinancing schemes for agricultural financial assistance provided by commercial and rural banks. Another example can be that of Small Industries Development Bank of India (SIDBI) which re-finances assistance made to small scale units by other banks and institutions.

Question 6

Write short notes on the following:

- (a) Venture capital financing
- (b) Inter-bank participation certificate
- (c) Distinction between Money market and Capital market
- (d) Credit cards as part of Consumer finance
- (e) Stock Lending Scheme. (4 x 5 = 20 Marks)

Answer

- (a) Venture capital financing refers to financing of new high-risk ventures promoted by qualified entrepreneurs who lack experience and funds to give shape to their ideas. A venture capitalist invests in equity or debt securities floated by such entrepreneurs who undertake highly risky ventures with a potential of success.

Common methods of venture capital financing include:

- (i) Equity financing: The undertaking's requirements of long-term funds are met by contribution by the venture capitalist but not exceeding 49% of the total equity capital;
 - (ii) Conditional Loan: Which is repayable in the form of royalty after the venture is able to generate sales;
 - (iii) Income Note: A hybrid security combining features of both a conventional and conditional loan, where the entrepreneur pays both interest and royalty but at substantially lower rates;
 - (iv) Participating debenture: The security carries charges in three phases – start phase, no interest upto a particular level of operations; next stage, low interest; thereafter a high rate.
- (b) Inter-bank Participation Certificate (IBPC): This is a Money Market instrument to even out the short-term liquidity within the banking system. It is issued by a bank requiring funds and is subscribed to by another bank wanting to deploy surplus funds. It is issued against an underlying 'standard' advance and during the term of participation should always be covered by the outstanding balance in the account concerned.

IBPC can provide advantage to both the issuing bank and the participating bank. To the issuing bank it provides an opportunity to obtain funds against its advances without actually diluting the asset portfolio. To the participating lender-bank it provides an opportunity to deploy short-term funds profitably against assets qualified for bank funding.

IBPC is an instrument that has to comply with Reserve Bank of India's norms and can be issued by any scheduled commercial bank. IBPC's can be issued in two types – one with risk to the lender and the other without risk to the lender. If it is with risk to the lender,

the issuing bank will reduce the amount of participation from the advances outstanding and the participating bank will show the participation as part of its advances. When the issue is without risk passing on, the issuing bank will show the participation as borrowings from banks and the participating bank will show it as advances to other banks. Inter-bank Participation Certificates are short-term instruments to even out issues of short-term liquidity within the banking system.

The primary objective is to provide some degree of flexibility in the credit portfolio of banks.

- (c) There is a basic difference between the money market and capital market. The operation in the money market are for a duration upto one year and deals in short term financial assets whereas in the capital market operations are for a larger period beyond one year and therefore deals in medium and long term financial assets. Secondly, the money market is not a well-defined place like the capital market where business is normally done at a defined place like a stock-exchange. The transactions in the money market are done through electronic media and other written documents.
 - (a) In the capital market, there is a classification between primary market and secondary market. There is no such sub-division of the money market. Lately, however issues are afoot to develop a secondary money market.
 - (b) Capital market deals for fund requirements of a long-term whilst money market generally caters to short-term requirements.
 - (c) The quantum of transactions in the capital market is decidedly not as large as in the money market.
 - (d) The type of instruments dealt in the money market are like inter bank call money, notice money upto 14 days, short-term deposits upto three months, 91 days/182 days treasury bills, commercial paper etc.
 - (e) The players in the capital market are general/retail investors, brokers, merchant bankers, registrars to the issue, under-writers, corporate investors, FIs and bankers while the money market participants are the Government, Reserve Bank of India and the banks.
- (d) Credit cards are a simple and convenient means of access to short term credit for consumers. They enable the consumer to:
 - (a) Dispense with using cash for every transaction.
 - (b) Make Monthly payments.
 - (c) No interest charges if paid on due date every month.
 - (d) Insurance benefits are available.
 - (e) Special discounts can be availed which are not applicable on cash transactions.
 - (f) For high value purchases the consumer can use the roll over facility and pay for his purchases in instalments.

The disadvantages of credit cards are:

- (a) The consumer commits his future income.
- (b) If not used wisely the consumer lands into a debt trap.
- (c) The rate of interest on credit cards for long term finance (roll over) is around 40% per annum.
- (e) In stock lending, the legal title of a security is temporarily transferred from a lender to a borrower. The lender retains all the incidents of ownership, other than the voting rights. The borrower is entitled to use the securities/shares as required but is liable to the lender for all benefits such as dividends, interest, rights etc. The stock lending scheme is a means to cover short sales viz., selling shares without possessing them.

The procedure is used by the lenders to maximize yield on their portfolio. Incidentally, borrowers use the shares/securities lending programme to avoid settlement failures.

Securities/stock lending provides income opportunities for security-holders and creates liquidity to facilitate trading strategies among borrowers. Stock lending is particularly attractive for large institutional areas, as this is an easy way of generating income to off-set custody fees and requires little, if any, of their involvement or time.

Stock lending gives borrowers access to tender portfolios which provide the flexibility necessary when borrowing for strategic posturing and financing inventories. From the point of view of market, stock lending and borrowing facilitates timely settlement, increases the settlements, reduces market volatility and improves liquidity.

PAPER – 3 : ADVANCED AUDITING

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

Question 1

1. As a Statutory Auditor, how would you deal with the following:
 - (a) While adopting the accounts for the year, the Board of Directors of Sunrise Ltd. decided to consider the Interim Dividend declared @15% as final dividend and did not consider transfer of Profit to reserves. (4 Marks)
 - (b) V Ltd. sold 1 lakh vacuum pumps during the year 2006-07 with a condition to make good by repair/replacement any manufacturing defects reported within 6 months from the date of sale. Past experience in this regard showed that there were no replacements carried out, but minor/major repairs were necessitated to the extent of 10%/5% respectively of the units sold. The cost of such minor/major repairs would amount to Rs. 1,000/Rs. 6,000 respectively. While finalizing the accounts for the year, the company does not reflect any provision, in this regard. (5 Marks)
 - (c) XYZ Pvt. Ltd., manufacturing garments, has valued at the year end its closing stock of packed finished goods for which firm export contracts have been received, at realizable value inclusive of profit and export cash incentive. As at the year end, the ownership of the goods has not been transferred to the foreign buyers. (4 Marks)
 - (d) R Ltd. owns 51% voting power in S Ltd. It however holds and discloses all the shares as "Stock-in-trade" in its accounts. The shares are held exclusively with a view to their subsequent disposal in the near future. R Ltd. represents that while preparing Consolidated Financial Statements, S Ltd. can be excluded from the consolidation. (5 Marks)

Answer

- (a) Declaration of Interim Dividend: Section 205 (1A) of the Companies Act, 1956 provides that Board of Director may declare interim dividend and the amount of dividend including interim dividend should be deposited in a separate bank account within five days from the declaration of such dividend.

Based on Section 2(14A) read with Section 205(1C) of the Companies Act 1956, it can be said that since interim dividend is also dividend, companies should provide for depreciation as required by Section 205 and comply with the companies (Transfer of Profit to Reserve Rules, 1975) before declaration of interim dividend. As per Companies (Transfer of Profit to Reserve) Rules, 1975, where the dividend proposed exceeds 12.5 per cent but does not exceed 15 per cent of the paid-up capital, the amount to be transferred to the reserves shall not be less than 5 per cent of the current profits . The company has to provide depreciation for the full year before declaration of interim dividend. If the company does not transfer any profit to reserves, it can pay interim

dividend not exceeding 10% of the paid up capital. In the instant case, the Board has decided to pay interim dividend @15% of the paid-up capital without transfer of profit to reserves. Assuming that the company has complied with depreciation requirement, the interim dividend should be restricted to 10% without transfer of profit to reserves.

In the circumstances, the Board of Directors are wrong in declaring interim dividend at 15 %, though such dividend can be treated as final dividend. The statutory auditor should qualify his report.

- (b) Provisions: As per AS – 29, 'Provisions, Contingent Liabilities and Contingent Assets', a provision is a liability which can be measured only by using a substantial degree of estimation.

As per AS – 29 , a provision should be recognised when:

1. An enterprise has a present obligation as a result of a past event.
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and
3. A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

In the present case, V Ltd fulfils all the above conditions. The sale of pumps with a warranty obligation constitutes the present obligation as a result of past event. It is probable that some outflow will be involved in setting the warranty obligation, satisfy the second condition. As per the details based on past precedence reliable estimate can be made as under:

$$[6000 \times (5\% \text{ of } 100000) + 1000 \times (10\% \text{ of } 100000)] = \text{Rs. 400 lakhs}$$

Thus, V Ltd as on 31.3.07 should make a provision for warranty obligation against sale of vacuum pumps to the extent of rupees 400 lakhs. The auditor should insist on such provision being created. If provision is not made he should qualify his audit report.

- (c) Valuation of Inventories: AS 2 requires that inventories should be valued as lower of cost and Net realisable value(NRV). A departure from the general principle can be made if the AS is not applicable or having regard to the nature of industry.

AS 2 also states that (a) work in progress arising under construction contracts, including directly related service contracts (b) work in progress arising in the ordinary course of business of service providers; (c) shares, debentures and other financial instruments held as stock-in-trade; and (d) producers' inventories of livestock, agricultural and forest products are measured as NRV based on established practices.

In the given case the sale is assumed under a forward contract but the goods are not of a nature covered by the above exceptions. Taking into account the facts the closing stock of finished goods should have been valued at cost, as it is lower than the realisable value.

(as it includes profit). Further, export cash incentives should not be included for valuation purposes.

The policy adopted by the company for valuing its closing stock of inventory of finished goods on selling price plus export incentives is not correct. The statutory auditor should give a qualified report.

(d) Consolidation of Financial Statement: AS 21 states that a subsidiary should be excluded from consolidation when:

1. Control is intended to be temporary because the shares are acquired and held exclusively with a view to its subsequent disposal in the near future or
2. Subsidiary operates under severe long term restrictions which significantly impair its ability to transfer funds to the parent.

Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares held as 'stock-in-trade' are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary.

In this case, R Ltd's intention is to dispose off the shares in the near future as shares are being held as stock in trade and it is quite clear that the control is temporary.

Hence, in this case the exclusion of the concerned subsidiary from consolidation is correct.

However, reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

If an entity is excluded from the consolidated financial statements for reasons other than those allowed by the above AS, the auditor should consider the effect on the report to be issued.

Question 2

Comment on the following with reference to the Chartered Accountants Act, 1949 as amended by the Chartered Accountants (Amendment) Act, 2006 and schedules thereto:

- (a) As a Chartered Accountant in practice, you are asked to conduct a review of the "Profit Forecast" prepared by a Company in connection with its application for a Term loans from a bank. (4 Marks)
- (b) X, a Chartered Accountant availed a loan against his shares held as investments from a nationalized bank. He issued 2 cheques towards repayment of the said loan. Both the cheques were returned back by the bank with the remarks "Refer to Drawer". (5 Marks)
- (c) BC & Co, a firm of Chartered Accountants, accepted an assignment for audit under State level VAT Act, without any prior communication with the previous auditor. (4 Marks)

- (d) M, a Chartered Accountant in practice, is the Statutory Auditor of S Ltd. for the year ended 31st March 2008. In January 2008, he was appointed as a Director in H Ltd., which is the holding Company of S Ltd. (5 Marks)

Answer

- (a) Under Clause 3 of Part I of Second Schedule to The Chartered Accountants Act, 1949, a CA in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast. "The guidance note on accountants' report on profit/financial forecast" provides that profit forecasts can be prepared or reviewed by a CA provided he discloses in his report the sources of information, the basis of forecasts and major assumptions involved and so long as he does not vouch for the accuracy of the forecast. Hence, the offer can be accepted if the above guidance note is complied with.

- (b) A Chartered Accountant is expected to maintain the highest standard of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work would expose him to disciplinary action.

A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, if he is found guilty of any professional or "Other Misconduct".

As per part IV of the First Schedule to the Chartered Accountants Act, A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he in the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

The question whether a particular act or omission constitutes "other misconduct" should be based on fact and circumstances of each case.

Under Negotiable Instruments Act 1881, where any cheque drawn by a person for the discharge of any liability, is returned by the bank unpaid, either for insufficiency of funds or the cheque amount exceeds the arrangements made by the drawer of the cheque, the drawer of such cheque shall be deemed to have committed an offence.

In the given case the cheque was dishonoured with the remark "refer to drawer". However, such dishonour need not necessarily be only due to insufficiency of funds.

If it is proved that the cheques were dishonoured due to insufficiency of funds, the CA would be held guilty of "other misconduct".

- (c) As per Clause 8 of Part I of First Schedule to the CA Act 1949, A chartered accountant in practice is deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant or a certified auditor who has

been issued certificate under the Restricted Certificates Rules 1932, without first communicating with him in writing.

In the instant case, BC & Co. accepted VAT – audit under State Level Act, carried out by another firm of chartered accountants in the previous year, without prior communication with the previous auditor.

A communication is mandatory requirement for all types of audit, if the previous auditor is a chartered accountant. Hence, the firm is guilty of professional misconduct.

- (d) In terms of clause 11 of Part I of the First Schedule to the CA Act, 1949, a CA in practice cannot engage (unless permitted by the council) in any business or occupation other than the profession of Chartered accountant, but he can be a director of a company wherein he or any of his partners is not interested in such company as auditor.

However, public conscience is expected to be ahead of law and the requirement of independence should be interpreted much more strictly. Members should thus not place themselves in position which would either compromise or jeopardise their independence.

In view of the above, an auditor of a subsidiary cannot be a director of a holding company as it will affect his independence.

Question 3

Answer the following:

- (a) "Use of Audit Software would increase the probability of detecting frauds". Comment. (6 Marks)
- (b) Elaborate under Clause 49 of the Listing Agreement, who is an Independent Director. (6 Marks)
- (c) What is an Audit Trail? (4 Marks)

Answer

- (a) Use of Audit Software: CAATs allow the auditor to give access to data without dependence on the client, test the reliability of client software and perform audit tests more efficiently. CAATs are used to perform various audit procedures like;
- (i) Tests of details of transactions and balances e.g. use of audits software to test all or a few transactions in a computer file.
 - (ii) Analytical review procedures e.g. use of audit software to identify unusual fluctuations or items.
 - (iii) Compliance tests of IT application controls e.g. use of test data to test the functioning of a programmed procedure.

However, the methods of applying audit procedures to gather evidence may be influenced by the methods of computer processing. Sometimes, in some accounting

systems that use of computer for processing significant applications, it may difficult or impossible for an auditor to obtain certain data for inspection, inquiry or confirmation without computer assistance.

CAAT in fraud Detection: In an EDP environment, the Auditor is required to plan his work by exercising reasonable care and skill in such a manner that there is reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error.

Use of the CAAT/ audit software systems will help the auditor to identify errors and frauds in the accounting and internal control system.

Conclusion: Frauds are intentional. Auditing through the computer with adequate knowledge of computer systems may highlight some frauds, but there is no empirical evidence to prove the assertion that the use of audit software systems has unearthed well concealed frauds.

Thus, it cannot be conclusively said that use of audit software systems increases the probability of detection of fraud.

- (b) Clause 49 of the listing agreement on Independent Director: As per Clause 49 of the listing agreement, an Independent Director shall mean a non-executive director of the company who:
- (i) apart from receiving director's remuneration, does not have any material pecuniary relationship or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiary(s) and associates which may affect independence of the director;
 - (ii) is not related to promoters or persons occupying management positions at the board level or at one level below the Board;
 - (iii) has not been an executive of the company in the immediately preceding three financial years;
 - (iv) is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:
 - (a) The statutory audit firm or the internal audit firm that is associated with the company, and
 - (b) The legal firm(s) and consulting firm(s) that have a material association with the company.
 - (v) is not a material supplier, service provider or customer or a lessor or lessee of the company which may affect independence of the director and
 - (vi) is not a substantial shareholder of the company i.e. owning two per cent or more of the block of voting shares.

- (c) **Audit Trail:** Audit Trail can be defined as those documents, records, journals, ledgers, master files etc. that enables an auditor to trace the transactions from the source document to the summarised total in accounting reports or vice-versa.

Audit trail is the visible means whereby the auditor may have a business transactions through all the stages in which it features in the records of the business. For example, sequentially numbered sales invoice copies would normally be listed in a register or day book and subsequently filed either in numerical or chronological sequence. It would then be possible to trace a particular invoice from the day book to the original file or vice-versa by reference to the number or date of the invoice.

In a manual accounting system, it is possible to relate the recoding of a transaction at each successive stage enabling an auditor to locate and identify all documents from beginning to end for the purposes of examining documents, totalling and cross-totalling referencing.

However, in an EDP environment, the use of exception reporting by management has effectively eliminated the audit trail between input and output. Frequently computer generated totals, analysis and balances are not printed out in detail because the management is not exercising control through verification of the individual items processed.

Question 4

Answer the following:

- (a) What are the major differences between Financial and Operational Auditing? (8 Marks)
- (b) As a Statutory Auditor, how would you deal with the following :
- (i) PQR Ltd. has not deposited Provident Fund contribution of Rs. 10 lakhs with the authorities till the year-end. (4 Marks)
 - (ii) LM Ltd. had obtained a Term Loan of Rs. 300 lakhs from a bank for the construction of a factory. Since there was a delay in the construction activities, the said funds were temporarily invested in short term deposits. (4 Marks)

Answer

- (a) The major differences between financial and operational auditing can be described as follows:
- (i) **Purpose:** The financial auditing is basically concerned with the opinion that whether the historical information recorded is correct or not, whereas the operational auditing emphasizes on effectiveness and efficiency of operations for future performance.
 - (ii) **Area:** Financial audits are restricted to the matters directly affecting the appropriateness of the presented financial statements whereas the operational audit

covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organisation.

- (iii) Reporting: The financial audit report is sent to all stock holders, bankers and other persons having interest in the organisation. However, the operational audit report is primarily for the management.
- (iv) End task :The financial audit has reporting the findings to the persons getting the report as its end objectives, however, the operational audit is not limited to the reporting only, but includes suggestions for improvements also.

The main objective of operational auditing is to verify the fulfillment of plans, and sound business requirements. Operational auditing is considered as specialized management information tool. Operational auditing is essentially a function of internal auditing staff. Operational auditing is a systematic process of evaluating an organisation's effectiveness, efficiency and economy of operations under management control and reporting to appropriate persons, the result of the evaluation alongwith recommendations for improvements. Operational audit concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end with the reporting of the findings but also recommends the steps for improvements in future. Operational auditing is not different from internal auditing, it is merely an extension of internal auditing into operational areas.

While in financial auditing, the concentration is more in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are minimized or removed. In financial auditing, an auditor is called upon to review the financial statements of an enterprise to ascertain whether they reflect true and fair view of its state of affairs and of its working results. He may analyse the operations of an enterprise to appraise their cost effectiveness and also he may seek evidence to review the managerial performances.

- (b) (i) Under Clause 4 (ix) (a) of CARO, 2003 the auditor has to report on the regularity of depositing undisputed statutory dues including provident fund with the appropriate authority and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

It should be accounted in the books on accrual basis whether paid or not. As per Sec. 209 (3) of the companies Act, a company has to maintain proper books of account on accrual basis of accounting.

In the instant case, even though accrual principles have been followed, disclosure of non-payment is necessary in view of CARO requirements. The auditor should disclose the fact of non-payment of Rs. 10 lakhs in his report.

- (ii) As per paragraph 4(xvi) of CARO, 2003, an auditor need to comment "whether the term loans applied for the purpose for which the loan were obtained".

In the present case, the term loan obtained by LM Ltd. have not been put to use for construction activities and temporarily invested the same in short term deposit.

Here, the auditor should report the fact in his report that pending utilization of the term loan for construction of a factory, the funds were temporarily used for the purpose other than the purpose for which the loan was sanctioned, as per paragraph 4(xvi) of CARO, 2003.

Question 5

Answer the following:

- (a) As a Statutory Auditor, how would you verify advances against Goods? (8 Marks)
- (b) Explain the concept of Audit risk:
 - (i) At the level of financial statements (4 Marks)
 - (ii) At the level of account balance and class of transactions. (4 Marks)

Answer

- (a) Verification of advances against goods(Banking Companies):
 - (i) Sanction: Examine the sanction letter, letter of hypothecation and note the important terms and conditions of the advances.
 - (ii) Stock statements: Verify the quantity and value of goods hypothecated based on the stock statements received from the borrower. Test check the Godown Register and examine the valuation of goods to ascertain the reasonableness of the same.
 - (iii) Inspection: Ascertain as to whether the premises of the borrowers are periodically visited by the bank officials to verify the quantity as per the periodic stock statements.
 - (iv) Stock Audit: See whether the bank has got a system of obtaining stock and receivables audit report in respect of such advances. If so, review the stock audit report and identify adverse comments, if any.
 - (v) Hypothecation/Pledge: Examine the letter of hypothecation and certificate of registration of charge, in respect of goods pledged with the bank.
 - (vi) Insurance: Examine the insurance policies for their validity, adequacy etc. and see that policies are in favour of the bank.
 - (vii) Documents of title: Inspect the documents of title to goods like bill of lading, dock warrant, railway receipts etc to ensure that they are endorsed registered in favour of the bank.
 - (viii) Third party certificate: Where the hypothecated goods are in possession of third parties, such as clearing and forwarding agents, transporters, bankers, etc. undertaking has been obtained by the bank that they will handover the goods or sale proceeds thereof to the bank only. In such cases, certificate should be obtained

by the bank from such third parties regarding quantities on hand, on balance sheet date. The valuation of such goods should be checked by the auditor.

- (b) (i) Audit risk at the financial statement level: Audit risk is considered at the financial statement level during the audit planning process. At this time, the auditor should undertake an overall audit risk assessment based on his knowledge of the client's business, industry, management, control environment and operations. Such an assessment provides preliminary information about the general approach to the engagement, the auditor's staffing needs and the framework within which materiality and audit risk assessment can be made at the individual account balances or class of transactions level. For assessing inherent risk, the auditor uses professional judgement to evaluate numerous factors, examples of which are:
- The integrity of management
 - Management experience, knowledge and changes during the period (e.g. the inexperience of management may affect the preparation of the financial statements of the entity)
 - Unusual pressure on management
 - The nature of entity's business (e.g. its technological obsolescence of products and services, complex capital structure, significance of related parties and the number of locations and geographical spread of its production (facilities), factors affecting the industry in which the entity operates (e.g. economic and competitive conditions, changes in technology).
- (ii) Audit risk at the account balance and class of transactions level: Majority of audit procedures are directed to, and carried out at the account balance and class of transactions level. Accordingly, audit risk should be considered by the auditor at this level taking into account the results of the overall audit risk assessment made at the financial statement level. To assess inherent risk, the auditor uses professional judgement to evaluate numerous factors, examples of which are:
- (i) The complexity of underlying transactions which might require the use of the work of an expert;
 - (ii) Susceptibility of assets to loss or misappropriation;
 - (iii) The completion of unusual and complex transactions, particularly at or next year end, and
 - (iv) Transactions not subjected to the normal processing mode.

Question 6

Answer the following:

- (a) RQ Insurance Ltd. has made a provision of 25% on unexpired risks reserve in its books.
Comment. (5 Marks)

- (b) In the context of Audit of members of Stock Exchanges, explain what is Rolling Settlement? (5 Marks)
- (c) What is Haphazard Sampling? (6 Marks)

Answer

- (a) Unexpired risks reserve: The need for unexpired risks reserve arises from the fact that all policies are renewed annually except in specific cases where short period policies are issued. Since the insurers close their accounts on a particular date, not all risks under policies expire on that date.

In other words at the closing date, there is an unexpired liability under various policies which may occur during the remaining term of the policy beyond the year end.

The minimum amount of unexpired risks reserve to be created is determined as per the Insurance Act, 1938 at a specified percentage of net premium as under:

- (i) for marine hull insurance – 100% of net premium
- (ii) For fire, marine cargo and miscellaneous business – 50% of net premium.

Provisions of income Tax Act 1961 and Income Tax rules 1962 permit deduction of above reserves at the prescribed rates.

Conclusion: In the given case, the Auditor of RQ Insurance Ltd should qualify his report as the company has made a provision of only 25% against the prescribed minimum of 50% or 100% as mentioned above, thereby resulting in overstatement of profit.

- (b) Rolling settlement: A rolling settlement is one in which trades outstanding at the end of the day have to be settled (payments made for purchases or deliveries in the case of sale of securities) within 'X' business days from the transaction date.

In the rolling settlement, trades on each single day are settled separately from the trades done earlier or subsequent trade days. The netting of trades is done only for the day and not for multiple days.

SEBI has gradually mandated most of the scrips to be settled exclusively on Rolling Settlement basis [t +2]. Thus, in a T+2 rolling settlement, a transaction entered into on Monday, for instance, will be settled on Wednesday when the pay-in or pay-out takes place. The transaction in the Compulsory Rolling Settlement (CRS) are settled on T+2 basis i.e. both pay in and pay out of monies and securities for transactions in scrips on transaction day (T-Day) would take place on the day after immediately following day.

However, transactions in 'Z' group securities are settled only on trade to trade basis on T+2, i.e. the facility of netting up of buy and sell transactions of the same day, as available in other securities, is not available with securities falling under 'Z' group. In

other words, if the investor buys and sells X number of shares on the same day, then he shall first have to actually deliver and then receive the securities on the settlement day.

Value at Risk (VaR) based margining approach has been adopted for transactions done in CRS scrips w.e.f. July 2, 2001. In the VaR system of margining, historical volatilities of scrips and overall market volatility is considered to arrive at a VaR margin percentage for a scrip. Further the mark-to-market difference are collected on a daily basis and the broker members are required to maintain a capital level, as prescribed by the exchange, adequate to support their exposure at all times.

In case, a member fails to deliver the shares sold in rolling settlement, the exchange conducts an auction session on T+2, to meet the shortfall created by non-delivery of shares. In this auction session, offers are invited from the other members to deliver the shares sold by originally selling member, since delivery has to be made to the buying member. In case no shares are received in auction, the sale transaction is closed-out at a close-out price, determined by higher of the following:

- Highest price, recorded in the scrip from the settlement in which the transaction took place upto a day prior to the auction OR
- 20% above the closing price on a day prior to the auction.

In this case, the auction price/ close-out and difference between sale price, if positive is payable by the seller who failed to deliver the scrips. In case, auction/ close out price is less than sale price, the difference is not given to the seller, but is credited to investor protection fund.

- (c) Haphazard Sampling: In haphazard selection, the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

Haphazard selection of sample, may be an acceptable alternative to random selection of sample, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units.

When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.

Question 7

Answer the following:

- (a) What are the areas in which Due Diligence can take place ? (5 Marks)

- (b) What are the steps to be taken by a firm of Chartered Accountant to ensure that its appointment as Statutory Auditor of a Company is valid? (6 Marks)
- (c) As the tax auditor of a Company, how would you report on payments exceeding Rs 20,000 made in cash to a supplier against an invoice for expenses booked in an earlier year? (5 Marks)

Answer

- (a) Areas in which Due Diligence can take place :

1. Commercial/operational due diligence: It is generally performed by the concerned acquire enterprise involving an evaluation from commercial, strategic and operational perspectives. For example, whether proposed merger would create operational synergies.
2. Financial Due Diligence: It involves analysis of the books of accounts and other information pertaining to financial matters of the entity. It should be performed after completion of commercial due diligence.
3. Tax Due diligence: It is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. The accountant has to look at the tax affect of the merger or acquisition.
4. Information systems due diligence: It pertains to all computer systems and related matter of the entity.
5. Legal due diligence: This may be required where legal aspects of functioning of the entity are reviewed. For example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws.
6. Environmental due diligence: It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.
7. Personnel due diligence: It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.

- (b) Validity of appointment as a statutory auditor: To ensure that the appointment is valid, the incoming auditor should take the following steps before accepting his appointment:

1. Ceiling limit: Ensure that a certificate has been issued u/s 224 of the Companies Act, so that the total number of company audits held by the firm (including the new appointment) will not exceed the specified number.
2. Resolution at AGM: Verify that at AGM of the Company, a proper resolution is passed. Inspect general meeting minutes book to see that the appointment is duly recorded.

3. Compliance with law: Satisfy that the legal procedure contemplated in section 224 and 225 of the Companies Act, dealing with removal of existing auditor, if required, has been followed. Also see whether section 224A (provision of special resolution in case of companies in which not less than 25% of the subscribed capital of the Company is held by public financial institutions or Government Companies) and section 619B (in case of a company in which not less than 51 % of the paid up share capital is held by Central / State Government - C&AG appointment) are attracted and complied with..
 4. Code of conduct: Communicate with the previous auditor, if any, to ascertain if there are any professional reasons for not accepting the appointment.
- (c) Reporting of payments exceeding Rs. 20000 in cash: Such reporting is required to be done while conducting the tax audit u/s 44AB of the Income Tax Act, 1961 in Form 3CD with effect from A. Y. 2008-09. The tax auditor shall have to report for clause 17 (h) for the above as per the amended section 40 A(3) of the Income Tax Act, 1961.

In the instant case the invoice for expenses has been booked in an earlier year. However, since payment for the same is made during the current year by cash exceeding Rs. 20000, the reporting thereof would be necessary in clause 17(h) of Form 3CD. The sub-clause (h) required furnishing of the amount inadmissible under section 40A(3) read with rule 6 DD along with computation.

The entire amount paid as above, is likely to be disallowed u/s 40 A(3) of the Income Tax Act, 1961.

Question 8

Write short notes on any four of the following:

- (a) Securities Transaction Tax
 - (b) Price/Earnings (P/E) ratio
 - (c) Key Management Personnel
 - (d) Normal Capacity for the purpose of Inventory valuation
 - (e) Integral Foreign Operations
 - (f) Emphasis of matter paragraph in Audit Reports
- (4 X 4 = 16 Marks)

Answer

- (a) Security Transaction Tax (STT): In the union budget for 2004-05, Government has introduced Security Transaction Tax to be levied on all transactions done on stock exchanges. As per the provisions of the Finance Bill the stock exchanges have been entrusted with the responsibility of levy, collection and remittance of the STT on all transactions from the date of notification by the Government of India.

SEBI vide its Circular no. MRD / DOP /Cir – 28 / 2004 dated August 23, 2004 directed that no stock exchange shall permit trading activities unless it implements necessary software and procedures for the levy, collection and remittance of STT.

- (b) Price/Earning Ratio: The pre-issue price/earning ratio should be calculated by using the following formula:

Issue price per share / EPS

The issue price per share which is to be used for computing this ratio (and not the market price per share which is normally used for computation of the price/earning ratio).

Accordingly, for this purpose issue price per share is required to be used. However, P/E ratio of the company based on issue price is to be compared with the industry P/E ratio, based on market price. For the purpose of the industry P/E ratio, the auditor should check that the market price should be the market price for the industry prevailing within one month prior to the date of auditor's report or as close thereto as possible.

- (c) Key management personnel: Key management personnel are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

It may be noted here that non-executive directors of a company will not be considered as key management personnel under AS 18 by virtue of merely their being directors, unless they have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Further, the requirements of AS 18 should not be applied in respect of a non-executive director even if he participates in the financial and/or operating policy decision of the enterprise unless he falls in any of the categories discussed in Accounting Standard Interpretation 21.

- (d) Normal capacity for inventory valuation: As per AS 2, allocations of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. Due to this, the fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. In periods of high production, these overheads allocated are decreased so that inventories are not measured above cost.

- (e) Integral Foreign Operations: As per AS 11, there are foreign operations, the activities of which are an integral part of the reporting enterprise. This is important since the

method used to translate financial results of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise.

A foreign operation that is integral to the operation of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. In such cases, change in exchange rates between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rates affects the individual monetary items held by the foreign operation rather than the net investment in that operation.

- (f) **Emphasis of matter paragraph in audit reports:** An auditor's report can be modified for matters that do not affect the auditor's opinion. An "emphasis of matter" paragraph is such a type of notification in an audit report. In certain circumstances, such a paragraph is added to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such a paragraph does not affect the auditor's opinion. Such a paragraph is preferably included preceding the opinion paragraph and would ordinarily refer to fact that the auditor's opinion is not quantified in this respect. (AAS 28).

An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor report is as follows :

"Without qualifying our opinion, we draw attention to Note X of schedule to the financial statements. The entity is the defendant in a lawsuit alleging infringement of certain patent right and claiming royalties and punitive damages. The entity has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate of the matter can not presently be determined, and no provision for any liability, that may result, has been made in the financial statements."

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) Primus Group of Companies has three Companies, viz., Primus Rolling Mills Ltd., Primus Steel Pipe Manufacturers Ltd. and Primus marketing Company Ltd. All the three Companies want to appoint Mr. Prem as their Managing Director. You are required to state with reference to the provisions of the Companies Act, 1956 whether such appointments are permissible. (5 Marks)
- (b) Working of City Stock Exchange Association Ltd., is not being carried on by its governing Board in public interest. On receipt of representations from various investors and Investors' Association, the Central government is thinking to withdraw the recognition granted to the said Stock Exchange. You are required to state the circumstances the procedure for withdrawal of such recognition as per the provisions of Securities Contracts (Regulation) Act, 1956 in this regard. Also state the effect of such withdrawal on the contracts outstanding on the date of withdrawal. (5 Marks)
- (c) The governing body of City Stock Exchange Association Ltd., is desirous of putting various restriction on voting rights of its members to be exercised in a meeting and on their right to appoint a proxy. You are required to state whether the same is permissible. Also state the role of Central Government in this respect. (5 Marks)

Answer

- (a) As per provisions of Section 316(1) and 316(2) of the Companies Act, 1956, no public company and no private company which is a subsidiary of a public company can appoint or employ a person as its managing director if such person is a managing director or manager of more than one other company, whether public company or private company which is a subsidiary of public company. In view of the above legal provisions, Mr. Prem can be appointed as a managing director of only two public companies and not three public companies.

However, Section 316(4) of the said Act provides an exception and states that the Central Government may, by order, permit any person to be appointed as a Managing Director of more than two companies, if the Central Government is satisfied that it is necessary that the companies should, for their proper working, function as a single unit and have a common Managing Director.

According to the exception provided, the Primus Group of Companies have to approach the Central Government and satisfy it about the necessity of having a common Managing Director for all the three companies. If the Central Government is satisfied and issues an order accepting the plea of the Group, then the Group can appoint Mr. Prem as Managing Director of all the three companies of the Group.

- (b) Section 5 of the Securities Contracts (Regulation) Act, 1956 empowers the Central Government to withdraw the recognition granted to a stock exchange. The circumstances and procedure to be followed for withdrawal of such recognition is stated below
- (i) if considering the interest of the trade or the public interest, the Central government is of the opinion that the recognition granted to a stock exchange should be withdrawn, the Central Government shall serve a written notice on the governing body of the stock exchange.
 - (ii) The said notice shall specify the reasons for the proposed withdrawal of the recognition.
 - (iii) The governing body of the stock exchange shall be afforded an opportunity of being heard by the Central Government.
 - (iv) Even after hearing the governing body, the Central Government is satisfied that the recognition granted to the stock exchange should be withdrawn; the Central Government may, by way of a notification in the Official Gazette, withdraw the recognition granted to the stock exchange.

The proviso to the said section 5 states that no such withdrawal shall affect the validity of any contract entered into or made prior to the date of notification withdrawing the recognition and the Central Government may, after consultation with the stock exchange, make such provision as it deems fit in the notification of withdrawal or in any subsequent notification for the due performance of any contracts outstanding on that date.

- (c) As per Section 7A(1) of the Securities Contracts (Regulation) Act, 1956 a recognized stock exchange may make rules or amend any rules made by it in respect of voting rights of its members and also on appointment of proxy. The restrictions can be put in respect of the following matters:
- (a) The restriction of voting rights to the members only in respect of any matter placed before the stock exchange at any meeting.
 - (b) The regulation of any voting rights in respect of any matter placed before the stock exchange at any meeting so that each member may be entitled to have one vote only, irrespective of his share of the paid up equity capital of the stock exchange.
 - (c) The restriction on the right of a member to appoint another person as his proxy to attend and vote at a meeting of the stock exchange.
 - (d) Such incidental, consequential and supplementary matters as may be necessary to give effect to the matters as stated (a), (b) and / or (c) above.

As per Section 7A(2) of the said Act, the role of the Central Government in respect of the restrictions placed by the stock exchange as stated above is as follows:

- (i) Approval of the proposed changes by the stock exchange
- (ii) Publishing the same in the Official Gazette

- (iii) To make such modification in the proposed changes as it deems fit.

Question 2

Answer any two of the following

- (a) TKM Exporter of New Delhi are engaged in Export Business. It made certain exports but failed to realise and repatriate to India the foreign exchange due on its exports. The Adjudicating Authority imposed a penalty under the provisions of Foreign Exchange Management Act, 1999 (FEMA). Being aggrieved by this penalty, the said exporter seeks your advice as to the authority to which appeal can be made and the time limit for making such appeals. You are required to advise on the matter. (7 Marks)
- (b) Mr. Kale, an Indian National desires to obtain foreign exchange for the following purposes:
- (i) Remittance of US Dollar 50,000 out of winnings on a lottery ticket.
 - (ii) US Dollar 100,000 for sending a tour of a cultural group to USA.
 - (iii) US Dollar 50,000 for meeting the expenses of his business tour to Europe.
- Advise him, if he can get the Foreign Exchange and under what conditions. (7 Marks)
- (c) (i) In a proceeding before the Competition Commission of India involving two Pharmaceutical companies, the plaintiff requested the presiding officer to call upon the services of experts from the pharmaceutical sector to determine the truth of the allegations leveled by it against the respondent. The respondent opposed the request on the ground that such action cannot be taken by the Competition Commission. You are required to state with reference to the provisions of the Competition Act, 2002, whether the contention of the respondent is tenable. (3 Marks)
- (ii) The Central Government has formed as opinion that Mr. CBM (a member of the Competition Commission of India) has acquired such financial interest that it may affect prejudicially his functions as a member of the Competition Commission and it wants to remove him from his office. You are required to state with reference to the provisions of the Competition Act, 2002, whether the Central Government can do so and if yes, how? (4 Marks)

Answer

- (a) Sections 17 and 19 of Foreign Exchange Management Act 1999 provide for appeals against orders of Adjudicating Authority. If the Adjudicating Authority is Assistant Director of Enforcement or Deputy Director of Enforcement, appeal will lie to Special Director (Appeals). Further appeal shall lie with Appellate Tribunal for foreign Exchange. However, the Adjudicating Authority is senior to the Assistant Director of Enforcement or Deputy Director of Enforcement, then the appeal shall lie directly to the Appellate Tribunal.

Appeal to Special Director (Appeals)

Appeal against order of Assistant Director of Enforcement or Deputy Director of Enforcement can be filed with Special Director (Appeals) under Section 17 of the said act within 45 days from the date on which the copy of the order made by the Adjudication Authority is received by the aggrieved person. The Special Director (Appeals) can condone the delay in filing the appeal if he is satisfied that there were sufficient cause for not filing the appeal within the stipulated time. Special Director (Appeals) will hear the parties and then pass his order. Copy of the order shall be sent to the concerned parties and the Adjudicating Authority.

Appeal to Appellate Tribunal

Appeal against the order of Adjudicating Authority being senior to Assistant Director of Enforcement or Deputy Director of Enforcement or against the order of Special Director (Appeals) can be made to the Appellate Tribunal for Foreign Exchange under Section 19 of Foreign Exchange Management Act, 1999 within 45 days from the date on which the copy of the order made by such Adjudicating Authority or Special Director (Appeals) is received by the aggrieved person. In this case also, the delay can be condoned by the Appellate Tribunal. In case of an appeal against the order imposing penalty, the appellant has to deposit the amount of such penalty with the authority prescribed by the Central Government. However, the Appellate Tribunal may waive such deposit to mitigate the likely hardship that may be caused to the appellant. After hearing of the appeal, the Appellate Tribunal shall pass a reasoned order.

It may be noted that the Tribunal is the final fact finding authority and no appeal lies against the facts determined by the Tribunal.

- (b) Under provisions of Section 5 of the Foreign Exchange Management Act, 1999 certain rules have been made for drawal of Foreign Exchange for Current Account transactions. As per these Rules, 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 or Reserve Bank of India.
- (i) Remittance out of lottery winnings, is prohibited and the same is included in First Schedule to the Foreign Exchange Management (Current Account Transactions) Rules, 2000. Hence Mr. Kale cannot withdraw Foreign Exchange for this purpose.
 - (ii) Foreign Exchange or meeting expenses of cultural tour can be withdrawn by any person after obtaining permission from Government of India, Ministry of Human Resources Development, (Department of Education and culture) as prescribed in Second Schedule to the Foreign Exchange Management (Current Account Transactions) Rules, 2000. Hence, in respect of item (ii), Mr. Kale can withdraw the Foreign Exchange after obtaining such permission.
 - (iii) The type of payment as envisaged is covered under Third Schedule to the Foreign Exchange Management (Current Account Transactions) Rules, 2000 and for withdrawing foreign Exchange exceeding US Dollar 25,000 for a business tour

irrespective of period of stay Mr. Kale will require the prior permission of the Reserve Bank of India.

In all the cases, where remittance of Foreign Exchange is allowed, either by general or specific permission, the remitter has to obtain the Foreign Exchange from an Authorised Person as defined in Section 2(c) read with Section 10 of the Foreign Exchange Management Act, 1999.

- (c) (i) As per provisions of Section 36(4) of the Competition Act, 2002 the Competition Commission may call upon such experts from the fields of economics, commerce, accountancy, international trade or other disciplines as it deems necessary, to assist the Commission in the conduct of any enquiry or proceeding before it. As per Regulation 54 of the Competition Commission (General) Regulations, 2004 made by the Commission under Section 64 of the Competition Act, 2002, it may draw up a panel of such experts.

In view of the above stated specific powers given to the Competition Commission, it can call upon the services of an expert from the pharmaceutical sector to determine the truth of the allegations leveled by the plaintiff against the respondent. Hence, the contention of the respondent is not tenable.

- (ii) Provisions of Section 11(2) of the Competition Act, 2002 empower the Central Government to remove, by an order, a member of the Competition Commission of India from his office if such member has acquired such financial interest as is likely to affect prejudicially his functions as a Member of the Competition Commission. However, provisions of Section 11(3) of the said Act put some restrictions on such powers of the Central Government. According to this section, in case as stated in the question, the Central Government wants to remove a member of the Competition Commission from his office, it has to make a reference to the Supreme Court. The Supreme Court shall hold an enquiry in accordance with the procedure formulated by it and then report that the member in question ought to be removed from his office.

Thus, the Central Government can remove a member of Competition Commission from his office by following the above procedure.

Question 3

Answer any two of the following:

- (a) (i) What do you understand by the term "Price Sensitive Information" as contemplated in the Securities and Exchange Board of India Act, 1992 ? What are the information which can be deemed to be "Price Sensitive Information". (4 Marks)
- (ii) MGR Ltd. wants to issue certain shares on preferential basis and has sought your advise in respect of pricing the shares for such issues. You are required to state the Guidelines issued by Securities and Exchange Board of India in respect of pricing of the issue of shares on a preferential basis. (4 Marks)
- (b) Excel Ltd., a Public Limited Company listed with the Stock Exchange, Mumbai, wants to

make issue of equity shares on preferential basis pursuant to a scheme approved under Corporate Debt Restructuring framework specified by Reserve Bank of India to various persons as may be selected by the Board of Directors of the Company. Following information relevant to the preferential issue is available.

- (i) Total No. of equity shares to be issued : 50 lac equity shares of Rs. 10 each out of which 30 lac equity shares will be allotted on 30th June, 2008 as fully paid up and balance 20 lac equity shares shall be allotted on the same date but paid up to Rs. 5 each and balance Rs. 5 shall be called upon at a later date and shall be paid up on 30th November, 2008.
- (ii) Out of the proposed allottees some persons are holding their shares in Excel Ltd. in physical form and not in dematerialized form and some persons had sold their entire shareholding in Excel Ltd. in January, 2008.
- (iii) The meeting of general body of shareholders for approving the preferential issue was held on 15th March, 2008.

Based on the above information you are required to answer the following queries with reference to the SEBI (Disclosure and Investor Protection) Guidelines, 2000:

- (i) What would be the lock-in period for the shares allotted on preferential basis?
- (ii) Who are the persons not entitled for allotment of shares on preferential basis?

(8 Marks)

- (c) (i) Explain the rules relating to interpretation of statutes when the terms "notwithstanding" and "Subject to" are used in any provision of an Act. (5 Marks)
- (ii) State the effect of the words "notwithstanding anything contained in this Act" used in Section 408 of the Companies Act, 1956 which vests certain powers in the Central Government to prevent oppression or mismanagement. (3 Marks)

Answer

- (a) (i) Any information which relates directly or indirectly to a company and which if published is likely to materially affect the price of securities of the company, is referred to as "Price Sensitive Information".

The following can be deemed to be "Price Sensitive Information":

- (i) Periodical financial results of the company
- (ii) intended declaration of dividends (both interim and final)
- (iii) issue of securities or buy-back of securities
- (iv) any major expansion plans or execution of new projects
- (v) Amalgamation or merger or takeovers
- (vi) disposal of the whole or substantial part of the undertaking
- (vii) any significant changes in policies, plans or operations of the company.

(ii) According to the Securities and Exchange Board of India (Disclosure and investor Protection) Guidelines, 2000 the issue of shares on a preferential basis can be made at a price not less than the higher of the following:

(i) the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date;

or

(ii) the average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date.

For the purpose of above, “relevant date” means the date thirty days prior to the date on which the meeting of General Body of shareholders is held, in terms of Section 81(1A) of the Companies Act, 1956 to consider the proposed issue.

(b) (i) Lock-in period

As per Guidelines issued by SEBI (Para 13.3 1(e)), the lock-in period in respect of the shares issued on preferential basis pursuant to a scheme approved under Corporate Debt Restructuring framework specified by Reserve Bank of India, shall commence from the date of allotment and shall continue for a period of one year in case of fully paid up shares. In the case of allotment of partly paid shares, the lock-in period shall commence from the date of allotment and continue for a period of one year from the date when shares become fully paid up.

In view of the above guidelines of SEBI, the lock-in period for 30 lac shares to be allotted as fully paid up shall commence from 30th June, 2008 and shall continue for one year from that date. In case of 20 lac shares allotted as partly paid up on 30th June, 2008 and to be made fully paid up on 30th November, 2008, the lock-in period shall commence from 30th June, 2008 and shall continue till one year from 30th November, 2008 the date on which the same were made fully paid up.

(ii) Non-eligibility for preference shares

As per Guidelines issues by SEBI [Para 13.3 1(f)], where any shares are issued on preferential basis, any person who does not hold his entire shareholding in the issuing company in dematerialized form shall not be entitled for the preferential allotment of shares. Para 13.3 1(h) of the said guidelines disentitles any persons from receiving shares in a preferential issue, if such person has sold his shares in the issuing company during the six months period prior to the relevant date.

In view of the above guidelines, the persons who are holding the shares in Excel Ltd. In physical form and not in dematerialized form and the persons who have sold their shares in the said company in January, 2008 being falling within the period of six months prior to the relevant date, are not entitled to receive the shares in the preferential issue.

Relevant date for this purpose means the date thirty days prior to the date on which the meeting of general body of shareholders is held under Section 81(1A) of the Companies Act, 1956 to consider the proposed issue.

- (c) (i) The term 'notwithstanding' used along with the words 'anything contained' in an Act characterises the non obstante clause. It is used in a provision of an Act when the intention of the legislature is to give an over-riding effect to that provision over other provisions of that Act and/or over provisions of other Acts as may be specified later in such provision. If there is any inconsistency or departure between the non-obstante clause and other provisions, then the provisions as contained in the non-obstante clause shall prevail. [K Parsuramaiah Vs. Pakari Lakshman AIR (1965) AP 220].

As against the above non obstante clause, the term 'subject to' is used in a provision of an Act to convey the intention of the legislature that the particular provision is yielding place to another provision or provisions to which is made 'subject to'. Thus, it can be concluded that the effect of non obstante clause (i.e., not withstanding) is the opposite to a provision or provisions which includes the term "subject to".

- (ii) Section 408 of the Companies Act, 1956 starts with the words "notwithstanding anything contained in this Act". This is a non obstante clause which vests over-riding powers in the Central Government to nominate directors to prevent mismanagement or oppression. [Oriental Industrial Investment Corporation Ltd. Vs. Union of India (1981) 52 Comp. Cas. 487, 493]. This expression indicates that the appointment of the directors under this section is not to be controlled by other provisions of the Companies Act, 1956 such as maximum number or other proportion, if any, fixed by the said Act. Further, the directors so appointed are also not liable to be removed by the company at general meeting under the provisions of Section 284 of the Companies Act, 1956.

Question 4

- (a) Mr. Raj is director in 14 public limited companies as on 30th July, 2007 and continues to be so till 26th September, 2007. The following companies appoints Mr. Raj as a director at their respective Annual General Meetings held on dates mentioned against their names:
- (1) MLP Ltd. (AGM held on 27th September, 2007)
 - (2) PAT Private Ltd. (AGM held on 25th September, 2007)
 - (3) Retail Traders Association (a company registered under Section 25 of the Companies Act, 1956 (AGM held on 26th September, 2007)
 - (4) KMC Ltd. (AGM held on 29th September, 2007)

You are required to state with reference to the relevant provisions of the Companies Act, 1956 the options available to Mr. Raj in respect of accepting or not accepting the appointment of the above companies. (8 Marks)

- (b) What do you understand by the term "Director Identification Number" (DIN) ? Describe the procedure to obtain the same as enumerated under the Companies Act, 1956 read with the relevant Rules. (7 Marks)

Answer

- (a) Section 275 of the Companies Act, 1956 debars any person to hold office as a director of more than 15 companies simultaneously.

As per the provisions of Section 277(2) of the Companies Act, 1956 where a person holds directorship of 14 or less companies is appointed as a director of other companies and such appointments make the total number of his directorships more than 15, then the person concerned has to choose the directorships which he wishes to continue to hold or to accept so that the total number of directorships, old or new, henceforth to be held by him does not exceed 15.

The said section further provides that none of the new appointments shall be effective until such a choice is to be made and in case of failure of the person to make such a choice within 15 days of the day on which the last of the new appointments was made, all the new appointments shall become void.

Section 278 of the Companies Act, 1956 states that for the purpose of Section 275 and Section 277 the number of companies of which a person may be a director, following companies are not to be counted.

- (a) A private company unless it is a subsidiary of a public company
- (b) An unlimited company
- (c) An association not carrying on business for profit or which prohibits the payment of dividend
- (d) A company in which such person is only an alternate director.

In view of the abovementioned legal provisions, Mr. Raj who is already a director in 14 companies has to consider the following aspects.

As per provisions of Section 278 of the Companies Act, 1956 PAT Private Ltd. being a private company and Retail Traders Association being an association not carrying on business for profit and prohibiting payment of dividend by virtue of being a company registered under section 25 are not to be counted for the purpose of Section 277 read with Section 275.

Thus Mr. Raj can accept the appointment in PAT Private Ltd. and Retail Traders Association without any obstacle.

The appointment of Mr. Raj in the other two public companies along with the old directorships in 14 companies makes a total of 16 which is excess of 15 prescribed by Section 275. As per provisions of Section 277, Mr. Raj has to decide within 15 days from 29th September, 2007, the date on which the last appointment was made, as to the directorships which he wishes to continue hold or to accept so that the number of his total directorships does not exceed 15 and in case he fails to be decide within the said 15

days then his appointments as a director of MLP Ltd. and KMC Ltd. shall become void on the expiry of the said 15 days.

Note: A different view can also be taken to the extent that the appointment of Mr. Raj in MLP Ltd. on 26th September, 2007 will make the total number of directorships to 15 which is within the prescribed parameters. However, his appointment as Director of KMC Ltd. on 29th September, 2007 will make it 16 which is in excess of the permissible limit. Hence, the appointment in KMC Ltd. will become void and ineffective in case Mr. Raj does not decide about which of the two companies he should choose within 15 days.

- (b) Director Identification Number (DIN) is a Unique Identification Number given by the Ministry of Corporate Affairs. It is required to be obtained by every person who is intended to become a director of any company. DIN is a pre-requisite for filing various forms with the Registrar of Companies. The electronic system of the Ministry of Corporate Affairs will not allow to file / submit the forms if DIN of the signatory director is not mentioned in the form being filed / submitted.

In order to obtain DIN from the Ministry of Corporate Affairs following procedure is to be adopted:

- (i) To check whether the computer system through which the DIN Application is being made has the requisite hardware and the software as well as the internet facility.
- (ii) Using the internet facility, DIN Application Form has to be downloaded from the website of Ministry of Corporate Affairs
- (iii) The DIN application form is to be filled up and submitted electronically
- (iv) On electronic submission of the DIN application form, a provisional DIN will be generated and displayed on the said application form.
- (v) Thereafter, the form is to be printed, signed and submitted to the Ministry of Corporate Affairs – DIN Cell along with following papers/documents
 - (a) Passport size photograph of the applicant duly attested by a Magistrate or a Notary Public or a practicing Chartered Accountant or a practicing Company Secretary or a practicing Cost Accountant or a Gazetted Officer.
 - (b) Attested copy of any one of the following as a proof of identify
 - (i) Passport
 - (ii) Election / Voter Identity card
 - (iii) Driving Licence
 - (iv) Income tax PAN card
 - (v) Ration Card
 - (vi) Any other document which will prove the identity of the applicant
 - (c) Attested copy of any one of the following as a proof of residence
 - (i) Passport

- (ii) Election / voter identity card
- (iii) Driving Licence
- (iv) Ration Card
- (v) Electricity Bill
- (vi) Telephone Bill
- (vii) Bank Account Statement
- (viii) Any other document which will prove the identity of the applicant

On submission of the above, the DIN Cell of the Ministry of Corporate Affairs shall allot Final DIN and send an intimation letter to the applicant.

Question 5

- (a) A group of shareholders has approached you for advice regarding the affairs of LPM Paper Mills Ltd. According to them, the management of the company is not carrying out its functions in accordance with the prudent commercial practice and if the affairs of the company are allowed to run in future in the same manner, the company's solvency would be in danger. They want that a Special Audit be conducted to find out the actual nature of the transactions.
- (i) You are required to state with reference to the provisions of the Companies Act, 1956, as to when a special audit can be directed and by whom ?
 - (ii) Draft an application to be submitted to the appropriate authority in this respect.

(8 Marks)

- (b) Big Ball Ltd., a reputed Public Company, over the years, has performed excellently and its General Reserve is many times more than the paid up capital of the Company. The Chairman of the company came to know that a group of unscrupulous persons is cornering the shares of the company and may lodge them for transfer in their names. It is apprehended that such transfer may lead to change in the composition of Board of Directors which may be prejudicial to the Public interest.

You are required to state with reference to the provisions of the Companies Act, 1956 as to how Big Ball Ltd. can block the above stated transfer of shares. (7 Marks)

Answer

- (a) (i) Provision regarding Special Audit: Section 233A of the Companies Act, 1956 deals with the matter relating to Special Audit. The Special Audit can be ordered by Central government if it is of the opinion:
- (i) that the affairs of the company are not being managed in accordance with sound business principles or prudent commercial practices, or

(ii) that the company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains, or

(iii) that the financial position of the company is such as to endanger its solvency.

Thus, the dissatisfied group of shareholders may make a complaint to the Central Government requesting for conducting the special audit. If the Central Government is satisfied that there exist sufficient reasons, it may order a special audit to be carried out by a Chartered Accountant who may or may not be company's statutory auditor or who may or may not be in practice.

(ii) DRAFT APPLICATION

Dated

To
The Secretary,
Ministry of Corporate Affairs,
Government of India,
New Delhi.

Sir,

We, the undersigned, the shareholders of LPM Paper Mills Ltd. would like to bring to your kind notice that for a long time the affairs of the said company are not being managed in accordance with sound business principles and prudent commercial practices.

We are of the view that certain expenditures which are being incurred by the company are not related to the business of the company and the company is not getting any benefit out of such expenses. Moreover, we have the apprehension that there are certain business transactions which are being entered into by the directors with the concerns which are owned by the relatives of the Directors and the prices charged for such transactions are not comparable with the prices charged by the other parties for similar transactions.

If such state of affairs is allowed to be carried on for long, the financial position of the company will reach a stage where it will endanger its solvency.

We feel that the modus operandi of the transaction is such that it may be difficult for the regular statutory auditor to detect them in course of normal audit.

It is, therefore, prayed that the Central Government be pleased to appoint, pursuant to Section 233A of the Companies Act, 1956, a Special Auditor to properly audit the

accounts of the Company and find the real nature of the transactions and determine the losses so far sustained and being sustained by the company on this account.

Yours faithfully

1.....
2.....
3.....
4.....
5.....

(Shareholders)

- (b) As per Section 250(4) of the Companies Act, 1956 where the Company Law Board (Company Law Board till the Company Law Tribunal becomes operational referred to as CLB hereinafter) has reasonable ground to believe that a transfer of shares in a company is likely to take place and the CLB is of the opinion that any such change would be prejudicial to the public interest, the CLB may, by an order, direct that any transfer of shares in the concerned company; during such period not exceeding three years, as may be specified in the order, shall be void.

As per Section 250(1) & (2) of the Companies Act, 1956, if the CLB is of the view that there are good reasons to find out the relevant facts about any shares and the CLB is of the opinion that such facts can not be found out unless the restrictions are imposed, as an interim measure, it may, by an order, direct that transfer of any; such shares shall be void and no voting right shall be exercised in respect of such shares.

However, the CLB is empowered to vary or rescind its order any time.

The facts given in the question squarely falls within the provisions of Section 250 of the Companies Act, 1956. The management of Big Ball Ltd. may make a complaint to the CLB and convince it that the transfer of shares in favour of the group of unscrupulous persons would change the composition of the Board of Directors of the Company which shall be prejudicial to the public interest and if the CLB is convinced of the plea of the company, it may pass an order as stated above which would block the transfer of shares as stated in the question.

Question 6

- (a) (i) An inter-state co-operative society has been incorporated on 1st May, 2008 as a Producer Company under the provisions of the Companies Act, 1956. Give your comments on its proposal to have 18 directors on its Board after incorporation as a Producer Company.
- (ii) Mr. Zameen, a member of a Producer Company, wants to transfer his shares. You are required to state as to how he can transfer his shares under the provisions of the Companies Act, 1956.

- (iii) A Producer Company wants to issue bonus shares. You are required to state the relevant provisions of the Companies Act, 1956 in this regard.
- (iv) What are the modes of investment, from and out of its general reserves, available to a Producer Company formed and registered under Section 581C of the Companies Act, 1956 ? (8 Marks)
- (b) Amar Textiles Ltd. is a company engaged in manufacture of fabrics. The Company has investments in shares of other bodies corporate including 70% shares in Amar Cotton Co. Ltd., and it has also advance loans to other bodies corporate. The aggregate of all the investments made and loans granted by Amar Textiles Ltd. exceeds 60% of its paid up share capital and free reserves and also exceeds 100% of its free reserves. In course of its business requirements, Amar Textiles Ltd. has obtained a term loan from Industrial Development Bank of India and is still subsisting. Now the Company wants to increase its holding from 70% to 80% of the equity share capital in Amar Cotton Co. Ltd. by purchase of additional 10% shares from other existing shareholders.

State the legal requirements to be complied with by Amar Textiles Ltd. under the provisions of the Companies Act, 1956 to give effect to the above proposal. Will answer be different in Amar Textiles Ltd. would have defaulted in payment of matured fixed deposits accepted by it from the public ? (7 Marks)

Answer

- (a) (i) As per provisions of Section 581-O of the Companies Act, 1956, any producer Company can not have more than fifteen directors. However, by way of a proviso, the said section further provides that in the case of an inter-state cooperative society which is incorporated as a Producer Company, may have more than fifteen directors for a period of one year from the date of its incorporation as a Producer Company.

In view of the above provisions of the Companies Act, 1956 the proposal to have 18 directors by the Producer Company after its incorporation as such, is a valid proposition, but since it is incorporated on 1st May, 2008, it can have more than 15 directors for one year only from the date of its incorporation.

- (ii) According to the provisions of Section 581ZD(1) and (2) of the Companies Act, 1956, the shares of a member of a Producer Company shall not be transferable but a member of a Producer Company may after obtaining the previous approval of the Board, transfer the whole or part of his shares along with any special rights, to an active member at par value.

Based on the above provisions relating to the transfer of shares of a member in a Producer Company, Mr. Zameen has to obtain prior approval of the Board and then transfer his shares to an active member of the Producer Company at par value.

- (iii) As per provisions of Section 581ZJ of the Companies Act, 1956, any Producer Company may, upon recommendation of the Board and passing of resolution in the general meeting, issue bonus shares by capitalization of amounts from general

reserves referred to in Section 581ZI in proportion to the shares held by the Members on the date of the issue of such shares.

- (iv) As per Producer Companies (General Reserves) Rules, 2003 issued by the Department of Company Affairs, Ministry of Finance, Government of India on 7th August, 2003, a producer company formed and registered under Section 581C of the Companies Act, 1956, shall make investments from and out of its general reserves in the following manner namely:
- (a) in approved securities, fixed deposits, units and bonds issued by the Central or State governments of cooperative societies or scheduled banks; or
 - (b) in a co-operative bank, State co-operative Bank, co-operative land development bank or Central co-operative bank; or
 - (c) with any other schedule bank; or
 - (d) in any of the securities specified in Section 20 of the Indian Trusts Act, 1882; or
 - (e) in the shares or securities of any other multi-State Co-operative society or any co-operative society; or
 - (f) in the shares, securities or assets of a public financial institutions specified under Section 4A of the Companies Act, 1956 specified.

Further, Section 581ZL of the Act provides that the general reserves of any producer company shall be invested to secure the highest returns available from approved securities. A producer company may, for promotion of its objectives acquire the shares of another producer company. Again a producer company, either by itself or together with its subsidiaries may invest in the shares of any other company, other than a producer company for an amount not exceeding thirty per cent of the aggregate of its paid up capital and free reserves. Provided that a producer company may, by special resolution passed in its general meeting and with prior approval of the Central Government, invest in excess of the limits specified in the section. All investments by a producer company may be made if such investments are consistent with the objects of the producer company.

- (b) Amar Cotton Co. Ltd. is not a wholly-owned subsidiary of Amar Textiles Ltd. and hence investments in such a subsidiary company is not covered by exemption under Section 372A(8) (e) of the Companies Act, 1956. As the aggregate of the investments in shares and loans granted to other bodies corporate exceeds 60% of the paid-up share capital and free reserves and also 100% of the free reserves, it is necessary for Amar Textiles Ltd., to pass a special resolution in the General Meeting before increasing its holding from 70% to 80%. [First proviso to Section 372A(1)]

The notice of special resolution must indicate clearly the specific limits, the particulars of the body corporate in which the investment is proposed to be made, the purpose of the investment, specific source of funding and such other details [third proviso to Section 372A(1)].

In the present case, Amar Textiles Ltd., obtained a term loan from Industrial Development Bank of India (IDBI) which is a public financial institution within the meaning of Section 4A of the Companies Act, 1956 and therefore the provisions of Section 372A(2) are attracted and such loan is still subsisting. The company is required to obtain prior approval of IDBI for making any further investment.

As required by provisions of Section 372(2), the investment proposal must be passed at the Board meeting by unanimous decision of all the directors present at the meeting.

The company must enter the prescribed particulars of investment in a register of investment within 7 days of making the investment. [Section 372A(5)]

The company must also take into consideration the guidelines, if any, prescribed by the Central Government under Section 372A(7) of the Companies Act, 1956.

If the company has defaulted in payment of matured fixed deposits accepted from the public, the company has violated the provisions of Section 58A(3A) of the Companies Act, 1956. Section 372A(4) of the said Act prohibits the company from making any additional investment till such default is subsisting. The company must make good the default under Section 58A(3A) in order to give effect to the proposed additional investment.

Question 7

- (a) The last three years' Balance Sheet of PTL Ltd., contains the following information and figures:

	As at 31.3.2006 Rs.	As at 31.3.2007 Rs.	As at 31.3.2008 Rs.
Paid up capital	50,00,000	50,00,000	75,00,000
General Reserve	40,00,000	42,50,000	50,00,000
Credit Balance in			
Profit & Loss Account	5,00,000	7,50,000	10,00,000
Debenture Redemption Reserve	15,00,000	20,00,000	25,00,000
Secured Loans	10,00,000	15,00,000	30,00,000
On going through other records of the Company, the following is also determined:			
Net Profit for the year (as calculated in accordance with the provisions of Section 349 & 350 of the Companies Act, 1956)	12,50,000	19,00,000	34,50,000

In the ensuing Board Meeting schedule to be held on 5th May, 2008 among other items of agenda, following items are also appearing:

- (i) To decide about borrowing from financial institutions on long terms basis.

(ii) To decide about contributions to be made to charitable funds.

Based on above information, you are required to find out as per provisions of the Companies Act, 1956 the amount upto which the Board can borrow from financial institutions and the amount upto which the Board of Directors can contribute to charitable funds during the Financial Year 2008-09 without seeking the approval in general meeting.

(8 Marks)

- (b) OGC Ltd. was a supplier of Raw Materials to SAM Ltd., which could not make payment to OGC Ltd. owing to huge losses and financial constraints. Ultimately, SAM Ltd. went into liquidation and Official Liquidator was appointed. OGC Ltd. filed a suit for recovery of its dues. The Court awarded a decree in favour of OGC Ltd. Armed with the Court's decree, OGC Ltd. approached the Official Liquidator to pay the amount to it in preference over dues of the workmen. The workmen protested the demand of OGC Ltd. and contended that their dues rank *pari passu* with the Secured Creditors and will override all other claims of other creditors even where a decree has been passed.

You are required to ascertain the validity of the argument of the workmen in the light of the provisions of the Companies Act, 1956 and the decide cases on the subject.

(7 Marks)

Answer

- (a) (i) Borrowing from Financial Institutions:

As per Section 293(1)(d) of the Companies Act, 1956, the Board of Directors of a public company or a private company which is a subsidiary of a public company without obtaining the approval of shareholders in a general meeting, can borrow the funds already borrowed upto an amount which does not exceed the aggregate of paid up capital of the company and its free reserves. Such borrowing shall not include temporary loans obtained from the company's bankers in ordinary course of business. Here, free reserves do not include the reserves set apart for specific purpose.

Since the decision to borrow is to be taken in a meeting to be held on 5th May, 2008, the figures relevant for this purpose are the figures as per the Balance Sheet as at 31.03.2008. According to the above provisions, the Board of Directors of PTL Ltd. can borrow without obtaining approval of the shareholders in a general meeting, upto an amount calculated as follows:

Paid up capital	Rs. 7,500,000/-
General Reserve (being free reserve)	Rs. 5,000,000/-
Credit Balance in Profit & Loss Account (to be treated as free reserve)	Rs. 1,000,000/-
Debt Redemption Reserve (this reserve is not to be considered since it is kept apart for specific purpose of	-----

debenture redemption)

Aggregate of paid up capital and free reserve	Rs. 13,500,000/-
Total borrowing power of the Board of Directors of the company. i.e., 100% of the aggregate of paid up capital and free reserves	Rs. 13,500,000/-
Less amount already borrowed as secured loans	Rs. 3,000,000/-
Amount upto which the Board of Directors can further borrow without the approval of shareholders in a general meeting	Rs. 10,500,000/-

- (ii) Contribution to Charitable Funds: As per Section 293(1)(e) of the Companies Act, 1956, the Board of Directors of a public company or a private company which is a subsidiary of a public company, without obtaining the approval of shareholders in a general meeting, can make contributions to charitable and other funds not directly related to the business of the company or the welfare of its employees upto an amount which, in a financial year, does not exceed Rs. 50,000/- or five per cent of its average net profits as determined in accordance with the provisions of Sections 349 and 350 of the Companies Act, 1956 during the three financial year immediately preceeding which ever is greater.

According to the above provisions the Board of Directors of the PTL Ltd. can make contributions to charitable funds without obtaining approval of the shareholders in a general meeting, upto an amount calculated as follows:

Net profit for the year (as calculated in accordance with the provisions of Section 349 and 350 of the Companies Act, 1956.

For the financial year ended 31.03.2006	Rs. 1,250,000/-
For the financial year ended 31.03.2007	Rs. 1,900,000/-
For the financial year ended 31.03.2008	Rs. 3,450,000/-
TOTAL	Rs. 6,600,000/-
Average of net profits during three preceding financial years	Rs. 2,200,000/-
Five per cent thereof	Rs. 110,000/-

Since this amount is higher than Rs. 50,000/- the Board of Directors of PTL Ltd. can make contribution to charitable funds upto Rs. 110,000/- during the financial year 2007-08 without obtaining the approval of shareholders in a general meeting.

- (b) The problem given in the question is covered by the provisions of Section 529A of Companies Act, 1956 read with Sections 529 and 530 of the said Act. The effect of combined reading of these sections is that the workmen of the company become secured creditors by operation of law to the extent of the workmen's dues and are entitled to proportional payment along with other secured creditors. If there is no secured creditor

then the workmen of the company become unsecured preferential creditors under the said Section 529A to the extent of workmen's dues. The purpose of the said section 529A is to ensure that the workmen should not be deprived of their legitimate claims on the event of the liquidation of the company and the assets of the company would remain charged for the payment of workmen's dues and such charge will be pari passu with the charge of other secured creditors. There is no other statutory provision overriding the claim of the secured creditors except the said Section 529A.

Thus under the said Section 529A, the dues of the workmen and debt due to the secured creditors are to be treated pari passu and have to be treated as prior to all other dues.

Thus, the law is very much clear in this respect and the Hon'ble Supreme Court of India held in the case of UCO Bank [(1994) 81 Comp. Case 780] that the provisions of Section 529A of the Companies Act, 1956 will override all other claims of the creditors even where a decree has been passed by a court.

In view of the above stated legal position, the contention of the workmen of SAM Ltd. is valid and the Official Liquidator will have to pay their dues as provided in Section 529A of the Act.

Question 8

- (a) HPC Ltd. for a number of years was in various types of business. In order to exit from its non-core business, its management decided to hive off the business of food processing by demerging the said business with an associate company, namely BCD Ltd. You are required to advise briefly, with reference to the provisions of the Companies Act, 1956, the steps the management should take to give effect to the proposed demerger.

(8 Marks)

- (b) (i) Whether guarantee commission paid to a Director is remuneration to director requiring Central Government's permission when the amount of such commission exceeds the limit prescribed in Section 309 of the Companies Act, 1956.
- (ii) BHP Ltd. wants to make the liability to its directors unlimited. You are required to state with reference to the provisions of the Companies Act, 1956 whether this can be done.
- (iii) Mr. John is a director of MNC Ltd., which had accepted deposits from public. The Financial position of MNC Ltd. turned very bad and it failed to repay the deposits which fell due for payment on 10th April, 2007 and such repayment has not been made till 5th May, 2008. Another company JKL Ltd. wants to appoint the said Mr. John as its director at its annual general meeting to be held on 6th May, 2008. You are required to state with reference to the provisions of the Companies Act, 1956 whether Mr. John can be appointed as a director of JKL Ltd.

(7 Marks)

Answer

- (a) HPC Ltd. can demerge its food processing business with an associate company, BCD Ltd. by obtaining the approval of National Company Law Tribunal (NCLT) [earlier such

power was vested in High Court and the High Court can continue to exercise such power till the CLT becomes fully functional] as provided in Section 394 of the Companies Act, 1956. For this purpose, HPC Ltd. is required to take the following steps:

1. HPC Ltd., known as "transferor Company" for this purpose, has to prepare a scheme under which its properties and liabilities in respect of food processing business will be transferred to BCD Ltd., known as "Transferee Company" for this purpose. Such scheme must contain the consideration for transfer, known as "Exchange Ratio".
 2. An application under Section 391(1) of the said Act must be made to NCLT / High Court for an order convening meetings of creditors and / or members.
 3. Notice(s) of the meeting(s) must be sent to members/creditors as per the direction of NCLT/ High Court. Such notice must be accompanied by a statement under Section 393(1) of the said Act setting forth the terms of the compromise or arrangement and explaining its effect in general and in particular, the effect on the interests of Managerial Personal.
 4. To hold the said meetings and pass necessary resolution approving the scheme subject to the conformation of NCLT/ High Court. It may be noted that the resolution must be passed by a majority in number representing 3/4th in value of the members / creditors as required under Section 391(2) of the said Act.
 5. Thereafter, HPC Ltd. is required to move to NCLT / High Court jointly with BCD Ltd. for approval of the scheme disclosing all material facts relating to the Company. [Proviso to Section 391(2)], the High Court as required under Section 394A shall give notice to the Central Government and shall take into consideration any representation received from Central Government before passing any order on the application made to it for approval of the scheme.
 6. On receipt of NCLT's / High Court's order, HPC Ltd. is required to file a certified copy of the order with the Registrar of Companies (ROC) for registration within 30 days after making of the order by NCLT / High Court [Section 394(3)]. This is very important since the non-filing of the order with ROC would make the approval order ineffective.
 7. Lastly, to proceed to give effect to the scheme as approved by NCLT / High Court in the manner as directed by it.
- (b) (i) As per decision of the Hon'ble Delhi High Court in the case of Sussen Textile Bearings Ltd. Vs. Union of India, [(1984)55 Com Cases 492] guarantee commission paid to directors for giving surety against loans and credit facilities taken by the company from financial institutions is not a remuneration for any services rendered and therefore, permission of Central Government as envisaged under Section 309 of the Companies Act, 1956 is not necessary. The director giving guarantee does not render manual, clerical, technical, supervisory or administrative services. He gets the guarantee commission for the risk which he bears and that has nothing to do with his directorship. After the said decision, the then Department of Company

Affairs also issued a circular in the year 1994 accepting the view expressed therein.

- (ii) Section 323(1) of the Companies Act, 1956 states that a limited company may, if so authorized by its Articles of Association, by special resolution, alter its memorandum of association so as to render unlimited the liability of its directors or of any director or manager. Hence, by amending the Memorandum of Association of the company by way of passing a special resolution in a general meeting, BHP Ltd. can make the liability of directors unlimited.
- (iii) Section 274(1)(g) of the Companies Act, 1956 states that where a person is a director of a public company which has failed to repay its deposit on due date and such failure continues for one year or more, then such person shall not be eligible to be appointed as a director of any other public company for a period of five years from the date on which such public company, in which he is a director, failed to repay its deposit. In the instant case, MNC Ltd., has failed to repay its deposit on due dates and the default continues for more than one year. Hence, Mr. John will not be eligible to be appointed as a director of JKL Ltd.

Question 9

- (a) LMB Ltd., Kolkata is a multiproduct manufacturing company having paid up capital of Rs. 5.00 crores. In order to increase the product portfolio, the said company intends to procure certain machines and equipments worth Rs. 1.00 crore from a partnership firm, namely, M/s MLPK, in which the son of managing director of LMB Ltd. is a partner. The contract for purchase of said machines and equipments is to be placed before the board of directors of the company for its consideration.

In view of above facts, you are required to explain briefly the procedure under the provisions of the Companies Act, 1956 to be followed by the LMB Ltd., to enter into the said contract. (8 Marks)

- (b) Answer any one of the following:
 - (i) Board of Directors of DBM Limited held a board meeting on 2nd May, 2008 at its registered office. You are required to state the salient points to be taken into account while drafting the minutes of the said board meeting.
 - (ii) Draft a board resolution for appointment of Mr. Paul as the managing director for 5 years with effect from 1st June, 2008 of DBM Limited passed in the above stated board meeting (3 Marks).
- (c) Annual General Meeting of a Company has been concluded on 30th April, 2008. Now the Company is required to submit / file its Annual Return and Annual Accounts with Registrar of companies. You are required to state the procedure for such submission/filing. (4 Marks)

Answer

- (a) As per provisions of section 297 of the Companies Act, 1956, when a Company enters into a contract in which some of the directors are interested, then consent of the Board of

Directors of the Company is required to be obtained. In the present case since the Managing Director of LMB Ltd. is interested in the contract for the purchase of machines and equipments because of his son's partnership in the supplier firm, the same should be approved by the board of directors of the company.

Proviso to Section 297(1) states that in the case of a company having a paid-up capital of not less than rupees one crore, no such contract shall be entered into except with the previous approval of the Central Government. Since the paid up capital of LMB Ltd. is Rs. 5 crore, the company is required to take over prior approval of the Central Government.

For this purpose, following steps are required to be taken:

- (i) Hold a board meeting and place the terms of the contract for consideration. The managing director should disclose the nature of his interest as required under Section 299 of the Companies Act, 1956.
- (ii) The managing director should not participate in discussion when in the board meeting, the matter in respect of the abovementioned contract is being discussed. He must not also vote on the relevant resolution. Moreover, his presence shall also not be counted for determining the quorum of the board meeting. [Section 300 of the Companies Act. 1956]
- (iii) The consent of the board of directors must be accorded by way of a resolution and not otherwise.
- (iv) An application to the Central Government (by delegation to Regional Director) should be made in prescribed form (Form No. 24A). Following enclosures should be made with the said form:
 - (a) a certified true copy of the board resolution approving the contract
 - (b) a copy of the proposed agreement
 - (c) a copy of the Memorandum and Articles of Association of the company
 - (d) a copy of latest audited annual accounts with directors' and auditors' reports thereon.
 - (e) bank draft or treasury challan evidencing the payment of prescribed fees.
- (v) Necessary entries are to be made in the Register of Contracts (Section 301)

On receiving the approval from the Central Government (Regional Director), the company can proceed to enter into the contract for supply of machines and equipments with the firm M/s MLPK in which the son of Managing Director is a partner.

- (b) (i) While drafting the minutes of a board meeting following salient points should be kept in mind:
 - (a) the minutes may be drafted in a tabular form or they may be drafted in the form of a series of paragraphs, numbered consecutively and with relevant headings.
 - (b) the place, date and time of the meeting should be stated.

- (c) the minutes should contain the constitution of the meeting, i.e., persons present and the capacity in which present, e.g. name of the person chairing the meeting, names of the directors and secretary, identifying them as director or secretary, names of persons in attendance like auditor, internal auditor etc. The minutes should also contain the subject of leave of absence granted, if any, to any of the board members.
- (d) content of the meeting giving serial number of the minute, brief subject heading, full terms of the resolution adopted including the statistical details, if any.
- (e) names of the directors dissenting or not concurring with any resolution passed at the board meeting.
- (f) reference about interested directors abstaining from voting is also required to be stated in the minutes.
- (g) Chairman's signature and date of verification of minutes as correct.

- (ii) Resolution passed at the meeting of board of directors of DBM Limited held at its registered office situated at on 2nd May, 2008 at AM.

"RESOLVED that subject to the approval by the shareholders in a general meeting and pursuant to provisions of Sections 198, 309, 310, Schedule XIII and other applicable provisions of the Companies Act, 1956, Mr. Paul be and is hereby appointed as the Managing Director of the Company with effect from 1st June, 2008 for a period of five years on a remuneration approved by the Remuneration Committee as enumerated below:

- (1) Salary : Rs. per month
- (2) Perquisites, Benefits and Facilities

"RESOLVED FURTHER that Mr. Paul, so long as the functions as the Managing Director of the Company shall not be entitled to any sitting fee for attending any meeting of the board of directors or any committee thereof and that he shall not be liable to retire by rotation."

"RESOLVED FURTHER that Mr. Paul till he holds the office of Managing Director of the Company shall not become interested or concerned in any selling agency directly or through his wife or minor children in future without prior approval of the Central Government."

"RESOLVED FURTHER that Mr. Paul, the Chairman, as well as the Company shall have right to terminate the appointment by giving 3 (three) months' notice in writing."

"RESOLVED FURTHER that the Secretary of the company be and is hereby directed and authorized to file necessary returns with the Registrar of Companies and to do all other necessary things required under the provisions of the Companies Act, 1956."

- (c) The Annual Return of a company has to be filed with Registrar of Companies within sixty days from the day on which the Annual General Meeting of a company is held. This return is filed as an enclosure to Form No. 20B and is to be electronically submitted.

Similarly, Annual Accounts are to be electronically filed within 30 (thirty) days from the day on which the Annual General Meeting of a company is held. The Directors' Report, Auditors' Report, Balance Sheet and related schedules are enclosed to Form No. 23AC and the Profit and Loss Account and related schedules are enclosed to Form No. 23ACA.

Following procedure is to be followed for submitting / filing the above:

- (i) To check whether the computer has the required hardware, software and the internet connection.
- (ii) To download the forms, one by one, from the website of Ministry of Corporate Affairs.
- (iii) To fill up the Company Identification Number (CIN), as a first step, in the forms and thereafter, by clicking the profile button, company's name is automatically filled. It is to be noted that at this time, the computer must remain connected to internet.
- (iv) To fill up the desired information in the forms.
- (v) To attach the Annual Return and Annual Accounts to the respective forms.
- (vi) To check the forms with the help of the "check form" button provided in the forms.
- (vii) To digitally sign the forms
- (viii) To electronically submit / file the forms
- (ix) To pay the filing fee either through credit card or cash / cheque on generation of challan.
- (x) To check from the website of Ministry of Corporate Affairs, in due course, whether the forms submitted / filed have been approved.

SUMMARY OF EXAMINERS' COMMENTS ON THE PERFORMANCE OF CANDIDATES

PAPER – 1 : ADVANCED ACCOUNTING

General Comments

The overall performance of the candidates was quite average. As noted by the examiners, candidates were not able to draft their sentences in constructive manner and therefore were not able to express themselves as desired and were rather sketchy. Candidates are advised to work out on practical application of accounting standards and guidance notes specifically on the recent ones. Also a thorough practice and lots of reading of the subject is required to maintain the level of knowledge expected from the candidates of final level.

Specific Comments

Question 1. Consolidated Balance Sheet:

The performance of the candidates was average in this question. An adjustment for re-valuation of plant and machinery and furniture and fixtures was not correctly done by many candidates. Consequently, the candidates could neither give the required adjustment in the capital values of the assets, nor could compute the depreciation claim on the assets over the period. Also adjustments regarding the exclusion of common items in the debtors and creditors as between the companies have not been properly done by the candidates. Even a minor adjustment on the disclosure of contingent liability has not been properly done by the candidates.

Question 2. Accounting for Amalgamations:

Poor performance of the candidates was observed in this question. The candidates were required to calculate goodwill on the basis of profit figures of the prior three years and many of the candidates have shown a total ignorance of the steps necessary to do this and also not deducted income from non-trade investment while working out average profit. The candidates have also failed to show the ratios of exchange of shares between the amalgamated companies and the amalgamated companies.

Question 3. (a) Employees Share Based Payments:

It has been a poor performance of the candidates. This part of the question was based on Guidance Note. Candidates seem to be unaware of the concept of the stock options reserved for employees and also to the nature of accounts dealt with, while recording the necessary transactions. Candidates failed to correctly arrive at the amounts to be expensed at each stage and that to be transferred to general reserves.

Question 3. (b) Valuation of Shares:

Answer to this part of the question has been satisfactory. Many candidates had distributed the retained earnings over the number of shares after making adjustments for the partly paid shares and therefore led to wrong solution.

Question 4. (a) Accounting Standard 16:

This part has been very well attempted and answered by many candidates. The essential steps in solving this problem lies in the determination of the average cost of the borrowing which some of the candidates did not even know how to compute.

Question 4. (b) Human Resource Accounting:

The answer to this part of the question exhibited lack of knowledge of the topic "Human Resource Accounting". Most of the candidates considered it as a part of social balance sheet. As per the examiners, many candidates showed 'Human assets' on liabilities side of the balance sheet under wrong heading like 'Reserve' or 'Human Liability' instead of 'Human Equity'.

Question 5. (a) AS 26:

Poor performance of the candidates was observed in this question. It seems that the candidates are not well versed with the provisions of AS 26. Unfortunately, many candidates did not know what to capitalize and when. In many cases, there has been a mix up between Rs. 22 lakhs and Rs. 28 lakhs as to which amount has to be capitalized.

Question 5. (b) Fund Based Accounting:

Part (b) of the question requires a couple of journal entries to be shown for stock and medicines received as donation and issue of medicines. Here again, there has been a total lack of application by the candidates in finding the solution.

Question 5. (c) AS 29:

In part (c) of the question, many candidates wrongly applied AS 19 instead of AS 29. Candidates clearly missed out the point that the lease in question was an onerous contract on which no future benefit was available and hence should be fully expensed out.

Question 5. (d) AS 24:

Part (d) of the question was on practical application of AS 24. Poor performance of the candidates has been noted in this part also.

Question 6. Theory Questions:

Satisfactory performance by the candidates was observed in this question. Most of the candidates were unable to express their thoughts in a clear and precise language. In part (a) of the question, candidates elaborated the value added statement instead of the advantages

of value added statement. Vague answers have been given by most of the candidates in theory parts.

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

General Comments

Candidates, generally were found to be wanting in preparation of working notes and presentation of answers. Lack of observation and practice could be the reasons.

Specific Comments

Question 1.(a) This question on investment analysis and evaluation was compulsory. The standard of answers was good. However, many candidates could not present their workings logically. The cash flows were not grouped properly in such a manner for the reader to appreciate the logic.

Following errors were found in the answers given by candidates:

- (i) Wrong computation of depreciation and tax benefit thereon.
 - (ii) Students who adopted the incremental approach to answer the question could not compute the cash flows:
 - (iii) Some students considered depreciation as Rs.2,00,000 p.a. instead of Rs.4,00,000, though question clearly indicates to provide depreciation on Straight Line Method (SLM) basis @ 20%.
- (b) The question was on security analysis and was answered well. However, in the calculation of standard deviation, many candidates had missed the relevance of aggregating the yield (by adding together dividend and capital appreciation) and measuring the variation.

The following major types of errors were found in the answers.

- (a) Calculation of Comparative Risk was generally wrong.
- (b) Most of the students could write a few steps correctly however, thereafter they followed a wrong approach leading to wrong conclusions.
- (c) Some students were unable to calculate Standard Deviation.
- (d) Some students directly calculated Weighted Average (expected) return without showing the required calculations of yield of individual securities of M. Ltd., and N Ltd.

Question 2.(a) This question, also on security analysis, was easy as could be seen from the fact that many candidates had scored well. However, some students had shown lack of conceptual knowledge while attempting sub part (iii).

(b) This question on CAPM Application was exactly the same as a worked out illustration in the reading material for the course. It was, therefore, surprising that quite a number of candidates had not done it correctly. The common error was found in lack of properly understanding the question and wrong calculation of expected return on each item of Portfolio (Using CAPM). Further, errors were also noted in calculation of average Return on Portfolio.

Question 3.(a) The question required recommendations regarding capital sourcing and called for some analysis and thinking. This was left out by many candidates, as there was a choice. Wherever attempted, the standard of answers was very poor. Candidates had failed to highlight that debt is cheaper and should be a preferred choice for funding the investment in fixed assets.

(b) Most of the candidates had shown the lack of understanding about the concepts of Repo and Reverse Repo. The presentations was also not upto the mark.

Question 4.(a) This question on valuation of equity shares was fairly well answered by the candidates. While correct answers were worked out on net assets basis and profit earning capacity basis, "fair value" based on a simple average of the two methods was skipped by many candidates. This could have been due to inadequate reading of the question. The following common mistakes were also found in answers.

- (i) Wrong calculation of share value either based on Net Asset Method or Profit Earning Capacity Method.
- (ii) Wrong treatment of additional depreciation.

(b) This was short notes question requiring comments on Social Cost Benefit Analysis. In many cases, answers were not to the point. Some candidates appeared confused mixing up their answers with 'social accounting'.

Question 5.(a) The question required proving the aspects of Miller-Modigliani theory stating that the value of the share is not affected by dividend declaration. Many candidates had problems in handling formula based valuation of equity shares. There were good answers too in some cases. Some of the students could not calculate the new shares to be issued. Those who calculated the correct number of new shares to be issued committed following mistakes:

- (i) They could not prove that the value of M Ltd., shall not be affected by the dividend whether paid or not paid.

OR

- (ii) Applied wrong formula while calculating the value of firm.

(b) Calculations of profit and loss due to 'forward cover' of foreign currency under two hypothetical situations were required. The question was fairly straight and simple. However, answers showed lack of understanding of basic concepts and inability to present the workings in most cases.

Following errors were noted:

- (i) The candidates made mistakes in the calculation of premium amount.
- (ii) They could not calculate interest on premium amount of Rs.39,000/- for 9 months @ 10%.
- (iii) Some students took the problem as Money Market Hedge question.
- (c) The short notes question on 'Refinancing' was poorly answered. Many candidates had not understood the concept and explained it as saying it as a method of financing the same asset a second time. Most of students were not able to understand the question. They confused it with bridge loan, securitization; consortium and other forms of finance.

Question 6.(a)-(e) Being a theoretical question, it was attempted fairly well. However, the concept of Inter Bank Participatory Certificates and Stock Lending was not clear to the most of examinees. The other mistakes found in the answers were as follows:

- (i) Some candidates confused money market with forex market.
- (ii) Some students confused IBPC as an instrument of foreign exchange market, money market transactions and lending rates.
- (iii) Some students confused Stock Lending Scheme with loan secured against stock, shares and Mutual Fund etc.

PAPER – 3 : ADVANCED AUDITING

General Comments

Performance in general was quite satisfactory. Candidates in few cases misunderstood the questions and some of them were unaware of the fact that "layman's replies" were not required. Emphasis was on technical aspects but which was lacking.

It is very sad to observe that majority of the students, in spite of presenting relevant subject matters could not apply the same for the practical issues posed in compulsory questions. It was also observed by an examiner that many candidates finishing all answers with main answer books only have obtained better marks than candidates who attempted to take and fill up more additional answer books.

The observation states that illegible handwriting led to misunderstanding of answers. Some of the candidates did not put the question numbers correctly. Even the sequence of answers and sub divisions of questions were not maintained by the candidates.

Specific Comments

Question 1. (a) Most of the students attempted this part properly. Some of the examinees failed to explain the requirements of Sec. 205. Many students' answers were not brief and to the point.

(b) Majority of the examinees made a good attempt but very few students were able to correctly make the provision for repairs. Though many examinees mentioned AS 29, very few could discuss fully. Many argued that the repairs/replacement cost was negligible and therefore there was no need to make any provision for the same. Many students made arithmetic mistake while calculating.

(c) Students have explained about AS 9 rather than AS 2. However, the conclusion was rightly given by the students. Some candidates failed to do the valuation of closing stock of garments correctly rather revenue recognition was unnecessarily discussed.

(d) Candidates on an average attempted correctly but many students failed to discuss the requirements of AS 21, while some examinees wrongly referred AS 13.

Question 2.(a) Most of the candidates attempted well. Maximum number of students has not given the guidance note on Accountants Report on which profit forecast could be made. Few students intelligently guessed and have simply answered the CA cannot give profit forecast.

(b) Many students answered fairly well but some of them failed to refer section 21 of CA Act. Some of the candidates argued that the remark "Refer to Drawer" was not misconduct.

(c) Many candidates are under the impression that clause 8 was not applicable to VAT Audit. Most of the students referred permission of previous auditor is not required under VAT. Some argued that VAT audit is not within the ambit of Company Act and hence CA was not guilty. While some others have wrongly written audit under VAT Act as allotted by Government, therefore, communication to previous auditor is not required. However, few examinees have stated that communication is required if the previous auditor is a CA.

(d) Some examinees could not understand the problem. They failed to state the auditor of a subsidiary company can not be a director of the holding company as it would affect his independence.

Question 3.(a) Many could answer correctly but specific points on CAAT were left out. Majority of the examinees admits that the Audit Software increases the probability of detecting and reducing frauds in financial statements.

(b) Majority of the examinees referred audit committee and its relevant provisions and only few could state who is an independent auditor. Many have not understood clause 49 of the listing agreement on independent director.

(c) Few examinees stated correctly what is Audit Trail, while some others are unaware of it. Many have stated that it is a computer process. Few others expressed that it is an auditing technique.

Question 4.(a) Many students attempted this part well but some of them could not explain the difference between financial and operational audit. The concept of extension of internal audit into operational areas has not been touched upon by many students.

(b)(i). Many students gave answers without referring to CARO but explained income tax provisions. Again majority of the students ignored the points on maintenance of proper books of accounts on accrual basis.

(ii). Majority of the students have not referred the fact that the loan obtained has not been utilized for the purpose for which it was taken. Instead of discussing on Para 4 (xvi) of CARO,2003, the candidates discussed about borrowing cost under AS 16.

Question 5.(a) The answers given by the students did not touch about inspection, insurance, stock audit and hypothecation/pledge. It showed lack of preparation on the examinees. While answering, many of the students had not considered banking company.

(b) Very few candidates could understand the implication of Audit Risk and the answers were very casual. Many students have written points relating to inherent risk, control risk and detection risk.

Question 6.(a) This part of the question was attempted well by the examinees but some of them did not mention that the provision of 25% of net premium was inadequate and required auditor's qualification. Many examinees were unaware of the term reserve for unexpired risks in insurance business.

(b) Most of the students did not touch upon "auction session on T + 2.

(c) Maximum number of students did not attempt properly and some of them failed to explain haphazard Sampling.

Question 7.(a) Most of the students displayed their ignorance about "Due Diligence". Many students made only headline reference on Due Diligence some others listed some points.

(b) Many of the students did well this part.

(c) Many students felt that 20% of the amount will be disallowed. They were quite ignorant about the provisions of section 40A (3) of Income Tax Act.

Question 8.(a) The policy of the Government in the Union Budget did not touch by many candidates.

(b) The candidates have not used the issue price per share but calculated at market price.

(c) Many were not clear about the concept of "Key Management Personnel". Candidates were confused as to AS 18 in respect of non executive director and so it was not highlighted by many candidates.

(d) This part has not been attempted well by many candidates. Some of the students generally failed to explain application of normal capacity with regard to allocation of fixed overheads.

- (e) This part of the question was not attempted well since no mention was there on AS 11.
- (f) Many candidates wrote on different paragraphs of audit report rather than correct presentation.

PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE

General Comments

The performance in general was “average”. The following improvements are required

- (a) Application of Legal provisions to the questions.
- (b) Improvement in the English Language and conceptual clarity.
- (c) Main Sections/Important case laws, if any and relevant to the answer should form part of the answer.
- (d) Updating the knowledge in the subject by way of amendments if any related to the questions.
- (e) Drafting skills in respect of answers to questions based on secretarial practice.

Specific Comments

Question 1. Many of the candidates answered correctly the question by stating that same person can be appointed as the Managing Director in three companies of the group with the permission of the Central Government. Few of them did not state about the provision of Section 316(4) of the companies Act.

Though the candidates by and large performed well in the sub-part (b) of the question, however some of them did not state about the effect of such withdrawal on the contracts outstanding on the date of withdrawal as provided in the proviso to Section 5 of the Securities Contracts (Regulation) Act, 1956.

The performance to sub-part (c) of the question was satisfactory.

Question 2. The provisions relating to Sections 17 and 19 of FEMA 1999 for appeals against orders of Adjudicating Authority and the time limit were not stated correctly by most of the candidates.

The sub-part (b) of the question have been attempted well by the candidates.

Though many candidates by and large performed well in the sub-part (c) of the question, some of them did not explain properly the provisions of Section 11 of the Competition Act, 2002 for removal of member of Competition Commission from his office by the Central Government.

Question 3. The performance of the candidates to this question was satisfactory; however some candidates did not define the term “relevant date”.

In sub-part (b) of the question with regard to problem relating to the lock-in period for the shares allotted on preferential basis, most of the candidates answered well but with regard to the persons not entitled for allotment of shares on preferential basis, candidates were not well aware about the guidelines issued by SEBI [Para 13.3 1(f)]

The sub-part (c) of the question have been attempted well by the candidates.

Question 4. Though most of the candidates attempted well in the provisions of Section 275, 277 and 278 of the Companies Act, 1956 but while applying these provisions in the practical question given, many candidates were confused about the option available to Mr. Raj in respect of accepting or not accepting the appointment of the given companies.

In sub-part (b) of the question most of the candidates stated well about what is 'Director Identification Number' but some of them did not state the procedure for obtaining it.

Question 5. Most of the candidates attempted well the provision regarding Special Audit as per Section 233A of the Companies Act, 1956. However candidates did not draft the application to be submitted to the appropriate authority in a proper manner.

In the sub-part (b) of the question, most of the candidates stated well the provision of Section 250 of the Companies Act, 1956.

Question 6. Many of the candidates were not aware of the provision relating to appointment of more than 15 directors in the case of inter-state cooperative society which is incorporated as a Producer Company as per section 581-O of the Companies Act, 1956, the provisions of Section 581ZD relating to transfer of shares by a member of a producer company, the provisions of Section 581ZJ relating to issue of bonus shares by a producer Company and the modes of investment, from and out of its general reserves available to a Producer Company formed and registered under Section 581C.

In the sub-part (b) of the question, most of the candidates performed satisfactorily.

Question 7. Most of the candidates answered correctly about the amount upto which the Board of Directors can borrow from financial institutions under the provisions of the Section 293(1)(d) of the Companies Act, 1956 and the amount upto which the Board of Directors can contribute to charitable funds during the Year 2008-09 without seeking the approval in general meeting under the provisions of the Section 293(1)(e) of the Companies Act, 1956.

In the sub-part (b) of the question most of the candidates performed satisfactorily.

Question 8. Most of the candidates have attempted this question in a proper manner.

In the sub-part (b)(i) of the question most of the candidates did not knew the provision that whether guarantee commission paid to the directors would be treated as remuneration or not.

Similarly in the sub-part (b)(ii) of the question many candidates were unaware about the unlimited liability of the directors.

Question 9. The performance of the candidates for this question was satisfactory.

In the sub-part (b) of the question, candidates properly stated the important points for drafting minutes of Board Meeting but drafting of resolution in other part was not upto the mark. It requires a lot of improvement.

In the sub-part (c) of the question while most of the candidates properly stated the correct time limit for filing Annual Return and Annual Accounts with Registrar of Companies but failed to state the procedure for such submission/filing.

PAPER – 5 : COST MANAGEMENT

Question 1

- (a) A Ltd. Makes and sells a single product. The company's trading results for the year are:

	Figs. – Rs. '000 (Year 2007)	
Sales		3,000
Direct materials	900	
Direct labour	600	
Overheads	<u>900</u>	<u>2,400</u>
Profits		<u>600</u>

For the year 2008, the following are expected:

- (i) Reduction in the selling price by 10%.
- (ii) Increase in the quantity sold by 50%.
- (iii) Inflation of direct material cost by 8%.
- (iv) Price inflation in variable overhead by 6%.
- (v) Reduction of fixed overhead expenses by 25%.

It is also known that :

- (a) In 2006, overhead expenditure totalled to Rs. 8,00,000.
- (b) Total overhead cost inflation for 2007 has been 5% more than 2006.
- (c) Production and sales volumes have been 25% higher in 2007 than in 2006.

The high-low method is being used by the company to estimate overhead expenditure.

You are required to:

- (i) Prepare a statement showing the estimated trading results for 2008.
 - (ii) Calculate the Break-even point for 2007 and 2008.
 - (iii) Comment on the BEP and profits of the years 2007 and 2008.
- (b) The following information is available:

Activity		No. of days	No. of men required per day
A	1–2	4	2
B	1–3	2	3
C	1–4	8	5

D	2—6	6	3
E	3—5	4	2
F	5—6	1	3
G	4—6	1	8

- (i) Draw the network and find the critical path.
(ii) What is the peak requirement of Manpower? On which day(s) will this occur?
(iii) If the maximum labour available on any day is only 10, when can the project be completed?
- (c) Draw and explain the angle of incidence in a break-even chart. What is its significance to the management? (12 + 9 + 3 = 24 Marks)

Answer

(a) (i)

Trading Results				
Figures Rs. '000				
	2006	2007	2008	Workings
Sales:		3,000	4,050	$(3,000 \times 1.5 \times .9)$
				(Refer to Note 1)
Direct Material		900	1,458	$(900 \times 1.5 \times 1.08)$
Direct Labour		600	900	$(600 \times 1.5 \times 1)$
Variable Overhead		<u>300*</u>	<u>477</u>	$(300 \times 1.06 \times 1.5)$
		(Refer Note 2)		
Total Variable Cost		<u>1,800</u>	<u>2,835</u>	Total variable cost
Contribution		1,200	1,215	
Fixed Overhead		600	450	$(600 \times .75)$
		(Refer to Note 3)		
Total Overhead	800	<u>900</u>	<u>927</u>	
Total Cost		2,400	3,285	
Profits		600	765	

(ii)	P/V Ratio	Contribution/ Sales	40%	30%
	BEP	Fixed Cost/PV Ratio	$\frac{600}{40\%} = 1,500$	$\frac{450}{30\%} = 1,500$

(Note 1) $3,000 \times 1.5 \times 0.9$

(Note 2) Overhead Cost in 2006 = 800

Increase in price = 5%

$\therefore$ Overhead cost for same production $800 \times 5\% + 800 = 840$.

Overhead increase due to quantity = $900 - 840 = \text{Rs. } 60$

Rs. 60 represents increase in variable Overhead in 2007 due to increase in quantity by 25%.

$\therefore$ Variable Overhead amount in 2007 = $1\frac{1}{4}$ times

i.e. $\frac{5}{4} = 5 \text{ times } \left(\frac{1}{4} \text{ th quantity} \right) = 5 \times 60 = 300$

(Note 3)

In 2007 Total Overhead	900
Variable Overhead (Refer to Note 2)	<u>300</u>
Fixed Overhead	<u>600</u>

(iii)	2007	2008	Difference	%
BEP	1,500	1,500	0	
Fixed Overhead	600	450	150	25%
PV Ratio	40%	30%	10%	$25\% \frac{10}{40}$
Profit	600	765	165	27.5%

$$\text{BEP} = \frac{\text{Fixed Cost}}{\text{P/V ratio}}$$

Both Fixed Cost and P/V ratio have declined by 25% equally. So BEP sales remains the same.

The contribution is only Rs. 1,215 in 2008 though quantity is increased by 50%. This is due to increase in production cost and decrease in selling price. This is more than made up by decrease in fixed cost so that overall profit has increased by 27.5%.

Alternative Solution (for identifying variability and fixedness of overheads):

$$V_1 q_1 = \text{Variable Overhead / unit in 2007} \times \text{quantity in 2007}$$

$$V_2 q_2 = \text{Variable Overhead / unit in 2008} \times \text{quantity in 2008}$$

$$V_2 q_2 = V_1 (1.06) (1.5) q_1 = 1.59 V_1 q_1$$

$$V_0 q_0 + F_0 = 800$$

$$V_1 q_0 + F_0 = \underline{840} \text{ where } q_0 \times 1.25 = q_1$$

$$V_1 q_0 - V_0 q_0 = 40$$

$$V_0 q_0 = V_1 q_0 - 40$$

$$V_1 q_0 + F_1 - (V_0 q_0 + F_0) = \frac{5}{100} \times 800 = 40$$

$$\text{i.e. } V_1 q_0 + F_1 = 840$$

$$V_1 q_1 + F_1 = \underline{900}$$

$$V_1 (q_0 - q_1) = -60$$

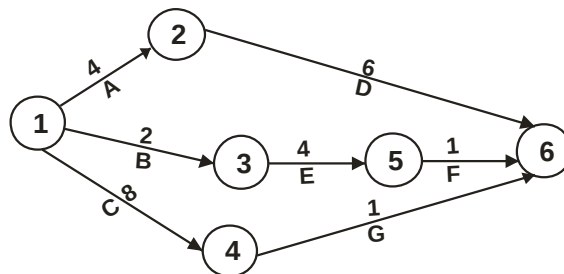
$$V_1 (q_1 - 1.25 q_0) = -60 \times 1.25$$

$$V_1 (-.25) q_1 = -75$$

$$V_1 q_1 = \frac{-75}{-.25} = 300$$

	Variable Overhead	300
Year 2007	Fixed Overhead	<u>600</u>
		900

(b)



Path	Days
AD	10 → CP
BEF	7
CG	9

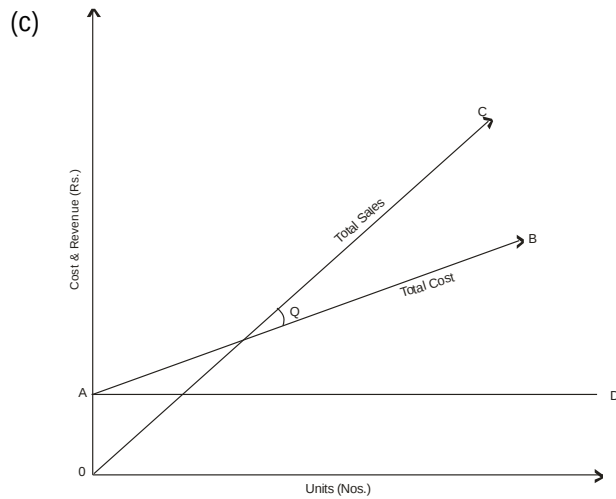
Critical Path = 1– 2 – 6

i.e. AD = 10 days.

Peak requirement is 11 men, required on days 7 and 9.

If only 10 men are available on any day, shift F,G to days 10 and 11 and the project can be completed in 11 days.

Day	1	2	3	4	5	6	7	8	9	10	11	12	13	14
	A ₂	A ₂	A ₂	A ₂										
					D ₃	D ₃	D ₃	D ₃	D ₃	D ₃				
	B ₃	B ₃	E ₂	E ₂	E ₂	E ₂								
							F ₃							
	C ₅	C ₅	C ₅	C ₅	C ₅	C ₅	C ₅	C ₅						
									G ₈					
	10	10	9	9	10	10	11	8	11	3				
If s/o shift										F ₃	G ₈			
New	10	10	9	9	10	10	8	8	3	6	8			



Angle of incidence (0) is the angle between the total cost line and the total sales line.

If the angle is large, the firm is said to make profits at a high rate and vice-versa.

A high angle of incidence and a high margin of safety indicate sound business conditions.

Question 2

- (a) Is it justifiable to sell at a price below marginal cost at any time? Mention the circumstances in which it is justifiable.
- (b) The following information has been extracted from the books of Goru Enterprises which is using standard costing system:

Actual output	=	9,000 units
Direct wages paid	=	1,10,000 hours at Rs.22 per hour, of which 5,000 hours, being idle time, were not recorded in production
Standard hours	=	10 hours per unit
Labour efficiency variance	=	Rs. 3,75,000 (A)
Standard variable Overhead	=	Rs. 150 per unit
Actual variable Overhead	=	Rs. 16,00,000

You are required to calculate:

- (i) Idle time variance
 - (ii) Total variable overhead variance
 - (iii) Variable overhead expenditure variance
 - (iv) Variable overhead efficiency variance.
- (c) M Ltd. Manufactures a special product purely carried out by manual labour. It has a capacity of 20,000 units. It estimates the following cost structure:

Direct material	30 Rs. / unit
Direct labour (1 hour / unit)	20 Rs. / unit
Variable overhead	10 Rs. / unit

Fixed overheads at maximum capacity is Rs. 1,50,000.

It is estimated that at the current level of efficiency, each unit requires one hour for the first 5,000 units. Subsequently it is possible to achieve 80% learning rate. The market can absorb the first 5,000 units at Rs.100 per unit. What should be the minimum selling price acceptable for an order of 15,000 units for a prospective client?

(6 + 6 + 7 = 19 Marks)

Answer

- (a) It is justifiable to sell at a price below marginal cost for a limited period.

The circumstances may be:

- (i) Where materials are of perishable nature.
- (ii) Where stocks have been accumulated in large quantities and the market prices have fallen. This will save the carrying cost of stocks, e.g., electronic goods – market prices fall due to quick obsolescence or advanced technological replenishment.
- (iii) It is essential to reduce the prices to such an extent in order to popularize a new product.
- (iv) Where such reduction enables the firm to boost the sales of other products having larger profit margin.

- (b) Actual output = 9,000 units

Idle time = 5,000 hours

Production time (Actual) = 1,05,000 hours

Standard hours for actual production = 10 hours / unit × 9,000 units = 90,000 hours.

Labour efficiency variance = 3,75,000 (A)

i.e. Standard rate × (Standard Production time – Actual production time) = 3,75,000(A).

SR (90,000 – 1,05,000) = – 3,75,000

$$SR = \frac{-3,75,000}{-15,000} = \text{Rs. } 25$$

- (i) Idle time variance = 5,000 hours × 25 Rs. / hour = 1,25,000. (A)

- (ii) Standard Variable Overhead = Rs. 150 / unit

Standard hours = 10 hours / unit

Standard Variable Overhead rate / hour = 150 / 10 = Rs. 15 / hour

$$\begin{aligned} \text{Total Variable Overhead variance} &= \text{Standard Variable Overhead} - \text{Actual Variable Overhead} \\ &= \text{Standard Rate} \times \text{Standard hours} - \text{Actual rate} \times \text{Actual hours} \\ &= (15) \times (10 \times 9,000) - 16,00,000 \\ &= 13,50,000 - 16,00,000 \end{aligned}$$

Total Variable Overhead Variance = 2,50,000 (A)

- (iii) Variable Overhead Expenditure Variance = (Standard Rate × Actual Hours) – (Actual Rate × Actual Hours)

$$\begin{aligned}
 &= (15 \times 1,05,000) - 16,00,000 \\
 &= 15,75,000 - 16,00,000 \\
 &= 25,000 \text{ (A)} \\
 \text{(iv) Variable Overhead Efficiency Variance} &= \text{Standard Rate} \times (\text{Standard Hours for} \\
 &\quad \text{actual output} - \text{Actual hours for} \\
 &\quad \text{Actual output}) \\
 &= 15 (90,000 - 1,05,000) \\
 &= 15 (-15,000) \\
 &= 2,25,000 \text{ (A)}
 \end{aligned}$$

(b) Alternative Solution

Actual Output = 9,000 Units

Idle time = 5,000 hrs

Direct Wages Paid = 1,10,000 hours @ Rs. 22 out of which 5,000 hours being idle, were not recorded in production.

Standard hours = 10 per unit.

Labour efficiency variance = Rs. 3,75,000 (A)

or

Standard Rate (Standard Time – Actual Time) = – 3,75,000

$$\text{Or } (90,000 - 1,05,000) = \frac{-3,75,000}{\text{Standard Rate}}$$

Or Standard Rate = Rs 25/-

(i) Idle time variance = Standard Rate $\times$ Idle time

$$25 \times 5,000 = \text{Rs } 1,25,000 \text{ (A)}$$

(ii) Standard Variable Overhead / unit = 150

$$\text{Standard Rate} = \frac{150}{10} = \text{Rs. } 15/\text{hour}$$

Standard Quantity = 10 hours

Actual Variable Overhead = 16,00,000

Standard Variable Overhead = $150 \times 9,000 = 13,50,000$

Actual Variable Overhead = 16,00,000

Total Variable Overhead Variance = 2,50,000 (A)

$$\begin{aligned}
 \text{(iii) Variable Overhead expenditure Variance} &= \text{Standard Variable Overhead for} \\
 &\quad \text{actual hours} - \text{Actual Variable} \\
 &\quad \text{Overhead} \\
 &= (150 \times 1,05,000) - 16,00,000
 \end{aligned}$$

	=	15,75,000 – 16,00,000	
	=	25,000 (A)	
(iv) Variable overhead efficiency variance	=	Standard Variable Overhead for actual output – Standard Variable Overhead for Actual hours)	
	=	15 (10 hours × 90,000 units – 1,05,000)	
	=	15 (90,000 – 1,05,000)	
	=	15 (–15,000)	
	=	2,25,000 (A)	
(c)		5,000 units	20,000 units
Material	1,50,000		6,00,000
Direct Labour	1,00,000		2,56,000
			Refer to W Note i
Variable Overhead	<u>50,000</u>		<u>2,00,000</u>
Total Variable Cost	3,00,000		10,56,000
Fixed Cost	<u>1,50,000</u>		<u>1,50,000</u>
Total Cost	4,50,000		12,06,000
Total cost / unit	90		60.3
Sales 100 × 5,000	5,00,000		<u>5,00,000</u>
15,000 × x(assumed selling price)			15,000 x
(Total Sales less Total Cost) = Profit	50,000		15,000 x – 7,06,000

Or minimum selling price = 50.4(refer to Working Note ii)

Working Note: I

Units	Hours
5,000	5,000
10,000	$10,000 \times 1 \times .8 = 8,000$ hours
20,000	$20,000 \times 1 \times .8 \times .8 = 12,800$ hours

Working Note: II

$$15,000 x - 7,06,000 > 50,000$$

$$15,000 x > 7,56,000$$

$$\text{or } x > 50.4$$

Alternative Solution:

Total cost / unit of capacity 20,000 = 60.3

Weighted average selling price > 80.4

$$\text{i.e. } \frac{5,000 \times 100 + 15,000x}{20,000} > 60.3$$

$$= 5,00,000 + 15,000x > 60.3 \times 20,000$$

$$= 15,000x > 12,06,000 - 5,00,000$$

Or

$$15,000x > 7,06,000$$

$$x > 47.06$$

Minimum price to cover production Cost = 47.06

Minimum price to cover same amount of profit = 50.40 (refer to Working Note 1)

Working Note 1

$$(-47.06 + 50.04) \times 15,000 \text{ units}$$

$$= \text{Rs. } 50,000$$

Question 3

- (a) X Ltd. has two divisions, A and B, which manufacture products A and B respectively. A and B are profit centres with the respective Divisional Managers being given full responsibility and credit for their performance.

The following figures are presented:

	Division A Rs. Per Unit	Division B Rs. Per Unit	
Direct material cost	50	24*	*(other than A)
Material A, if transferred from Division A	—	144	
Material A, if purchased from outside	—	160	
Direct labour	25	14	
Variable production overhead	20	2	
Variable selling overhead	13	26	
Selling price in outside market	160	300	
Selling price to B	144	—	
Selling price to S Ltd.	—	250	

Other Information:

To make one unit of B, one unit of component A is needed. If transferred from A, B presently takes product A at Rs.144 per unit, with A not incurring variable selling overheads on units transferred to B.

Product A is available in the outside market at Rs. 160 per unit from competitors.

B can sell its product B in the external market at Rs. 300 per unit, whereas, if it supplied to X Ltd.'s subsidiary, S Ltd., it supplies at Rs. 250 per unit, and need not incur variable selling overhead on units transferred to S Ltd. S Ltd. requires 6,000 units and stipulates a condition that either all 6,000 units be taken from B or none at all.

	A(units)	B(units)	
Manufacturing capacity	20,000	28,000	
Demand in external market	18,000	26,000	
S Ltd.'s demand	—	6,000	or zero

Assume that Divisions A and B will have to operate during the year.

What is the best strategy for:

- Department A?
- Department B, given that A will use its best strategy?
- For X Ltd. As a whole?

(b) What is Pareto Analysis? Name some applications. (14 + 5 = 19 Marks)

Answer

(a)	Div A	B	B
	Rs. / unit	Rs. / unit	Rs. / unit
Direct Material (Other than A)	50	24	
Direct Labour	25	14	
Variable Overhead (Production)	<u>20</u>	<u>2</u>	
Variable Production Cost (excl. A)	95	40	40
From A		144	
From Outside		—	<u>160</u>
Variable production Cost / unit		184	200
Selling Price			
From outside	160	300	
Less: Selling Overhead	<u>13</u>	<u>26</u>	
Net Selling Price (outside)	<u>147</u>	<u>274</u>	

Net Selling Price to B	<u>144</u>		
Net Selling Price to S		<u>250</u>	
Net Selling Price (outside)	147	274	274
Variable Production Cost	<u>- 95</u>	<u>- 184</u>	<u>-200</u>
Contribution / unit (outside)	52	90	74
(Sale to B & S respectively)	144	250	250
Variable Production Cost	<u>-95</u>	<u>-184</u>	<u>-200</u>
Contribution / unit	<u>49</u>	<u>66</u>	<u>50</u>

Best strategy

A = Maximise Production; Sell maximum no. of units @ 18,000 × 52 = 9,36,000
52 / unit (outside)

(To B) remaining units 2,000 × 49 = 98,000

Total Contribution for A 10,34,000

Best strategy for B:

Maximise contribution / unit by selling outside and procuring from A 90 / unit

Contribution × 2,000 units

Balance units can yield contribution of either 74/ unit for outside or Rs. 50 / unit to S Ltd.

Production Capacity = 28,000.

Option I			Option II
Outside Sales	Sales to S		Outside Sales × contribution / unit
20,000 × 74 = 14,80,000	6,000 × 50 = 3,00,000		24,000 × 74 = 17,76,000
2,000 × 90 = 1,80,000			2,000 × 90 = 1,80,000
16,60,000	3,00,000		
Total Contribution	(16,60,000 + 3,00,000)19,60,000		19,56,000

(B) Choose Option I i.e. get 2,000 units from A, sell 6,000 units to S and 20,000 to outside. Make 28,000 units @ full capacity. Total Contribution Rs19,60,000.

If A and B are allowed to act independent of the group synergy,

	Rs.
Total contribution	A – 10,34,000
	B – <u>19,60,000</u>
Total contribution for X Ltd.	<u>29,94,000</u>

Cost from X Ltd.'s Perspective

Variable Cost of production	Div A	Rs. 95
	Div B	
Variable cost of production other than A	40	40
A supplied by Division	95	
A – Variable Cost		
A purchased		<u>160</u>
	<u>135</u>	<u>200</u>

Option I	Outside 26,000 units	Option II	
Outside 20,000 × (274 – 135)	27,80,000	20,000 (274 – 135)	27,80,000
<u>2,000</u> × (274 – 200)	1,48,000	6,000 (274 – 200)	<u>4,44,000</u>
22,000			
S Ltd. 6,000 units (250 – 200)	<u>3,00,000</u>		
	<u>32,28,000</u>		<u>32,24,000</u>

Choose Option I

Contribution = Rs. 32,28,000 for X Ltd. as a whole

Transfer (2,000 units)

Make A transfer all output to B. Sell 6,000 units of B to S and 22,000 units to outside market. This will make X Ltd. better off by 32,28,000 – 29,94,000 = Rs 2,34,000

(i.e. 18,000 units of A sold to outside increases contribution to A by 3 Rs. / unit and decreases contribution to B by 16 Rs. / unit Net negative effect = 13 × 18,000 = Rs.2,34,000).

- (b) Vilfredo Pareto, an Italian economist, observed that about 70 – 80% of value was represented by 30 – 20% of volume. This observation was found to exist in many business solutions.

Analysing and focusing on the 80% value relating to 20% volume helps business in the following areas.

- Pricing of a product (in a multi-product company)
- Customer profitability.

- (iii) Stock control.
- (iv) Activity Based Costing (20% cost drivers are responsible for 80% of total cost)
- (v) Quality Control.

Question 4

- (a) Biscuit Ltd. Manufactures 3 types of biscuits, A, B and C, in a fully mechanised factory. The company has been following conventional method of costing and wishes to shift to Activity Based Costing System and therefore wishes to have the following data presented under both the systems for the month.

Inspection cost	Rs. p.m.	73,000
Machine – Repairs & Maintenance	Rs. p.m.	1,42,000
Dye cost	Rs. p.m.	10,250
Selling overheads	Rs. p.m.	1,62,000

	Product A	B	C
Prime cost (Rs. per unit)	12	9	8
Selling price (Rs. per unit)	18	14	12
Gross production (units/production run)	2,520	2,810	3,010
No. of defective units / production run	20	10	10
Inspection:			C
No. of hours / production run	3	4	4
Dye cost / production run (Rs.)	200	300	250
No. of machine hours / production run	20	12	30
Sales – No. of units / month	25,000	56,000	27,000

The following additional information is given:

- (i) No accumulation of inventory is considered. All good units produced are sold.
- (ii) All manufacturing and selling overheads are conventionally allocated on the basis of units sold.
- (iii) Product A needs no advertisement. Due to its nutritive value, it is readily consumed by diabetic patients of a hospital. Advertisement costs included in the total selling overhead is Rs. 83,000.
- (iv) Product B needs to be specially packed before being sold, so that it meets competition. Rs. 54,000 was the amount spent for the month in specially packing B, and this has been included in the total selling overhead cost given.

You are required to present productwise profitability of statements under the conventional system and the ABC system and accordingly rank the products.

- (b) What do you mean by a dummy activity? Why is it used in networking?
 (c) How would you use the Monte Carlo Simulation method in inventory control?

(11 + 4 + 4 = 19 Marks)

Answer

(a)	Sales	A	B	C	Total
(i)	Units Rs.	25,000	56,000	27,000	1,08,000
	Selling price/unit	18	14	12	
(ii)	Sales Value (Rs.)	4,50,000	7,84,000	3,24,000	15,58,000
(iii)	Prime Cost Overhead	12	9	8	
(iv)	No. of units/run	2,520	2,810	3,010	
(v)	Prime Cost Rs.	3,02,400	5,05,800	2,16,720	
(vi)	Gross Margin (ii – v)	1,47,600	2,78,200	1,07,280	5,33,080

	Total	A	B	C
Inspection Cost				
$\left(\frac{7,3000}{146} \times 30/80/36 \text{ respectively} \right)$	73,000	15,000	40,000	18,000
Machine Maintenance				
$\left(\frac{1,42,000}{710} \times 200/240/270 \text{ respectively} \right)$	1,42,000	40,000	48,000	54,000
Dye Cost	<u>10,250</u>	<u>2,000</u>	<u>6,000</u>	<u>2,250</u>
Sub Total	<u>2,25,250</u>	<u>57,000</u>	<u>94,000</u>	<u>74,250</u>
Selling Overhead Advertisement				
$\left(\frac{83,000}{56,000 + 27,000} \times 56/27 \text{ respectively} \right)$	83,000	—	56,000	27,000
Other Overheads				
$\left(\frac{25,000}{108} \times 25/56/27 \text{ respectively} \right)$	25,000	5,787	12,963	6,250
Packing			<u>54,000</u>	
Sub Total Selling Overhead	<u>1,62,000</u>	<u>5,787</u>	<u>1,22,963</u>	<u>33,250</u>

Workings:

	A	B	C	Total
Gross Production/unit /run (1)	2,520	2,810	3,010	
Defectives/run (2)	20	10	10	
Good units / run (3)	2,500	2,800	3,000	
Sales (Goods units)(4)	25,000	56,000	27,000	
No. of runs (5)	10	20	9	
Gross Production (6) = (1) × (5)	25,200	56,200	27,090	
Prime Cost / unit (7)	12	9	8	
Prime Cost (8) Rs.	3,02,400	5,05,800	2,16,720	10,24,920
Inspection hours/run (9)	3	4	4	
Inspection hours (10) = (9) × (5)	30	80	36	146
M/c hours / run (11)	20	12	30	
M/c hours (12) = (1) × (5)	200	240	270	710
Dye Cost/run (13)	200	300	250	
Dye cost (14) (13) × (5)	2,000	6,000	2,250	10,250

Conventional Accounting System

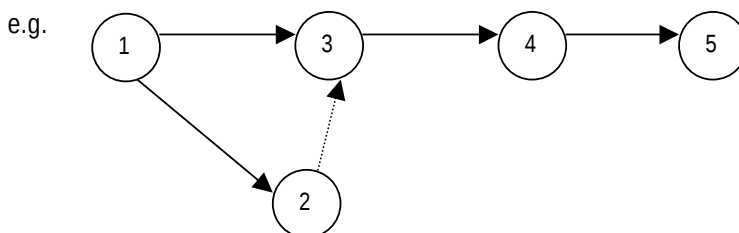
	Total	A	B	C
Sales – units / Production (good units)	1,08,000	25,000	56,000	27,000
Gross Margin (Rs.)	5,33,080	1,47,600	2,78,200	1,07,280
Production overheads (Rs.)	2,25,250	52,141	1,16,797	56,313
Selling Overhead (Rs.)	1,62,000	37,500	84,000	40,500
Sub-Total Overhead (Rs.)	3,87,250	89,641	2,00,797	96,813
Net profit (Rs.)	1,45,830	57,959	77,403	10,467
Ranking		II	I	III

Activity Based System

	A	B	C
Sales – units /	25,000	56,000	27,000
Production (good units)			
Gross Margin (Rs.)	1,47,600	2,78,200	1,07,280
Production overheads (Rs.)	57,000	94,000	74,250
Selling Overhead (Rs.)	5,787	1,22,963	33,250

Sub-Total Overhead (Rs.)	62,787	2,16,963	1,07,500
Net profit (Rs.)	84,813	61,237	(220)
Ranking	I	II	III

- (b) Dummy activity is a hypothetical activity which consumes no resource or time. It is represented by dotted lines and is inserted in the network to clarify an activity pattern under the following situations.
- To make activities with common starting and finishing events distinguishable.
 - To identify and maintain the proper precedence relationship between activities that are not connected by events.
 - To bring all "loose ends" to a single initial and single terminal event.



Dummy (2) – (3) is used to convey that can start only after events numbered (2) and (3) are over:

- (c) The Monte Carlo Simulation:

It is the earliest mathematical Model of real situations in inventory control:

Steps involved in carrying out Monte Carlo simulation are:

- ◆ Define the problem and select the measure of effectiveness of the problem that might be inventory shortages per period.
- ◆ Identify the variables which influence the measure of effectiveness significantly for example, number of units in inventory.
- ◆ Determine the proper cumulative probability distribution of each variable selected with the probability on vertical axis and the values of variables on horizontal axis.
- ◆ Get a set of random numbers.
- ◆ Consider each random number as a decimal value of the cumulative probability distribution with the decimal enter the cumulative distribution plot from the vertical axis. Project this point horizontally, until it intersects cumulative probability distribution curve. Then project the point of intersection down into the vertical axis.
- ◆ Then record the value generated into the formula derived from the chosen measure

of effectiveness. Solve and record the value. This value is the measure of effectiveness for that simulated value. Repeat above steps until sample is large enough for the satisfaction of the decision maker.

Question 5

- (a) Transport Ltd. Provides tourist vehicles of 3 types – 20-seater vans, 8-seater big cars and 5-seater small cars. These seating capacities are excluding the drivers. The company has 4 vehicles of the 20-seater van type, 10 vehicles of the 8-seater big car types and 20 vehicles of the 5-seater small car types. These vehicles have to be used to transport employees of their client company from their residences to their offices and back. All the residences are in the same housing colony. The offices are at two different places, one is the Head Office and the other is the Branch. Each vehicle plies only one round trip per day, if residence to office in the morning and office to residence in the evening. Each day, 180 officials need to be transported in Route I (from residence to Head Office and back) and 40 officials need to be transported in Route II (from Residence to Branch office and back). The cost per round trip for each type of vehicle along each route is given below.

You are required to formulate the information as a linear programming problem, with the objective of minimising the total cost of hiring vehicles for the client company, subject to the constraints mentioned above. (only formulation is required. Solution is not needed).

	Figs. – Rs. /round trip		
	20-seater vans	8-seater big cars	5-seater small cars
Route I —			
Residence — Head Office and Back	600	400	300
Route II —			
Residence — Branch Office and Back	500	300	200

- (b) Explain the concept and aim of theory of constraints. What are the key measures of theory of constraints?
- (c) What are the major areas of decision-making in which differential costing is used?

(8 + 7 + 4 = 19 Marks)

Answer

(a) Type	I	II	III	Total no. of passengers
	20 – Seater vans	8 – Seater Big cars	5 – Seater Small cars	
Route I Residence H.O.	600	400	300	180
Residence				

Route II Residence	500	300	200	40
Br. Residence				
No. of vehicles	4	10	20	
Max. capacity	80	80	100	220
No. of passengers			260	

Let i be the i th route,

and j be the type of vehicle, so that

S_{11} = no. of vans (vehicles on Route I, Type I)

S_{12} = no. of 8 seater cars on Route I

S_{13} = no. of 5 seater cars on Route I

S_{21} = no. of vans — on Route II

S_{22} = no. of 8 seater cars on Route II

S_{23} = no. of 5 seater cars on Route II

Objective:

Minimise

$$\text{Cost } Z = 600 S_{11} + 400 S_{12} + 300 S_{13} + 500 S_{21} + 300 S_{22} + 200 S_{23}$$

Subject to

$$20 S_{11} + 8 S_{12} + 5 S_{13} = 180$$

$$20 S_{21} + 8 S_{22} + 5 S_{23} = 40$$

$$S_{11} + S_{21} \leq 4$$

$$S_{21} + S_{22} \leq 10$$

$$S_{31} + S_{32} \leq 20$$

$$\text{All } s_{ij} \geq 0$$

- (b) The theory of constraints focuses its attention on constraints and bottlenecks within organisation which hinder speedy production. The main concept is to maximize the rate of manufacturing output is the throughput of the organisation. This requires to examine the bottlenecks and constraints. A bottleneck is an activity within the organization where the demand for that resource is more than its capacity to supply.

A constraint is a situational factor which makes the achievement of objectives / throughput more difficult than it would otherwise, for example of constraint may be lack of skilled labour, lack of customer orders, or the need to achieve high quality in product output.

For example let meeting the customers' delivery schedule be a major constraint in an organisation. The bottleneck may be a certain machine in the factory. Thus bottlenecks and constraints are closely examined to increase throughput.

Key measures of theory of constraints:

- (i) **Throughput contribution:** It is the rate at which the system generates profits through sales. It is defined as, sales less completely variable cost, sales – direct are excluded. Labour costs tend to be partially fixed and conferred are excluded normally.
 - (ii) **Investments:** This is the sum of material costs of direct materials, inventory, WIP, finished goods inventory, R & D costs and costs of equipment and buildings.
 - (iii) **Other operating costs:** This equals all operating costs (other than direct materials) incurred to earn throughput contribution. Other operating costs include salaries and wages, rent, utilities and depreciation.
- (c) Differential costing can be used for all short, medium and long term decisions. When two levels of activities are being considered, or while choosing between competing alternatives differential cost analysis is essential. The differential cost is useful for decision making in the following areas:
- ◆ Capital expenditure decisions
 - ◆ Make or buy decision
 - ◆ Production planning
 - ◆ Sales mix decision
 - ◆ Production or product decision
 - ◆ Change in level or nature of an activity.

Question 6

- (a) Goods manufactured at 3 plants, A, B and C are required to be transported to sales outlets X, Y and Z. The unit costs of transporting the goods from the plants to the outlets

are given below:

	Plants	A	B	C	Total Demand
Sales outlets					
X		3	9	6	20
Y		4	4	6	40
Z		8	3	5	60
Total supply		40	50	30	120

You are required to:

- (i) Compute the initial allocation by North-West Corner Rule.

- (ii) Compute the initial allocation by Vogel's approximation method and check whether it is optional.
- (iii) State your analysis on the optionality of allocation under North-West corner Rule and Vogel's Approximation method.
- (b) Kangan Resorts operates a lodging house with attached facilities of a shopping arcade and restaurant on a National Highway. The following details are available:
- (i) The lodging house has 40 twin-bedded rooms, which are to be rented for Rs. 200 per night on double occupancy basis. The occupancy ratio is expected at 85% and always both the beds in the room will be occupied. The lodging facilities are operated, for 200 days in the year during foreign tourists season time only.
- (ii) As per past record the spending pattern of each tourist staying in the lodge will be as under:
Rs. 50 per day in the shopping arcade and Rs. 80 per day in the restaurant.
- (iii) Ratios of variable cost to respective sales volume are:
Shops Restaurant
50% 60%
- (iv) For the lodging house the variable cost on house-keeping and electricity will amount Rs. 30 per day per occupied room.
- (v) Annual fixed overhead for the entire complex is estimated at Rs. 10,00,000.
- Required:
- (i) Prepare an income statement for the next year.
- (ii) The Lodging House Manager suggests a proposal of reducing room rent to Rs. 150 per day on double occupancy basis, which will increase occupancy level to 95%. Should the proposal be accepted or not?

What do you mean by a flexible budget? Give an example of an industry where this type of budget is typically needed? (10 + 7 + 2 = 19 Marks)

Answer

(a)

	20	—	—	20
3		9	6	
	20	20	—	40
4		4	6	
	—	30	30	60
8		3	5	
	40	50	30	120

(i) Initial allocation under NW corner rule is as above.

$$\begin{array}{rcl}
 \text{Initial cost : } 20 \times 3 & = & 60 \\
 & 20 \times 4 & = 80 \\
 & 20 \times 4 & = 80 \\
 & 30 \times 3 & = 90 \\
 & 30 \times 5 & = \underline{150} \\
 & & \underline{460}
 \end{array}$$

(ii) Initial solution by VAM:

3	20	—	—	20	3		
9		6		40	0	0	2
4	20	—	20	60	2	2	2
4		4	6				
8		50	10				
	3	5					
40	50	30					
1	1	1					
4	1	1					
	1	1					

$$\begin{array}{rcl}
 \text{Initial solution: } 20 \times 3 & = & 60 \\
 & 20 \times 4 & = 80 \\
 & 50 \times 3 & = 150 \\
 & 20 \times 6 & = 120 \\
 & 10 \times 5 & = \underline{100} \\
 & & \underline{460}
 \end{array}$$

Checking for optimality

3			$u_1 = 0$
4		6	$u_2 = 1$
	3	5	$u_3 = 0$
$v_1 = 3$	$v_2 = 3$	$v_3 = 5$	

$u_i + v_j$

	3	5	0
	4		1
3			0
3	3	5	

$$\Delta_{ij} = c_{ij} - (u_i + v_j)$$

	6	1
	0	
5		

$$\Delta_{ij} \geq 0 \quad \therefore \text{Solution is optimal}$$

Conclusion:

The solution under VAM is optimal with a zero in R_2C_2 which means that the cell C_2R_2 which means that the cell C_2R_2 can come into solution, which will be another optimal solution. Under NWC rule the initial allocation had C_2R_2 and the total cost was the same Rs. 460 as the total cost under optimal VAM solution. Thus, in this problem, both methods have yielded the optimal solution under the 1st allocation. If we do an optimality test for the solution, we will get a zero for Δ_{ij} in C_3R_2 indicating the other optimal solution which was obtained under VAM.

(b) (i) Income Statement of Kangan Resort for the next year

	Rs.
Sales Revenue	
Lodging house room receipts (40 Rooms $\times$ 200 days $\times$ Rs. 200 $\times$ 85%)	13,60,000
Shopping Arcade (40 Rooms $\times$ 2 persons $\times$ 200 days $\times$ Rs. 50 $\times$ 85%)	6,80,000
Restaurant (40 Rooms $\times$ 2 persons $\times$ 200 days) $\times$ Rs. 80 $\times$ 85%)	<u>10,88,000</u>
Total Sales Revenue	<u>31,28,000</u>
Variable Cost	
Lodging house rooms (40 Rooms $\times$ 200 days $\times$ Rs. 30 $\times$ 85%)	2,04,000
Shopping Arcade (50% of Rs. 6,80,000)	3,40,000
Restaurant (60% of Rs. 10,88,000)	<u>6,52,800</u>
Total Variable Cost	<u>11,96,800</u>

Contribution (Total Sales Revenue – Total Variable Cost)	19,31,200
Less: Fixed Cost	<u>10,00,000</u>
Profit (Estimated)	<u>9,31,200</u>

(ii) Income Statement on the basis of reduced room rent

	Rs.
Sales Revenue	
Lodging house room receipts (40 Rooms × 200 days × Rs. 150 × 95%)	11,40,000
Shopping Arcade (40 Rooms × 2 persons × 200 days × Rs. 50 × 95%)	7,60,000
Restaurant (40 Rooms × 2 persons × 200 days × Rs. 80 × 95%)	<u>12,16,000</u>
Total Revenue	<u>31,16,000</u>
Less: Variable Cost	
Lodging house rooms (40 Rooms × 200 days × Rs. 300 × 95%)	2,28,000
Shopping Arcade (50% of Rs. 7,60,000)	3,80,000
Restaurant (60% of Rs. 12,16,000)	<u>7,29,600</u>
Total Variable Cost	<u>13,37,600</u>
Contribution	17,78,400
Less: Fixed Cost	<u>10,00,000</u>
Profit	<u>7,78,400</u>

The profitability decreases by $9,31,200 - 7,78,400 = \text{Rs. } 1,52,800$.

Hence reducing room rent proposal may not be accepted.

- (c) A flexible budget is a budget which, by recognizing the difference between fixed, semi-variable and variable costs, is designed to change in relation to the level of activity attained.

E.g. seasonal products – e.g. soft drink industry

industries in make to order business like ship building

industries influenced by change in fashion.

Industries which keep on introducing new products / new designs.

Alternative Solution (6b):

Occupancy ratio 85%

Lodging facilities for 200 days

40 twin bedded rooms – Rs. 200 per night

Shopping Arcade = Rs. 50 per day.

Restaurant = Rs. 80 per day.

Annual Fixed Overhead Rs. 10,00,000.

	Lodging House 30/days/ occupied/room	Shopping Arcade Variable Cost 50%	Restaurant 60%	
Revenue 40 rooms × 200 days × 85% × 200 Rs. / person × 2 persons / room				
Days:	170	170	170	
No. of persons: 2 × 170 × 40:	13,600			
Revenue / person	100	50	80	
Revenue	1,360	680	1,088	in '000
Variable Cost 30 × 170 × 40	<u>204</u>	<u>340</u>	<u>652.80</u>	
Contribution	1,156	340	435.20	
Contribution	19,31,200			
Fixed Cost	10,00,000			
Profit	9,31,200			
Room Days: 95% × 40 × 200 = 7,600				
Person days	15,200			
Rev. 150/2 × 15,200	1,140	760	1,216	
Cost: 30/days :	<u>228</u>	<u>380</u>	<u>729.6</u>	
	<u>912</u>	<u>380</u>	<u>486.4</u>	
				1,778.40

No, do not accept the proposal as there is decrease in profit by Rs 1,52,800.

PAPER – 6 : MANAGEMENT INFORMATION AND CONTROL SYSTEMS

Question No. 1 is compulsory.

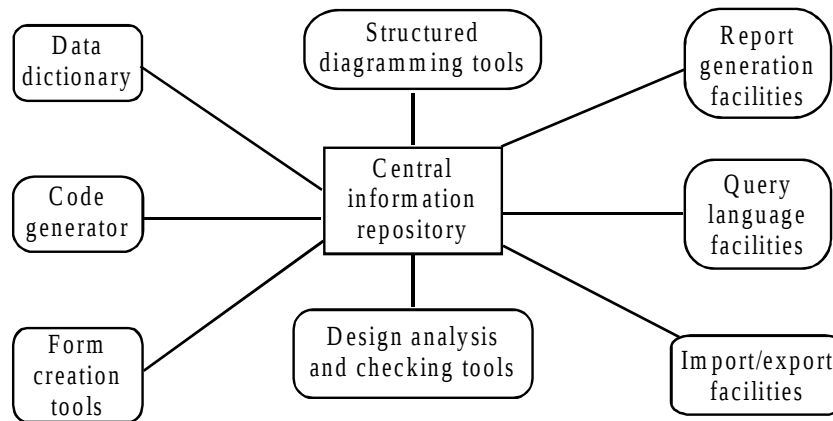
Answer any four questions from remaining six questions.

Question 1

- (a) Discuss various factors that render manual audit method ineffective in Information System audit.
- (b) Briefly explain the components of an analysis and design work bench.
- (c) Briefly discuss any five database control features.
- (d) Discuss briefly the powers of Central Government under Section 87 to make rules in respect of Information Technology Act, 2000. (5 + 5 + 5 + 5 = 20 Marks)

Answer

- (a) The audit methods that are effective for manual audits prove ineffective in many IS audits because of following factors.
 - (i) Electronic evidence: Essential evidence is not physically retrievable by most auditors and it is not readable in its original electronic form.
 - (ii) Terminology: The tools and techniques used in automated applications are described in terms that are difficult for the non-EDP auditors to understand.
 - (iii) Automated processes: The methods of processing are automated rather than manual, making it difficult for the non-EDP auditors to comprehend processing concepts and the logic of these concepts.
 - (iv) New risks and controls: Threats to computer systems and the counter measures to those threats are new to non-EDP auditors, and the magnitude of the risks and the effectiveness of the controls are not understood.
 - (v) Reliance on controls: In manual systems, the auditor can place some reliance on hard-copy evidence, regardless of the adequacy of the controls. Whereas, in automated systems, the electronic evidence is only as valid as the adequacy of controls.
- (b) Analysis and design work benches are designed to support the analysis and design stages of the software process where models of the system are created. A typical model is shown in the figure below:



The components of this model are:

- (i) Diagram editors to create data flow diagrams, structured charts, entity relationship diagram and so on.
 - (ii) Design analysis and checking tools which process the design and then submit report on errors and anomalies. These are integrated with editing system so that user errors are trapped at an early stage in the process.
 - (iii) Repository query languages which allow the designer to find the designs and associate design information in the repository.
 - (iv) A data dictionary which maintains precise and unambiguous information about all data elements used in a system design.
 - (v) Report definition and generation tools which take information from the central store and automatically generate system documentation.
 - (vi) Forms definition tools which allow screen and document formats to be specified.
 - (vii) Import-export facilities which allow the interchange of information from the central repository with other development tools.
 - (viii) Code generators which generate code or code skeletons automatically from the design captured in the central store.
- (c) Database control features include the following:
- (i) User View: The user view or subschema is a subset of the total database that defines the user's data domain and provides access to the database. Access privileges to the data, as defined in their views, should be commensurate with the users' legitimate needs. Several users may share a single user view but have different authority levels. Effective access control requires additional security measures.

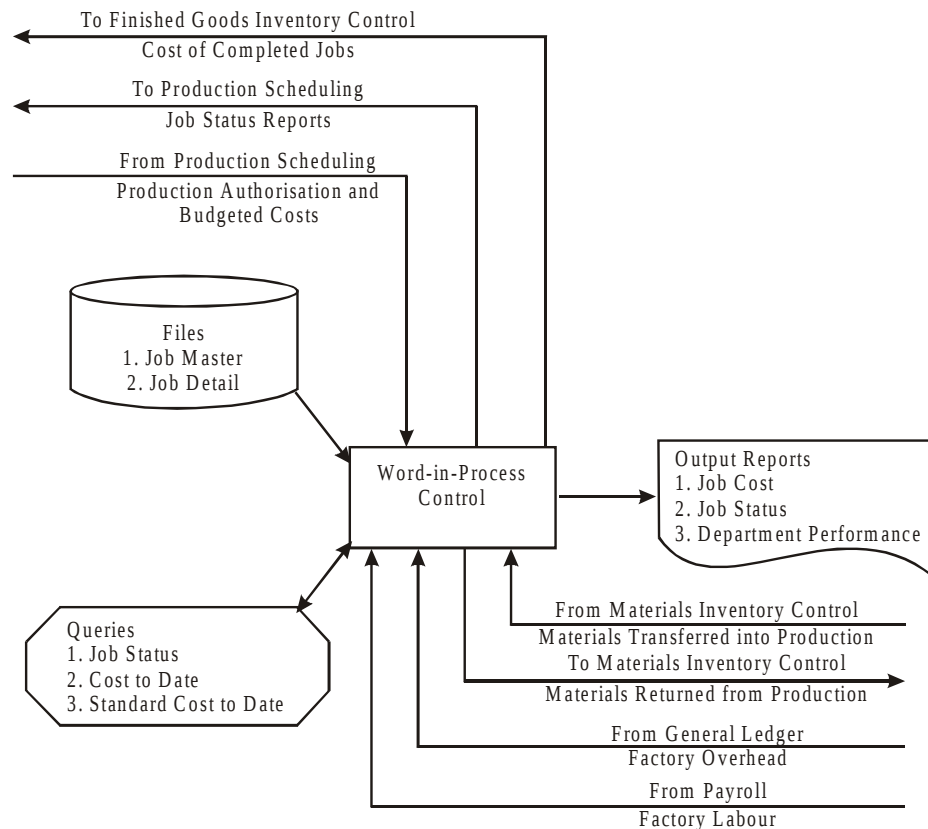
- (ii) Database Authorisation Table: The database authorization table contains rules that limit the actions that a user can take. This technique is similar to the access control list used in the operating system. Each user is granted certain privileges that are coded in the authority table, which is used to verify the user's action requests.
 - (iii) User-Defined Procedures: A user defined procedure allows the user to create a personal security program or routine to provide more positive user identification than a single password can.
 - (iv) Data Encryption: Many database systems use encryption procedures to protect highly sensitive data like password files, certain financial data, product formulae etc. Data encryption uses an algorithm to scramble selected data, thus making it unreadable to an intruder "browsing" the database. Encryption is used for protecting data that are transmitted across networks.
 - (v) Biometric Devices: User authentication procedures use biometric devices, which measure various personal characteristics, such as fingerprints, voice prints, retina prints, or signature characteristics. These user characteristics are digitized and stored permanently in a database security file or on an identification card that the user carries. When an individual attempts to access the database, a special scanning device captures his or her biometric characteristics, which is compared with the profile data stored internally or on the ID card. If the data do not match, access is denied.
- (d) Section 87 of the Act confers on the Central Government the power to make rules. These are:
- (1) The manner in which any matter may be authenticated by a digital signature.
 - (2) The manner and format in which electronic records shall be filed or issued.
 - (3) The type of digital signature, manner and format in which it may be affixed.
 - (4) The security procedure for the purpose of creating same electronic record and secure digital signature.
 - (5) The qualifications, experience and terms and conditions of service of Controller, Deputy Controllers and Assistant Controllers.
 - (6) The requirements, manner and form in which application is to be made for a license to issue Digital Signature Certificates.
 - (7) The period of validity of the license.
 - (8) The qualification, experience of an adjudicating Officer, as well as other officers.
 - (9) The salary, allowances and terms and conditions of service of the Presiding Officer, etc.

Question 2

- (a) What is work-in-process control system? Describe briefly the system interfaces, files and inputs, and reports involved in this system.
- (b) Describe the main prerequisites of a MIS which makes it an effective tool. Explain the major constraints in operating it .(10 + 10 = 20 Marks)

Answer

- (a) The work-in-process control system assigns materials, labour and overhead costs to production jobs or products. In a job order system, each cost is assigned to a specific job. In a process costing system, costs are assigned to departments and then to products. The objectives of a work-in-progress system are to cost jobs through the manufacturing process and provide management with information to assist in controlling cost and measuring the performance of departments or other units within the factory. Therefore, to function properly, the system needs information concerning materials requisitioned for each job, labour employed on each job, overhead costs allocated to each job and the production status of each job. The figure given below depicts the flow of information to and from the job-order control system:



System Interfaces

The work-in-process control system interfaces directly with the payroll, general ledger, finished goods inventory control, production scheduling and materials inventory control systems. Labour cost distribution and factory overhead allocation are inputs from pay-roll and the general ledger systems respectively. Aggregate work-in-process inventory transferred to finished goods is sent from work-in-process control to the general ledger. Once manufacturing is complete, jobs are transferred from work-in-process control to finished goods inventory control.

Authorization to start production along with a bill of materials, specifications, production schedule, and budgeted standard costs are transferred from the production scheduling system. Job status reports are available to this system. Direct and indirect materials are requisitioned from the materials inventory control system.

Files and Inputs

A typical work-in-process system in a manufacturing firm contains a job file that has one record for each job in the manufacturing process. The record contains information regarding job identification number, customer identification, promised completion date, estimated shipping date, promised shipping date, total estimated material cost, total standard labour cost and total standard overhead cost etc.

The job detail file contains in-depth information about each job. When authorization to start a job is received from production scheduling, a record is created for the job. A bill of materials, a machine schedule and a labour schedule are entered into the file.

Reports

The work-in-process control system produces job cost, job status and department performance reports periodically. A job cost report contains a detailed summary of the costs incurred to date, the budgeted cost, and estimated completion dates for each job in this system. Reports are helpful in saving time because we get all the information in summarized form.

(b) The main pre-requisites of an effective MIS are as follows:

- (i) Database: It can be defined as a "superfile" which consolidates data records formerly stored in many data files. The data in a database is organized in such a way that access to the data is improved and redundancy is reduced. The characteristics of database are:
 - ◆ The database is sub-divided into major information subsets needed to run a business wherein each subsystem utilizes same data and information kept in same file to satisfy its information needs.
 - ◆ It is user-oriented.
 - ◆ It is capable of being used as a common data source, to various users, helps in avoiding duplication of efforts in storage and retrieval of data and information.

- ◆ It is available to authorized persons only.
 - ◆ It is controlled by a separate authority established for the purpose, known as Data Base Management System (DBMS).
 - ◆ The maintenance of data in database requires computer hardware, software and experienced computer professionals.
- (ii) Qualified system and management staff: The second pre-requisite is that it should be manned by qualified officers. For this, the organisational management base should comprise of two categories of officers.
- ◆ Systems and Computer experts: They, in addition to their expertise in their subject area should be capable of understanding management concepts to facilitate the understanding of problems faced by the concern. They should also be clear about the process of decision making and information requirements for planning and control functions.
 - ◆ Management experts: They should understand quite clearly the concepts and operations of a computer.
- (iii) Support of Top Management: The management information system to be effective, should receive the full support of the top management. The reasons for this are as follows:
- ◆ Subordinate managers are usually lethargic about activities which do not receive the support of their superiors.
 - ◆ The resources involved in computer-based information systems are large and are growing larger in view of importance gained by management information system.
- Their whole hearted support and cooperation will help in making MIS an effective one.
- (iv) Control and Maintenance of MIS: Control of the MIS means the operation of the system as it was designed to operate. Sometimes users develop their own procedures or short cut methods to use the system, which reduce its effectiveness. To check such habits of users, the management at each level in the organization should device checks for the information system control. At times, there may be the need for improvements to the system. Formal method and documenting always must be provided. Maintenance is closely related to control.
- (v) Evaluation of MIS: The evaluation of MIS should take into account the following points:
- ◆ Examining whether enough flexibility exists in the system, to cope with any expected or unexpected information requirement in future.
 - ◆ Ascertaining the views of users and the designers about the capabilities and deficiencies of the system.

- ◆ Guiding the appropriate authority about the steps to be taken to maintain effectiveness of MIS.

Constraints in operating MIS

Major constraints which come in the way of operating an information system are:

- (1) Non-availability of experts, who can diagnose the objectives of the organization and provide a desired direction for installing an operating system.
- (2) Experts usually face the problem of selecting the sub-system of MIS to be installed and operated upon.
- (3) Due to varied objectives of business concerns, the approach adopted by experts for designing and implementing MIS is a non-standardised one.
- (4) Non-availability of cooperation from staff in fact is a crucial problem. It should be handled tactfully. Educating the staff by organizing lectures, showing films, training on system and utility of the system may solve this problem.
- (5) There is high turnover of experts in MIS. Turnover in fact arises due to several factors like pay packet, promotion chances, future prospects, behaviour of top ranking managers etc.
- (6) Difficulty in quantifying the benefits of MIS, so that it is easily comparable with cost.

Question 3

- (a) Discuss in detail, how the investigation of present system is conducted by the system analyst.
- (b) Briefly explain various kinds of controls that can be incorporated in the system to make frauds difficult to perpetrate. (10 + 10 = 20 Marks)

Answer

- (a) Detailed investigation of the present system involves collecting, organizing and evaluating facts about the system and the environment in which it operates. Survey of existing methods, procedures, data flow, output, files, input and internal controls should be intensive in order to fully understand the present system and its related problems.

The following areas should be studied in depth:

- (1) Review historical aspects: A brief history of the organization is a logical starting point for an analysis of the present system. The historical facts should identify the major turning points and milestones that have influenced its growth. A review of annual reports provides historical perspective. Organisation chart can identify the growth of management levels as well as the development of various functional areas and departments. The system analyst should investigate what system changes have occurred in the past.
- (2) Analyse inputs: A detailed analysis of present inputs is important since they are basic to the manipulation of data. Source documents are used to capture the

originating data for any type of system. The system analyst should be aware of the various sources from where the data are initially captured. The system analyst must understand the nature of each form, what is contained in it, who prepared it, from where the form is initiated, where it is completed, the distribution of the form and other similar considerations.

- (3) Review data files maintained: The analyst should investigate the data files maintained by each department, noting their number and size, where they are located, who uses them and the number of times per given time interval these are used. The system analyst should also review all on-line and off-line files which are maintained in the organization as it will reveal information about data that are not contained in any outputs.
- (4) Review methods, procedures and data communications: A procedure review is an intensive survey of the methods by which each job is accomplished, the equipment utilized and the actual location of the operations. Its basic objective is to eliminate unnecessary tasks or to perceive improvement opportunities in the present information system. He must review the types of data communication equipments including data interface, data links, modems, dial-up and leased lines and multiplexers. The system analyst must understand how the data communication network is used in the present system so as to identify the need to revamp the network when the new system is installed.
- (5) Analyse outputs: The outputs or reports should be scrutinized carefully by the system analysts in order to determine how well they meet the organization's needs. The analysts must understand what information is needed and why, who needs it and when and where it is needed. Additional questions concerning the sequence of the data, how often the form reporting it is used, how long it is kept on file, etc., must be investigated.
- (6) Review internal controls: Locating the control points helps the analyst to visualize the essential parts and framework of a system. An examination of the present system of internal controls may indicate weaknesses that should be removed in the new system.
- (7) Model the existing physical system and logical system: The logical flow of the present information system may be depicted with the help of system flow charts. The physical-flow of the existing system may be shown by employing data flow diagrams. The data elements needed in the new system will be found in the present system only.
- (8) Undertake overall analysis of present system: The final phase of the detailed investigation includes the analysis of:
 - (a) the present work volume
 - (b) the current personnel requirements
 - (a) the present benefits and costs.

- (b) One way to deter fraud is to design a system with sufficient controls to make fraud difficult to perpetrate. These controls help to ensure the accuracy, integrity and safety of system resources.
- (i) **Develop a strong system of Internal Controls:** The overall responsibility for a secure and adequately controlled system lies with top management. Managers typically delegate the design of adequate control systems to systems analysts, designers, and end users. The corporate information security officer and the operations staff are typically responsible for ensuring that control procedures are followed.
 - (ii) **Segregate Duties:** There must be an adequate segregation of duties to prevent individuals from stealing assets and covering up their tracks.
 - (iii) **Require vacations and Rotate Duties:** Many fraud schemes, such as lapping and kiting, require the ongoing attention of the perpetrator. If mandatory vacations were coupled with a temporary rotation of duties, such ongoing fraud schemes would fall apart.
 - (iv) **Restrict Access to Computer Equipment and Data Files:** Computer frauds can be reduced significantly if access to computer equipment and data files is restricted. Physical access to computer equipment should be restricted, and legitimate users should be authenticated before they are allowed to use the system.
 - (v) **Encrypt Data and Programs:** Another way to protect data is to translate it into a secret code, thereby making it meaningless to anyone without the means to decipher it.
 - (vi) **Protect Telephone Lines:** Computer hackers use telephone lines to transmit viruses and to access, steal, and destroy data. One effective method to protect telephone lines is to attach an electronic lock and key to them.
 - (vii) **Protect the System from Viruses:** There are hundreds of thousands of virus attacks every year, and estimated 90% of the PCs that suffer a virus attack are re-infected within 30 days by the same virus or some other virus. A system can be protected from viruses by ensuring that the latest versions of the anti-virus programs are used.
 - (viii) **Control Sensitive Data:** Controls can be placed over data files to prevent or discourage copying. Employees should be informed of the consequences of using illegal copies of software, and the company should institute controls to see that illegal copies are not in use. Backup tapes, and system documentation should be locked up. Servers and PCs should also be locked when not in use. Companies should never store all of their data in one place or give an employee access to all of it. Closed-circuit televisions can be used to monitor areas where sensitive data or easily stolen assets are handled.
 - (ix) **Control Laptop Computers:** To control laptops, companies should take following measures:

- ◆ Establish laptop security policies to require employees to back up data before travelling and to a separate source when on the road, and to never leave a laptop unattended.
- ◆ Install software that makes it impossible for the computer to boot up without a password.
- ◆ Password protect and encrypt data on the hard disk so that if a laptop is stolen, the data cannot be used.
- ◆ Employees should be asked to store confidential data on a disk, rather than the hard drive, and always keep the diskette in their possession.

Question 4

- (a) Briefly explain the characteristics and features of an Enterprise Resource Planning.
- (b) Briefly discuss four basic components of Decision Support System.
- (c) Define the following computer fraud and abuse technique:
 - (i) War dialing
 - (ii) Scavenging
 - (iii) Cracking
 - (iv) Internet terrorism
 - (v) Masquerading. (5 + 5 + 10 = 20 Marks)

Answer

- (a) Characteristics of ERP are briefly explained below:
 - (i) Flexibility: An ERP system should be flexible to respond to the changing needs of an enterprise. The client-serves technology enables ERP to run across various database backend through Open Database Connectivity (ODBC).
 - (ii) Modular and Open: EPR system has to have open system architecture. This means that any module can be interfaced or detached whenever required without affecting the other modules. It should support multiple hardware platforms for the companies having heterogeneous collection of systems. It must support some third party add-ons also.
 - (iii) Comprehensive: It should be able to support variety of organizational functions and must be suitable for a wide range of business organizations.
 - (iv) Beyond the Company: It should not be confined to the organizational boundaries, rather it should support the on-line connectivity to the other business entities of the organization.
 - (v) Best Business Practices: It must have a collection of the best business processes applicable worldwide. An ERP package imposes its own logic on a company's strategy, culture and organization.

Some of the major features of ERP are:

- ◆ ERP provides multi-platform, multi-facility, multi-mode manufacturing, multi-currency, multi-lingual facilities.
- ◆ It supports strategic and business planning activities, operational planning and execution activities, creation of Materials and Resources.
- ◆ It has end-to-end supply Chain Management to optimize the overall Demand and Supply Data.
- ◆ ERP facilitates company-wide Integrated Information system covering all functional areas like manufacturing, selling and distribution, payables, receivables, inventory accounts, human resources, purchases etc.
- ◆ ERP performs core activities and increases customer service, thereby augmenting the corporate image.
- ◆ ERP bridges the information gap across organizations.
- ◆ ERP provides complete integration of systems not only across departments but also across companies under the same management.
- ◆ ERP is the solution for better project management.
- ◆ ERP allows automatic introduction of the latest technologies like Electronic Fund Transfer (EFT), Electronic Data Interchange (EDI), Internet, Intranet, Video conferencing and E-Commerce etc.
- ◆ ERP eliminates most business problems like material shortages, productivity enhancements, customer service, cash management, inventory problems, quality problems, prompt delivery etc.
- ◆ ERP provides intelligent business tools like Decision Support System (DSS), Executive Information System (EIS), Data mining and easy working systems to enable better decisions.

(b) A decision support system has the following components:

- (i) The User: The user of a decision support system is usually a manager with an unstructured or semi-structured problem to solve. Users do not need a computer background to use a decision support system for problem solving. The most important knowledge is a thorough understanding of the problem and the factors to be considered in finding a solution. A user does not need extensive education in computer programming in part because a special planning language performs the communication function within the decision support system.
- (ii) One or more databases: Decision support systems include one or more databases which contain both routine and non-routine data from both internal and external sources. The data from external sources include data about the operating environment surrounding an organization. Decision support system users may

construct additional database themselves. Some of the data may come from internal source.

- (iii) A planning language: Two types of planning languages that are commonly used in decision support system are (1) general purpose planning languages and (2) special purpose planning languages. General purpose planning languages allow users to perform many routine tasks like-retrieving various data from a database or performing statistical analysis. The languages in most electronic spreadsheets are good example of general purpose planning languages. These languages enable the user to tackle a broad range of budgeting, forecasting and other worksheet oriented problems. Special purpose planning languages are more limited. Some statistical languages, such as SAS, SPSS and Minitab are examples of special purpose planning languages.
- (iv) Model Base: The model base is the "brain" of the decision support system because it performs data manipulation and computations with the data provided to it by the user and the database. There are many types of model bases but most of them are custom-developed models that do some type of mathematical functions. The analysis provided by the routine in the model base is the key to supporting the user's decision.
- (c) (i) War dialing: It relates to programming a computer search for an idle modem by dialing thousands of phone lines. Perpetrator enters the system through idle modem, captures the personal computer attached to the modem, and gain access to the network to which the personal computer is attached.
- (ii) Scavenging: Gaining access to confidential information by searching corporate records is termed as scavenging. Scavenging methods range from searching for printouts or carbon copies of confidential information to scanning the contents of computer memory.
- (iii) Cracking: Unauthorized access to and use of computer systems, usually by means of a personal computer and a telecommunications network is called cracking. Crackers are hackers with malicious intentions.
- (iv) Internet terrorism: Using internet to disrupt electronic commerce and to destroy company and individual communications is referred as internet terrorism.
- (v) Masquerading: Under this technique, perpetrator gains access to the system by pretending to be an authorized user and enjoys same privileges as the legitimate user. Fraud messages can be sent to the receiver by using legitimate users identity and thus can prove to be harmful.

Question 5

- (a) Discuss various issues that should be considered while designing system input.
- (b) Briefly explain the risks associated with client / server model.
- (c) "Personnel information system deals with flow of information relating to people." Explain.

- (d) Briefly describe various steps involved in system testing. (5 + 5 + 5 + 5 = 20 Marks)

Answer

- (a) Various issues involved in designing systems input are discussed below:
- (i) Content: The analyst is required to consider the types of data that are needed to be gathered to generate the desired user outputs. Sometimes, the data needed for a new system are not available within the organization. Hence, the system designer has to prepare new documents for collecting such information.
 - (ii) Timeliness: In data processing, it is very important that data is inputted to computer in time because output cannot be produced until certain inputs are available. Hence, a plan must be established regarding when different types of inputs will enter the system. In transaction data processing, the people requiring output are not the same who input most of the data. Hence, timeliness of input becomes more relevant for such systems.
 - (iii) Media: Input consideration includes the choice of input media and subsequently the devices on which to enter the data. Various user input alternatives available in the market include display workstations, magnetic tapes, magnetic disks, key-boards, optical character recognition, pen-based computers and voice input etc. A suitable medium may be selected depending on the application to be computerized.
 - (iv) Format: While specifying the record formats, the type and length of each data field as well as any other special characteristics must be defined. Designing input formats in mainframe and mini computer database environments often require the assistance of a professional programmer or database administrator. Format is different for different type of operating system.
 - (v) Input volume: Input volume refers to the amount of data that has to be entered in the computer system at any one time.
- (b) The four categories of risks associated with client / server model are briefly discussed below:
- (i) Technological Risks: The technological risk is quite simple. The first risk is – Will the new system work? But more important is the risk that in the long run the system may become obsolete. To resolve this issue, the firm and the IT consultant / division should understand system standards and market trends and use them in their decision making processes while deciding what system to incorporate into their organization.
 - (ii) Operational Risk: These risks parallel the technological risks in both the short and long run. Respectively, they are – Will you achieve the performance you need from the new technology and will the software that you chose be able to grow or adapt to the changing needs of the business.
 - (iii) Economic Risk: In the short run, firms are susceptible to hidden costs associated with the initial implementation of new client / server system. Cost will rise in the

short term since one needs to maintain the old system (mainframe) and the new client server architecture development. In the long run, the concern centres around the support costs of the new system.

- (iv) Political Risks: Finally, political (people) risks involved in this transition are addressed. Here, the short-term question is – will end users and management be satisfied? The answer to this is definitely not if the system is difficult to use or is plagued with problems.
- (c) Personnel Information system deals with the flow of information relating to people working in the organization and future personnel needs. It is concerned with six basic sub-systems of the personnel functions as discussed below:
 - (1) Recruitment: Properly managed recruitment sub-system may forecast personnel needs and skills required for recruiting personnel at the proper time to meet organizational manpower needs.
 - (2) Placement: This sub-system is concerned with the task of matching the available persons with the requirements. A good placement sub-system makes use of latest behavioural tools and techniques.
 - (3) Training and Development: As technological changes and demands for new skills accelerate, many companies find that they must develop much of their requirements from internal sources. In addition, a large part of the work force must constantly be updated in new techniques and developments.
 - (4) Compensation: This sub-system is concerned with the task of determining pay and other benefits for the workers of the concern. It makes use of traditional payroll and other financial records, government reports and unions expectation before arriving at the final figure of pay and other benefits for each category of workers.
 - (5) Maintenance: This sub-system is designed to ensure that personnel policies and procedures are achieved. It may be extended to the operation of systems control, work standards which are required to measure performance against financial plans or other programs and the many subsidiary records normally associated with the collection, maintenance and discrimination of personnel data.
 - (6) Health and Safety: This sub-system is concerned with the health of personnel and the safety of jobs in the organization.
- (d) Steps involved in system testing: System level testing must be conducted prior to installation of an information system. It involves (a) preparation of realistic test data in accordance with the system test plan, (b) processing the test data using the new equipment (c) thorough checking of the results in all system tests and (d) reviewing the results with future users, operators and support personnel. System level testing is an excellent time for training employees in the preparation of the IS as well as maintaining it. One of the most effective ways to perform system-level testing is to perform parallel operations with the existing system. Parallel operations consist of feeding both systems the same input data and comparing data files and output results. Despite the fact that

the individual programs were tested, related conditions and combinations of conditions that have not envisioned are likely to occur. Last minute changes to computer programs are necessary to accommodate the new conditions.

One procedure for testing the new interactive system is to have several remote input terminals connected on line, which are operated by supervisory personnel backed up by other personnel operating in the old system. The outputs are checked for compatibility and appropriate corrections are made to the on-line computer programs. Once this segment of the new system has proved satisfactory, the entire terminal network can be placed into operation for this one work. Additional sections of the system can be added by testing in this manner until all programs are operational.

During parallel operations, the mistakes detected are often not those of the new system but of the old one. These differences should be reconciled as far as it is feasible economically.

Question 6

- (a) Briefly explain the best approach to implement information security policy?
- (b) What is the purpose of the system evaluation? How is it performed?
- (c) Discuss, how a controlled source program library environment can help to deter unauthorized changes to program.
- (d) Briefly explain the role of Information Security Administrator. (5 + 5 + 5 + 5 = 20 Marks)

Answer

- (a) To meet the security objective, develop and maintain adequate controls in compliance with generally accepted core principles, an ongoing and integrated approach is necessary. Executive management and especially chief executive officer support is essential for the successful development, design, implementation, and monitoring of security controls.
 - (i) Security Policies: Every organization should have a security policy that defines acceptable behaviours and the reaction of the organisation when such behaviours are violated.
 - (ii) Policy Development: The security objectives and core principles provide a framework for the first critical step for any organization developing a security policy. The security policy should support and complement existing organizational policies.
 - (iii) Roles and Responsibilities: For security to be effective, it is imperative that individual roles, responsibilities and authority are clearly communicated and understood by all.
 - (iv) Design: Once a policy has been approved by the governing body of the organization and related roles and responsibilities assigned, it is necessary to develop a security and control framework.

- (v) **Implementation:** Once the design of the security standards, measures, practices and procedures has been approved, the solution should be implemented on a timely basis, and then maintained.
 - (vi) **Monitoring:** Information systems are subject to a wide range of disruptive incidence. Hence, there is a need to institute monitoring measures and procedures over systems, processes and their environment to promptly identify, contain damage and expedite recovery.
 - (vii) **Awareness, Training and Education:** People are often the weakest link in securing information. Awareness of the need to protect information, training in the skills needed to operate them securely, and education in security measures and practices are of critical importance for the success of an organization's security program.
- (b) **System evaluation** provides the feedback necessary to assess the value of information and the performance of personnel and technology in the newly designed system. The feedback provides information regarding adjustments required in the Information system. There are two basic dimensions of information systems that should be evaluated. The first dimension is concerned with whether the newly developed system is operating properly. The other dimension is concerned with whether the user is satisfied with the information system with regard to the reports supplied by it.
- (1) **Development evaluation:** Evaluation of the development process is primarily concerned with whether the system was developed on schedule and within budget. It requires schedules and budgets to be established in advance and that records of actual performance and cost be maintained. Due to the uncertainty and mystique associated with system development, they are not subject to traditional management control procedures.
 - (2) **Operation evaluation:** The evaluation of the information system's operation pertains to whether the hardware, software and personnel are capable to perform their duties and they do actually perform them so. Operation evaluation answers such questions.
 - 1. Are all transactions processed on time?
 - 2. Are all values computed accurately?
 - 3. Is the system easy to work with and understand?
 - 4. Is terminal response time within acceptable limits?
 - 5. Are reports processed on time?
 - 6. Is there adequate storage capacity for data?
 - (3) **Information evaluation:** An information system should also be evaluated in terms of information it provides. Satisfaction can be used as a measure to evaluate the information provided by an information system. Measurement of user satisfaction can be accomplished using the interview and questionnaire technique. If

management is generally satisfied with an information system, it is assumed that the system is meeting the requirements of the organization. If management is not satisfied, modifications ranging from minor adjustments to complete redesign may be required.

- (c) A Controlled Source program library environment helps to deter unauthorized changes to program which are discussed below:

Password Control: One form of access control over the SPL (Source Program Library) is provided by assigning passwords. Every financially significant program stored in the SPL can be assigned a separate password.

Separation of Test Libraries: A strict separation is maintained between the production programs that are subject to maintenance in the SPL and those being developed. Production programs are copied into the programmer's library for maintenance and testing purposes only. Passwords for production programs can be changed regularly disclosed only on a need-to-know basis.

Audit trail and Management Report: Important feature of SPL Management software is the creation of reports that enhance management control and the audit function. Program modification reports, which describe in detail all program changes to each module are most useful. During an audit, these reports can be reconciled against program maintenance requests to verify that only the required changes were actually implemented. These reports can be produced as hard copy and also on disk.

Program Version Number: The SPLMS assigns a version number automatically to each program stored on the SPL. When programs are first placed in the libraries, they are assigned a version numbers of zero. With each modification to the program, the version number is increased by one. This feature, when combined with audit trail reports, provides evidence for identifying unauthorized changes to program modules.

Controlling Access to Maintenance Commands: Powerful maintenance commands are available for most library systems that can be used to alter or eliminate program passwords, alter the program version number and temporarily modify a program without generating a record of the modification. Access to the maintenance commands themselves should be password controlled and the authority to use them should be controlled by management or the security group.

Message sequence numbering: An intruder in the communications channel may attempt to delete a message from a stream of messages, change the order of messages received, or duplicate a message. A sequence numbers is inserted in each message and any such attempt will become apparent at the receiving end.

- (d) Role of an Information Security Administrator

An Information Security Administrator (ISA) is a person who is solely responsible for controlling and coordinating the activities pertaining to all security aspects of the

organization. The roles of an ISA are:

- ◆ A security administrator attempts to ensure that the facilities in which systems are developed, implemented, maintained and operated are safe from threats that affect the continuity of installation and or result in loss of security.
- ◆ The security administrator sets policy, subject to board approval.
- ◆ He also investigates, monitors, advise employees, counsels management on matters pertaining to security.
- ◆ He is responsible for establishing the minimal fixed requirements for classification of information based on the physical, procedural and logical security elements. He assigns responsibilities to job classifications and formulates what to be done in case of exceptions.
- ◆ The security administrator guides other information security administrators and users on the selection and application of security measures.
- ◆ Investigates all security violations.
- ◆ Advises senior management on matters of information resource control.
- ◆ Consults on matters of information security.
- ◆ A security administrator also has the responsibility of conducting a security program, which is a series of ongoing, regular, periodic evaluation of the facilities available.
- ◆ A security administrator has to consider an extensive list of possible threats to the organization, prepare an inventory of assets, evaluate the existing controls, implement new controls etc.

The security administrator requires the assistance of many individuals because of their expertise in that particular field. The auditor should see that these steps are performed on a regular basis, the results of the reviews are analysed and documented and advises the management of appropriate action in light of the results.

Question 7

Write short notes on the following:

- (a) Closed and open systems
- (b) Programmed decisions
- (c) Program documentation
- (d) Firewalls.

(4 × 5 = 20 Marks)

Answer

- (a) Closed Systems: 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 eventually. For example, if a marketing system does not get feed back from the market, its efficiency will gradually continue to decrease.

A relatively closed system is one that has only controlled and well defined inputs and outputs. It is not subject to disturbances from its environment. A computer program can be taken as an example of relatively closed system because it accepts only previously defined inputs, processes them and provides previously defined outputs.

Open Systems: Open systems actively interact with their environment. Such systems regularly get inputs and give outputs to its environment. These systems are also subject to unknown inputs and environmental disturbances. Open systems are also able to adapt to environmental changes for their survival and growth. Business organization is an example of such system.

- (b) Programmed Decisions: Such decision procedures are applicable to situations and problems which are routinely recurring, are more familiar and can be structured. Programmed decisions have built-in pre-decided rules or procedures which are well-structured in advance and are time tested for their validity. Thus, programmed decisions are said to refer to decisions made on problems and situations by reference to a predetermined set of precedents, procedures, techniques and rules. As a consequence, by applying these rules to a problem, a decision emerges. Manager's judgement or discretion is not required. Thus, decision making is simplified.

Organisations evolve a repertory of procedures, rules, processes and techniques for handling routine and recurring problem situations. For example, for many organisations there is a set procedure for receipt of materials, payment of bills etc. These are examples of programmed decisions which tend to be consistent over situations and time.

- (c) Program documentation: The writing of narrative procedures and instructions for people who will use software is done throughout the program life cycle. User documentation should also be reviewed for understandability. Program design and a set of technical design specifications must include the following:
1. A brief narrative description of what the program should do.
 2. A description of the outputs, inputs and processing to be performed by the program.
 3. A deadline for finishing the program.
 4. The identity of the programming language to use and the coding standards to follow.
 5. A description of the system environment into which the program should fit.
 6. A description of the testing required to certify the program for use.
 7. A description of documentation that must be generated for users, maintenance programmers and operational personnel.

(d) A firewall is a system that enforces access control between networks. To accomplish this:

- ◆ All traffic between the outside network and the organization's intranet must pass through the firewall.
- ◆ Only authorized traffic between the organization and the outside, as specified by formal security policy, is allowed to pass through the firewall.
- ◆ The firewall must be immune to penetration from both outside and inside the organization.

Firewalls are of two types as discussed below:

- ◆ Network level firewall: This type of firewall consists of screening router that examines the source and destination addresses that are attached to incoming messages. The firewall accepts or denies access requests based on filtering rules that have been programmed into it.
- ◆ Application level firewall: It provides a high level of customized network security, but can be highly expensive. These systems are configured to run security applications called proxies that permit routine services to pass through firewall. It can also perform functions such as logging or user authentication for specific task. If an outside user attempts to connect to an unauthorized service or file, the network administrator can be notified immediately.

The Suggested Answers for Paper 7: - Direct Taxes are based on the provisions applicable for A.Y. 2008-09, which is the assessment year relevant for May, 2008 examination.

PAPER – 7 : DIRECT TAXES

Answer all questions

Question 1

The net profit for the year ended on 31.3.2008 of India Biotech Ltd. engaged in the business of bio-technology works out to Rs.45 lacs after debit/credit of the following items:

- (i) Profit of Rs.2,50,000 from a hedging contract entered into for meeting out the loss in foreign currency payments towards an imported machinery of Rs.80 lacs installed on 1.2.2008.
- (ii) Incidental charges of Rs.20 lacs paid to a financial institution for taking short-term loan of Rs.25 crores repayable in 18 months.
- (iii) Commission of Rs.25,000 paid to a recovery agent for getting realisation of an old outstanding.
- (iv) Registration fees of Rs.20,000 and listing fees of Rs.30,000 paid to the Registrar of Companies and the Stock Exchange respectively on the issue of bonus shares.
- (v) Amount of Rs.1,00,000 towards carry forward losses for Asst. year 1998-99 of X Ltd., which got merged with the company during the financial year 2003-04.
- (vi) Interest received from banks of Rs.90,000 net of TDS of Rs.10,000.
- (vii) Amount of Rs.1,50,000 incurred towards reconditioning of generator.
- (viii) Employees share to the EPF for the month of March, 2008 of Rs.40,000. The amount was deposited with the PF Commissioner on 22.4.2008.

Compute the total income of the company for Asst. year 2008-09 and give brief reasons for the treatment given to each of the items. (13 Marks)

Answer

Computation of Total Income of India Biotech Ltd. for A.Y. 2008-09

Particulars	Amount	Amount
	Rs.	Rs.
Income from business		
Net Profit as per profit and loss account		45,00,000
Less: Items credited but to be considered separately		

Profit from hedging contract	2,50,000	
Interest from banks	<u>90,000</u>	<u>3,40,000</u>
		41,60,000
Add: Employee's share already charged in Profit & Loss Account but not deposited within the due date specified under the PF Act as per section 36(1)(va)		<u>40,000</u>
		42,00,000
Add: Depreciation on plant and machinery on account of hedging profit (7.5% on Rs.2,50,000)	18,750	
Additional depreciation (10% on Rs.2,50,000)	<u>25,000</u>	<u>43,750</u>
		42,43,750
Income from other sources		
Interest received from banks (gross)		<u>1,00,000</u>
Total Income		<u>43,43,750</u>

Notes -

- Hedging contract is entered into to safeguard the loss in currency fluctuation. The profit from such contract entered into for meeting loss in foreign currency payments towards imported machinery has to be adjusted against the cost of plant and machinery. Consequently, the same will have an impact on depreciation and additional depreciation on imported plant and machinery. It is presumed that the conditions for claim of additional depreciation are satisfied and accordingly, the additional depreciation has been charged to profit and loss account. Since there is a reduction in the cost of plant and machinery on account of the hedging profit of Rs.2,50,000, the excess depreciation and additional depreciation debited to the profit and loss account have to be added back to the profits.
- Incidental charges incurred for raising short term loan from financial institutions is allowable as deduction, since, as per CBDT letter F.No.32/6/62-IT(A-1) dated 16.1.1963,–
 - it is in respect of a short term loan of a duration of not more than 2 years; and
 - it does not exceed 1% of Rs.25 crores, being the amount of loan raised.
- Commission of Rs.25,000 paid to a recovery agent for realisation of old outstanding is an allowable expense under section 37 as per DCIT v. Super Tannery (India) Ltd. (2005) 274 ITR 338 (All). It is assumed that the company has deducted tax at source and remitted the same in accordance with the provisions of section 194H.

4. The Supreme Court has, in CIT v. General Insurance Corporation (2006) 286 ITR 232, observed that the issue of bonus shares does not result in expansion of the capital base of the company. Therefore, the expenditure incurred by the company on account of registration fees and listing fees for the issue of bonus shares is allowable as revenue expenditure.
5. As per section 72A, the unabsorbed business loss of the amalgamating company shall be deemed to be the loss of the amalgamated company for the previous year in which the amalgamation took place. Therefore, such loss can be set-off against the income of the amalgamated company in the year of amalgamation and the balance, if any, can be carried forward and set-off against the business income of the amalgamated company in the subsequent years. Such loss can be carried forward by the amalgamated company for a maximum period of 8 years from the year of amalgamation. In this case, the amalgamation took place in the financial year 2003-04 and therefore, the 8 year period has not expired in the financial year 2007-08. Therefore, the set-off of losses of Rs.1 lakh relating to X Ltd. is in order. It is assumed that the conditions specified in section 72A are satisfied.
6. Interest received from banks is chargeable to tax under the head "Income from other sources", assuming that there is no nexus between the interest income and the business of the assessee. For this purpose, the net amount of interest has to be grossed up by adding the amount of TDS of Rs.10,000. Since the net interest of Rs.90,000 is credited to profit and loss account, the same has to be reduced to compute the business income.
7. Expenditure on reconditioning of the generator is in the nature of normal repairs and is eligible for deduction under section 31.
8. As per section 2(24)(x), "income" includes any sum received by an employer from his employees as contributions to any provident fund. Section 36(1)(va) permits the employer to claim deduction in respect of such employee contributions to PF provided they are remitted within the due date specified under the PF Act, which is the 15th day of the succeeding month with a grace period of 5 days. Therefore, the due date in this case would be 20th April, 2008. However, since the amount of Rs.40,000 was deposited with the PF commissioner only on 22nd April, 2008, the same will not be allowed as deduction while computing the business income.

Question 2

- (a) A notice to levy penalty u/s 271(1)(c) was issued on 11.6.07. The assessee in response thereto filed on 13.7.07 a written submission requesting to decide the matter. The A.O. before whom this reply was filed retired on 31.7.07 and the officer, who succeeded him passed the penalty order without providing any further opportunity, but by taking into cognizance the reply filed by the assessee. Whether the order by the A.O. is valid?

(3 Marks)

- (b) An order for A.Y. 2006-07 was passed by the A.O. as per section 143(3), but the typist wrongly typed in the order assessment year as 2005-06 and the relevant previous year as ending on 31.3.2005. Assessee claimed in appeal that the same is an invalid order which was not accepted by the CIT(A) on the ground of error of clerical nature. What do you say about the correctness of the order of the CIT(A)? (3 Marks)
- (c) "Proceedings cannot be initiated under the Act, unless a proper notice to this effect has been served upon." In this context answer:
- (i) What are the prescribed modes of service of such notice?
 - (ii) On whom should the notice be addressed and served upon in the cases where the assessee is a company, a dissolved firm, a deceased person and a partitioned HUF. (5 Marks)

Answer

- (a) As per the provisions of section 129, whenever an Assessing Officer ceases to exercise jurisdiction and he is succeeded by another, then, the authority so succeeding may continue the proceedings from the stage at which the proceedings were left by the predecessor provided the assessee does not demand that before the proceeding is so continued he may be re-heard by the successor officer. In the present case, the assessee had only filed a written submission in respect of the notice for levy of penalty. However, he had not specifically requested to be reheard at the time of change in office. Accordingly, the penalty order passed by the successor officer without providing any further opportunity to be reheard is a valid order. This was also held by the Apex Court in the case of *Pradip Lamp Works v. CIT* (2001) 249 ITR 797.
- (b) Section 292B provides that no return of income, assessment, notice or summons furnished or made or issued or taken in pursuance of any of the provisions of the Income-tax Act shall be invalid or deemed to be invalid merely by reason of any mistake, defect or omission in such return of income, assessment or notice etc., if such return of income, assessment, notice, summons etc. is in substance and effect in conformity with or according to the intent and purpose of the Act. Therefore, a clerical mistake cannot invalidate an otherwise valid assessment. Thus, the typographical error in the assessment order as to assessment year and previous year does not make the same invalid unless established otherwise. Accordingly, the action of the Commissioner of Income-tax (Appeals) in not accepting the claim of the assessee is valid.
- (c) (i) According to section 282(1), a notice may be served on the person named therein either by post or as if it was a summon issued by a Court under Code of Civil Procedure, 1908.
- (ii) The service of notice in the given cases should be on the persons mentioned hereunder:-

Person	Notice be addressed and served on
A company	Principal officer of the company
A dissolved firm	Any person (not being a minor) who was a partner immediately before dissolution.
A deceased person	The legal heirs of the deceased.
A partitioned HUF	Last Manager of the HUF, or, if he is dead, then, all adult members of the erstwhile HUF.

Question 3

- (a) M/s. Nagdiwala Enterprises, a partnership firm constituted by a doctor and a non-doctor engaged in running a multispeciality hospital, seeks your opinion in the context of provisions of the Act as to allowability/chargeability of the following transactions for preparing its return for A.Y. 2008-09:
- Depreciation on the instruments, imported from U.K. for Rs.2 lacs cleared by customs on 22.3.2008 on payment of duty of Rs.1 lakh, installed and ready for use on 26.3.2008. Only one operation with the help of such instruments was performed till 31.3.2008.
 - The book profits calculated as per section 40(b) are Rs.3 lacs and payment of salary to working partners was Rs.1 lakh. Clause for payment of salary to working partners though appears in the deed, but the same is silent as to quantum and the manner of distribution.
 - Salary of Rs.10,000 p.m. paid to the wife of a partner for working as an anesthetist. The normal salary of an anesthetist in the town is Rs.7,500 p.m. or less.
 - Purchase of medicines in cash on 18.12.2007 for Rs.35,000.
 - Revenue expenditure of Rs.10,000 incurred for promoting family planning amongst its employees.
 - Interest of Rs.3,000 paid on an overdraft of Rs.1 lac taken for making payment of installment of advance tax of Rs.1.25 lacs. (8 Marks)
- (b) An assessee, who is aggrieved by all or any of the following orders, is desirous to know the available remedial recourse and the time limit against each under the Income-tax Act, 1961:
- passed under section 143(3) by the A.O.
 - passed under section 263 by the CIT.
 - passed under section 272A by the Director General.
 - passed under section 254 by the ITAT. (6 Marks)

Answer

- (a) The allowability/chargeability of each of the transactions entered into by M/s Nagdiwala Enterprises for the purpose of computation of income for Assessment Year 2008-09 shall be as under:-
- (a) The surgical instruments used by a firm engaged in the business of running a hospital are covered under the category of Plant & Machinery, on which the rate of depreciation is 15%. The depreciation on the instruments imported from U.K. is allowable to the firm since the same were put to use during the previous year ended on 31.3.08 because of performing of one operation. However, the same were used in the previous year for less than 180 days and accordingly the allowable depreciation will be one half of the normal depreciation. The cost of instruments is Rs.3 lakh and the amount of depreciation thereon works out to Rs.22,500 [$3,00,000 \times 15\% \times \frac{1}{2}$].
- (b) As per section 40(b), payment of remuneration to a working partner is allowable as deduction only if it is authorised by and in accordance with the terms of the partnership deed. CBDT Circular No.739 dated 25.3.96 clarifies that no deduction in respect of remuneration paid to partners is allowable unless the partnership deed either specifies the amount of remuneration payable to each individual working partner or lays down the manner of quantifying such remuneration. If the partnership deed contains a clause for payment of salary to working partners without specifying the manner of quantification or manner of distribution of such salary, the payment of salary to the working partners cannot be construed to be authorised by and in accordance with the partnership deed.
- (c) Section 40A(2) provides that if any expenditure in respect of which payment has been made to, inter alia, any relative of the partner of a firm and the Assessing Officer is of the opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the services for which the payment is made, then disallowance under this section is attracted to the extent the same is excessive or unreasonable. In this case, salary of Rs.10,000 p.m. is paid to the partner's wife, who is working as an anesthetist. The fair market value of a similar service is Rs.7500 p.m. Therefore, disallowance under section 40A(2) is attracted to the extent of Rs.2500 p.m., since to that extent, the same is excessive.
- (d) Section 40A(3) provides for 100% disallowance of an expenditure, in respect of which payment is made in a sum exceeding Rs.20,000 otherwise than by way of account payee cheque or account payee bank draft. Therefore, the entire amount of Rs.35,000 incurred for purchase of medicines in cash is disallowed under section 40A(3).
- (e) Section 36(1)(ix) provides for deduction in respect of expenditure incurred by companies to promote family planning amongst its employees. However, since the assessee in this case is a partnership firm, such expenses are not allowable as deduction under section 36(1)(ix).

- (f) Interest on the overdraft taken for making payment of installment of advance tax is not allowable under section 37(1) since it is not an expenditure wholly and exclusively incurred for the purpose of business as held by the Apex Court in the case of East India Pharmaceutical Works Ltd. v. CIT (1997) 224 ITR 627.
- (b) (i) An assessee, aggrieved by the order passed under section 143(3) by the Assessing Officer, can file an appeal before the Commissioner of Income-tax (Appeals) under section 246A(1) within 30 days of the date of service of the notice of demand relating to the assessment. However, where the assessee does not want to prefer an appeal, then he can move a revision petition before the Commissioner of Income-tax under section 264 within a period of one year from the date of on which the order was communicated to him or the date on which he otherwise came to know of it, whichever is earlier.
- (ii) An assessee, aggrieved by the order passed under section 263 by the Commissioner of Income-tax, can file an appeal to Income-tax Appellate Tribunal under section 253(1)(c) within 60 days of the date on which the order sought to be appealed against is communicated to the assessee.
- (iii) An assessee, aggrieved by the order passed under section 272A by the Director General, can file an appeal before the Income-tax Appellate Tribunal under section 253(1)(c) within 60 days of the date on which the order sought to be appealed against is communicated to the assessee.
- (iv) An assessee, aggrieved by the order passed under section 254 by the Income-tax Appellate Tribunal, can file an appeal before the High Court under section 260A within 120 days from the date of receipt of order of Income-tax Appellate Tribunal, only where the order gives rise to a substantial question of law.

Question 4

- (a) State with reasons, based on the provisions of the Act, as to chargeability of the following receipts to tax in the assessment year 2008-09:
 - (1) Rent of Rs.60,000 charged from tenants occupying houses constructed on the land situated in India and used for agricultural purposes.
 - (2) Rameshwar Das Birla National award of Rs.51,000 was given to Mr. X, a Chartered Accountant by "Rameshwar Dasji Birla Smarak Kosh" for his contributions and work.
 - (3) Hundi superscribing "contributions in this hundi form part of corpus of trust fund" kept at Lord Venkateshwara Temple, Tirumala, was opened on 30.3.2008. Cash of Rs.100 lacs and valuable articles worth Rs.250 lacs were found to have been contributed by the devotees.
 - (4) Minister of Surface Transport was in receipt besides salary an amount of Rs.2,000 p.m. as entertainment allowance.
 - (5) Rent of Rs.30,000 for the period 1.4.2005 to 30.6.2005 due till the property sold out by the owner on 16.5.2007 was received on 12.2.2008 because of an order of court.

(2 × 5 = 10 Marks)

- (b) Tax Recovery Officer can recover the arrears of demand from the assessee in default by sale of the attached property after making a proclamation. How can such proclamation be made by the Tax Recovery Officer? (3 Marks)

Answer

- (a) (1) Section 10(1) exempts agricultural income. The meaning and scope of agricultural income is defined in section 2(1A). According to Explanation 2 to section 2(1A), any income derived from any building from the use of such building for any purpose (including letting for residential purposes or for the purpose of any business or profession) other than agriculture shall not be agricultural income. It appears that in this case, the house was occupied for residential purposes. Therefore, the rent of Rs.60,000 from letting out of houses constructed on agricultural land shall not be treated as agricultural income by virtue of Explanation 2 to section 2(1A). Hence, such income would be chargeable to tax.
- (2) Section 10(17A)(i) exempts any payment made in pursuance of any award instituted in public interest by the Central Government or any State Government or instituted by any other body and approved by the Central Government in this behalf. As per Notification No.199/19/98-IT(A-II) dated 15.11.2000, the Rameshwar Das Birla National Award instituted by Rameshwar Dasji Birla Smarak Kosh was approved by the Central Government only for three assessment years 1999-2000 to 2001-02. Hence, for A.Y.2008-09, no exemption would be available under section 10(17A).
- (3) As per section 11(1)(d), income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution shall not be included in the total income of the recipient. Therefore, in order to get the benefit under this section, it is necessary that the donor gives a specific direction that the voluntary contribution made by him should form part of the corpus of the trust. However, in this case, the donors have not given any specific directions that the contribution should form part of the corpus of the trust. Therefore, the benefit of exemption under section 11(1)(d) would not be available to the collections made through the hundi and such collections would be treated as income from the property held under trust.

It may be noted that the provision relating to taxability of anonymous donations @ 30% under section 115BBC does not apply to voluntary contributions received by a trust or institution created or established wholly for religious purposes.

Note - As per section 11(1)(d), income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution shall not be included in the total income of the recipient. In the given case, there is a specific declaration by the temple authorities that the contributions being put in the hundi would form part of the corpus of the trust fund. Therefore, it is possible to presume that those who put the contributions in the hundi give a tacit declaration that the contributions would form part of the corpus. Hence, a view can

be taken that such contributions shall not be included in the total income of the recipient.

- (4) The entertainment allowance received by the Minister of Surface Transport is taxable under the head "Salaries". However, deduction under section 16(ii) is allowable to the extent of least of the following –
 - (i) 1/5th of the salary
 - (ii) Rs.5,000
 - (iii) Actual entertainment allowance received, i.e., Rs.24,000 in this case.
- (5) As per section 25AA, unrealised rent would be deemed to be the income chargeable under the head "Income from house property". Accordingly, it would be chargeable to income-tax as income of that previous year in which such rent is realised whether or not the assessee is the owner of that property in that previous year. Therefore, in this case, unrealised rent of Rs.30,000 would be charged to tax in the P.Y.2007-08 under the head "Income from house property" even though he is no longer the owner of the house property.
- (b) The mode of attachment and sale of both movable and immovable property is dealt with in the Second Schedule to the Income-tax Act:

Immovable property [Rule 54 of Schedule II to the Income-tax Act,1961]

Where the Tax Recovery Officer orders sale of immovable property which has been attached under the provisions of Act, he has to make a proclamation thereof in accordance with Rule 54 of the second schedule. Various modes of such proclamation are:

- (a) by beat of drum or other customary mode on or near such property;
- (b) by publication in a local news paper or in the Official Gazette or in both.

However, where the property to be sold is divided into lots, then it is not necessary to make the proclamation for each lot of property separately, unless the Tax Recovery Officer considers that proper notice of the sale cannot be otherwise given.

Movable Property [Rules 38 & 39 of Schedule II to the Income-tax Act,1961]

Where the Tax Recovery Officer orders sale of movable property, he should issue a proclamation in the language of the district of the intended sale, specifying the time and place of sale and whether the sale is subject to confirmation or not.

The proclamation should be made by beat of drum or other customary mode, -

- (a) in the case of property attached by actual seizure –
 - (i) in the village in which the property was seized, or, if the property was seized in a town or city, then, in the locality in which it was seized; and
 - (ii) at such other places as the Tax Recovery Officer may direct;
- (b) in the case of property attached otherwise than by actual seizure, in such places, if any, as the Tax Recovery Officer may direct.

A copy of the proclamation should also be affixed in a conspicuous part of the office of the Tax Recovery Officer.

Question 5

- (a) Examine the following cases and state whether the same are liable for penalty as per the provisions of the Income-tax Act:
- (i) Raman & Associates had made payment in excess of the limits prescribed to the contractors for carrying out labour job work at various sites, but had not deducted tax at source as per section 194C.
 - (ii) Hotels and Hotels were asked by Income-tax Officer (CIB) to furnish details of all such tourists who stayed in their hotels and had paid bill amount in excess of Rs.10,000. They have not furnished the requisite information inspite of various reminders.
 - (iii) An assessee whose turnover in the previous year was Rs.20 lacs had neither opted to be taxed as per section 44AF of the Act nor had kept and maintained books of accounts. (2 × 3 = 6 Marks)
- (b) Explain the meaning of “eligible business” referred to in section 80-IE granting tax holiday in respect of profits and gains of certain undertakings in North-Eastern States. (4 Marks)
- (c) Examine the correctness of the statement “that the jurisdiction of an Assessing Officer cannot be objected by the assessee”. (4 Marks)

Answer

- (a) (i) Penalty under section 271C is attracted for failure to deduct tax at source. The penalty would be a sum equal to the amount of tax which such person has failed to deduct. Such penalty can be imposed only by the Joint Commissioner. Therefore, Raman & Associates shall be liable for penalty under section 271C equal to the amount of tax which they have failed to deduct under section 194C from the payments made to the contractors.
- (ii) Section 133(6) empowers an Income-tax Officer to require any person to furnish information in relation to such points or matters which will be useful for or relevant to any enquiry or proceeding under the Act. Failure on the part of an assessee to furnish the information in relation to such points or matters as required by the Income-tax Officer makes him liable for penalty under section 272A(2) of Rs.100 for every day during which the failure continues.

Note – In a case where no proceeding is pending, the Income-tax Officer can exercise this power only after obtaining the approval of the Director or Commissioner, as the case may be. In this case, it is presumed that the Income-tax

Officer has obtained the approval of the Director or Commissioner before exercising this power.

- (iii) In this case, since the assessee has not opted for presumptive taxation under section 44AF, he has to maintain books of accounts as prescribed under section 44AA. Since he has not maintained the books of accounts, he is liable to pay a penalty of Rs.25,000 under section 271A for default in complying with the provisions of section 44AA.
- (b) Eligible business as referred to in section 80-IE of the Act means the business of :
 - (a) hotel (not below two star category),
 - (b) adventure and leisure sports including ropeways;
 - (c) providing medical and health services in the nature of nursing home with a minimum capacity of 25 beds;
 - (d) running an old-age home;
 - (e) operating vocational training institute for hotel management, catering and food craft, entrepreneurship development, nursing and para-medical, civil aviation related training, fashion designing and industrial training;
 - (f) running information technology related training center;
 - (g) manufacturing of information technology hardware; and
 - (h) bio-technology.
- (c) According to section 124(3), the assessee can raise a question as to the jurisdiction of an Assessing Officer within the prescribed time limit as under:
 - (i) where a return has been filed under section 139(1) or section 115WD(1), then, within one month from the date of service of notice under section 142(1) or section 115WE(2) or section 143(2) or before the completion of assessment, whichever is earlier.
 - (ii) where no return has been filed, then, within the expiry of time allowed by the notice under section 115WD(2) or section 142(1) or section 115WH(1) or section 148 for filing the return or within the time allowed to show cause as to why best judgment assessment under section 115WF or section 144 should not be made, whichever is earlier.

Where the assessee calls in question the jurisdiction of an Assessing Officer and the Assessing Officer is not satisfied with such claim, he shall refer the matter for determination by the Director General or Chief Commissioner or Commissioner before the assessment is made.

Therefore, in view of the above provisions, the statement that "the jurisdiction of an Assessing Officer cannot be objected by the assessee" is not correct.

Question 6

- (a) "Income-tax Act, 1961 extends to whole of India". What meaning has been assigned to "India" under this Act? (3 Marks)
- (b) Explain those conditions which are required to be fulfilled by both the predecessor and successor co-operative banks in order to claim benefit of Section 72AB of the Act? (5 Marks)
- (c) Specify all those public facilities which have been notified by CBDT as infrastructure facility for the purpose of section 36(1)(viii). (5 Marks)

Answer

- (a) The Finance Act, 2007, has, with retrospective effect from 25.08.1976, substituted section 2(25A) by defining the term "India" to mean the territory of India as referred to in Article 1 of the Constitution, its territorial waters, seabed and sub-soil underlying such waters, continental shelf, exclusive economic zone or any other maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976 and the air space above its territory and territorial waters.
- (b) The benefit of carry forward and set-off of accumulated loss and unabsorbed depreciation allowance in case of business reorganisation of co-operative banks would be available under section 72AB only on fulfillment of the following conditions -
- (a) Conditions to be fulfilled by the predecessor bank
- (1) it should have been engaged in the business of banking for three or more years; and
 - (2) it should have held at least three-fourths of the book value of fixed assets as on the date of the business reorganisation, continuously for two years prior to the date of business reorganisation.
- (b) Conditions to be fulfilled by the successor bank
- (1) it should hold at least three-fourths of the book value of fixed assets of the predecessor co-operative bank acquired through business reorganisation, continuously for a minimum period of five years immediately succeeding the date of business reorganisation;
 - (2) it continues the business of the predecessor co-operative bank for a minimum period of five years from the date of business reorganisation; and
 - (3) it fulfils such other conditions as may be prescribed to ensure the revival of the business of the predecessor cooperative bank or to ensure that the business reorganisation is for genuine business purpose.

- (c) The CBDT, vide Notification No. 188/2006 dated 20.07.2006, has notified the following public facilities as infrastructure facility for the purpose of section 36(1)(viii):
- (1) Inland Container Depot and Container Freight Station notified under the Customs Act, 1962
 - (2) Mass Rapid Transit system
 - (3) Light Rail Transit system
 - (4) Expressways
 - (5) Intra-urban or semi-urban roads like ring roads or urban by-passes or flyovers
 - (6) Bus and truck terminals
 - (7) Subways
 - (8) Road dividers
 - (9) Bulk Handling Terminals which are developed or maintained or operated for development of rail system
 - (10) Multilevel Computerised Car Parking.

Question 7

Answer the following in the context of provisions contained in Income-tax Act, 1961:

- (a) Ram Kripa Kuber Gramin Bank, a co-operative society engaged in banking business, provided training to its employees before regular employment. The employees undergoing such training were required to execute a contract bond and to furnish security deposit. Certain such employees left the services of the bank in between and as per terms of the contract the security deposit was forfeited and the recoveries against notice pay and training charges were also made. A.O. taxed these amounts as income which is objected and claimed to be not subject to tax by the bank.
- (b) The A.O. within the powers vested in him under section 142(2A), while examining the accounts of PNF Ltd., had ordered to get the same audited. The company challenges this order on the ground "that the opportunity was not provided to them by the A.O. prior to passing of such an order".
- (c) Assessment for A.Y. 2002-03 was completed as per section 143(3) considering the various claims so made by the assessee on 23.12.2003. Subsequently, this was reopened under section 147 on certain issues, but excluding the claim of the assessee as to "Lease Equalisation Fund". The order of reassessment was passed on 24.11.2006. The Commissioner within the powers vested under section 263 passed an order on 11.1.2008 rejecting the claim of assessee as to "Lease Equalisation Fund". The assessee challenges that the action of the CIT is not sustainable because the same was barred by limitation.

(4 × 3 = 12 Marks)

Answer

- (a) The facts given in the question are similar to the facts in the case of Gorakhpur Kshetriya Gramin Bank v. CIT (2007) 292 ITR 205 decided by the Allahabad High Court. In that case, the High Court observed that for claiming exemption under section 80P(2)(a)(i), the assessee is required to establish that the income is attributable to carrying on the business of banking. The business of banking cannot be carried on without the aid of the employees. Therefore, the amounts recovered from the employees, who have left the job in between as per terms of the contract, and forfeiture of the security deposit are amounts attributable to the activity of carrying on the business of banking. It was not a case where the assessee, apart from carrying on the business of banking, was also running the training institute for training persons in the banking industry for providing services of trained persons to other banks. Thus, the Court held that receipts on account of pay recovered from resigned staff, recovery of training cost and security forfeiture were allowable as deduction.

Therefore, the action of Assessing Officer to tax the amounts recovered by Ram Kripa Kuber Gramin Bank as income chargeable to tax is incorrect because the amount recovered by the bank shall be treated as an income attributable to the banking business and would be eligible for deduction under section 80P.

- (b) The Assessing Officer had passed an order to get the accounts audited under section 142(2A) without providing the assessee an opportunity of being heard before issuing such order. The Apex Court, in the case of Rajesh Kumar v. DCIT (2006) 287 ITR 91, has observed that the order under section 142(2A) is a quasi judicial order. Therefore, the principles of natural justice have to be applied and the assessee has to be given an opportunity of being heard before directing the special audit. The principles of natural justice are based on two principles, namely, (i) nobody shall be condemned unheard; (ii) nobody shall be a judge of his own cause. Once it is held that the assessee suffers civil consequences and any order passed would be prejudicial to him, the principles of natural justice must be held to be implicit.

Accordingly, to give effect to this observation of the Supreme Court, the Finance Act, 2007 has inserted a proviso to section 142(2A) to provide that the Assessing Officer shall not direct the assessee to get the accounts so audited unless the assessee has been given a reasonable opportunity of being heard.

Therefore, in this case, the order of the Assessing Officer is not valid since the assessee was not given an opportunity of being heard prior to passing of such order.

- (c) This issue was settled by the Supreme Court in CIT v. Alagendran Finance Ltd. (2007) 293 ITR 1. The Supreme Court observed that though there was no doubt that once an order of assessment is reopened, the previous assessment will be held to be set aside and the whole proceedings would start afresh, however, it would not mean that even

when the subject-matter of reassessment is distinct and different, the entire proceeding would be deemed to have been reopened. The doctrine of merger would apply only in a case where the subject-matter of reassessment and the subject-matter of assessment are the same. However, in this case, the revision proceedings related to Lease Equalisation Fund, which was not the subject matter of reassessment. Therefore, the doctrine of merger does not apply in this case and the revision proceedings are barred by limitation.

Section 263(2) provides no order shall be made under section 263(1) after the expiry of two years from the end of the financial year in which the order sought to be revised was passed. The period of limitation as referred to in section 263(2) relates to the assessment in which the claim of the assessee as to Lease Equalisation Fund was considered by the Assessing Officer. This issue was not the subject matter of reassessment proceedings. Accordingly, the period of limitation shall be reckoned with reference to the original assessment order and not from the date of the order of reassessment. Therefore, in this case, the revision proceedings are barred by limitation since the original assessment order was made on 23.12.2003 and the revision should have been made by 31.3.2006.

Question 8

- (a) State with reasons whether the following constitute assets chargeable to wealth-tax on the valuation date 31.3.2008:
- (i) Agricultural farm house situated 26 kms outside the municipal limits of Jaipur, but within 22 kms of Niwai Municipal Corporation.
 - (ii) Factory building and godowns leased out on rent.
 - (iii) Silver and gold in the jewellers shop
 - (iv) Aircraft held by a shipping company having turnover of Rs.800 crores for exclusive use of its managing director.
 - (v) A cash balance of Rs.1,50,000. (5 Marks)
- (b) Rakesh, a married coparcener having no son but two minor daughters, gets a commercial property on disruption of the HUF on 17.3.2008. He, therefore, seeks your advice to know in whose hands the value of this property would be subject to wealth-tax on the valuation date 31.3.2008. (3 Marks)
- (c) How can the arrear demand of wealth-tax be recovered by the department where the assessee dies prior to making payment thereof? (2 Marks)

Answer

- (a) (i) According to the definition of the term 'asset' under section 2(ea), building includes a farm house situated within 25 kms from the local limits of a municipality.

Therefore, the farm house situated within 25 kms from the local limits of Niwai Municipal Corporation is an asset as per section 2(ea) of the Wealth-tax Act.

- (ii) There are some exceptions to the chargeability of building to wealth-tax. One of the exceptions is property in the nature of commercial establishments or complexes. Therefore, factory buildings and godowns leased out on rent are not assets within the meaning of section 2(ea) of the Wealth-tax Act.
 - (iii) The silver and gold lying in a jeweller's shop are not assets under section 2(ea) of the Wealth-tax Act as the same constitute stock-in-trade of the assessee.
 - (iv) The definition of asset under section 2(ea) includes yachts, boats and aircrafts, other than those used by the assessee for commercial purposes. Therefore, the aircraft held by a shipping company for the exclusive use of its managing director is an asset chargeable to tax.
 - (v) The cash in hand in excess of Rs.50,000 is an asset chargeable to wealth-tax in case of individuals and HUFs. In case of any other person, any cash not recorded in the books will only be treated as an asset.
- (b) The facts given in the question are similar to the facts of the case decided by the Apex Court in the case of *Narendra Nath v. CWT* (1969) 74 ITR 190 wherein it was held by the Court that if a co-parcener not having a son but having two minor daughters receives his share in the joint family property on disruption, then, such property would belong to the HUF comprising of himself, his wife and minor daughters and cannot be assessed as his individual property.

It may be noted that any property in the nature of commercial establishments are excluded from the definition of asset under section 2(ea). Therefore, commercial property received by Rajesh would not be chargeable to wealth-tax on the valuation date.

- (c) Where the assessee dies prior to making of payment of demand of wealth tax, the same shall be recovered as per section 19(1) out of the estate of the deceased from his executor, administrator or other legal representative. The executor, administrator or other legal representative shall be liable to pay out of the estate of the deceased person, to the extent to which the estate is capable of meeting the charge, the wealth tax assessed as payable by such person if he had not died.

The suggested answers for Indirect Taxes (Paper 8) are based on the provisions as amended by the Finance Act, 2007 and Notifications/Circulars issued up to 31.10.2007 which are relevant for May 2008 examinations.

PAPER – 8 : INDIRECT TAXES

Answer to 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 Central Excise Rules, 2002:
- (i) Assessee
 - (ii) Daily stock account
 - (iii) Large tax payer (2 x 2 =4 Marks)
- (b) M/s. Khan Ltd. is a small scale unit manufacturing plastic name plates for motor vehicles as per specifications provided to them by their customers, who are vehicle manufacturers. For purposes of classification under the first schedule to the Central Excise Tariff Act, 1985 the assessee has claimed that the plastic name plates are “parts and accessories of motor vehicles”. The Central Excise Department has proposed classification as “other plastic products” in respect of these plastic name plates. The department’s view is that the motor vehicle is complete without the affixation of name plates and cannot be treated as a part of the motor vehicle. Write a brief note on whether the stand taken by the department is correct in law. (4 Marks)
- (c) Discuss briefly the validity of the following statements with reference to the CENVAT Credit Rules, 2004:
- (i) Basic excise duty credit can be utilized for payment of basic excise duty and education cess and secondary and higher education cess.
 - (ii) CENVAT credit on inputs lying in stock or in process or contained in the final product shall be reversed when the final product is subsequently exempted unconditionally in terms of an exemption notification issued under section 5A of the Central Excise Act, 1944. (3 x 2 = 6 Marks)
- (d) State briefly whether the following circumstances would constitute “manufacture” for purposes of section 2(f) of the Central Excise Act, 1944:
- (i) Both inputs and the final product fall under the same tariff heading under the first schedule to the Central Excise Tariff Act, 1985 (Tariff Act.)
 - (ii) Inputs and final product fall under different tariff headings of the Tariff Act. (3 x 2 = 6 Marks)

Answer

- (a) (i) Rule 2(c) of Central Excise Rules, 2002, states that 'assessee' means any person who is liable for payment of duty assessed or a producer or manufacturer of excisable goods or a registered person of a private warehouse in which excisable goods are stored and includes an authorized agent of such person.
- (ii) As per Rule 10 of the Central Excise Rules, 2002, there is a specific requirement about maintenance of 'Daily Stock Account'. Such account should be maintained on daily basis, in a legible manner, indicating the particulars regarding:
- (a) description of the goods produced or manufactured,
 - (b) opening balance, quantity produced or manufactured,
 - (c) inventory of goods,
 - (d) quantity removed,
 - (e) assessable value,
 - (f) the amount of duty payable; and
 - (g) particulars regarding amount of duty actually paid [Rule 10(1)]

The first page and last page of such account books shall be duly authenticated by the producer or manufacturer or his authorized agent [Rule 10(2)]. All such records shall be preserved for a period of five years immediately after the financial year to which such records pertain [Rule 10(3)].

- (iii) As per Rule 2(ea) of the Central Excise Rules, 'large taxpayer' means a person who
- (a) has one or more registered premises under the Central Excise Act, 1944; or
 - (b) has one or more registered premises under Chapter V of the Finance Act, 1994;

and is an assessee under the Income-tax Act, 1961, who holds a Permanent Account Number issued under section 139A of the said Act, and satisfies the conditions and observes the procedures as notified by the Central Government in this regard.

The following persons have been notified to be eligible to opt as large taxpayer:

- (i) Any person engaged in the manufacture or production of goods, except the goods falling under chapter 24 or pan masala falling under chapter 21 of the First schedule of the Central Excise Tariff Act, 1985, or

- (ii) a provider of taxable service,

who has paid during the financial year 2004-05 or during the financial year preceding the year of filing of application for large tax payer-

- (a) duties of excise of more than Rs.500 lakhs in cash or through account current; or

- (b) service tax of more than Rs.500 lakhs in cash or through account current; or
- (c) advance tax of more than Rs.1000 lakhs, under the Income Tax Act, 1961, and is presently assessed to income tax or corporate tax under the Income Tax Act, 1961, under the jurisdiction of Chief Commissioner of Income Tax – I, Bangalore (other than revenue district of Tumkur) and Chief Commissioner of Income Tax – II, Bangalore (other than district of Kolar).

- (b) No, the stand taken by the Department is not valid in law. The plastic nameplates should be classified as parts and accessories of motor vehicles on following grounds:
 - (i) name plates are solely and exclusively used for motor vehicles.
 - (ii) classification as parts and accessories of motor vehicles is more specific while the classification as other plastic products is residuary and more general in nature.

The Department has examined only whether the name plates can be considered 'parts' of motor vehicles, it has not at all considered whether these name plates can be considered 'accessories' of motor vehicle – An 'accessory' by its very definition is something supplementary or subordinate in nature and need not be essential for the actual functioning of the product.

In a similar case of *Pragati Silicons Pvt. Ltd. v. CCEx. Delhi* (2007) 211 ELT 534 (SC), the Apex Court applying the test laid down in the case of *Mehra Bros. v. Joint Commercial Officer* (1991) 51 ELT 173 (SC) has held that name plates add to convenient use of motor vehicle and give an identity to it. They add effectiveness and value to vehicle and are at very least accessories of vehicles. Thus, even if there was any difficulty in the inclusion of the name plates as 'parts' of the motor vehicles, they would most certainly have been covered by the broader term 'accessory' as car seat covers and upholstery etc.

- (c) (i) Correct. There is no restriction in the said rules on utilization of CENVAT credit of basic excise duty (BED) for payment of education cess (EC) and secondary and higher education cess (SHEC). Rule 3(4) of the said rules provides that credit of BED can be utilized for payment of any duty of excise on any final product. Since EC and SHEC are 'duties of excise' as per statutory provisions hence, credit of BED can be utilized for payment of cesses.
- (ii) Correct. As per Rule 11(3) of CENVAT Credit Rules, 2004, as inserted w.e.f. 1.3.2007, when final product has been exempted absolutely under section 5A of the Central Excise Act, CENVAT credit on inputs, lying in stock or in process or contained in final product shall be reversed. The balance, if any, still remaining shall lapse and shall not be allowed to be utilized for payment of duty on any other final product or for payment of service tax on any output service.
- (d) (i) 'Manufacture' is bringing into being goods known in the market having distinctive name, character or use and separate and identifiable function. Once a new commodity having a definite and distinct commercial identity in market is produced and the same has been specified in the tariff, it is exigible to duty. It is irrelevant

whether the new article falls into the same tariff heading as the duty paid raw material from which it is manufactured or belongs to a separate tariff heading.

It was held in *CCEx. v. Kapri International (P) Ltd.* (2002) 142 ELT 10 (SC) that if manufacture takes place, the commodity is dutiable even if the raw material and the resultant product fall under the same tariff heading. It was followed recently in *CCEx., Jaipur v. Mahavir Aluminium Ltd.* (2007) 212 ELT 3 (SC), wherein it was held that converting aluminium ingots (7601.10 – old entry) into aluminium billets (7601.10 – old entry) is 'manufacture', because they have separate, distinct and identifiable marketability and saleability.

- (ii) As held in *CCEx. v. Markfed Vanaspati* (2003) 153 ELT 491 (SC), mere change in tariff does not mean there is 'manufacture'. It was again confirmed in *CCEx. v. S R Tissues* (2005) 186 ELT 385 (SC) that just because raw material and finished product fall in different tariff headings it cannot be presumed that process of obtaining finished product from such raw material automatically constitutes 'manufacture'.

Therefore, manufacturing is not only about a process and a product but it is about a new identity that must emerge out of the given process. Mere mention of process in tariff entry is not sufficient, it must be specifically stated that a particular process 'amounts to manufacture' – *Shyam Oil Cake Ltd. v. CCEx.* (2005) 174 ELT 145 (SC – 3 members bench).

Question 2

- (a) Explain briefly, with reference to rule 21 of the Central Excise Rules, 2002 relating to remission of duty, the following:
- Can remission of duty be granted on goods cleared from the factory after payment of duty, but which were destroyed by fire in transit?
 - Upon grant of remission of duty, the CENVAT credit on inputs used in final product has to be reversed. (2 x 2 = 4 Marks)
- (b) A unit availing small scale exemption in terms of Notification No. 8/2003-C.E. dated 1.3.2003 as amended, found that it has exceeded the exemption limit by Rs.20 lakh during the year 2006-07. Accordingly, appropriate duty was paid after obtaining registration and in accordance with the prescribed procedure.
- In the year 2007-08, the unit estimates that the aggregate value of clearances for the purpose of the aforesaid notification would be Rs.140 lakh. Write a brief note on the steps to be adopted for the purpose of due compliance with the requirements of the aforesaid notification and the requirements of the Central Excise Act, 1944 and the rules made thereunder. (5 Marks)
- (c) Write a note on the valuation of goods on the basis of retail sale price under section 4A of the Central Excise Act, 1944. (6 Marks)

Answer

- (a) (i) Remission of duty is granted when the goods are lost or destroyed by natural causes or by unavoidable accident or are claimed by the manufacturer as unfit for consumption, at any time before removal.

Hence, in this case remission of duty cannot be granted under rule 21 of the Central Excise Rules, 2002 as goods have already been cleared from the factory after payment of duty.

- (ii) As per sub-rule (5C) of rule 3 of CENVAT Credit Rules, 2004 inserted vide Notification No. 33/2007 CE (NT) dated 07.09.2007, where on any goods manufactured or produced by an assessee, the payment of duty is ordered to be remitted under rule 21 of the Central Excise Rules, 2002, the CENVAT credit taken on the inputs used in the manufacture or production of said goods shall be reversed.
- (b) The SSI exemption limit till the year 2006-07 was Rs.100 lakh. Since the turnover of the unit exceeded the exemption limit by Rs.20 lakh during the year 2006-07 hence, the turnover of the unit in the year 2006-07 must have been Rs.120 lakh.

Though in the year 2007-08, the unit expects clearance of Rs.140 lakh, it can still avail full exemption up to Rs.140 lakh as with effect from 01.04.2007, the exemption limit under the SSI scheme has been increased from Rs.100 lakh to Rs.150 lakh vide Notification No. 8/2007 CE dated 01.03.2007. However, the unit can avail full exemption up to the turnover of Rs.150 lakh only if it does not avail CENVAT credit on inputs being used by it. If it avails CENVAT credit, it will have to pay normal duty on all clearances.

The unit will be required to submit a declaration in prescribed form as its turnover is expected to be more than the 'specified turnover' of Rs.90 lakh.

As per the second proviso to rule 12(1) of the Central Excise Rules, 2002, SSI unit availing concession on the basis of annual turnover has to file a return of production and removal of goods on quarterly basis within 20 days from the close of quarter in the form ER-3.

- (c) The provisions of section 4A are as follows:
- (a) Excisable goods are valued on the basis of retail sale price when they are packaged and it is required under Standard of Weights and Measures Act, 1976 or Rules or under any other law to declare on such packages the retail sale price thereof. The Government may notify the products for the purpose of this section.
- (b) The assessable value shall be deemed to be the retail sale price declared on the package less amount of abatement. Abatements can be given by the Central Government through notifications after taking into account the amount of duties and taxes payable on such goods.
- (c) The retail sale price has been defined to mean the maximum price at which the excisable goods in packaged form may be sold to the ultimate consumer inclusive of all taxes and expenses and price is the sole consideration for such sale.

However, if the provisions of the Act, rules or other law as referred to in (a) above require the retail sale price to exclude any taxes, local or otherwise, the retail sale price shall be construed accordingly.

- (d) Where there is more than one retail sale price, the maximum of such retail sale price will be deemed to be the retail sale price for the purpose of this section.
- (e) Where different retail sale prices are declared on different packages for different areas, each such retail price shall be the retail sale price for the purposes of valuation of the excisable goods intended to be sold in the area to which the retail sale price relates.
- (f) The excisable goods shall be confiscated and the retail sale price will be ascertained in the manner prescribed by the Central Government if the manufacturer:
 - ♦ tampers, alters or obliterates the retail sale price declared on the package of goods after their removal, or
 - ♦ removes such goods without declaring the retail sale price on the packages or declares a retail sale price which is not the retail sale price as required to be declared under the provisions of the Act, rules or other law as referred to in (a) above.
- (g) If the retail sale price declared on the package of goods at the time of removal is altered to increase the retail sale price, such altered retail sale price shall be deemed to be the retail sale price.

Question 3

- (a) With reference to the Central Excise Act, 1944 and the rules made thereunder, write a brief note on the circumstances when personal penalty could be imposed on a director of a company or a partner of a firm or an employee or a transporter. (4 Marks)
- (b) M/s MM & Co., a machinery manufacturer, effected clearances from its factory with effect from 1.4.2006 by payment of duty under protest and had also filed an appeal against the order for payment of duty. On 15.5.2006, one of its customers M/s BB & Co. purchased the machines from M/s MM & Co. On 23.5.2007, the appeal filed by M/s MM & Co. was decided in favour of M/s MM & Co. Pursuant to the said order in the appeal filed by M/s MM & Co., its customer M/s BB & Co. filed a refund claim on 1.6.2007 claiming refund of duty suffered by M/s BB & Co. This claim for refund of duty was rejected by the department on the ground of 'unjust enrichment' as well as on the ground of 'limitation'. Explain briefly with reference to section 11B of the Central Excise Act, 1944 whether the action of the department is correct in law. (5 Marks)
- (c) Explain briefly the following with reference to the provisions of the Central Excise Rules, 2002 and relevant notification issued thereunder with regard to e-payment of duty:
 - (i) The threshold limit for mandatory e-payment of duty;
 - (ii) How and in what manner the time of payment would be reckoned under the e-

payment system?

- (iii) The due dates for payment of duty under the e-payment scheme in respect of an assessee. (2 x 3 = 6 Marks)

Answer

- (a) As per rule 26(1) any person who acquires possession of, or is in any way concerned in transporting, removing, depositing, keeping, concealing, selling or purchasing, or in any other manner deals with, any excisable goods which he knows or has reasons to believe are liable to confiscation under the Act or these rules, shall be liable to a penalty not exceeding the duty on such goods or Rs.2,000 whichever is greater. Section 9(1)(bbb) of the Central Excise Act also contemplates punishment for such dealings by any person. Thus a director, partner, employee or transporter or trader will be personally liable to penalty if he is personally involved in clandestine removal etc.

Further, penalty can be imposed on such persons if they issue any duty invoice without delivery of the goods or abet in making such invoice [Rule 26(2)(i)].

Penalty is also imposable on such persons if they issue any other document or abet in making such document on the basis of which, user of such document takes any ineligible benefit such as CENVAT credit or refund [Rule 26(2)(ii)].

- (b) Section 11B provides that every claim of refund shall be made within 1 year from the relevant date. Though the time limit is not applicable when duty is paid under protest [Second proviso to section 11B(1)], such benefit is available only to the manufacturer, who has paid duty under protest and not to the purchaser as decided in the case of Allied Photographics 2004 (166) ELT 3 (SC). The Apex Court, in the said case, explained that the claim of refund by the manufacturer and the buyer are different. Under section 4, every payment by manufacturer, whether under protest or otherwise, is on its own account. It cannot be said that after the buyer has borne the incidence of duty, it has stepped into the shoes of manufacturer. Thus, the benefit of no limitation period in case of protest cannot be extended to the buyer.

Thus, in the given question, since the refund claim filed by M/s. BB & Co., the purchaser, was not within a period of one year from the date of purchase, being 15.05.2006, the same is barred by period of limitation. Thus, the Department's action is correct in law.

- (c) (i) With effect from 01.04.2007, a third proviso has been inserted in rule 8(1) of Central Excise Rules, 2002 vide Notification No. 8/2007 CE (NT) dated 01.03.2007 to make e-payment mandatory for payment of duty by all assesseees who have paid excise duty of Rs.50 lakhs or more in cash during the preceding financial year. For others, it is optional.
- (ii) This a 24 x 7 facility. Payment can be made anytime from anywhere. All payments effected upto 8 p.m. will be accounted for the day as that day's receipt.
- Payments effected after 8 p.m. will be accounted as the next working day's receipt.
- (iii) For payment of excise duty by electronic means, the due date will be 6th of the succeeding month. For assesseees availing SSI exemption, the due date will be 16th

of the following month [Notification No.34/2007-CE (NT) dated 11.09.2007]. For the month of March, the due date will remain unchanged i.e., 31st March.

Question 4

- (a) State briefly the procedure to be adopted for clearance of 'prototypes' which are sent for trial or development test from the factory in terms of the Central Excise Rules, 2002. (2 Marks)
- (b) Will omission on the part of the assessee to provide correct information constitute 'suppression of facts' for purpose of the proviso to section 11A of the Central Excise Act, 1944. Write a brief note with reasons. (3 Marks)
- (c) Briefly examine the provisions relating to 'Settlement Commission' under the Central Excise Act, 1944 with particular reference to the changes brought in by the Finance Act, 2007. (5 Marks)
- (d) M/s Smart Ltd. manufactures certain excisable goods that are exempt from duty in terms of a notification, provided CENVAT credit of duty paid on input is not taken by the manufacturer. M/s Smart Ltd. had taken the credit of duty paid on inputs, but reversed the same before its utilization. The department denied the benefit of exemption on the ground that once the credit is taken it is immaterial whether the same is reversed before or after utilisation of such credit. State briefly whether the action of the department is correct under the Central Excise Act and rules made thereunder with reference to decided case law, if any. (5 Marks)

Answer

- (a) As per CBEC's Central Excise Manual of Supplementary Instructions 2005, if a prototype is to be sent out for trial purpose by actually putting them to effective use after conducting certain test to ensure that it meets with certain standard/specific norm, clearance has to be made on payment of duty. Its subsequent return to the factory is regulated in terms of rule 21 of the Central Excise Rules, 2002.
Rule 16C prescribing a special procedure for removal of excisable good for carrying out certain processes does not apply to 'prototypes'.
- (b) Omission on the part of the assessee to provide correct information does not constitute suppression of facts as the expression 'suppression of facts' used in the proviso to section 11A of Central Excise Act is accompanied by very strong words as 'fraud' and 'collusion' and, therefore, has to be construed strictly. Suppression means failure to disclose full information with intent to evade payment of duty. When the facts are known to both the parties, omission by one party to do what he might have done would not render it suppression.
Supreme Court in the case of Continental Foundation Joint Venture v. CCEX. (2007) 216 ELT 177 (SC) elaborated that mere omission to give correct information is not suppression of facts unless it was deliberate to evade the payment of duty.
- (c) The various amendments made by the Finance Act, 2007 in the provisions relating to Settlement Commission tend to curtail the scope of Settlement Commission. The

amendments are discussed in brief as under:

(i) Application only if the case is pending

Prior to 01.06.2007, an application for settlement could be filed even when original adjudicating authority had passed an order and the appeal was pending before a Central Excise Officer or the Central Government.

However, as per amended section 31(c), application can be made only when a 'case' is pending before adjudicating authority on the date of application. The Commission can also not be approached when the matter is remanded for fresh adjudication.

(ii) Amendment of section 32E putting certain restrictions

No application can be made if proper records are not maintained in daily stock register or when there is clandestine removal of goods. The additional amount of duty accepted by the applicant as payable shall be more than Rs.3 lakhs (the limit was Rs.2 lakhs upto 01.06.07). The appellant is required to pay duty admitted to be payable by him along with interest.

(iii) Application for settlement only once in life time

Section 32-O of the Central Excise Act (amended w.e.f. 01.06.07) provides that application for settlement can be made only once during the life time of the applicant.

(iv) Commission debarred from re-opening completed proceedings

Section 32H empowered the Settlement Commission to re-open completed proceedings. However, the Finance Act, 2007 has disempowered the Commission to reopen the proceedings in cases where applications are made on or after 01.06.2007.

(v) Commission debarred from granting immunity from prosecution for any offence under Indian Penal Code or any Central Act other than Central Excise Act

Section 32K empowered Settlement Commission to grant immunity from prosecution and penalty. However, with effect from 01.06.2007, the immunity can be granted only in respect of prosecution under the Central Excise Act. Further, with effect from 01.06.2007, the Commission shall also not have the power to grant immunity from payment of interest as provided under this Act.

Note: The Finance Act, 2007 has made few other amendments also in the provisions relating to the Settlement Commission. All such amendments are given in point no. 5 of the Final Course Supplementary Study Paper 2007.

- (d) The case is similar to CCEx. v. Bombay Dyeing & Mfg. Co. Ltd. (2007) 215 ELT 3 (SC), wherein it was held by the Apex Court that since the entry for credit was reversed before utilizing the same, it would amount to not taking of credit.

Hence, in view of this decision, M/s Smart Ltd. is entitled to claim the benefit of exemption notification and thus the Department's action is not correct.

Question 5

- (a) State briefly the provisions of the Central Excise Act, 1944 relating to arrest of a person.

(3 Marks)

(b) Write short notes on the following:

- (i) Desk review under Excise Audit, 2000.
- (ii) Duty drawback under section 37 of the Central Excise Act, 1944.

(3 x 2 = 6 Marks)

(c) Based on the following particulars, arrive at the CENVAT credit available on clearance of goods to Domestic Tariff Area (DTA) from an Export Oriented Unit (EOU):

Assessable value	Rs. 20 lakhs
Basic customs duty	10%
Excise duty	16%
Education cess	2%
Secondary and Higher Education cess	1%
VAT payable under State VAT law	4%

(6 Marks)

Answer

- (a) Any Central Excise Officer not below the rank of Inspector may arrest any person whom he has reason to believe to be liable to punishment under the provisions of the Central Excise Act or rules made thereunder. Such arrest can be made only with the prior approval of the Commissioner of Central Excise [Section 13 of Central Excise Act].

As per section 19 of the Act, every person arrested under the Act shall be forwarded without delay to the nearest Central Excise Officer empowered to send persons so arrested to a Magistrate, or if there is no such Central Excise Officer within a reasonable distance, to the officer-in-charge of the nearest police station. The arrest should be made as per the provisions of the Code of Criminal Procedure [Section 18 of the Central Excise Act].

- (b) (i) Desk Review is the first step in Excise Audit, 2000. Upon assignment of an audit, the auditor is required to be sufficiently prepared before the visit to the unit. For this purpose, the auditor reviews all the information available about the unit, its operations, and reasons for selection for audit and possible issues that can be identified at desk review stage. Perusal of assessee's profile, annual report, trial balance, cost audit report and income-tax audit report is involved in desk review.

Department has also decided to take help of practicing chartered/cost accountants in desk review of Excise Audit 2000.

- (ii) Under duty drawback scheme, excise and customs duties paid on inputs is given back to the exporters of finished products. Section 37 of Central Excise Act, 1944 empowers the Central Government to make rules to carry into effect the purpose of

the Act.

The Central Government, in exercise of powers conferred by section 37 of the Central Excise Act, 1944, section 75 of the Customs Act, 1962 and section 93A read with section 94 of the Finance Act, 1994 has made the Customs, Central Excise Duties and Service Tax Drawback Rules, 1995.

Under these rules, drawback is allowed on the export of goods at such amount, or at such rates, as may be determined by the Central Government.

The All Industry Rates of Drawback are given separately i.e., when CENVAT credit has been availed of and when such credit facility has not been availed of.

- (c) As per Notification No. 23/2003 CE dated 31.3.2003, 75% of basic customs duty is exempt in case of clearance of goods by an EOU to DTA. The amount of CENVAT credit can be calculated as under:

	Rs.
(i) Assessable value	20,00,000
(ii) Customs duty 25% of 10% of Rs.20,00,000	50,000
(iii) Additional duty (CVD) @ 16% of (Rs.20,00,000 + Rs.50,000)	3,28,000
(iv) Education cess @ 2% of Rs.3,28,000	6,560
(v) S & H education cess @ 1% of Rs.3,28,000	3,280
(vi) Special CVD (as VAT is payable)	NIL

As per rule 3 of CENVAT Credit Rules, 2004, the amount of CENVAT credit will be as under:

	Rs.
Additional duty of customs (CVD)	3,28,000
Education cess	6,560
S & H education cess	<u>3,280</u>
Total amount of credit	<u>3,37,840</u>

The credit can also be computed by using the formula provided in rule 3(7) of the CENVAT Credit Rules, 2004. The said rule gives the following formula for availing credit when goods are cleared by EOU to DTA after 1.3.2006:

$$\begin{aligned}
 \text{Credit available} &= \text{Assessable value} \times [(1 + \text{BCD}/400) \times \text{CVD}/100] \\
 &= 20,00,000 \times [(1 + 10/400) \times 16/100] \\
 &= 20,00,000 \times 1.025 \times 0.16 \\
 &= \text{Rs.}3,28,000 \\
 \text{Add: education cess @ 2\%} &= \text{Rs.}6,560
 \end{aligned}$$

Add: secondary and higher education cess @ 1%	= Rs.3,280
Total credit available	= Rs.3,37,840

PART - B

Question 6

- (a) Explain briefly with reference to the provisions of the Customs Act, 1962 the following :
- Appointment of officers of customs
 - Tariff value (2 x 2 = 4 Marks)
- (b) M/s Hind IT Co. imported laptops with Hard Disc Drives (HDD) preloaded with operating software like Windows XP, XP home etc. The department has claimed that the said laptop along with the operating software was classifiable and assessable as a single unit. It is the claim of the assessee that the software loaded HDD should be classified and assessed separately as an exemption is available as per notification issued under section 25(1) of the Customs Act, 1962. Decide with a brief note whether the action proposed by the department is correct in law. (4 Marks)
- (c) Write a note on "Project Imports" under the Customs Tariff Act, 1975 enumerating the eligible projects and the minimum investment criteria, if any. (6 Marks)
- (d) XYZ Industries Ltd., has imported certain equipment from Japan at an FOB cost of 2,00,000 Yen (Japanese). The other expenses incurred by M/s. XYZ Industries in this connection are as follows:
- Freight from Japan to India Port 20,000 Yen
 - Insurance paid to Insurer in India Rs.10,000
 - Designing charges paid to Consultancy firm in Japan 30,000 Yen
 - M/s. XYZ Industries had expended Rs.1,00,000 in India for certain development activities with respect to the imported equipment
 - XYZ Industries had incurred road transport cost from Mumbai port to their factory in Karnataka Rs. 30,000
 - The Central Board of Excise and Customs had notified for purpose of section 14(3)* of the Customs Act, 1962 exchange rate of 1 Yen = Rs.0.3948. The inter bank rate was 1 Yen = Rs.0.40
 - M/s XYZ Industries had effected payment to the Bank based on exchange rate 1 Yen = Rs. 0.4150
 - The commission payable to the agent in India was 5% of FOB cost of the equipment in Indian Rupees

FOB cost of the equipment in Indian Rupees

Arrive at the assessable value for purposes of customs duty under the Customs Act, 1962 providing brief notes wherever required with appropriate assumptions. (6 Marks)

*Note: In the amended section 14, the provisions relating to exchange rate are covered under explanation to section 14.

Answer

- (a) (i) Section 4(1) of the Customs Act, 1962 empowers the Central Board of Excise and Customs (CBEC) to appoint such persons as it thinks fit to be officers of customs.

Without prejudice to the provisions of sub-section (1), the Board may authorize a Chief Commissioner of Customs or a Commissioner of Customs or a Joint or Assistant Commissioner of Customs or Deputy Commissioner of Customs to appoint officers of customs below the rank of Assistant Commissioner of Customs. [Section 4(2) of the Customs Act, 1962].

- (ii) As per section 2(40) of the Customs Act, 'tariff value' in relation to any goods, means the tariff value fixed in respect thereof under sub-section (2) of section 14.

As per section 14(2) of the Act, notwithstanding anything contained in section 14(1), if the Board is satisfied that it is necessary or expedient so to do, it may, by notification in the Official Gazette, fix tariff values for any class of imported goods or export goods, having regard to the trend of value of such or like goods, and where any such tariff values are fixed, the duty shall be chargeable with reference to such tariff value.

- (b) The action proposed by the Department is correct in law. The facts of the case are similar to CCus. v. Hewlett Packard India Sales (P) Ltd. (2007) 215 ELT 484 (SC).

In this case, the Supreme Court observed that the pre-loaded operating system recorded in HDD in the laptop (item of import) forms an integral part of the laptop as the laptop cannot work without the operating system. A laptop without an operating system is like an empty building. Hence, laptop should be treated as one single unit and assessed accordingly.

However, if the operating system had been imported as packaged software like an accessory, then the benefit of exemption notification would have been available on it.

- (c) Setting up of a project in India may require a number of machines and equipments to be imported. This importation may spread over a period of time and thus assigning values and paying heavy customs duty on imported machineries make the initial project a cumbersome and costly process. Hence, concept of 'project import' has been introduced under heading 9801 of Customs Tariff to cover all machinery, instruments, apparatus and appliances, components or raw materials for initial setting up of a unit or substantial expansion of the existing project. The spare parts, raw material and consumables stores upto 10% of value of goods can be imported.

The eligible projects are:

- (i) Industrial plant
- (ii) Irrigation project
- (iii) Power project
- (iv) Mining project
- (v) Oil & other mineral exploration project
- (vi) Other projects as notified by the Central Government

Earlier, there was a condition that investment in plant and machinery should be at least Rs.5 crore. This condition has been waived with effect from 22.01.2007.

(d)	Yen
FOB value	2,00,000.00
Add: Ocean freight	20,000.00
Add: Designing charges paid in Japan	<u>30,000.00</u>
Total	<u>2,50,000.00</u>
Total value in Indian rupees	
$2,50,000 \times 0.3948$	Rs.98,700.00
(Rate of 1 yen = Rs.0.3948)	
Add: Insurance	Rs.10,000.00
Add: Agent's commission at 5% FOB value	<u>Rs.3,948.00</u>
(5% of 2,00,000 Yen x 0.3948)	
Total CIF price	Rs.1,12,648.00
Add: Landing charges @ 1%	Rs.1,126.48
(1% of 1,12,648)	
Assessable value for the purposes of customs duty	Rs.1,13,774.48
Rounded off	Rs.1,13,774.00

Notes:

- (i) Rule 10(1)(b)(iv) of the Customs Valuation (Determination of Value of Imported Goods) Rules, 2007 inter alia provides that value of development work undertaken elsewhere than in India is includible in the value of the imported goods. Thus, development charges paid for work done in India have not been included for the purposes of arriving at the assessable value.
- (ii) As per rule 10(2)(a) of the Customs Valuation (Determination of Value of Imported Goods) Rules, 2007, the cost of transport of the imported goods up to the place of

importation is includible for the purpose of valuation. Thus, transport cost from Mumbai port (place of importation) to the factory in Karnataka has not been considered for the purpose of customs valuation.

- (iii) Insurance has been assumed to be in respect of the cost of the equipment till the place of importation and is thus, includible [Rule 10(2)(c) of the Customs Valuation (Determination of Value of Imported Goods) Rules, 2007].
- (iv) As per rule 10(1)(a)(i) of the Customs Valuation (Determination of Value of Imported Goods) Rules, 2007, buying commission is not includible in the value of the imported goods. Since the agent's commission does not represent buying commission, hence, it is includible.
- (v) Landing charges have been considered as per clause (ii) of the proviso to rule 10(2) of the Customs Valuation (Determination of Value of Imported Goods) Rules, 2007.
- (vi) The rate of exchange notified by the CBEC has been considered [Clause (a) of the explanation to section 14 of the Customs Act, 1962].

Question 7

- (a) Explain briefly with reference to the provisions of the Customs Act, 1962 whether the owner of the warehoused goods has the right to relinquish his title to such goods after the expiration of the warehousing period or the extended warehousing period, as the case may be, and also state whether any charges shall become payable upon such relinquishment. (5 Marks)
- (b) State briefly any five illustrative cases under the Customs, Central Excise Duties and Service Tax Drawback Rules, 2006 (sic: 1995) where the All Industry Drawback rates will not apply. (5 Marks)
- (c) State briefly the provisions of the Customs Act, 1962 relating to payment of interest in case of provisional assessment. (5 Marks)

Answer

- (a) Yes, the owner of the warehoused goods has the right to relinquish his title to such goods after the expiration of warehousing period/extended warehousing period.

Proviso to section 68 of the Customs Act, 1962, provides that the owner of the warehoused goods can relinquish his title to such goods any time before an order for clearance of goods for home consumption has been made in respect of such goods. Similar view was expressed in the case of CCus. v. i2 Technologies Software (P) Ltd. 2007 (217) ELT 176 (Kar.)

However, the owner of any such warehoused goods shall not be allowed to relinquish his title to such goods regarding which an offence appears to have been committed under this Act or any other law for the time being in force.

On relinquishment of title to such goods, the owner of goods will be required to pay rent,

interest, other charges and penalties that may be payable. However, duty will not be payable on relinquishment.

- (b) Notification No. 68/2007 Cus. (NT) dated 16.07.2007 mentions that All Industry Drawback Rates do not apply to export of a commodity or product if such commodity or product is -
- (i) manufactured partly or wholly in a customs bonded warehouse.
 - (ii) manufactured or exported in discharge of export obligation against an Advance Licence or Advance Authorisation Scheme (however, excise portion of duty drawback rate is allowable).
 - (iii) manufactured or exported by a hundred percent export oriented undertaking.
 - (iv) manufactured or exported by a unit situated in free trade zone or export processing zone or special economic zone.
 - (v) manufactured or exported by availing the rebate of excise duty on inputs under rule 18 of the Central Excise Rules, 2002.
 - (vi) manufactured or exported without payment of duty under rule 19(2) of the Central Excise Rules, 2002.
 - (vii) manufactured or exported under duty entitlement pass book scheme.
- (c) Section 18 of the Customs Act, 1962 provides for provisional assessment. Duty is paid in two stages in case of provisional assessment; firstly, at the time of provisional assessment and another at the stage of finalization of assessment. Section 18(3) of the Customs Act provides that –
- (i) the importer or exporter shall be liable to pay interest, if differential amount is found to be payable.
 - (ii) the interest shall be payable at the rate prescribed under section 28AB of the Customs Act, 1962 (presently 13%).
 - (iii) the interest shall be payable from the first day of the month in which the duty is provisionally assessed till the date of payment thereof.
- Similarly, section 18(4) of the Customs Act, 1962 provides that –
- (i) if any amount is refundable after final assessment (subject to doctrine of unjust enrichment), interest shall be payable to the assessee.
 - (ii) interest shall be payable at the rate specified (6% presently) under section 27A of the Customs Act, 1962.
 - (iii) interest shall be granted if refund is not made within 3 months from the date of final assessment of duty.

Question 8

- (a) State briefly with reference to the provisions of section 27 of the Customs Act, 1962 whether the principle of “unjust enrichment” will apply in the following cases:

- (i) refund of wrongly encashed bank guarantee
 - (ii) refund of excess interest paid by the assessee
 - (iii) refund of duty on car imported for personal use. (2 x 3 = 6 Marks)
- (b) The Committee of Commissioners of Customs is empowered under the Customs Act, 1962 to direct the filing of an appeal before the Appellate Tribunal in certain cases while in certain others, it may direct an application to be filed before the Appellate Tribunal for determination of such points arising out of the decision or order as may be specified by the said committee. Write a brief note on the powers of the Committee of Commissioners of Customs bringing out the difference in the exercise of such powers. (4 Marks)
- *Note: The power to direct an application to be filed before the Appellate Tribunal for determination of such points arising out of the decision or order as may be specified by the Committee vests with the Committee of Chief Commissioner.
- (c) State in brief the provisions under the Customs Act, 1962 that seek to prohibit the import of goods infringing intellectual property rights (IPR). (5 Marks)

Answer

- (a) The bar of unjust enrichment applies in case of refund of customs duty under section 27(2) of the Customs Act, 1962. In the given cases, the applicability of the doctrine has been examined as under –
- (i) The provisions of section 27(2) apply when an assessee claims refund of duty, hence, bar of unjust enrichment will not apply to refund of wrongly encashed bank guarantee. An amount secured by bank guarantee cannot be held to be paid to the Revenue as duty. Hence, the Revenue will have to pay back the amount of bank guarantee (encashed wrongly), if the case is finally decided in favour of assessee – *Oswal Agro Mills Ltd. v. ACCE* (1994) 70 ELT 48 (SC).
 - (ii) The bar of unjust enrichment will apply in case of excess interest paid by the assessee as the words used under section 27(1) and 27(2) are “duty and interest, if any, paid on such duty”. The payment of interest is inextricably laced with payment of duty. Thus, the excess amount of interest paid by the assessee will be refunded to him only if he does not pass on the incidence of such interest to any other person.
 - (iii) The principle of unjust enrichment will not apply to refund of duty on car imported for personal use, as clause (b) of the proviso to sub-section (2) of section 27 of the Customs Act, 1962 stipulates that in case of imports made by an individual for his personal use, the refund should not be credited to consumer welfare fund, but shall be paid to the applicant.
- (b) Under section 129A(2) of the Customs Act, 1962, the Committee of Commissioners of Customs may direct the proper officer to file appeal on its behalf to the Appellate Tribunal against the order of Commissioner (Appeals), if it is of the opinion that the order is not legal or proper.

Under section 129D(1) of the Customs Act, 1962, the Committee of Chief Commissioners of Customs may, of its own motion, call for and examine the record of any proceedings in which a Commissioner of Customs has passed any decision or order under this Act for the purpose of satisfying itself as to the legality or propriety of any such decision or order and may, by order, direct such Commissioner or any other Commissioner to apply to the Appellate Tribunal for the determination of such points arising out of the decision or order as may be specified by the Committee of Chief Commissioners of Customs in its order.

Therefore, difference in two cases mentioned above is that in the former case the Department has to file a regular appeal with the Tribunal while in the latter case a review application is filed with the Tribunal. It may also be noted here that the review application is treated as appeal filed against the decision or order of the adjudicating authority vide section 129D(4) of the Customs Act, 1962.

Further, in the former case an appeal has to be filed within three months as specified in section 129A(3) of the Customs Act, 1962 while in the latter case application for review can be filed within four months; three months for the Committee of Chief Commissioner of Customs to issue order for review and further one month to the Commissioner to file an application .

- (c) The Government of India has an international obligation to protect Intellectual Property Rights (IPR) at the stage of import in terms of an agreement arrived at the WTO. Under clauses (n), (o) and (u) of the Customs Act, 1962 the Government has been empowered to prohibit, absolutely or conditionally, import or export of goods for the purpose of patent protection, trade marks or copyrights or for prevention of deceptive practices. Intellectual Property Rights (Imported Goods) Enforcement Rules, 2007 have been notified for this purpose vide Notification No. 47/2007 Cus. (NT) dated 08.05.2007.

Further, Notification No. 49/2007 Cus. (NT) dated 08.05.2007 has also been issued to prohibit the import of the goods described therein.

PART – C

Question 9

- (a) State briefly whether the following services under the Finance Act, 1994, relating to service tax, are taxable services. (Answer any three):
- (i) Services provided in the State of Rajasthan by a person having a place of business in the State of Jammu and Kashmir.
 - (ii) Services provided from India for use outside India.
 - (iii) Service provided from outside India and received in India by an individual, otherwise than from purpose of use in business or commerce.
 - (iv) Service provided to an Export oriented unit. (2 x 3 = 6 Marks)
- (b) Briefly state the provisions under the Service Tax Rules, 1994 relating to filing of returns and also state any late fee payable for delay in filing of returns. (3 Marks)

- (c) Answer the following with reference to the Finance Act, 1994 as amended relating to applicability of service tax:
- (i) Sale of lottery tickets.
 - (ii) Depository services and Electronic Access to Securities Information Services (EASI) provided by the Central Depository Services India Ltd.
 - (iii) Services provided by educational institutions like IIMs by charging a fee from prospective employers like corporate houses regarding recruiting candidates through campus interviews. (2 x 3 = 6 Marks)

Answer

- (a) (i) As per section 64(1) of the Finance Act, 1994, service tax provisions do not extend to the State of Jammu and Kashmir. However, since service tax is a destination based consumption tax, hence service provided in Rajasthan from Jammu and Kashmir would be liable to service tax.
- (ii) Since, service tax is a destination based-consumption tax, it is not leviable on export of services. Export of Services Rules, 2005 provide a scientific criteria to decide what is 'export of service'. The rules make it clear that exemption from service tax/rebate of service tax and excise duty paid is admissible only if there is 'export of service' as defined in these rules.
- Thus, assuming that the given service is exported in terms of Export of Services Rules, 2005, the export thereof would not be liable to service tax.
- (iii) Service tax would not be leviable in this case as the first proviso to section 66A(1) of the Finance Act, 1994 states that services received by an individual, otherwise than for the purpose of use in any business or commerce are exempt from payment of service tax.
- (iv) Service provided to export oriented undertaking is liable to service tax.
- (b) The service tax return is required to be filed under section 70 of the Finance Act, 1994 read with rule 7 of the Service Tax Rules, 1994, by any person liable to pay service tax in Form ST-3 as under:
- for the period from April to September – by 25th October
- for the period from October to March – by 25th April
- A single return has to be filed in respect of all taxable services provided by an assessee.
- As per rule 7C of the Service Tax Rules, 1994, delay in filing of return attracts late fee as under:
- (i) Delay upto 15 days - Rs.500
 - (ii) Delay upto 30 days – Rs.1,000
 - (iii) Delay beyond 30 days – Rs.1,000 + Rs.100 per day of delay beyond 30 days
- (c) (i) Section 65(19)(i) of the Finance Act, 1994 lays down that 'business auxiliary

service' means any service in relation to promotion or marketing or sale of goods produced or provided by or belonging to the client. Since, lottery tickets are actionable claims and not goods as decided by the Apex Court in the case of *Sunrise Associates v. Govt. of NCT of Delhi* (2006) 5 SSC (603), hence sale of lottery tickets is not liable to service tax.

- (ii) As per Circular No. 96/7/2007 ST dated 23.08.2007 definition of banking and other financial services inter alia specifically includes depository services [Section 65(12)(a)(v)] and provision and transfer of information and data processing [Section 65(12)(a)(vii)]. EASI services provided by the Central Depository Services India Ltd. (CDSL) fall within the scope of "provision and transfer of information and data processing". Therefore, the depository services provided by CDSL, including EASI services, for a fee are liable to service tax under banking and other financial services. [Section 65(105)(zm)]
- (iii) Manpower recruitment or supply agency is defined as 'any person engaged in providing any service, directly or indirectly, in any manner for recruitment or supply of manpower, temporarily or otherwise, to a client [Section 65(68)].

Educational institutes like IITs, IIMs etc. fall within the above definition. Thus, service tax is liable to be paid on services provided by such institutes in relation to campus recruitment under section 65(105)(k) of the Finance Act, 1994.

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 has not been satisfactory. It is essential for the students to understand various concepts related to both traditional as well as modern Cost Management. Students are advised to read extensively various reference books prescribed by Board of Studies and try to understand the different concepts of Cost Management in depth.

Specific Comments

Question 1.(a) This problem is from the area of Marginal Costing. Very few students were able to attempt this question on the desired lines. Errors were made in the computation of fixed and variable overheads.

(b) This problem of PERT / CPM requires examinees to draw Network diagram and find out peak requirement. Most of the students computed the critical path correctly but failed to calculate peak requirement of manpower and also the days on which they will occur.

(c) This theory part requiring an understanding of Angle of Incidence was not answered on the correct lines by most of the students. Many students were unable to draw a BEP chart correctly and failed to explain the angle of incidence.

Question 2.(a) This theory question part is from the area of Decision Making using concepts of Marginal Costing. Most of the students answered this question part well.

(b) This practical question part is from the area of Standard Costing. Some students were unable to compute the standard labour rate per hour and the standard variable overhead rate per hour correctly and hence derived wrong answers. Few students were confused between the variable expenditure variance and the total overhead variance.

(c) This practical question part requires an understanding of learning curve and basic cost concepts. While working out the minimum selling price per unit for an order of 15,000 units, a few students have included the fixed cost element also. The application of learning curve does not appear to be clear to a majority of students.

Question 3.(a) This question part is from the area of Transfer Pricing. Most of the students have not used the contribution approach and have computed the total cost and total sales for different options. Most of the students have not been able to find the correct strategy for Department A, Department B and the company as a whole.

(b) The answer to this theory part relating to Pricing decisions was satisfactory in most of the cases.

Question 4.(a) This numerical question part requires a sound understanding of Traditional and Activity Based Costing. Almost all candidates failed to prepare profitability statement

under conventional system correctly. Most of the examinees have calculated prime cost on the basis of sales units instead of gross production units.

(b) This theory question is based on Critical Path Analysis. Examinees were unable to show the use of dummy activity in networking with the help of diagram.

(c) This theory question is based on Basic concepts of Simulation. Many examinees have answered the use of inventory control in general, but have not explained the use of Monte Carlo Simulation method Inventory Control.

Question 5.(a) In this problem of Linear Programming, only a handful number of students were able to formulate Linear equations correctly.

(b) This theory question is based on Basic concepts of Linear Programming. Some have answered this question without realizing the important role of different constraints. The key measures of theory of constraints were explained by very few examinees.

(c) Examiners have reported a lack of clear understanding of various areas of decision making in which differential costing is used.

Question 6.(a) Many students were unable to compute the initial allocation by North-West corner rule. Few students applied both the method in the same manner.

(b) This numerical problem requires a basic understanding of costing concepts relating to operating and marginal costing. Some students have answered this cross functional question correctly. However, many of them has taken the 'difference of revenue' into the consideration only without finding total implication arising due to lodging house managers proposal.

(c) Students in general have answered this question well. However, only few have given correct examples.

PAPER – 6: MANAGEMENT INFORMATION AND CONTROL SYSTEMS

General Comments

Generally the candidates exhibited lack of conceptual clarity of the subject. They could not write the answers on expected lines due to lack of adequate preparation of the subject. Rather than writing the answer systematically, their answers were vague and out of context. Examinees are advised to read the study material and reference material thoroughly so that they can give to the point answers and avoid unnecessary details.

Specific comments:

Question 1.(a) Most of the candidates failed to discuss various factors that renders manual audit method ineffective in Information System Audit.

(b) Candidates exhibited lack of knowledge of the components of an analysis and design work bench.

(c) Examinees failed to discuss the database control features precisely.

(d) Some of the candidates could not discuss properly the powers of Central Govt. under section 87 of IT Act, 2000.

Question 2.(a) Majority of the candidates failed to discuss salient features of work-in-process control system.

(b) This part relating to pre-requisites of a MIS as an effective tool was not attempted satisfactorily by majority of the candidates.

Question 3.(a) Instead of describing the procedure for investigation of present system, many candidates mentioned fact finding technique.

(b) Instead of explaining controls that should be incorporated in the system to make frauds difficult to perpetrate, some of the candidates discussed various types of frauds.

Question 4.(a) Few candidates discussed benefits of ERP, while others clubbed the features and characteristics of ERP.

(b) Candidates explained components of EIS instead of Decision Support System.

(c) Some of the candidates wrote essay type answers rather than giving precise definition of various computer fraud and abuse techniques.

Question 5.(a) Many candidates discussed factors to be considered for form layout instead of discussing various issues that should be considered while designing system input.

(b) Candidates discussed limitations of client / server model instead of explaining the risk associated with it.

(c) Satisfactory performance by majority of the candidates.

(d) Only few candidates explained the concept of parallel run in system testing.

Question 6. In majority of the cases, the answers were vague and not specific.

Question 7.(c) Candidates could not explain programme documentation correctly. Some of them only gave objectives / advantages of programme documentation.

PAPER – 7 : DIRECT TAXES

General Comments

The coverage of the question paper is good and it has maintained a good balance between questions involving application provisions and theoretical questions as well as questions on latest amendments and case laws. However, the performance of candidates reflected lack of adequate preparation and lack of awareness of latest amendments and judicial rulings. Further, the candidates lacked 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.

Specific Comments

Question 1.

1. Profit of Rs.2,50,000 from hedging contract entered into for meeting any loss in foreign currency payments for purchase of imported machinery has to be deducted from the cost of machinery and the depreciation and the additional depreciation thereon debited to the profit and loss account has to be added back. However, some students have wrongly treated the profit from hedging contract as "Income from other sources". Further, even the students who have correctly deducted the profit from the cost of machinery, have not added back the excess depreciation and additional depreciation charged to profit and loss account.
2. Some candidates have wrongly disallowed incidental charges paid to financial institution for taking short-term loan repayable in 18 months.
3. A few candidates have wrongly stated that registration fees of Rs.20,000 paid to Registrar of Companies is not allowable whereas listing fees of Rs.30,000 paid to Stock Exchange on the issue of bonus shares is allowable or vice versa.
4. Brought forward loss of A.Y 1998-99 of X Ltd. which got merged with the company in the financial year 2003-04 is allowable for set off up to 8 years from the year of merger as per section 72A. Many students have wrongly treated that such loss is not allowable stating that the period of 8 years has to be calculated from 1998-99.
5. Employee's contribution to provident fund cannot be claimed as deduction since it is not paid within the due date specified under the PF Act as per section 36(1)(va). Many candidates have confused this payment with payment of employer's contribution to PF which is allowable as per 43B if paid before the due date for filing return of income.

Question 2.

- (a) This question is based on the provisions of section 129 and the Apex Court ruling in Pradip Lamp Works v. CIT (2001) 249 ITR 797. Most candidates were not aware of the provisions of this section or of the case law and have wrongly stated that the order was not valid since further opportunity was not given.
- (b) A typographical error cannot invalidate an assessment order if such order is in substance in conformity with or according to the intent and purpose of the Act. The question speaks about the appeal against the order passed by the Assessing Officer under section 143(3). The assessee wanted to treat this order as invalid so that the additions made under 143(3) would be deleted automatically. However, almost all the students have inferred that the appeal is against the typographical error and have answered that this is a mistake apparent from record and can be corrected.
- (c) The question is on the prescribed modes of service of notice and the persons on whom the notice is to be served. Many candidates have not understood the meaning of "mode of service" and have dealt with when and under what circumstances notices have to be issued. Even those who have specified the persons have not named the correct persons named in the Act (e.g. in the case of a company, the person on whom the notice is to be

served is the "principal officer" whereas many candidates have answered as "Managing Director" or "Director")

Question 3.(a) This question is on the allowability / chargeability of certain transactions of a partnership firm:

- (a) Depreciation on imported instruments ready for use on 26.03.2008 and used for one operation.

Some common mistakes are -

- (i) Not including customs duty paid in the cost of instruments;
 - (ii) Not applying the correct rate of depreciation on instruments;
 - (iii) Providing for additional depreciation, though the same is not allowable since instruments are not used for production of any article or thing.
- (b) Salary to working partners: The salary paid to a working partners is not allowable since the deed is silent as to the quantum and the manner of distribution. This concept is not known to many candidates.
- (c) Salary to wife of partner: In the answer to this question, candidates were required to discuss about the allowability of salary in the hands of firm i.e. whether the salary is excessive or unreasonable as per section 40A(2). However, some candidates have wrongly discussed about the clubbing of salary of the wife of the partner with her husband.
- (d) Purchase of medicines in cash for Rs.35,000: A few candidates have wrongly disallowed only 20% of Rs.35,000 instead of disallowing the entire expenditure.
- (e) Revenue expenditure incurred for promoting family planning amongst its employees: Such expenditure is allowable only in the case of a company. However, many candidates have wrongly allowed the same in the hands of the firm also.
- (b) Some candidates were not aware of the time limit within which an appeal should be filed in each case even though they have correctly answered the available remedial recourse.

Question 4.(a) In answering sub-part (3) of this question, some candidates were not aware that anonymous donations to religious trusts are not chargeable to tax under section 115BBC.

In answering sub-part (4) of this question, many candidates were not aware that entertainment allowance received by the Minister of Surface Transport is exempt upto Rs.5,000 or 1/5th salary as per section 16(ii).

For sub-part (5), though the candidates have answered that the rent of Rs.30,000 is chargeable to tax, they have not clearly stated that the amount received is recovery of unrealised rent chargeable to tax under section 25AA under the head "Income from house property".

- (b) Most of the candidates were not aware of the mode of attachment and sale of property dealt with in the Second Schedule to the Income-tax Act.

Question 5.(a) Most candidates could not correctly state the quantum of penalty leviable in each case.

(b) The question requires the candidates to explain the meaning of "eligible business" referred to in section 80-IE. However, many students have given the meaning of "eligible article or thing" under section 80-IE. Besides, almost all students have set forth the conditions to be satisfied to claim the deduction under section 80-IE, which is not required.

(c) Most of the candidates were not aware of the provisions of section 124(3), which provides for the circumstances when the assessee can raise a question as to the jurisdiction of an Assessing Officer.

Question 6.(a) Some candidates were not aware of the new definition of India as per section 2(25A) as substituted by the Finance Act, 2007.

(c) The question requires the candidates to specify the public facilities notified by the CBDT as infrastructure facility for the purpose of section 36(1)(viii). Many candidates have wrongly discussed about "specified entity" and "eligible business" under that section.

Question 7.(a) This question is on taxability of the forfeiture of security deposit from employees who have resigned and also recovery of notice pay and training charges from them. Many candidates were not aware of the Allahabad High Court ruling providing that such forfeiture and recovery are income attributable to business of banking and hence eligible for deduction under section 80P.

(b) Many candidates were neither aware of the amendment made by the Finance Act 2007 nor of the Apex Court ruling that the assessee has to be given a reasonable opportunity of being heard before directing special audit under section 142(2A).

(c) This question is based on the Apex Court ruling in CIT vs. Alagendran Finance Ltd. (2007) 293 ITR 1. Many candidates were not aware of this ruling.

Question 8.(a) This question requires the candidates to state whether the assets mentioned therein constituted assets chargeable to wealth-tax. An agricultural farm house situated within 25 kms of a municipality is an asset under section 2(ea). Some candidates were confused with the distance and stated that since it is not within 8 kms (which is applicable for purposes of agricultural income under the Income-tax Act), the same is not an asset.

(b) This question is based on the Apex Court ruling in Narendra Nath v. CWT (1969) 74 ITR 190. However, most of the candidates were not aware of this Apex Court ruling and were hence not able to answer correctly.

PAPER – 8 : INDIRECT TAXES

General comments

The performance in the paper was not satisfactory. It is suggested that candidates should make an in-depth study of the subject so as to score good marks. They should also improve their presentation skills and follow an analytical approach while answering the questions. Candidates should substantiate their answers by quoting sections, rules and case laws etc. as far as possible.

Question 1.(a)(i) Few candidates got confused between the definition of assessee as provided in the Central Excise Rules, 2002 and the definition of assessee given in the Income-tax Act, 1961.

(a)(iii) Many candidates wrongly explained that assessee's whose turnover exceed the limit prescribed by the Central Government are treated as large tax payers.

(b) The answers were largely correct for this question. However, the relevant case law was not cited by a large number of candidates.

(c)(i) Majority of the candidates wrongly concluded that basic excise duty credit can only be utilized for payment of basic excise duty and not for payment of education cess and secondary and higher education cess.

(c)(ii) Most of the candidates wrongly concluded that CENVAT credit on inputs lying in stock or in process or contained in the final product cannot be reversed when the final product is subsequently exempted.

(d) Many candidates performed satisfactorily in this part of the question. However, few of them answered without explaining the requirements of the manufacture.

Question 2.(a): Many candidates wrongly mentioned that remission of duty should be granted on the goods which are cleared from the factory after payment of duty but destroyed by fire during transit.

(b) Majority of the candidates could not explain the steps to be initiated for the purpose of compliance with the requirements of the small scale exemption notification and the Central Excise Act, 1944 and the rules made thereunder.

Question 3.(b): Performance of the candidates in this part of the question was very poor. Almost all of them could not correctly explain the provisions relating to time limit available for filing refund claim in case of duty paid under protest.

(c)(i) A few candidates wrongly mentioned the threshold limit for e-payment of duty as Rs.100 lakh.

(c)(ii) A large number of the candidates were not able to write the manner in which the time of payment would be reckoned under the e-payment system. Instead they wrongly mentioned the due dates for payment of duty in this part of the question.

(c)(iii) Some of the candidates wrongly mentioned the due date for payment of duty in case of e-payment as fifth day of the succeeding month instead of sixth day of the succeeding month.

Question 4.(a): Majority of the candidates wrongly explained that clearance of 'prototypes' could be made without any payment of duty with the prior approval of the Deputy/Assistant Commissioner of Central Excise. Further, some of them got confused between the removal of prototypes and provisions relating to job work.

(b) Many candidates failed to properly explain the concept and meaning of the term 'suppression of facts' for the purpose of the proviso to section 11A of the Central Excise Act. They were unable to bring out the difference between omission and suppression of facts. They did not highlight the intention to avoid payment of duty.

(c) Candidates were generally ignorant about the amendments made by the Finance Act, 2007 in the provisions relating to Settlement Commission.

(d) A few candidates wrongly concluded that the Department was justified in denying the benefit of exemption on the ground that once the credit is taken, it is immaterial whether the same is reversed before or after utilization thereof.

Question 5.(a): Many candidates explained certain unnecessary details which did not have any relation with the provisions relating to arrest.

(c) Majority of the candidates failed to compute the CENVAT credit available on clearance of goods by an EOU to DTA with the given data. They were not aware of the 75% exemption available on basic custom duty in respect of clearance of goods by EOU to DTA. Further, many candidates forgot to add the basic customs duty to the assessable value for calculating additional duty of customs.

Question 6.(b): Few candidates wrongly concluded that exemption under section 25 would be available for software as software and laptops are different articles.

(d) Most of the candidates were not able to correctly compute the assessable value. The common mistakes observed are:

- (i) Adoption of incorrect rate of exchange
- (ii) Wrong determination of the amount of commission
- (iii) Not considering landing charges
- (iv) Not considering the designing charges paid in Japan

Question 7.(b): Most of the answers given by the candidates were irrelevant and based on mere guess work. They failed to give the illustrative cases relating to the non applicability of All Industry Drawback rates.

Question 8.(a)(i): Candidates failed to explain that bank guarantee and payment of excise duty are not the same. Thus, they wrongly concluded that the principle of unjust enrichment would be applicable in case of refund of wrongly encashed bank guarantee.

(a)(ii) Candidates wrongly concluded that payment of interest is separate from payment of duty and thus, principle of unjust enrichment would not apply in case of refund of excess interest paid by the assessee.

(c) Majority of the candidates failed to state the provisions of the Customs Act, 1962 and notifications issued thereunder which seek to prohibit the import of goods infringing intellectual property right.

Question. 9(a)(iv) Many candidates were not aware that services provided to export oriented undertakings are liable to service tax.

(c)(ii) A few candidates wrongly answered that depository services and electronic access to securities information services provided by the Central Depository Services India Ltd. are in the nature of information technology services and thus, are not liable to service tax.

(c)(iii) Some candidates wrongly concluded that IIMs, being educational institutes, could not be construed as manpower recruitment agencies even when they provide services in relation to campus interviews by charging a fee.