

PAPER – 1 : ADVANCED ACCOUNTING

Answer all questions.

Working notes should form part of the answer.

Question 1

The draft Balance Sheets of 3 Companies as at 31st March, 2007 are as below:

	(In Rs.000's)		
	Morning Ltd.	Evening Ltd.	Night Ltd.
Liabilities			
Share Capital – shares of Rs.100 each	40,000	20,000	10,000
Reserves	1,800	1,000	900
P/L A/c (1.4.06)	1,500	2,000	800
Profit for 2006-07	7,000	3,800	1,800
Loan from Morning Ltd.	—	5,000	—
Creditors	<u>2,500</u>	<u>1,000</u>	<u>1,400</u>
	<u>52,800</u>	<u>32,800</u>	<u>14,900</u>
Assets			
Investments:			
1,60,000 shares in Evening	18,000	—	—
75,000 shares in Night	8,000	—	—
Loan to Evening Ltd.	5,000	—	—
Sundry assets	<u>21,800</u>	<u>32,800</u>	<u>14,900</u>
	<u>52,800</u>	<u>32,800</u>	<u>14,900</u>

Following additional information is also available:

- Dividend is proposed by each company at 10%.
- Stock transferred by Night Ltd. to Evening Ltd. fully paid for was Rs.8 lacs on which the former made a Profit of Rs.3 lacs. On 31st March, 2007, this was in the inventory of the latter.
- Loan referred to is against 8% interest. Neither Morning Ltd. nor Evening Ltd. has considered the interest.
- Reserves as on 1.4.2006 of Evening Ltd. and Night Ltd. were Rs.8,00,000 and Rs.7,50,000 respectively.
- Cash-in-transit from Evening Ltd. to Morning Ltd. was Rs.1,00,000 as on 31.3.2007.
- The shares of the subsidiaries were all acquired by Morning Ltd. on 1st April, 2006.

Prepare consolidated Balance Sheet as on 31st March, 2007. Workings should be part of the answer. (16 Marks)

Answer

Consolidated Balance Sheet of Morning Ltd. with its subsidiaries Evening Ltd. and Night Ltd.

As on 31st March, 2007

(Rs. in thousand)

Liabilities	Rs.	Rs.	Rs.	Assets	Rs.	Rs.	Rs.
Share Capital			40,000	Sundry Assets*			
Minority Interest				Morning Ltd.		21,800	
Evening Ltd.		4,880		Evening Ltd.	32,800		
Night Ltd.		<u>3,125</u>	8,005	Less: Unrealized profit	<u>300</u>	32,500	
Capital Reserve [Refer Note 5]			902.5	Night Ltd.		<u>14,900</u>	69,200
General Reserve							
Morning Ltd.		1,800					
Evening Ltd.		160					
Night Ltd.		<u>112.5</u>	2,072.5				
Profit & Loss A/c							
Balance on 1.04.06	1,500						
Profit during 06-07	7,000						
Add: Interest on Loan	<u>400</u>						
	8,900						
Less: Proposed dividend	<u>4,000</u>	4,900					
Add: P& L Account of Evening Ltd.		2,720					
Add: P& L Account of Night Ltd		<u>1,050</u>	8,670				
Creditors							
Morning Ltd.		2,500					
Evening Ltd.		1,000					
Night Ltd		<u>1,400</u>	4,900				

* The total of Sundry Assets of the Group mutually sets off the effect of Cash-in-transit of Rs.1 lac from Evening Ltd. to Morning Ltd. Hence, cash in transit has not been separately shown.

Proposed Dividend			
Morning Ltd.	4,000		
Evening Ltd. (Minority)	400		
Night Ltd. (Minority)	<u>250</u>	<u>4,650</u>	
		<u>69,200</u>	<u>69,200</u>

Workings Notes:

- A. Morning Ltd.'s holding in Evening Ltd. is 1,60,000 shares out of 2,00,000 shares, i.e., 4/5th or 80%; Minority holding 1/5th or 20%.
- B. Morning Ltd.'s holding in Night Ltd. is 75,000 shares out of 1,00,000 shares, i.e., 3/4th or 75%; Minority holding 1/4th or 25%.

Analysis of Reserves and Profits of Subsidiary Companies

	Evening Ltd. (Rs.'000)	Night Ltd Rs.('000)	Minority interest in Evening Ltd. (1/5) Rs.('000)	Minority interest in Night Ltd. (1/4) Rs.('000)
1. Capital Reserve (pre-acquisition reserves and profits)				
Reserves on 1.04.2006	800	750		
Profit on 1.04.2006	<u>2,000</u>	<u>800</u>		
	2,800	1,550		
Less: Minority interest	<u>560</u>	<u>387.5</u>	560	387.5
	<u>2,240</u>	<u>1,162.5</u>		
2. General Reserve				
Reserves as per Balance Sheet	1,000	900		
Less: Capital Reserve [See Note A]	<u>800</u>	<u>750</u>		
	200	150		
Less: Minority interest	<u>40</u>	<u>37.5</u>	40	37.5
	<u>160</u>	<u>112.5</u>		
3. Profit and Loss Account				
Profit for the year as per Balance Sheet	3,800	1,800		
Less: Interest on Loan (5,000 x 8%)	<u>400</u>			
	3,400			

Less: Minority Interest	<u>680</u>	<u>450</u>	680	450
	2,720	1,350		
Less: Unrealised profit on stock transfer	<u> </u>	<u>300*</u>		
	<u>2,720</u>	<u>1,050</u>		
4. Share Capital				
As per Balance sheet	20,000	10,000		
Less: Minority interest	<u>4,000</u>	<u>2,500</u>	<u>4,000</u>	<u>2,500</u>
Transferred for computation of Goodwill/Capital Reserve	<u>16,000</u>	<u>7,500</u>	5,280	3,375
Less: Proposed dividend shown separately			<u>400</u>	<u>250</u>
Transferred to Consolidated Balance Sheet			<u>4,880</u>	<u>3,125</u>

5. Computation of Cost of Control i.e. Goodwill / Capital Reserve on consolidation

(Rs. In thousand)

	Evening Ltd.	Night Ltd.
Cost of Investments	18,000	8,000
Less: Paid up value of shares [Refer Note 4]	<u>16,000</u>	<u>7,500</u>
	2,000	500
Less: Capital Reserve [Refer Note 1]	<u>2,240</u>	<u>1,162.5</u>
	<u>-240</u>	<u>-662.5</u>
Total Capital Reserve (Rs.240 + Rs.662.5)	902.5	

Question 2

The Balance Sheets of Strong Ltd. and Weak Ltd. as on 31.03.2007 is as below:

Balance Sheet as on 31.03.2007

Liabilities	Strong Ltd. Rs.	Weak Ltd. Rs.	Assets	Strong Ltd. Rs.	Weak Ltd. Rs.
Equity Share Capital (Rs.100 each)	50,00,000	30,00,000	Fixed Assets other than Goodwill	30,00,000	20,00,000
Reserve	4,00,000	2,00,000	Stock	8,00,000	6,00,000
P/L A/c	6,00,000	4,00,000	Debtors	14,00,000	9,00,000

* As per para 17 of AS 21, 'Unrealised profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full.

Creditors	5,00,000	3,00,000	Cash & Bank	12,00,000	3,50,000
			Preliminary Expenses	1,00,000	50,000
	<u>65,00,000</u>	<u>39,00,000</u>		<u>65,00,000</u>	<u>39,00,000</u>

Strong Ltd. takes over Weak Ltd. on 01.07.07. No Balance Sheet of Weak Ltd. is available as on that date. It is however estimated that Weak Ltd. earns estimated profit of Rs.2,00,000 after charging proportionate depreciation @ 10% p.a. on fixed assets, during April-June, 2007.

Estimated profit of Strong Ltd. during these 3 months is Rs.4,00,000 after charging proportionate depreciation @ 10% p.a. on fixed assets.

Both the companies have declared and paid 10% dividend within this 3 months' period. Goodwill of Weak Ltd. is valued at Rs.2,00,000 and Fixed Assets are valued at Rs.1,00,000 above the estimated book value. Purchase consideration is to be satisfied by Strong Ltd. by shares at par. Ignore Income-tax.

You are required to calculate the following:

- No. of shares to be issued by Strong Ltd. to Weak Ltd. against purchase consideration;
- Net Current Assets of Strong Ltd. and Weak Ltd. as on 01.07.2007;
- P/L A/c balance of the Strong Ltd. as on 01.07.2007;
- Fixed Assets as on 01.07.2007;
- Balance Sheet of Strong Ltd. as on 01.07.2007 after take over of Weak Ltd. (16 Marks)

Answer

- Number of shares to be issued by Strong Ltd. to Weak Ltd. against purchase consideration

Weak Ltd.	Rs.	Rs.
Goodwill		2,00,000
Fixed Assets	20,00,000	
Less: Depreciation	<u>50,000</u>	
	19,50,000	
Add: Appreciation	<u>1,00,000</u>	20,50,000
Stock		6,00,000
Debtors		9,00,000
Cash and Bank balances	3,50,000	
Add: Profit after depreciation	2,00,000	
Add: Depreciation (non-cash)	<u>50,000</u>	2,50,000

Less: Dividend	<u>(3,00,000)</u>	<u>3,00,000</u>
		40,50,000
Less: Creditors		<u>3,00,000</u>
Purchase Consideration		<u>37,50,000</u>

(ii) Calculation of Net Current Assets as on 01.07.2007

		Strong Ltd. Rs.		Weak Ltd. Rs.
Current assets:				
Stock		8,00,000		6,00,000
Debtors		14,00,000		9,00,000
Cash and Bank	12,00,000		3,50,000	
Less: Dividend	(5,00,000)		(3,00,000)	
Add: Profit before depreciation	<u>4,75,000</u>	<u>11,75,000</u>	<u>2,50,000</u>	<u>3,00,000</u>
		33,75,000		18,00,000
Less: Creditors		<u>5,00,000</u>		<u>3,00,000</u>
		<u>28,75,000</u>		<u>15,00,000</u>

(iii) Profit and Loss Account balance of Strong Ltd. as on 1.07.2007

	Rs.
P & L A/c balance as on 31.03.2007	6,00,000
Less: Dividend paid	<u>5,00,000</u>
	1,00,000
Add: Estimated profit for 3 months after charging depreciation	<u>4,00,000</u>
	<u>5,00,000</u>

(iv) Fixed Assets as on 01.07.2007

Fixed Assets of Strong Ltd. as on 31.03.2007		30,00,000
Less: Depreciation for 3 months		<u>75,000</u>
		29,25,000
Fixed assets taken over of Weak Ltd. as on 31.03.2007	20,00,000	
Less: Proportionate depreciation for 3 months on fixed assets	<u>50,000</u>	
	19,50,000	
Add: Appreciation above the estimated book value	<u>1,00,000</u>	<u>20,50,000</u>
		<u>49,75,000</u>

(v) Balance Sheet of Strong Ltd. as on 01.07.2007 (after Take Over)

Liabilities	Rs.	Assets	Rs.
Equity Share capital: 87500 (50,000+ 37,500) shares of Rs.100 each	87,50,000	Goodwill Fixed assets [as computed in (iv)]	2,00,000 49,75,000
Reserves	4,00,000	Stock	14,00,000
Profit and Loss Account [as computed in (iii)]	5,00,000	(8,00,000 + 6,00,000) Debtors	23,00,000
Creditors (5,00,000 + 3,00,000)	8,00,000	(14,00,000 + 9,00,000) Cash and Bank (11,75,000+ 3,00,000)	14,75,000
		Preliminary expenses	1,00,000
	<u>1,04,50,000</u>		<u>1,04,50,000</u>

Question 3

- (a) Shivaji Ltd. purchased Fixed assets worth Rs.90,00,000 on 1st April, 2002. The life of the assets is 10 years and they are to be depreciated on straight line basis. The assets were revalued on 1st April, 2004 when 50% of the assets was assessed at 10% less than the book value, and the remaining assets were revalued at 15% higher than book value. The assets were ultimately sold on 1.4.2006 for Rs.54,80,000. Excess depreciation on revaluation, if any, should be charged to Revaluation Reserve.

Show Fixed Assets A/c, Depreciation A/c and Revaluation Reserve A/c, supported by Workings wherever necessary.

- (b) The Balance Sheet of Domestic Ltd. as on 31st March, 2007 is as under:

(All figures are in lacs)

Liabilities	Rs.	Assets	Rs.
Equity Shares Rs.10 each	3,000	Goodwill	744
Reserves (including provision for taxation of Rs.300 lacs)	1,000	Premises and Land at cost	400
5% Debentures	2,000	Plant and Machinery	3,000
Secured Loans	200	Motor Vehicles	40
Sundry Creditors	300	(purchased on 1.10.06)	
Profit & Loss A/c		Raw materials at cost	920
Balance from previous B/S	Rs.32	Work-in-progress at cost	130
Profit for the year (After taxation)	<u>Rs.1,100</u>	Finished Goods at cost	180
		Book Debts	400

Investment (meant for replacement of Plant and Machinery)	1,600
Cash at Bank and Cash in hand	192
Discount on Debentures	10
Underwriting Commission	<u>16</u>
	<u>7,632</u>

The resale value of Premises and Land is Rs.1,200 lacs and that of Plant and Machinery is Rs.2,400 lacs. Depreciation @ 20% is applicable to Motor Vehicles. Applicable depreciation on Premises and Land is 2%, and that on Plant and Machinery is 10%. Market value of the Investments is Rs.1,500 lacs. 10% of book debts is bad. In a similar company the market value of equity shares of the same denomination is Rs.25 per share and in such company dividend is consistently paid during last 5 years @ 20%. Contrary to this, Domestic Ltd. is having a marked upward or downward trend in the case of dividend payment.

Past 5 years' profits of the company were as under:

2001-02	Rs.67 lacs
2002-03	(-) Rs.1,305 lacs (loss)
2003-04	Rs.469 lacs
2004-05	Rs.546 lacs
2005-06	Rs.405 lacs

The unusual negative profitability of the company during 2002-03 was due to the lock out in the major manufacturing unit of the company which happened in the beginning of the second quarter of the year 2001-02 and continued till the last quarter of 2002-03.

Value the Goodwill of the Company on the basis of 4 years' purchase of the Super Profit. (Necessary assumption for adjustment of the Company's inconsistency in regard to the dividend payment, may be made by the examinee). (8+12 = 20 Marks)

Answer

(a)		In the books of Shivaji Ltd.			
		Fixed Assets Account			
Dr.				Cr.	
		Rs.		Rs.	
1.4.2002	To Bank	90,00,000	31.3.2003	By Depreciation	9,00,000
				By Balance c/d	<u>81,00,000</u>
		<u>90,00,000</u>			<u>90,00,000</u>

1.4.2003	To	Balance b/d	81,00,000	31.3.2004	By	Depreciation	9,00,000
					By	Balance c/d	72,00,000
			<u>81,00,000</u>				<u>81,00,000</u>
1.4.2004	To	Balance b/d	72,00,000	1.4.2004	By	Revaluation Reserve (W.N.2)	3,60,000
	To	Revaluation Reserve (W.N.1)	5,40,000	31.3.2005	By	Depreciation (W.N.3)	9,22,500
					By	Balance c/d	64,57,500
			<u>77,40,000</u>				<u>77,40,000</u>
1.4.2005	To	Balance b/d	64,57,500	31.3.2006	By	Depreciation	9,22,500
					By	Balance c/d	55,35,000
			<u>64,57,500</u>				<u>64,57,500</u>
1.4.2006	To	Balance b/d	55,35,000	1.4.2006	By	Bank	54,80,000
					By	Revaluation Reserve (loss)	55,000
			<u>55,35,000</u>				<u>55,35,000</u>

Depreciation Account

			Rs.				Rs.
31.3.2003	To	Fixed assets	<u>9,00,000</u>	31.3.2003	By	P&L Account	<u>9,00,000</u>
31.3.2004	To	Fixed assets	<u>9,00,000</u>	31.3.2004	By	P&L Account	<u>9,00,000</u>
31.3.2005	To	Fixed assets	9,22,500	31.3.2005	By	P&L Account	9,00,000
					By	Revaluation Reserve Account (W.N.4)	22,500
			<u>9,22,500</u>				<u>9,22,500</u>
31.3.2006	To	Fixed assets	9,22,500	31.3.2006	By	P&L Account	9,00,000
					By	Revaluation Reserve Account	22,500
			<u>9,22,500</u>				<u>9,22,500</u>

Dr.		Revaluation Reserve Account				Cr.	
		Rs.				Rs.	
1.4.2004	To	Fixed assets (Loss on revaluation)	3,60,000	1.4.2004	By	Fixed Assets (upward revaluation)	5,40,000
31.3.2005	To	Depreciation (W.N.4)	22,500				
	To	Balance c/d	<u>1,57,500</u>				
			<u>5,40,000</u>				<u>5,40,000</u>
31.3.2006	To	Depreciation	22,500	1.4.2005	By	Balance b/d	1,57,500
	To	Balance c/d	<u>1,35,000</u>				
			<u>1,57,500</u>				<u>1,57,500</u>
1.4.2006	To	Fixed assets (Loss on sale of revalued assets)	55,000	1.4.2006	By	Balance b/d	1,35,000
	To	General Reserve	<u>80,000</u>				
			<u>1,35,000</u>				<u>1,35,000</u>

Workings Notes:

- Calculation of Revaluation amount to be shown in revaluation reserve account:
 Downward revision of 50% of fixed assets = $(Rs.72,00,000 \times \frac{1}{2}) \times 10\% = Rs.3,60,000$
 Upward revision of remaining 50% of fixed assets = $(Rs.72,00,000 \times \frac{1}{2}) \times 15\% = Rs.5,40,000$
- Value of Fixed assets after revaluation as on 1.4.04:
 $[(72,00,000 \times \frac{1}{2}) - 3,60,000] + \{(72,00,000 \times \frac{1}{2}) + 5,40,000\} = Rs.32,40,000 + 41,40,000 = Rs.73,80,000$
- Depreciation per annum for remaining 8 years
 Value of Fixed Assets = Rs.73,80,000 (W.N.2)
 Remaining life of the asset = 8 years
 New Depreciation = $Rs.73,80,000 / 8 = Rs.9,22,500$
- Depreciation to be charged to Revaluation Reserve Account
 $= Rs.9,22,500 - Rs.9,00,000 = Rs.22,500$

(b) 1. Calculation of capital employed

Present value of assets:		Rs. (in lacs)
Premises and land		1,200
Plant and machinery		2,400
Motor vehicles (book value less depreciation for $\frac{1}{2}$ year)		36
Raw materials		920
Work-in-progress		130
Finished goods		180
Book debts (400 x 90%)		360
Investments		1,500
Cash at bank and in hand		<u>192</u>
		6,918
Less: Liabilities:		
Provision for taxation	300	
5% Debentures	2,000	
Secured loans	200	
Sundry creditors	<u>300</u>	<u>2,800</u>
Total capital employed on 31.3.07		<u>4,118</u>
2. Profit available for shareholders for the year 2006-07		
Profit for the year as per Balance Sheet		1,100
Less: Depreciation to be considered		
Premises and land	24*	
Plant & machinery	240*	
Motor vehicles	<u>4</u>	<u>268</u>
		832
Less: Bad debts		<u>40</u>
Profit for the year 2006-07		<u>792</u>
3. Average capital employed		
Total capital employed		4118
Less: $\frac{1}{2}$ of profit for the current year [Refer point 2]		<u>396</u>
Average capital employed		<u>3722</u>

* Depreciation on premises and land and plant and machinery have been provided on the basis of assumption that the same has not been provided for earlier.

		Rs. (in lacs)
4.	Average profit to determine Future Maintainable Profits	
	Profit for the year 2006-07	792
	Profit for the year 2005-06	405
	Profit for the year 2004-05	546
	Profit for the year 2003-04	<u>469</u>
		2212 / 4
		<u>553</u>
5.	Calculation of General Expectation:	
	Domestic Ltd. pays Rs.2 as dividend (20%) for each share of Rs.10.	
	Market value of equity shares of the same denomination is Rs.25 which fetches dividend of 20%.	
	Therefore, share of Rs.10 (Face value of shares of Domestic Ltd.) is expected to fetch $(20/25) \times 10 = 8\%$ return.	
	Since Domestic Ltd. is not having a stable record in payment of dividend, in its case the expectation may be assumed to be slightly higher, say 10%.	
6.	Calculation of super profit	Rs. (in lacs)
	Future maintainable profit [See point 4]	553
	Normal profit (10% of average capital employed as computed in point 3)	<u>372.2</u>
	Super Profit	<u>180.8</u>
7.	Valuation of Goodwill	
	Goodwill at 4 years' purchase of Super Profit	723.20

Notes:

- (1) It is evident from the Balance Sheet that depreciation was not charged to Profit & Loss Account.
- (2) It is assumed that provision for taxation already made is sufficient.
- (3) While considering past profits for determining average profit, the years 2001-02 and 2002-03 have been left out, as during these years normal business was hampered.

Question 4

- (a) Indian Engineering and Technological Institute, an autonomous body furnishes the following information:

On 1.4.2006, unutilised restricted government grant (capital) balance is Rs.40,00,000; unutilised unrestricted government grant (revenue) balance is Rs.9,00,000; Institute's own corpus fund is Rs.25,00,000. Besides, a private endowment fund of Rs.18,50,000 is there on that date. The entire endowment fund is in fixed deposit with a bank fetching interest of 9.5% p.a. half-yearly transferred on 30th September and 31st March to a current account meant for scholarship and awards. The said current account has a debit

balance of Rs.1,37,500. Apart from this, total cash and bank balance as on 1.4.06 is Rs.85,00,000.

Following transactions took place during the year 2006-07:

- (1) Salary paid out of own fund is Rs.65,00,000.
- (2) Salary to the research associates of a Government sponsored research scheme is Rs.4,00,000 paid out of unrestricted government grant.
- (3) Cost of renovation of the administrative building borne out of the Institute's own fund is Rs.4,75,000. The renovation work was completed on 21st November, 2006 which was also the date of payment. Book value of the building was Rs.38,00,000 on 1.4.06. The rate of depreciation is 5% p.a. calculated at full year's rate if the asset exists for a period exceeding 6 months, and at half-year's rate in other cases. The same principle is followed by the Institute in all cases of depreciation.
- (4) Tuition fees were received Rs.85,00,000.
- (5) Scholarships and awards of Rs.1,43,000 were given on 9th December, 2006.
- (6) A laboratory building was under construction for the last two years. Balance of capital work-in-progress on 1.4.06 was Rs.28,00,000. The work has been completed on 25th May, 2006. Final payment was made earlier on 29.4.2006. Total expenditure comes to Rs.37,00,000. Rate of depreciation on the laboratory building is 5%. The entire expenditure will be spent from the restricted government (capital) Grant on certain conditions attached by the government. The Institute follows the principles of AS 12 in the case of use of revenue and capital grant. Since certain conditionality will apply over a period of time, it is decided that deferred income method will be followed.

Show the following Ledger accounts:

- (i) Restricted Government Grant (capital) A/c.
 - (ii) Unrestricted Government Grant (revenue) A/c.
 - (iii) Current A/c of Endowment and Scholarship.
 - (iv) Cash and Bank A/c.
- (b) Value Added Ltd. furnishes the following Profit and Loss A/c:

Profit and Loss A/c for the year ended 31 st March, 2007		
Income	Notes	Rs.('000)
Turnover	1	29,872
Other Income		<u>1,042</u>
		<u>30,914</u>
Expenditure		
Operating expenses	2	26,741
Interest on 8% Debenture		987

Interest on Cash Credit	3	151
Excise duty		<u>1,952</u>
		<u>29,831</u>
Profit before depreciation		1,083
Less: Depreciation		<u>342</u>
Profit before tax		741
Provision for tax	4	<u>376</u>
Profit after tax		365
Less: Transfer to Fixed Assets Replacement Reserve		<u>65</u>
		300
Less: Dividend paid		<u>125</u>
Retained Profit		<u>175</u>

Notes:

- (1) Turnover is based on invoice value and net of sales tax.
- (2) Salaries, wages and other employee benefits amounting to Rs.14,761 ('000) are included in operating expenses.
- (3) Cash Credit represents a temporary source of finance. It has not been considered as a part of capital.
- (4) Transfer of Rs.54 ('000) to the credit of deferred tax account is included in provision for tax.

Prepare value added statement for the year ended 31st March, 2007 and reconcile total value added with profit before taxation.
(8+8 = 16 Marks)

Answer

(a) Restricted Government Grant (Capital) Account

Dr.		Rs.				Cr.
						Rs.
31.3.07	To Income and Expenditure A/c - Grant against laboratory building (recognized to the extent of amount spent)	37,00,000	1.4.06	By	Balance b/d	40,00,000
	To Balance c/d	<u>3,00,000</u>				
		<u>40,00,000</u>				<u>40,00,000</u>
			1.4.07	By	Balance b/d	3,00,000

Unrestricted Government Grant (Revenue) Account

		Rs.			Rs.
31.3.07	To Income & Expenditure A/c (salary paid to research associates)	4,00,000	1.4.06	By Balance b/d	9,00,000
	To Balance c/d	<u>5,00,000</u>			
		<u>9,00,000</u>			<u>9,00,000</u>
			1.4.07	By Balance b/d	5,00,000

Current Account of Endowment and Scholarship

		Rs.			Rs.
1.4.06	To Balance b/d	1,37,500	9.12.06	By Scholarship & awards	1,43,000
30.9.06	To Interest on fixed deposit (9.5% of Rs.18,50,000 for 6 months)	87,875	31.3.07	By Balance c/d	1,70,250
31.3.07	To Interest on fixed deposit (9.5% of Rs.18,50,000 for 6 months)	<u>87,875</u>			
		<u>3,13,250</u>			<u>3,13,250</u>
1.4.07	To Balance b/d	1,70,250			

Cash and Bank Account

		Rs.			Rs.
1.4.06	To Balance b/d	85,00,000	29.4.06	By Capital WIP (37,00,000 – 28,00,000)	9,00,000
31.3.07	To Tuition fee	85,00,000*	21.11.06	By Administrative Building A/c	4,75,000
			31.3.07	By Salary	65,00,000
			31.3.07	By Salary to research associates	4,00,000
			31.3.07	By Balance c/d	<u>87,25,000</u>
		<u>1,70,00,000</u>			<u>1,70,00,000</u>
1.4.07	To Balance b/d	87,25,000			

* Besides unrestricted government grant, tuition fee is also one of the primary source of income for unrestricted fund account. The question requires the preparation of unrestricted govt. grant account, therefore it is assumed that tuition fee has been credited to unrestricted fund account other than unrestricted government grant account.

(b)

Value Added Ltd.

Value Added Statement for the year ended 31st March, 2007

	Rs.('000)	Rs.('000)	%
Turnover		29,872	
Less: Cost of bought in materials and services:			
Operating expenses (26,741 –14,761)	11,980		
Excise duty	1,952		
Interest on Cash Credit	<u>151</u>	<u>14,083</u>	
Value added by manufacturing and trading activities		15,789	
Add: Other income		<u>1,042</u>	
Total value added		<u>16,831</u>	
Application of value added:			
To Pay to employees:			
Salaries, wages and other employee benefits		14,761	87.70
To Pay to Government:			
Corporation tax (376 – 54)		322	1.91
To Pay to providers of capital:			
Interest on 8% Debentures	987		
Dividends	<u>125</u>	1,112	6.61
To Provide for maintenance and expansion of the company:			
Depreciation	342		
Fixed Assets Replacement Reserve	65		
Deferred Tax Account	54		
Retained Profit	<u>175</u>	<u>636</u>	<u>3.78</u>
		<u>16,831</u>	<u>100</u>

Note: Deferred tax account could alternatively be shown as an item 'To pay to government'.

Reconciliation between total value added and profit before taxation

	Rs.('000)	Rs.('000)
Profit before tax		741
Add back: Depreciation	342	
Wages, salaries and other benefits	14,761	
Debenture interest	<u>987</u>	<u>16,090</u>
Total Value Added		<u>16,831</u>

Question 5

- (a) Arrange and redraft the following Cash Flow Statement in proper order keeping in mind the requirements of AS 3:

	Rs. (in lacs)	Rs.(in lacs)
Net Profit		60,000
Add: Sale of Investments		70,000
Depreciation on Assets		11,000
Issue of Preference Shares		9,000
Loan raised		4,500
Decrease in Stock		12,000
		1,66,500
Less: Purchase of Fixed Assets	65,000	
Decrease in Creditors	6,000	
Increase in Debtors	8,000	
Exchange gain	8,000	
Profit on sale of investments	12,000	
Redemption of Debenture	5,700	
Dividend paid	1,400	
Interest paid	<u>945</u>	<u>1,07,045</u>
		59,455
Add: Opening cash and cash equivalent		<u>12,341</u>
Closing cash and cash equivalent		<u>71,796</u>

- (b) P Ltd. has 60% voting right in Q Ltd. Q Ltd. has 20% voting right in R Ltd. Also, P Ltd. directly enjoys voting right of 14% in R Ltd. R Ltd. is a listed company and regularly supplies goods to P Ltd. The management of R Ltd. has not disclosed its relationship with P Ltd.

How would you assess the situation from the viewpoint of AS 18 on Related Party Disclosures?

- (c) Lessee Ltd. took a machine on lease from Lessor Ltd., the fair value being Rs.7,00,000. The economic life of the machine as well as the lease term is 3 years. At the end of each year Lessee Ltd. pays Rs.3,00,000. Guaranteed Residual Value (GRV) is Rs.22,000 on expiry of the lease. Implicit Rate of Return (IRR) is 15% p.a. and present value factors at 15% are 0.869, 0.756 and 0.657 at the end of first, second and third years respectively.

Calculate the value of machine to be considered by Lessee Ltd. and the interest (Finance charges) in each year.
(6+4+6 = 16 Marks)

Answer

(a) Cash Flow Statement		(Rs. in lacs)
Cash flows from operating activities		
Net profit		60,000
Less: Exchange gain		(8,000)
Less: Profit on sale of investments		<u>(12,000)</u>
		40,000
Add: Depreciation on assets		<u>11,000</u>
Change in current assets and current liabilities		51,000
(-) Increase in debtors	(8,000)	
(+) Decrease in stock	12,000	
(-) Decrease in creditors	<u>(6,000)</u>	<u>(2,000)</u>
Net cash from operating activities		49,000
Cash flows from investing activities		
Sale of investments	70,000	
Purchase of fixed assets	<u>(65,000)</u>	
Net cash from Investing activities		5,000
Cash flows from financing activities		
Issue of preference shares	9,000	
Loan raised	4,500	
Redemption of Debentures	(5,700)	
Interest paid	(945)	
Dividend paid	<u>(1,400)</u>	
Net cash from financing activities		<u>5,455</u>
Net increase in cash & cash equivalents		59,455
Add: Opening cash and cash equivalents		<u>12,341</u>
Closing cash and cash equivalents		<u>71,796</u>

- (b) P Ltd. has direct economic interest in R Ltd to the extent of 14%, and through Q Ltd. in which it is the majority shareholders, it has further control of 12% in R Ltd. (60% of Q Ltd's 20%). These two taken together (14% + 12%) make the total control of 26%.

Para 10 of AS 18 'Related Party Disclosures', defines related party as one that has at any time during the reporting period, the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Here, Control is defined as ownership directly or indirectly of more than one-half of the voting power of an enterprise; and Significant Influence is defined as participation in the financial and/or operating policy decisions of an enterprise but not control of those policies.

In the present case, control of P Ltd. in R Ltd. directly and through Q Ltd., does not go beyond 26%. However, as per para 12 of AS 18, significant influence may be exercised as an investing party (P Ltd.) holds, directly or indirectly through intermediaries 20% or more of the voting power of the R Ltd. As R Ltd. is a listed company and regularly supplies goods to P Ltd. therefore, related party disclosure, as per AS 18, is required.

- (c) Value of machine will be lower of the fair value or present value (PV) of Minimum Lease Payments (MLP).

Present value (PV) of Minimum Lease Payments (MLP)

Year	MLP	PV at 15% Rs.	PV Amount Rs.
1	3,00,000	0.869	2,60,700
2	3,00,000	0.756	2,26,800
3	3,22,000 (considering residual value)	0.657	<u>2,11,554</u>
			<u>6,99,054</u>

Since PV of MLP Rs. 6,99,054 being lower than the fair value Rs. 7,00,000, therefore, value of machine will be taken as Rs.6,99,054.

Calculation of interest (finance charges)

Year	Liability	Interest at 15%	Principal	Lease rental
	Rs.	Rs.	Rs.	Rs.
	6,99,054	1,04,858	1,95,142	3,00,000
1 st	Less: Principal <u>1,95,142</u>		(Rental – Interest)	
	5,03,912	75,587	2,24,413	3,00,000
2 nd	Less: Principal <u>2,24,413</u>		(Rental – Interest)	
	2,79,499	41,925	2,58,075	3,00,000
			(Rental – Interest)	
3 rd	Less: Principal <u>2,58,075</u>			
	Residual value <u>21,424*</u>			

* The difference between this figure and guaranteed residual value (Rs. 22,000) is due to approximation in computing the interest rate implicit in the lease.

Question 6

Write short notes on the following:

- (a) The concept of Materiality.
- (b) Maintenance of Books of Account by Stock Brokers.
- (c) Human Resources Accounting. (6+5+5 = 16 Marks)

Answer

- (a) Para 17 of AS 1 'Disclosure of Accounting Policies', states that financial statements should disclose all material items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements. Materiality depends on the size of item or error judged in the particular circumstances of its omission or misstatement. From a positive perspective, materiality has to do with the significance of an item or event to warrant attention in the accounting process. From a negative view point, materiality is critical because otherwise a great deal of time might be spent on trivial matters in the accounting process. Individual judgements are required to assess materiality, or to decide what the appropriate minimum quantitative criteria are to be set for given situations. What is material to one organisation, may not be material for another organisation.

The relevance of information is affected by its materiality. Information is material if its misstatements (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

- (b) Every stock broker is required to maintain the following books of account and records as per Rule 15 of the Securities Contracts (Regulation) Rules, 1957 and Regulation 17 of the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992:
 - (a) Register of transactions (Sauda book)/Daily transaction list;
 - (b) Clients ledger;
 - (c) General ledger;
 - (d) Journals;
 - (e) Cash book;
 - (f) Bank Pass Book;

- (g)* Documents register containing, inter-alia particulars of securities received and delivered in physical form and the statement of account and other records relating to receipt and delivery of securities provided by the depository participants (in respect of dematerialized securities);
- (h) Members' contract book showing details of all contracts entered into by him with other members of the stock exchange or counterfoils or duplicates of memos of confirmation issued to such other members;
- (i) Counterfoils or duplicates of contract notes issued to clients;
- (j) Written consent of clients in respect of contracts entered into as principals;
- (k) Margin deposit book;
- (l) Register of accounts of sub-brokers;
- (m) An agreement with a sub-broker specifying the scope of authority and responsibilities of the stock broker and such sub-broker.
- (n)**An agreement with the sub-broker and with the client of the sub-broker to establish privity of contract between the stock broker and the client of the sub-broker.

In addition to the above statutory requirements, stock brokers are also required to maintain scripwise clientwise list in respect of scripts of specified group, client upla statement, duplicate copies of self-certificates submitted on monthly basis, copies of margin statements downloaded by the stock exchange, copies of valan balance sheet (Form 31), details of spot delivery transactions, client data base and broker client agreement, copy of registration certificate of each sub-broker issued by SEBI, copies of the power of attorney/board resolution authorising directors and employees and copies of pool account statements.

- (c) Human Resource Accounting (HRA) is an attempt to identify, quantify and report investments made in human resources of an organization. Leading public sector units like OIL, BHEL, NTPC and SAIL etc. have started reporting human resources in their annual reports as additional information. Although human beings are considered as the prime mover for achieving productivity, and are placed above technology, equipment and money, the conventional accounting practice does not assign significance to the human resource. Human resources are not thus recognized as 'assets' in the Balance Sheet.

* Substituted by the SEBI (Stock Brokers of Sub-brokers) (Amendment) Regulations, 2003 w.e.f. 23.09.2003.

** Inserted by the SEBI(Stock Brokers and Sub-brokers) (Amendment) Regulations, 2003, w.e.f. 23.09.2003.

While investments in human resources are not considered as assets and not amortised over the economic service life, the result is that the income and expenditure statement comprising current revenue and expenditure gives a distorted picture of the real affairs of the organization.

Accountants have been severely criticized by the Behavioural Scientists for their failure to value human resources, as this has come out as a handicap for effective management.

Human resource accounting provides scope for planning and decision making in relation to proper manpower planning. Also, such accounting can bring out the effect of various new rules, procedures and incentives relating to work force, and in turn, can act as an eye opener for modifications of existing statutes and laws.

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

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

Figures in the margin indicate marks allotted to each question.

Working notes should form part of the answer.

Question 1

ABC Ltd. Sells computer services to its clients. The company has recently completed a feasibility study and decided to acquire an additional computer, the details of which are as follows:

- (1) The purchase price of the computer is Rs.2,30,000; maintenance, property taxes and insurance will be Rs.20,000 per year. The additional expenses to operate the computer are estimated at Rs.80,000. If the computer is rented from the owner, the annual rent will be Rs.85,000, plus 5% of annual billings. The rent is due on the last day of each year.
- (2) Due to competitive conditions, the company feels that it will be necessary to replace the computer at the end of three years with a more advanced model. Its resale value is estimated at Rs.1,10,000.
- (3) The corporate income tax rate is 50% and the straight line method of depreciation is followed.
- (4) The estimated annual billing for the services of the new computer will be Rs.2,20,000 during the first year, and Rs.2,60,000 during the subsequent two years.
- (5) If the computer is purchased, the company will borrow to finance the purchase from a bank with interest at 16% per annum. The interest will be paid regularly, and the principal will be returned in one lump sum at the end of the year 3.

Should the company purchase the computer or lease it? Assume (i) cost of capital as 12%, (ii) straight line method of depreciation, (iii) salvage value of Rs.1,10,000 and evaluate the proposal from the point of view of lessor also. (20 Marks)

Answer

Alternative 1

1. Evaluation of ABC Ltd's position under buying option considered.

Cost of Capital 12% as per question.

$$\text{Depreciation p.a.} = \frac{2,30,000 - 1,10,000}{3} = 40,000$$

Particulars	Y	E	A	R
	1	2	3	NPV
Service Charges Receivable	2,20,000	2,60,000	2,60,000	
Tax, Insurance etc	(-)20,000	(-)20,000	(-)20,000	
Cost of operation	(-)80,000	(-)80,000	(-)80,000	

Depreciation	(-)40,000	(-)40,000	(-)40,000	
Interest on Loan @ 16%	(-)36,800	(-)36,800	(-)36,800	
Incremental PBT	43,200	83,200	83,200	
Corporate tax @ 50%	(-)21,600	(-)41,600	(-)41,600	
Incremental PAT	21,600	41,600	41,600	
Depreciation added back	40,000	40,000	40,000	
Incremental recurrent cash flow	61,600	81,600	81,600	
Terminal Cash Flow				
Repayment of Loan			(-)2,30,000	
Disposal of the computer			1,10,000	
Cash flows of buying option	61,600	81,600	38,400	
Discounting factors @ 12%	*0.893	*0.797	*0.712	
NPV of buying option	55,009	65,035	27,341	92,703

2. Evaluation of ABC Ltd's position under leasing option.

Particulars	Y 1	E 2	A 3	R NPV
Service Charges Receivable	2,20,000	2,60,000	2,60,000	
Cost of operation	(-)80,000	(-)80,000	(-)80,000	
Lease Rent	(-)96,000	(-)98,000	(-)98,000	
Incremental PBT	44,000	82,000	82,000	
Corporate tax @ 50%	(-)22,000	(-)41,000	(-)41,000	
	22,000	41,000	41,000	
Discounting factor @ 12%	*0.893	*0.797	*0.712	
NPV of Leasing option	19,646	32,677	29,192	81,515
Higher NPV under buying option				11,188

In view of above buying option is recommended

Note:

1. Maintenance and particularly insurance are to be paid by the owner. So, cash outflow of Rs.10,000 = Rs.20,000* (1 - 0.5) is not considered under leasing option.
2. Cash flows on account of Service Charges Receivable and Cost of Operation of the computer are common to both of the alternatives. These could therefore, have been eliminated. The NPV's of the options will change but the net NPV of Rs.11,188 will be the same. Full credit should be given for such answers also.

Evaluation from the lessor's point of view

The lessor is also supposed to buy the computer under the same terms of financing. His position is analysed below:

Particulars	Y 1	E 2	A 3	R NPV
Lease Rental	96,000	98,000	98,000	
Taxes & Insurance – being the owner, will be borne by the lessor	(-)20,000	(-)20,000	(-)20,000	
Loan Interest	(-)36,800	(-)36,800	(-)36,800	
Depreciation	(-)40,000	(-)40,000	(-)40,000	
Incremental PBT	(-)800	1,200	1,200	
Corporate tax	400	(-)600	(-)600	
(Assuming that the less will get adjusted with other profits for leasing out other assets)	(-)400	600	600	
Depreciation added back	40,000	40,000	40,000	
	39,600	40,600	40,600	
Terminal Disposal			1,10,000	
Repayment of Loan			(-)2,30,000	
Cash Flow	39,600	40,600	79,400	
Discount factor @ 16 (1- 0.5)% = 8%	*0.926	*0.857	*0.794	
NPV of leasing	36,670	36,670	(-)63,044	8,420

The NPV being positive, the proposal would be acceptable to the lessor also.

Alternative answer

Particulars	Y 1	E 2	A 3	R NPV
Lease Rental	96,000	98,000	98,000	
Taxes & Insurance – being the owner, will be borne by the lessor	(-)20,000	(-)20,000	(-)20,000	
Loan Interest	(-)36,800	(-)36,800	(-)36,800	
Depreciation	(-)40,000	(-)40,000	(-)40,000	
Incremental PBT	(-)800	1,200	1,200	

Corporate Tax @50%		(-) 200	(-) 600	
PAT	(-) 800	1,000	600	
Depreciation added back	40,000	40,000	40,000	
			40,600	
			(-) 1,20,000	
	39,200	41,000	(-) 79,400	
	*0.926	*0.857	*0.794	
	36,299	35,137	(-) 63,044	8,392

In view of the positive NPV , the proposal should be accepted by lessor.

Alternative 2

Evaluation from the point of view of lessee. The lessee has two alternatives: (i) To acquire the computer out of borrowed funds, and (ii) To acquire the computer on lease basis. The financial implications of these two options can be evaluated as follows:

Option I: To acquire computer out of borrowed funds. In this case, the company has to pay interest @ 16% annually and repayment of loan at the end of 3rd year. However, the salvage value of Rs.1,10,000 will be available to it. The information can be presented as follows:

Year	Interest	Depreciation	Expenses	Tax Shield (5)=50% of (2+3+4)	Cash outflows	PVF (8%)	PV (Rs.)
(1)	(2)	(3)	(4)	(5)	6=(2+4-5)		
1.	Rs.36,800	Rs.40,000	Rs.20,000	Rs.48,400	Rs.8,400	.926	7,778
2.	36,800	40,000	20,000	48,400	8,400	.857	7,199
3.	36,800	40,000	20,000	48,400	8,400	.794	6,670
4.	Repayment – Salvage (2,30,000 – 1,10,000)				Rs.1,20,000	.794	95,280
	Present Value of Outflows						1,16,927

Option II: To acquire the Computer on lease basis: In this case, the Company will be required to pay an annual lease rent of Rs.85,000 + 5% of annual billing at the end of year. The financial implications can be evaluated as follows:

Year	Rental	5% of Billing	Tax Shield	Cash Outflow	PV (8%)	{PV}
	(1)	(2)	(3)= (50% of 1+2)	(4)= (1+2+3)		
1	Rs.85,000	Rs.11,000	Rs.48,000	Rs.48,000	.926	Rs.44,448
2	85,000	13,000	49,000	49,000	.857	41,993
3	85,000	13,000	49,000	49,000	.794	38,906
	Present Value of Outflows					1,25,347

As the PV of outflows is less in case of buying option, the Company should borrow funds to buyout the computer.

Note: It may be noted that the additional expenses of Rs.80,000 to operate the computer have not been considered in the above calculation. These expenses are required in both the options and are considered to be irrelevant to decide between lease or buy.

Evaluation from the point of view of lessor:

	Year 1	Year 2	Year 3
Lease Rental	85,000	85,000	85,000
5% of Billing	11,000	13,000	13,000
Total Income	96,000	98,000	98,000
Less: Maintenance Expenses	20,000	20,000	20,000
Depreciation	40,000	40,000	40,000
Income before tax	36,000	38,000	38,000
Tax @ 50%	18,000	19,000	19,000
Net Income after Tax	18,000	19,000	19,000
Depreciation added back	40,000	40,000	40,000
Cash Inflow (Annual)	58,000	59,000	59,000
Scrap Value	-	-	1,10,000
	58,000	59,000	1,69,000
PVF (12%)	.893	.797	.712
Present Value	51,794	47,023	1,20,328
Total Present Value			2,19,145
Less: Initial Cost			2,30,000
Net Present Value			<u>-10,855</u>

As the NPV for the lessor is negative, he may not accept the proposal.

Question 2

- (a) A Ltd. wants to acquire T Ltd. and has offered a swap ratio of 1:2 (0.5 shares for every one share of T Ltd.). Following information is provided:

	A Ltd.	T. Ltd.
Profit after tax	Rs.18,00,000	Rs.3,60,000
Equity shares outstanding (Nos.)	6,00,000	1,80,000

EPS	Rs.3	Rs.2
PE Ratio	10 times	7 times
Market price per share	Rs.30	Rs.14

Required:

- (i) The number of equity shares to be issued by A Ltd. for acquisition of T Ltd.
 - (ii) What is the EPS of A Ltd. after the acquisition?
 - (iii) Determine the equivalent earnings per share of T Ltd.
 - (iv) What is the expected market price per share of A Ltd. after the acquisition, assuming its PE multiple remains unchanged?
 - (v) Determine the market value of the merged firm. (10 Marks)
- (b) XY Ltd. which is specialized in manufacturing garments is planning for expansion to handle a new contract which it expects to obtain. An investment bank have approached the company and asked whether the Co. had considered venture Capital financing. In 2001, the company borrowed Rs.100 lacs on which interest is paid at 10% p.a. The Company shares are unquoted and it has decided to take your advice in regard to the calculation of value of the Company that could be used in negotiations using the following available information and forecast.

Company's forecast turnover for the year to 31st March, 2005 is Rs.2,000 lacs which is mainly dependent on the ability of the Company to obtain the new contract, the chance for which is 60%, turnover for the following year is dependent to some extent on the outcome of the year to 31st March, 2005. Following are the estimated turnovers and probabilities:

Turnover Rs. (in lacs)	Year - 2005	Turnover Rs.(in lacs)	Year - 2006
	Prob.		Prob.
2,000	0.6	2,500	0.7
		3,000	0.3
1,500	0.3	2,000	0.5
		1,800	0.5
1,200	0.1	1,500	0.6
		1,200	0.4

Operating costs inclusive of depreciation are expected to be 40% and 35% of turnover respectively for the years 31st March, 2005 and 2006. Tax is to be paid at 30%. It is assumed that profits after interest and taxes are free cash flows. Growth in earnings is expected to be 40% for the years 2007, 2008 and 2009 which will fall to 10% each year after that. Industry average cost of equity (net of tax) is 15%. (10 Marks)

Answer

- (a) (i) The number of shares to be issued by A Ltd.:

The Exchange ratio is 0.5

So, new Shares = $1,80,000 \times .5 = 90,000$ shares.

- (ii) EPS of A Ltd. After a cquisition:

Total Earnings	(18,00,000+3,60,000)	Rs.21,60,000
No. of Shares	(6,00,000 + 90,000)	6,90,000
EPS	(21,60,000)/6,90,000)	Rs.3.13

- (iii) Equivalent EPS of T Ltd.:

No. of new Shares	0.5
EPS	Rs.3.13
Equivalent EPS (3.13 x .5)	Rs.1.57

- (iv) New Market Price of A Ltd. (P/E remaining unchanged):

Present P/E Ratio of A Ltd.	10 times
Expected EPS after merger	Rs.3.13
Expected Market Price (3.13 x 10)	Rs.31.30

- (v) Market Value of merged firm:

Total number of Shares	6,90,000
Expected Market Price	Rs.31.30
Total value (6,90,000 x 31.30)	Rs.2,15,97,000

- (b) Estimation of earnings for the years ended 31st March, 2005 & 2006

(Rs. In lacs)

Prob.	Turnover	Expected Turnover	Prob.	Turnover	Expected Turnover
0.6	2000	1200	0.6 x 0.7	2500	1050
			0.6 x 0.3	3000	540
0.3	1500	450	0.3 x 0.5	2000	300
			0.3 x 0.5	1800	270

0.1	1200	120	0.1 x 0.6	1500	90
		<u>1770</u>	0.1 x 0.4	1200	<u>48</u>
					2298
Operating Costs (40%)		(708)		(35%)	(804)
Interest 100 x 1		(10)			(10)
Profit after Interest		1052			1484
Tax		316			445
Earnings/Cash flows		736			1039

Estimated Cash flows for 2007 2008 & 2009:-

2007 - 1039 x 1.4 = 1455/-

2008 - 1455 x 1.4 = 2037/-

2009 - 2037 x 1.4 = 2852/-

Discounted Cash flows for the year 2005-2009

Year		Cash flows	Disc. Factor at 15%	PV
2005	-	736	0.870	640
2006	-	1039	0.756	785
2007	-	1455	0.658	957
2008	-	2037	0.572	1165
2009	-	2852	0.497	<u>1417</u>
				<u>4964</u>

Estimates of value of Cash flows from 2010 to infinity

Earnings in 2010 - 2852 x 1.1 = 3137

In today's money - 3137 x 0.497 = 1559

$$P_0 = D_1 / (K_e - G)$$

$$= 1559 / 0.15 - 0.10 = 31180/-$$

Present value of all future estimated cash flows:-

2005 - 2009	-	4964
2009 onwards	-	<u>31180</u>
		<u>36144</u>

∴ Company valuation is 36144/-

Note: Few printing errors have crept in this question viz 40% growth in earnings has appeared as 405 likewise 10% growth in earnings has been wrongly printed as 105. The answer provided above pertains to 40% and 10% growth.

Question 3

- (a) A USA based company is planning to set up a software development unit in India. Software developed at the Indian unit will be bought back by the US parent at a transfer price of US \$10 millions. The unit will remain in existence in India for one year; the software is expected to get developed within this time frame.

The US based company will be subject to corporate tax of 30 per cent and a withholding tax of 10 per cent in India and will not be eligible for tax credit in the US. The software developed will be sold in the US market for US \$ 12.0 millions. Other estimates are as follows:

Rent for fully furnished unit with necessary hardware in India	Rs.15,00,000
Man power cost (80 software professional will be working for 10 hours each day)	Rs.400 per man hour
Administrative and other costs	Rs.12,00,000

Advise the US company on financial viability of the project. The rupee-dollar rate is Rs.48/\$. (4 Marks)

- (b) BSE 500
- | | |
|-------------------------|--------------|
| Value of portfolio | Rs.10,10,000 |
| Risk free interest rate | 9% p.a. |
| Dividend yield on Index | 6% p.a. |
| Beta of portfolio | 1.5 |

We assume that a future contract on the BSE index with four months maturity is used to hedge the value of portfolio over next three months. One future contract is for delivery of 50 times the index.

Based on the above information calculate:

- (i) Price of future contract.
(ii) The gain on short futures position if index turns out to be 4,500 in three months. (8 Marks)

- (c) Following information relates to AKC Ltd. which manufactures some parts of an electronics device which are exported to USA, Japan and Europe on 90 days credit terms.

Cost and Sales information:

	Japan	USA	Europe
Variable cost per unit	Rs.225	Rs.395	Rs.510
Export sale price per unit	Yen 650	US\$10.23	Euro 11.99

Receipts from sale due in 90 days	Yen 78,00,000	US\$1,02,300	Euro 95,920
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Foreign exchange rate information:

	Yen/Rs.	US\$/Rs.	Euro/Rs.
Spot market	2.417-2.437	0.0214-0.0217	0.0177-0.0180
3 months forward	2.397-2.427	0.0213-0.0216	0.0176-0.0178
3 months spot	2.423-2.459	0.02144-0.02156	0.0177-0.0179

Advice AKC Ltd. by calculating average contribution to sales ratio whether it should hedge it's foreign currency risk or not. (8 Marks)

Answer

(a) Proforma profit and loss account of the Indian software development unit.

	Rs.	Rs.
Revenue		48,00,00,000
Less: Costs:		
Rent	15,00,000	
Manpower (Rs.400 x 80 x 10 x 365)	11,68,00,000	
Administrative and other costs	12,00,000	11,95,00,000
Earning before tax		36,05,00,000
Less: Tax		10,81,50,000
Earning after tax		25,23,50,000
Less: Withholding tax(TDS)		2,52,35,000
Repatriation amount (in rupees)		22,71,15,000
Repatriation amount (in dollars)		\$4.7 million

Note : Students may assume the year of 360 days instead of 365 days as has been done in the answer provided above. In such a case where a year is assumed to be of 360 days, manpower cost is Rs 11,52,00,000 and repatriated amount Rs 22,87,15,000.

Conclusion : The cost of development software in India for the US based company is \$5.268 million. As the USA based Company is expected to sell the software in the US at \$12.0 million, it is advised to develop the software in India.

(b) Note: It is assumed that the BSE Index on the day of hedging is 5000 instead of 500 as printed in the question paper. The following workings are based on this assumption.

$$(i) \text{ Current future price of the index} = 5000 + 5000 (0.09 - 0.06) \frac{4}{12}$$

$$= 5000 + 50 = 5,050$$

$$\therefore \text{ Price of the future contract} = \text{Rs.}50 \times 5,050 = \text{Rs.}2,52,500$$

$$(ii) \text{ Hedge ratio} = \frac{1010000}{252500} \times 1.5 = 6 \text{ contracts}$$

Index after three months turns out to be 4500

$$\text{Future price will be} = 4500 + 4500 (0.09 - 0.06) \times \frac{1}{3} = 4,545$$

$$\text{Therefore, Gain from the short futures position is} = 6 \times (5050 - 4545) \times 50$$

$$= \text{Rs.}1,51,500$$

Alternative solution when BSE index is considered to be as 500

$$(i) \text{ Current future price of index} = 500 + 500 (0.09 - 0.06) \frac{4}{12} = 500 + 5 = 505$$

$$\therefore \text{ Price of the future contract} = \text{Rs.}50 \times 505 = \text{Rs.}25,250.$$

$$(ii) \text{ Hedge Ratio} = \frac{10,10,000}{25,250} \times 1.5 = 60 \text{ contracts}$$

Index after three months turn out to be 4,500.

Future Price will be

$$= 4,500 + 4,500 (0.09 - 0.06) \frac{1}{3} = 4,545$$

Therefore, gain from the short future position is

$$= 60 \times (505 - 4545) \times 50$$

$$= -12,12,00,00.$$

(c) If foreign exchange risk is hedged.

				Total (Rs.)
Sum due	Yen 78,00,000	US\$1,02,300	Euro 95,920	
Unit input price	Yen 650	US\$10.23	Euro 11.99	
Unit sold	12000	10000	8000	
Variable cost per unit	Rs.225/-	395	510	

Variable cost	Rs.27,00,000	Rs.39,50,000	Rs.40,80,000	Rs.1,07,30,000
Three months forward rate for selling	2.427	0.0216	0.0178	
Rupee value of receipts	Rs.32,13,844	Rs.47,36,111	Rs.53,88,764	Rs.1,33,38,719
Contribution	Rs.5,13,844	Rs.7,86,111	Rs.13,08,764	Rs.26,08,719
Average contribution to sale ratio				19.56%

If risk is not hedged

Rupee value of receipt	Rs.31,72,021	Rs.47,44,898	Rs.53,58,659	Rs.1,32,75,578
Total contribution				Rs.25,45,578
Average contribution to sale ratio				19.17%

AKC Ltd. Is advised to hedge its foreign currency exchange risk.

Question 4

- (a) MP Ltd. issued a new series of bonds on January 1, 2000. The bonds were sold at par (Rs.1,000), having a coupon rate 10% p.a. and mature on 31st December, 2015. Coupon payments are made semiannually on June 30th and December 31st each year. Assume that you purchased an outstanding MP Ltd. Bond on 1st March, 2008 when the going interest rate was 12%.

Required:

- What was the YTM of MP Ltd. Bonds as on January 1, 2000?
- What amount you should pay to complete the transaction? Of that amount how much should be accrued interest and how much would represent bonds basic value.

(6 Marks)

- (b) AB Ltd. has recently approached the shareholders of CD Ltd. which is engaged in the same line of business as that of AB Ltd. with a bid of 4 new shares in AB Ltd. for every 5 CD Ltd. shares or a cash alternative of Rs.360 per share. Past records of earnings of CD Ltd. had been poor and the company's shares have been out of favour with the stock market for some time.

Pre bid information for the year ended 31.3.2006 are as follows:

	AB Ltd in lakhs	CD Ltd. in lakhs
Equity share capital	60	170
Number of shares	24	17
Pre-tax profit	125	110
P/E Ratio	11	7
Estimated post tax cost of Equity Capital per Annum	12%	10%

Both AB Ltd. and CD Ltd. pay income tax at 30%. Current earnings growth forecast is 4% for the foreseeable future of both the Companies.

Assuming no synergy exists, you are required to evaluate whether proposed share to share offer is likely to be beneficial to the shareholders of both the companies using merger terms available. AB Ltd.'s directors might expect their own pre bid P/E ratio to be applied to combined earnings.

Also comment on the value of the two Companies from the constant growth form of dividend valuation model assuming all earnings are paid out as dividends. (14 Marks)

Answer

- (a) (i) Since the bonds were sold at par, the original YTM was 10%.

$$Y + M = \frac{\text{Interest}}{\text{Principal}} = \frac{\text{Rs.100}}{\text{Rs.1,000}} 10\%$$

- (ii) Price of the bond as on 1st July, 2015 = Rs.50 × 9.712 + 1,000 × 0.417
 = Rs.902.60
 Total value of the bond on the next interest date = Rs.902.60 + Rs.50
 = Rs.952.60
 ∴ Value of bond at purchase date = Rs.952 × $\frac{1}{(1+0.6)^{2/3}}$
 = Rs.952.60 × Rs.0.731004 (by using excel)
 = Rs.696.35

The amount to be paid to complete the transaction is Rs.696.35. Out of this amount Rs.16.57 represent accrued interest and Rs.679.68 represent the bond basic value.

Alternative solution:

$$B_0 = \sum_{t=1}^{2n} \frac{\frac{1}{2}(Int_t)}{(1+\frac{kd}{2})^t} + \frac{B_m}{(1+\frac{kd}{2})^{2n}}$$

$$B_0 = \sum_{t=1}^{2 \times 15} \frac{\frac{1}{2}(100)}{(1+\frac{12}{2})^t} + \frac{1000}{(1+\frac{12}{2})^{2 \times 15}}$$

$$B_0 = \sum_{t=1}^{30} \frac{50}{(1.06)^t} + \frac{1000}{(1.06)^{2 \times 15}}$$

$$B_0 = 50 \times 13.765 + 1000 \times .174$$

$$= 688.25 + 174 = 862.25$$

Therefore Value of Bond at purchase date

$$= \text{Rs } 862.25 \times \text{Rs } 0.731004$$

$$= \text{Rs. } 630.31$$

The amount to be paid to complete the transaction is Rs.630.31. Out of this amount Rs.16.57 represent accrued interest and Rs.613.64 represent the bond basic value.

- (b) Alternative 1 (when number of shares are 2.4 and 1.7 lakhs respectively)

Evaluation:-

Background calculations:-

	(Figures in lakhs)		
	AB Ltd.	CD Ltd.	Total
PBT	125	110	235
PAT	87.5	77	164.5
Pre bid EPS	36.46	45.29	
P/E ratio	11	7	
Pre-bid Price Per Share	401.06	317.03	
Market value of the company	962.54	538.95	1,501.49
No. of New Shares Post bid	2.4	1.36	3.76
% combined company owned by	63.83%	36.17%	
Value to the original Shareholders	958.40	543.09	1,501.49
Post bid Price per share to original shareholders i.e., 2.40 lakhs and 1.70 lakhs shareholders respectively.	399.33	319.46	

(Note: The Post bid Price per share to new shareholders as per terms of acquisition works out to Rs.399.33 for both the companies)

These figures suggest post bid acquisition share price of Rs.399.33 for AB Ltd., and 319.46 for CD Ltd.'s. Original shareholders. The price of CD Ltd share is likely to be influenced by the value of cash alternative.

The post bid share price of the new firm can be estimated by applying the P/E ratio to the combined earnings of the two old companies.

In that case,

Market Value would be = $164.5 \times 11 = 1809.50$

Price per share of the combined company would be = $\frac{1809.50}{3.76} = \text{Rs.}481.25$

∴ Therefore share of AB Ltd., shareholders would raise by Rs.481.25 – Rs.401.06= Rs.80.19 i.e., 20%.

Share value of CD Ltd., shareholder expected to rise by

$$\left(\text{Rs.}481.25 \times \frac{4}{5} \right) - 317.03 = \text{Rs.}67.97 \text{ i.e. } 21.44\%$$

With the cash offer the premium is $\frac{360 - 317.03}{317.03} = 13.55\%$ only

Hence shareholders of CD Ltd are gaining more from the merger in a share exchange and cash alternative is unlikely to be accepted.

Using constant growth model the value of both the individual companies would be:

$$\text{AB Ltd., share price} = \frac{36.46(1.04)}{0.12 - 0.04} = \text{Rs.}473.98$$

$$\text{CD Ltd., share price} = \frac{45.29 \times 1.04}{0.10 - 0.04} = \text{Rs.}785.03$$

On this basis market slightly undervalues AB Ltd share but share of CD Ltd., are highly undervalued possibly because of previous disappointments. However, if AB Ltd. forecast is believed that the AB Ltd., is getting CD Ltd. shares, it will be a cheap proposal for AB Ltd. to acquire the CD Ltd. on share exchange basis and especially if any of the shareholder of CD Ltd. Accept the cash offer.

The shareholders of CD Ltd. would also be benefited post merger based on share exchange ratio since the value of their share would be going up from Rs.317.03 to Rs.399.33. However, their share price would still be undervalued as compared with the share price calculated by using constant growth model.

Alternative 2 (when number of shares are 24 and 17 lakhs respectively)

If we take into consideration the number of shares being 24 lakhs and 17 lakhs the Pre-bid share price works out to Rs.40.15 and Rs.31.71 respectively, which seems to be illogical against a cash offer @ Rs.360/- per share. However, since many students may have solved this question based on the figures of 24 lakhs and 17 lakhs number of shares, an alternative solution is provided below.

Evaluation:	Figures in lakhs		
Background calculations:	AB Ltd.	CD Ltd.	Total
PBT	125	110	235
PAT	87.5	77	164.5
Pre bid EPS	3.65	4.53	
P/E Ratio	11	7	
Pre-bid Price per share	40.15	31.71	
Market value of the company	963.60	539.07	1502.67
No. of new shares Post-bid	24	13.6	37.6
% of combined company owned by	63.83	36.17	
Value to the original shareholders	959.15	543.52	1502.67
Post-bid Price to original shareholders i.e., 24 lakhs and 17 lakhs shareholders respectively	39.96	31.97	

(Note: The Post bid price per share works out to Rs.39.96 for both the companies)

These figures suggest Post acquisition share price of Rs.39.96 for AB Ltd and Rs.31.97 for CD Ltd's original shareholders. The Price of CD Ltd. Share is likely to be influenced by the value of cash alternative.

The Post bid share price of the new firm can be estimated by applying the P/E ratio to the combined earnings of the two old companies.

In that case,

Market-value would be = $164.5 \times 11 = 1809.50$

Price per share of the combined company

Would be = $\frac{1809.50}{37.6} = 48.13$

∴ Shares of AB Ltd. shareholders would raise by Rs.48.13 – 40.15 = 7.98 i.e., 19.87% or 20%.

Share value of CD Ltd., shareholders expected to raise by Rs. $\left(48.13 \times \frac{4}{5}\right) - 31.71$
= Rs.7.40 or 23.34%.

However, with the cash offer the premium is $\frac{360 - 31.71}{31.71} = 1035.29\%$

Hence, the shareholders of CD Ltd., are substantially benefited by cash offer and they are unlikely to accept the share swap ratio.

Using constant growth model the value of shares of both the individual companies would be

$$\begin{aligned} \text{AB Ltd. Share Price} &= \frac{3.65(1.04)}{0.12 - 0.04} = \frac{3.80}{0.08} \\ &= \text{Rs.47.5} \end{aligned}$$

$$\begin{aligned} \text{CD Ltd. Share Price} &= \frac{4.53(1.04)}{0.10 - 0.04} = \frac{4.71}{0.06} \\ &= \text{Rs.78.5} \end{aligned}$$

On this basis market slightly undervalues AB Ltd. Share but share of CD Ltd., is highly undervalued possibly because of previous disappointments. However, if AB Ltd. forecast is believed that the AB Ltd. is getting CD Ltd. share it will be a cheap proposal for AB Ltd., to acquire CD Ltd., on share exchange basis.

The shareholders of CD Ltd., would however be more benefited by cash offer.

Question 5

- (a) From the following data for Government securities, calculate the forward rates:

Face value (Rs.)	Interest rate	Maturity (Year)	Current price (Rs.)
1,00,000	0%	1	91,500
1,00,000	10%	2	98,500
1,00,000	10.5%	3	99,000

(6 Marks)

- (b) On the basis of the following information:

Current dividend (Do)	=	Rs.2.50
Discount rate (k)	=	10.5%
Growth rate (g)	=	2%

- (i) Calculate the present value of stock of ABC Ltd.
- (ii) Is its stock overvalued if stock price is Rs.35, ROE = 9% and EPS = Rs.2.25?
Show detailed calculation. (6 Marks)
- (c) (i) What are derivatives?
- (ii) Who are the users and what are the purposes of use?
- (iii) Enumerate the basic differences between cash and derivatives market. (8 Marks)

Answer

- (a) Consider one year treasury bill.

$$91,500 = \frac{100,000}{1+r_1}$$

$$1+r_1 = \frac{100,000}{91,500}$$

$$= 1.092896$$

$$r_1 = 0.0929 \text{ or } 0.093$$

Consider two year Government Security

$$98,500 = \frac{10,000}{1.093} + \frac{110,000}{(1.093)(1+r_2)}$$

$$98,500 = 9149.131 + \frac{110,000}{1.093(1+r_2)}$$

$$\Rightarrow 89350.87 = \frac{100640.4}{1+r_2}$$

$$\Rightarrow 1+r_2 = 1.126351$$

$$r_2 = 0.12635$$

$$\Rightarrow r_2 = 0.1263$$

Consider three year Government Securities:

$$99,000 = \frac{10,500}{1.093} + \frac{10,500}{1.093 \times 1.1263} + \frac{110,500}{1.093 \times 1.1263(1+r_3)}$$

$$\Rightarrow 99,000 = 9606.587 + 8529.65 + \frac{89764.42}{1+r_3}$$

$$\Rightarrow 80863.763 = \frac{89764.42}{1+r_3}$$

$$\Rightarrow 1+r_3 = 1.1100697$$

$$\Rightarrow r_3 = .1100697$$

(b) (i) Present Value of the stock of ABC Ltd. Is:-

$$V_0 = \frac{2.50(1.02)}{0.105 - 0.02}$$

$$= \text{Rs.}30/-$$

(ii) Pay out ratio of ABC Ltd. $= \frac{2.5}{2.25}$

$$= 1.111$$

Hence, Retention ratio $= 1 - 1.111$

$$= -0.111$$

Or -11.1%

Sustainable growth ratio is $= -0.111 \times 0.09$

$$= -0.00999$$

$$= -0.999\%$$

Using the constant growth model, the value is

$$= \frac{\text{Rs.}2.50(0.99)}{0.105 - (-0.00999)}$$

$$= \frac{2.475}{0.11499}$$

$$= \text{Rs.}21.52$$

This value is less than the stock price of Rs.30/- as calculated above or Rs.35, as given in the question, which indicates that stock of ABC Ltd. is Overvalued.

Alternative answer (ii)

$$(\text{MV}) \text{ of Stock in Rs.} = \frac{D_1}{k_e - g} = \frac{D_0(1+g)}{(k_e - g)}$$

$$= \frac{2.5 \times 1.02}{0.105 - 0.02} = 30(\text{BV}) = \frac{\text{Rs.}225}{0.09} = \text{Rs.}25$$

Again $\frac{(\text{MV})}{(\text{BV})} = \frac{k_r - g}{k_e - g}$ where symbols denote their usual notations.

$$\text{So, } \frac{0.09 - 0.02}{0.105 - 0.02} = \frac{(MV)}{25} \text{ or, } \frac{0.07}{0.085} = \frac{(MV)}{25}$$

$$\therefore (MV) = \frac{\text{Rs.}0.07}{0.085} \times 25 = \text{Rs.}20.59$$

Based on $\frac{(MV)}{(BV)}$ ratio and based on perpetual growth model the price of the share should be Rs.20.59 and Rs.30 respectively which are lower than the present (MV) of Rs.35.

The stock is therefore, Overvalued.

- (c) (i) Derivative is a product whose value is to be derived from the value of one or more basic variables called bases (underlying assets, index or reference rate). The underlying assets can be Equity, Forex, Commodity.

	Users	Purpose
(i)	Corporation	To hedge currency risk and inventory risk
(ii)	Individual Investors	For speculation, hedging and yield enhancement.
(iii)	Institutional Investor	For hedging asset allocation, yield enhancement and to avail arbitrage opportunities.
(iv)	Dealers	For hedging position taking, exploiting inefficiencies and earning dealer spreads.

The basic differences between Cash and the Derivative market are enumerated below:-

In cash market tangible assets are traded whereas in derivate markets contracts based on tangible or intangibles assets likes index or rates are traded.

- In cash market tangible assets are traded whereas in derivative market contracts based on tangible or intangibles assets like index or rates are traded.
- In cash market, we can purchase even one share whereas in Futures and Options minimum lots are fixed.
- Cash market is more risky than Futures and Options segment because in "Futures and Options" risk is limited upto 20%.
- Cash assets may be meant for consumption or investment. Derivate contracts are for hedging, arbitrage or speculation.
- The value of derivative contract is always based on and linked to the underlying security. Though this linkage may not be on point-to-point basis.
- In the cash market, a customer must open securities trading account with a

securities depository whereas to trade futures a customer must open a future trading account with a derivative broker.

- (g) Buying securities in cash market involves putting up all the money upfront whereas buying futures simply involves putting up the margin money.
- (h) With the purchase of shares of the company in cash market, the holder becomes part owner of the company. While in future it does not happen.

Question 6

- (a) What is a Green share option? Explain its working mechanism. (5 Marks)
- (b) Write a short note on the application of Double taxation agreements on Global depository receipts. (4 Marks)
- (c) "Operations in foreign exchange market are exposed to a number of risks." Discuss. (3 Marks)
- (d) XYZ Ltd. has substantial cash flow and until the surplus funds are utilised to meet the future capital expenditure, likely to happen after several months, are invested in a

portfolio of short-term equity investments, details for which are given below:

Investment	No. of shares	Beta	Market price per share Rs.	Expected dividend yield
I	60,000	1.16	4.29	19.50%
II	80,000	2.28	2.92	24.00%
III	1,00,000	0.90	2.17	17.50%
IV	1,25,000	1.50	3.14	26.00%

The current market return is 19% and the risk free rate is 11%.

Required to:

- (i) Calculate the risk of XYZ's short-term investment portfolio relative to that of the market;
- (ii) Whether XYZ should change the composition of its portfolio. (8 Marks)

Answer

- (a) GREEN SHOE OPTION (GSO): Green Shoe Option (GSO) means an option available to the company issuing securities to the public to allocate shares in excess of the public issue and operating a post-listing price stabilising mechanism through a stabilising agent. SEBI inserted a new Chapter No. VIII-A, with effect from August 14, 2003, in the SEBI (Disclosure and Investors Protection) Regulations, 2000 to deal with the GSO. The GSO is available to a company which is issuing equity shares through book-building mechanism for stabilising the post-listing price of the shares. The following is the

mechanism of GSO:

1. The Company shall appoint one of the leading book runners as the Stabilising Agent (SA), who will be responsible for the price stabilising process.
2. The promoters of the company will enter into an agreement with SA to lend some of their shares to the latter, not exceeding 15% of the total issue size.
3. The borrowed shares shall be in the dematerialised form. These shares will be kept in a separate GSO Demat A/c.
4. In case of over subscription, the allocation of these share shall be on pro-rata basis to all applicants.
5. The money received from allotment of these shares shall also be kept in a 'GSO Bank A/c', distinct from the issue account, and the amount will be used for buying shares from the market during the stabilization period.
6. The shares bought from the market by SA for stabilization shall be credited to GSO Demat Account.
7. These shares shall be returned to the promoters within 2 days of closure of stabilisation process.
8. In order to stabilise post-listing prices, the SA shall determine the timing and quantity of shares to be bought.
9. If at the expiry of the stabilisation period, the SA does not purchase shares to the extent of over-allocated shares, then shares to the extent of shortfall will be allotted by the company to the GSO Demat A/c multiplied by the issue price. Amount left in the GSO Bank A/c (after meeting expenses of SA), shall be transferred to the Investors Protection Fund.

In April, 2004, the ICICI Bank Ltd. Became the first Indian company to offer GSO.

- (b) (i) During the period of fiduciary ownership of shares in the hands of the overseas depository bank, the provisions of avoidance of double taxation agreement entered into by the Government of India with the country of residence of the overseas depository bank will be applicable in the matter of taxation of income from dividends from the underlined shares and the interest on foreign currency convertible bonds.
- (ii) During the period if any, when the redeemed underlined shares are held by the non-residence investors on transfer from fiduciary ownership of the overseas depository bank, before they are sold to resident purchasers, the avoidance of double taxation agreement entered into by the government of India with the country of residence of the non-resident investor will be applicable in the matter of taxation of income from dividends from the underlined shares, or interest on foreign currency convertible bonds or any capital gains arising out of the transfer of the underlined shares.
- (c) A firm dealing with foreign exchange may be exposed to foreign currency exposures. The exposure is the result of possession of assets and liabilities and transactions denominated in foreign currency. When exchange rate fluctuates, assets, liabilities,

revenues, expenses that have been expressed in foreign currency will result in either foreign exchange gain or loss. A firm dealing with foreign exchange may be exposed to the following types of risks:

- (i) **Transaction Exposure:** A firm may have some contractually fixed payments and receipts in foreign currency, such as, import payables, export receivables, interest payable on foreign currency loans etc. All such items are to be settled in a foreign currency. Unexpected fluctuation in exchange rate will have favourable or adverse impact on its cash flows. Such exposures are termed as transactions exposures.
- (ii) **Translation Exposure:** The translation exposure is also called accounting exposure or balance sheet exposure. It is basically the exposure on the assets and liabilities shown in the balance sheet and which are not going to be liquidated in the near future. It refers to the probability of loss that the firm may have to face because of decrease in value of assets due to devaluation of a foreign currency despite the fact that there was no foreign exchange transaction during the year.
- (iii) **Economic Exposure:** Economic exposure measures the probability that fluctuations in foreign exchange rate will affect the value of the firm. The intrinsic value of a firm is calculated by discounting the expected future cash flows with appropriate discounting rate. The risk involved in economic exposure requires measurement of the effect of fluctuations in exchange rate on different future cash flows.

(d) (i) **Computation of Beta of Portfolio**

<i>Investment</i>	<i>No. of Shares</i>	<i>Market Price</i>	<i>Market Value</i>	<i>Dividend Yield</i>	<i>Dividend</i>	<i>Composition</i>	β	<i>Weighted β</i>
I.	60,000	4.29	2,57,400	19.50%	50,193	0.2339	1.16	0.27
II.	80,000	2.92	2,33,600	24.00%	56,064	0.2123	2.28	0.48
III.	1,00,000	2.17	2,17,000	17.50%	37,975	0.1972	0.90	0.18
IV.	1,25,000	3.14	3,92,500	26.00%	1,02,050	0.3566	1.50	0.53
			<u>11,00,500</u>		<u>2,46,282</u>	<u>1.0000</u>		<u>1.46</u>

$$\text{Return of the Port Folio} = \frac{2,46,282}{11,00,500} = 0.2238$$

$$\text{Beta of Port Folio} = 1.46$$

Market Risk implicit

$$0.2238 = 0.11 + \beta \times (0.19 - 0.11)$$

$$\text{Or, } 0.08 \beta + 0.11 = 0.2238$$

$$\beta = \frac{0.2238 - 0.11}{0.08} = 1.42$$

Market β implicit is 1.42 while the portfolio β is 1.46. Thus the portfolio is marginally risky compared to the market.

- (ii) The decision regarding change of composition may be taken by comparing the dividend yield (given) and the expected return as per CAPM as follows:

Expected return

R_s as per CAPM is:

$$R_s = I_{RF} + (R_M - I_{RF}) \beta$$

$$\begin{aligned} \text{For investment I } R_s &= I_{RF} + (R_M - I_{RF}) \beta \\ &= .11 + (.19 - .11) 1.16 \\ &= 20.28\% \end{aligned}$$

$$\text{For investment II, } R_s = .11 + (.19 - .11) 2.28 = 29.24\%$$

$$\begin{aligned} \text{For investment III, } R_s &= .11 + (.19 - .11) .90 \\ &= 18.20\% \end{aligned}$$

$$\begin{aligned} \text{For investment IV, } R_s &= .11 + (.19 - .11) 1.50 \\ &= 23\% \end{aligned}$$

Comparison of dividend yield with the expected return R_s shows that the dividend yields of investment I, II and III are less than the corresponding R_s . So, these investment are over-priced and should be sold by the investor. However, in case of investment IV, the dividend yield is more than the corresponding R_s , so, XYZ Ltd. should increase its proportion..

PAPER – 3 : ADVANCED AUDITING

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

Question 1

As a Statutory Auditor, how would you deal with the following?

- (a) Z Ltd. provided, Rs. 5 lakhs for inventory obsolescence in the last year's accounts. In the subsequent year, it was determined that 50% of this stock was actually usable. The Company wants to adjust the same as a "Prior period adjustment." (5 Marks)
- (b) A company capitalises interest on borrowings incurred for holding investments by adding the same to the cost of investment every year. (4 Marks)
- (c) For the year ended 31st March, 2007, a company has paid Minimum Alternative tax under section 115 JB of the Income Tax Act, 1961. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same. (5 Marks)
- (d) X Ltd. is engaged in manufacture of Cement. In the Profit and Loss Account for the year ended 31st March, 2007, it discloses its revenue from sales transactions (turnover) net of excise duty. The excise duty collected and paid on sales transactions and that related to difference between Closing stock and Opening stock is, however, disclosed in the "Notes to Accounts". (4 Marks)

Answer

- (a) As per Accounting Standard 5 "Net Profit or Loss for the period, Prior Period Items and Change in Accounting Policies", Prior period items are income or expenditure which arise in the current period as a result of errors or omissions in the preparation of the Financial Statements of one or more prior periods.

The write back of provision made in respect of inventories in the earlier year does not constitute prior period adjustment since it neither constitutes error nor omission but it merely involves making estimates based on prevailing circumstances when Financial Statements were being prepared.

An estimate may have to be revised -

- (i) If changes occur in the circumstances on which the estimate was based or
- (ii) as a result of new information, more experience or subsequent developments.

The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

A change in an accounting estimate may affect the current period only or both the current period and future periods. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

- (b) Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. As per AS-13 "Accounting for Investment", cost of investments includes acquisition charges such as brokerage, fees and duties. As per AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Assets that are ready for their intended use or sale when acquired are not qualifying assets. Therefore such investment is not an qualifying assets, therefore interest cost of holding investments cannot be capitalized.

The decision of the Directors to capitalize the interest on borrowings is not proper. So the Auditor should qualify his report and state the financial effect of deviation from AS.

- (c) The concerned issue is discussed in the Guidance Note issued by ICAI on "Accounting for Credit available in respect of MAT under the IT Act 1961". As per para 6 of the said Guidance Note , Although MAT credit is not a deferred tax asset under AS 22 , yet it give rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specified period.

The Framework for the Preparation and Presentation of Financial Statements, issued by the ICAI, defines the term 'asset' as follows:

"An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

MAT paid in a year in respect of which the credit is allowed during the specified period under the Income Tax Act is a resource controlled by the company as a result of past event, namely the payment of MAT. MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period. Accordingly, MAT credit is an asset.

According to the framework, once an item meets the definition of the term 'asset', it has to meet the criteria for recognition of an asset so that it may be recognized as such in the financial statements. Para 88 of the Framework provides the following criteria for recognition of an asset: an asset is recognized in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

Thus, if the auditor is satisfied that the probability of the company to claim the said credit is high, it could recognize the same as an asset. In Balance sheet it should be shown under the head "Loans & Advances" as "MAT credit entitlement" .

- (d) As per Accounting Standard Interpretation – ASI 14 ' Disclosure of Revenue from Sales Transactions' (Revised) issued by ICAI in Aug 2006, turnover should be disclosed as follows on the face of the statement of Profit & Loss:

Turnover (Gross)	XX
Less : Excise duty	<u>XX</u>
Turnover (Net)	XX

Further, the excise duty shown above should be the total duty except the duty related to the difference between closing stock & opening stock which should be recognized separately in the statement of profit and loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

Since the company, X Ltd has not followed the above ASI 14, the auditor would have to qualify his report accordingly.

Question 2

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

- (a) Mr. A, a practicing Chartered Accountant agreed to select and recruit personnel, conduct training programmes for and on behalf of a client. (5 Marks)
- (b) XY & Co., a firm of Chartered Accountant having 2 partners X & Y, one in charge of Head Office and another in charge of Branch at a distance of 80 kms, puts up a name-board of the firm in both premises and also in their respective residences. (5 Marks)
- (c) A practicing Chartered Accountant was appointed to represent a company before the tax authorities. He submitted on behalf of his clients certain information and explanations to the authorities, which were found to be false and misleading. (4 Marks)
- (d) AB & Co., a firm of Chartered Accountants, included the name of P as a partner while filing an application for empanelment as auditor for Public Sector bank branches. It was subsequently noticed that on the date of application, P was not a partner with AB & Co. (4 Marks)

Answer

- (a) Under Section 2(2)(iv) of the Chartered Accountants Act, 1949, "A member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice. Pursuant to Section 2(2) (iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".
The definition of the expression "Management Consultancy and other Services" includes Personnel recruitment and selection. Personnel Recruitment and selection includes, development of human resources including designing and conduct of training programmes, work study, job description, job evaluation and evaluations of work loads. So A is not guilty of professional misconduct.

- (b) The council of the Institute has decided that with regard to the use of the name-board, there will be no bar to the putting up of a name-board in the place of residence of a member with the designation of chartered accountant, provided, it is a name-plate or board of an individual member and not of the firm. In the given case partners of X Y & Co., put up a name board of the firm in both offices and also in their respective residences.

Thus the chartered accountants are guilty of misconduct. Distance given in the question is not relevant for deciding.

- (c) As per clause 5 of Part I of Second Schedule if a member in practice fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading, where he is concerned with that financial statement in a professional capacity, he will be held guilty under clause (5). As per clause 6 of Part I of Second Schedule if he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity, he will be held guilty under clause 6.

In given case, the Chartered Accountant had submitted the statements before the taxation authorities. These statements are based on the data provided by the management of the company. Although the statements prepared were based on incorrect facts and misleading, the Chartered Accountant had only submitted them acting on the instructions of his client as his authorized representative.

Hence the Chartered Accountant would not be held liable for professional misconduct.

- (d) Under clause 3 of Part II of second schedule, a Chartered Accountant whether in practice or not is guilty of professional misconduct if he includes in any information, statement, return or form to be submitted to the Institute, Council or any of its committees, Directors (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

In the instant case A B & Co. included another Chartered Accountant name as partner in his firm, in his application for empanelment as Auditor of branches of Public Sector Banks submitted to the Institute. In fact such a member was not a partner of the said firm on the date of application. He will be held guilty of professional misconduct.

Question 3

- (a) "The method of collecting Audit evidence and evaluating the same changes drastically under EDP Auditing". Comment on the above. (8 Marks)
- (b) What are the features of a qualified Audit Report? (8 Marks)

Answer

- (a) Effects of EDP Auditing: Auditor must provide a competent, independent opinion as to whether the financial statements records and report a true and fair view of the state of affairs of an entity. However, computer systems have affected how auditors need to

collect and evaluate evidence. These aspects are discussed below:

- (1) Changes to Evidence Collection - Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system, like:
 - (a) accurate and complete operations of a disk drive may require a set of hardware controls not required in manual system,
 - (b) system development control include procedures for testing programs that again are not necessary in manual control.

Since, Hardware and Software develop quite rapidly, understanding the control technology is not easy. With increasing use of data communication for data transfer, research is focussed on cryptographic controls to protect the privacy of data. Unless auditors keep up with these developments, it will become difficult to evaluate the reliability of communication network competently.

The continuing and rapid development of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls. Even collection of audit evidence through manual means is not possible. Hence, auditors have to run through computer system themselves if they are to collect the necessary evidence. Though generalized audit softwares are available the development of these tools cannot be relied upon due to lack of information. Often auditors are forced to compromise in some way when performing the evidence collection.

- (2) Changes to Evidence Evaluation - With increasing complexity of computer systems and control technology, it is becoming more and more difficult for the auditors to evaluate the consequences of strength and weaknesses of control mechanism for placing overall reliability on the system.

Auditors need to understand:

- (a) whether a control is functioning reliably or multi functioning,
- (b) traceability of control strength and weakness through the system. In a shared data environment a single input transaction may update multiple data item used by diverse, physically disparate user, which may be difficult to understand.

Consequence of errors in a computer system is a serious matter as errors in computer system tend to be deterministic, i.e., an erroneous program will always execute data incorrectly. Moreover, the errors are generated at high speed and the cost and effort to correct and rerun program may be high. Errors in computer program can involve extensive redesign and reprogramming. Thus, internal controls that ensure high quality computer systems should be designed implemented and operated upon. The auditors must ensure that these control are sufficient to maintain assets safeguarding, data integrity, system effectiveness and system efficiency and that they are in position and functioning.

(b) The features of a qualified report are:

1. Clarity: The Auditor must express the nature of qualification, in a clear and unambiguous manner.
2. Explanation: Where the Auditor answers any of the statutory affirmations in the negative or with a qualification his report shall state the reasons for such answer.
3. Placement: All qualifications should be contained in the Auditor's Report. When there are notes which are subject matter of a qualification, the same should preferably be annexed to the Auditors' Report. However a reference to the notes to Accounts in the Auditors' Report does not automatically become a qualification.
4. Subject to: The words 'subject to' are essential to state any qualification. The qualification should be preceded by words such as 'subject to' or 'except that' to make it clear that he is making an exception.
5. Quantification: It is also necessary that the auditor should quantify, wherever possible, the effect of individual as well as the total effect of all qualifications on profit or loss and/or state of affairs these qualifications on the financial statements in a clear and unambiguous manner. In circumstances where it is not possible to quantify the effect of the qualifications accurately the auditor may do so on the estimates made by the management after carrying out such audit tests as are possible and clearly indicate that the figures given are based on the estimates of the management.
6. Nature of qualification: Vague statements the effect of which on accounts cannot be ascertained like 'the debtors balances are subject to confirmation', 'no provision for taxation has been made in view of the loss during the year' etc., should be avoided.
7. Violation of law: Where the company has committed an irregularity resulting in a breach of law, the Auditor should bring the same to the notice of the shareholders by properly qualifying his report.
8. Notes – Report Relationship – Where notes of a qualificatory nature appear in the accounts the Auditors should state all qualifications independently in their report so that the user can assess the significance of these qualifications.
9. Draft Report: The auditor may discuss matters of qualification with the management of the company to acquire their views. It is not necessary that the Auditor should accept the managements view and modify his opinion. But it would enable the Auditor to accurately draft the qualifications in his Final Report.

Question 4

(a) What are the important aspects to be looked into a due diligence review of Cash flow?

(8 Marks)

(b) What is the meaning of "Small and Medium sized Company" as per the Companies (Accounting Standards) Rules, 2006?

(8 Marks)

Answer

(a) Due Diligence review of cash flow :

- (i) Review the historical pattern of cash flows of the organization and look for change in trends.
- (ii) See whether the company is able to meet its cash requirements from internal generations/accruals or does it seek outside sources from time to time.
- (iii) Check whether the company honours its commitments to creditors, Government and other stock holders.
- (iv) Verify the ability of the company to turn its stock into Debtors i.e sale ability of its products.
- (v) Ensure that the company follows up with Debtors and that the Debtors collection period is not very large.
- (vi) Check the ability of the company to deploy its funds in profitable investment opportunities.
- (vii) Look into the investment pattern of the company, whether they give maximum benefits to the company and are easily realizable.

(b) In exercise of the powers conferred by clause (a) of sub-section (1) of section 642 of the Companies Act, 1956 (1 of 1956), read with sub-section (3C) of section 211 and sub-section (1) of section 210A of the said Act, the Central Government, in consultation with National Advisory Committee on Accounting Standards, made the Companies (Accounting Standards) Rules, 2006. As per these rules "Small and Medium Sized Company" (SMC) means, a company-

- (i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
- (ii) which is not a bank, financial institution or an insurance company;
- (iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;
- (iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and
- (v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of this a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Question 5

(a) As the Statutory Auditor of a Manufacturing Company, what are the points you will consider to conclude "Whether the company has an Internal Audit system commensurate

with the size of the company and its operations"? (8 Marks)

- (b) In a Company, it is suspected that there has been an embezzlement in cash receipts. As an investigator, what are the areas that you would verify? (8 Marks)

Answer

- (a) This clause has mandatory application in case of companies having a paid-up capital and reserves exceeding rupees 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned. 'Financial year concerned' means the financial year under audit. This clause also mandatory applicable for the listed companies irrespective of the size of paid-up capital and reserves or turnover.

The auditor has to examine whether the internal audit system is commensurate with the size of the company and the nature of its business. The following are some of the factors to be considered in this regard:

- (i) What is the size of the internal audit department? In considering the adequacy of internal audit staff, it is necessary to consider the nature of the business, the number of operating points, the extent to which control is decentralised, the effectiveness of other forms of internal control, etc.
- (ii) What are the qualifications of the persons who undertake the internal audit work? Internal auditing is reasonable to expect that the internal audit department should normally be headed by a chartered accountant and that, depending upon the size of the department, it employs other qualified persons.
- (iii) To whom does the internal auditor report? In general, the higher the level to which the internal auditor reports, the greater will be his independence.
- (iv) What are the areas covered by the internal audit? Internal audit can cover a large number of areas including operational auditing, organisation and methods studies, special investigations and the like.
- (v) Has the internal auditor adequate technical assistance? This can be provided either by having full-time technically qualified persons in the internal audit department or by such persons being deputed to the internal audit department for specific assignments.
- (vi) What are the reports which are submitted by the internal auditor or what other evidence is there of his work? Auditor should satisfy himself that an internal audit system is functioning effectively. He can do so by examining the reports submitted by the internal auditor.
- (vii) What is the follow-up? It is necessary that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.

- (b) The following areas need to be verified in this regard:
- (i) Issuing a receipt for full amount collected, entering only a lesser amount on the counterfoil.
 - (ii) Showing a larger cash discount than actually allowed.
 - (iii) Adjusting a fictitious credit in the account of a customer for goods returned.
 - (iv) Cash sales entered as credit sales with debit to customer.
 - (v) Writing off a good debt as bad and irrecoverable to cover up misappropriation of amount collected.
 - (vi) Short-debiting customer's ledger account and withdrawing the difference on collection of full amount.
 - (vii) Under-casting the receipts side of cash book; carrying over a shorter total of the receipts from one page of the cash book to the next so as to cover up short banking misappropriated.
 - (viii) Over-casting the payment side of the cash book; over-carrying the total of the payments from one page of the cash book to the next so as to cover up misappropriation of a part of the amount withdrawn from the bank.

Question 6

- (a) List the matters to be included in the 'Auditors' report' in the case of Non Banking Financial Companies (NBFCs) accepting or holding public deposits. (8 Marks)
- (b) What are the steps for the Audit under the State level 'Value Added Tax' (VAT)? (8 Marks)

Answer

- (a) The Auditors are required to make a separate report to the Board of Directors and the RBI for every financial year as per the Non Banking Companies Auditors' Report (RBI) Direction 1998, in addition to the reporting obligations u/s 227 of the Companies Act 1956.
- (1) Reporting Requirements: The auditor shall make –a statement on the following matters, together with reasons in case of any unfavourable or qualified statement:
- (a) Registration: Whether the NBFC has obtained certificate of Registration or applied for registration.
 - (b) Communication from RBI: Whether the NBFC has received any communication from RBI refusing grant of Certificate of Registration.
- (2) NBFCs accepting/holding public deposits:
- (i) Limit on Public Deposits: Whether the public deposits and the following borrowings are within the permissible limits
 - (a) Borrowing from public by issue of unsecured Non-convertible Debentures/Bonds.

- (b) Borrowing from its share holders by a public limited company and
 - (c) Other deposits within the definition of "Public Deposit" in the NBFC (Reserve Bank) Direction, 1998.
 - (ii) Credit Rating: Whether Credit rating for fixed Deposits, assigned by the credit rating agency is in force.
 - (iii) Limit on Fixed Deposits: Whether aggregate amount of Deposit outstanding at any point during the year has exceeded the limit specified by the Credit Rating Agency.
 - (iv) Default: Whether the NBFC has defaulted in paying to its Depositors the interest and/or principal amount of the deposits after such interest and/or principal became due.
 - (v) Prudential Norms: Whether the NBFC has complied with NBFC Prudential Norms (Reserve Bank) Direction, 1998 in relation to Income Recognition. According standards, classification, Provisioning for bad and doubtful debts and concentration of Credit/Investment.
 - (vi) Capital Adequacy: Whether the capital Adequacy Ratio disclosed in the return submitted to the RBI is correctly determined and whether such ratio is in compliance with the minimum capital to Risk Asset Ratio prescribed by the RBI.
 - (vii) Liquidity: Whether the NBFC has complied with the prescribed liquidity requirement and kept the approved securities with designated Bank.
 - (viii) Return of Deposits: Whether the NBFC has furnished the return of deposits to the RBI within the stipulated period as required under First Schedule to NBFC Prudential Norms (Reserve Bank) Directions, 1998.
- (b) VAT is a tax on the value added to the commodity at each stage in the production and distribution chain. VAT is an indirect Tax on consumption. It is a tax on the value at the retail point of sale which is collected at each stage of sale.
- The essence of VAT is that it provides credit set off for input tax i.e. tax paid on purchases against the output tax i.e. tax payable on sales.
- The following steps have to be taken by the auditors while auditing under VAT.
- (i) Knowledge of Business: The Auditor should familiarize himself with the business of the Auditee.
 - (ii) Knowledge about VAT Law and Allied Laws: The Auditor should study the VAT Law particularly definitions, procedures to be adopted, provision regarding issues of invoices, claiming of input tax credit etc.
 - (iii) Major Accounting Policies: The Auditor should ascertainable major accounting policies with regard to sales purchases and valuation of inventory.

- (iv) Accounting Records maintained by Auditee: The auditor should obtain a complete list of all the accounting records relating to sales/purchase of goods, stock, various registers ledgers etc, maintained in which, the transactions are recorded.
- (v) Evaluation of Internal control: The Auditor should evaluate the internal controls prevalent in the entity with respect to sales, Purchases, Production and Accounting. He must examine the adequacy and effectiveness of the controls in order to plan the nature and timing of his audit procedures.

The following provisions of VAT need to be understood :

- Credit for inputs/supplies (and its accounting)
- Credit in case of capital goods.
- Utilising VAT credit for set off
- Valuation of inventories/capital goods
- Credit for goods lying in stock at inception of VAT scheme.
- VAT on sales.

Question 7

- (a) M/s PQR & Company, Chartered Accountants have been appointed Statutory Auditors of a listed Company for the year ended 31st March, 2008. Draft an appropriate engagement letter to be sent to the Board of Directors for the same. (12 Marks)
- (b) T Pvt. Ltd.'s paid up Capital & Reserves are less than Rs. 50 lakhs and it has no outstanding loan exceeding Rs. 25 lakhs from any bank or financial institution. Its sales are Rs. 6 crores before deducting Trade discount Rs. 10 lakhs and Sales returns Rs. 95 lakhs. The services rendered by the company amounted to Rs. 10 lakhs. The company contends that reporting under Companies Auditor's Reports Order (CARO) is not applicable. Discuss. (4 Marks)

Answer

- (a) Draft of an Engagement Letter:

To the Board of Directors

You have requested that we audit the balance sheet of (Name of the Company) as at 31st March, 2008 and the related profit and loss account and the cash flow statement for the year ended on that date. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the firm statements.

We will conduct our audit in accordance with the auditing standards generally accepted in India and with the requirements of the Companies Act, 1956. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on

a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

However, having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements of financial statements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems which might come to our notice.

The responsibility for the preparation of financial statements on a going concern basis is that of the management. The management is also responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards. The management is also responsible for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

The responsibility of the management also includes the maintenance of adequate accounting records and internal controls for safeguarding of the assets of the company and for the preventing and detecting fraud or other irregularities. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949. The reviewer may examine our working papers during the course of the peer review.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records; documentation and other information are requested in connection with our audit.

Our fees will be billed as the work progresses.

This letter will be effective for future years unless it is terminated, amended or superseded.

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

PQR & Co.
Chartered Accountants

.....
(Signature)
(Name of the Member)
(Designation)

Date :

Place :

Acknowledged on behalf of
_____ Company by

.....

(Signature)
Name and Designation
Date

- (b) Since paid up capital and reserves of T Pvt. Ltd. is less than Rs. 50 lakhs and has no loan outstanding exceeding rupees 25 lakhs from any bank or financial institution, the only other condition is whether turnover exceeds rupees five crores. Turnover is not defined in the CARO. Part II of Schedule VI defines the term "turnover" as the aggregate amount for which sales are affected by the company. "Sales affected" would include sale of goods as well as services rendered by the company.

For ascertaining turnover though trade discount and sales returns should be deducted, the inclusion of services rendered would result in a turnover of Rs. 5.05 crores (i.e. 6 - 0.10 - 0.95 + 0.10 crore) Hence CARO will apply to T. Pvt. Ltd.

Question 8

Write short notes on any four of the following:

- Peer review
- Supplementary Audit u/s 619(4) of the companies Act, 1956.
- Purchase method of Accounting for amalgamations.
- Accounting ratios in Form 3 CD of Tax Audit.
- Circuit Filters (as specified by SEBI)
- Situations where external confirmations can be used. (4X4 = 16 Marks)

Answer

- (a) Peer Review: The term "peer" means a person of similar standing. The term "review" means conduct of re-examination or retrospective evaluation of the subject matter. In

general, for a professional, the term "peer review" would mean review of work done by a professional, by another professional of similar standing. 'Peer Review' is defined as, a regulatory mechanism for monitoring the performances of professionals for maintaining quality of service expected of them for enhancing the reliance placed by the users of financial statements for economic decision-making.

As per the Statement of Peer Review (ICAI, 2002) "Peer Review" means an examination and review of the systems and procedures to determine whether they have been put in place by the practice unit for ensuring the quality of attestation services as envisaged and implied/mandated by the Technical Standards and whether these were effective or not during the period under review".

The examination and review of a practice unit would be carried out by a "reviewer", i.e., a member, selected from a panel of reviewers maintained by the Board. The term "practice unit" means members in practice, whether practising individually or as a firm of Chartered Accountants.

- (b) Supplementary Audit u/s 619(4) of the Companies Act, 1956: The auditor of a Government company shall be appointed or re-appointed by the Comptroller and Auditor-General of India . The auditor aforesaid shall submit a copy of his audit report to the Comptroller and Auditor-General of India who shall have the right to comment upon, or supplement, the audit report in such manner as he may think fit. Any such comments upon, or supplement to, the audit report shall be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.
- (c) Purchase method of Accounting for Amalgamation: Under the purchase method in preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company. Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve. The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortization period should not exceed five years unless a somewhat longer period can be justified. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account') which should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be

maintained, both the reserves and the aforesaid account should be reversed.

(d) Accounting Ratios in Form 3CD of Tax Audit:

- (i) Gross Profit/Turnover
- (ii) Net Profit/Turnover
- (iii) Stock in Trade/Turnover
- (iv) Material consumed/finished goods produced.

These ratios have to be calculated only for assessees who are engaged in manufacturing or trading activities. This clause is not applicable to assessees carrying on profession. Moreover, the ratios have to be given for the business as a whole and need not be given product wise. Further, the ratio mentioned in sub-clause (d) need not be given for trading concern.

(e) Circuit Filters: Circuit breakers or filters are the price bands that set the upper and lower limit within which a stock can fluctuate on any particular day. A price band for a day is a function of previous trading days' closing. SEBI has directed exchanges to apply circuit filters on scrips traded in rolling settlement if their price fluctuates more than 20% of the closing price of scrips on the previous day in any direction. However for scrips forming part of sensex or in which derivatives and futures are available, the fluctuation is restricted to 10%.

(f) Situations where external confirmations can be used: (Refer AAS 30)

- (i) Bank balance from bankers
- (ii) Account receivable balances
- (iii) Stocks held by third parties
- (iv) Property title deeds held by third parties
- (v) Investments purchased but delivery not taken
- (vi) Loan from lenders
- (vii) Account payable balances
- (viii) Long outstanding share application money.

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) M/s ABC Ltd. had power under its memorandum to sell its undertaking to another company having similar objects. The Articles of the company contained a provision by which directors were empowered to sell or otherwise deal with the property of the company. The Shareholders passed an ordinary resolution for the sale of its assets on certain terms and required the directors to carry out the sale. The Directors refused to comply with the wishes of the shareholders where upon it was contended on behalf of the shareholders that they were the principal and directors being their agents were bound to give effect to their decision. Based on the above facts, decide the following issues, having regard to the provisions of the Companies Act, 1956 and case laws.
- (i) Whether the contention of shareholders against the non-compliance of their wishes by the directors is tenable.
 - (ii) Can shareholders usurp the powers which by the articles are vested in the directors by passing a resolution in the general meeting? (5 Marks)
- (b) KYC a recognised Stock Exchange has not maintained proper books of account of the stock exchange, on the ground that such books of account are not essential. A compliant in this regard was made to SEBI who appointed Mr. E. An expert to make an enquiry. Explain whether SEBI is authorised to make inquiry and take action against the stock exchange. (5 Marks)
- (c) PQR Ltd. is holding 33% of the paid up equity capital of Koya Stock Exchange. The company appoints MNL Ltd. as its proxy who is not a member of the Koya Stock Exchange, to attend the vote at the meeting of the stock exchange. Examine whether the Koya Stock Exchange can restrict the appointment of MNL Ltd. as proxy for PQR Ltd. and further restrict, the voting rights of PQR Ltd. in the Koya Stock Exchange. (5 Marks)

Answer

- (a) General Powers vested in the Board of Directors:

The provisions relating to the general powers which are vested are given under Section 291 of the Companies Act, 1956. As per this section, the Board of Directors of a company is entitled to exercise all such powers and to do all such acts and things as the company is authorised to exercise and do. This means the powers of the Board of Directors are co-extensive with those of the company. The proposition is, however subject to two conditions:

Firstly, the Board shall not do any act which is to be done by the company in general meeting. Secondly, the Board shall exercise all such powers subject to the provisions

contained in the Companies Act, 1956 or in the Memorandum or the Articles of the Company or in any regulations made by the Company in general meeting. But no regulation made by the company in general meeting shall invalidate any prior act of the Board which would have been valid if that regulation had not been made.

It is the first and elementary principle of company law that when powers are vested in the Board of directors by the Articles of a company, they cannot be interfered with by the shareholders as such (*Murarka etc. Works Ltd. vs. Mohal Lal* AIR (1961) Cal 251).

In exercising their powers the directors do not act as agent for the majority members or even all the members. The members therefore cannot by resolution passed by a majority or even unanimously supercede the powers of directors or instruct them how they shall exercise their powers. The above problem is based on decision given by the Chancery Court in the case *Automatic Self Cleansing Filter Syndicate Co. Ltd. Vs. Cunninghame* (1906) 2 Ch 34 and this case was also followed in India in *MP & V Works Vs Murarka* AIR 1961 Cal 251.

In view of above discussion, the contention of shareholders against the non-compliance of their wish by the directors is not tenable and shareholders cannot usurp the power which by articles vested in the directors by passing even a resolution of a numerical majority at the general meeting. The shareholders have, however, the power to alter the Articles of Association of the company in the manner they like subject to the provisions of the Companies Act, 1956.

- (b) Section 6 of the Securities Contracts (Regulation) Act, 1956 empowers SEBI to carry out regular inspection of all exchanges at periodical intervals and also special investigation, if need be. According to section 6 every recognised stock exchange shall furnish periodical returns to SEBI in the prescribed format. These returns contain information on current affairs of the exchange including volume and value of transactions, short deliveries, important decisions taken by board etc. Every stock exchange has to maintain books of accounts for a period of 5 years and these books may be inspected by SEBI at any point of time. SEBI may by order in writing call for information or explanation relating to affairs of an exchange or its member. SEBI also has the power to appoint one or more inquiry officers who may submit their report to SEBI. Every director, manager, secretary or officer of the exchange is bound to provide information to enquiry officer or SEBI representative who is looking into the affairs of the exchange.

So, SEBI is authorised to make inquiry and take action against the stock exchanges. However, SEBI shall have the power to modify or withdraw its directions, either of its own motion or on the representation of the member concerned. (Rule 11 of Securities Contracts (Regulation) Act, 1956).

- (c) Section 7(a) of the Securities (Contracts) Regulation Act, 1956 provides that a recognised stock exchange is empowered to amend rules to provide for all or any of the following matters:
 - (a) Restriction of voting right to members only.

- (b) Regulation of voting rights by specifying that each member is entitled to one vote only irrespective of number of shares held.
- (c) Restriction on right of members to appoint proxy.

As such Koya Stock Exchange can restrict the appointment of MNL Ltd., if rules of the exchange so provide. If it is not so provided, rules may be amended and after getting approval of the Central Government regarding amendment, it can restrict appointment of proxies.

Koya Stock Exchange can also restrict the voting rights of PQR Ltd.

Question 2

Answer any two of the following:

- (a) Examine with reference to the provisions of the Foreign Exchange Management Act, 1999, the residential status of the branches mentioned below:
 - (i) NNM Ltd. an Indian Company having its registered office at Mumbai, India established a branch at New York USA on 1st April, 2005.
 - (ii) DDI Ltd. a company incorporated and registered in London established a branch at Kanpur in India on 1st April, 2005.
 - (iii) DDI Ltd. has a branch office at Singapore which is controlled by its Kanpur branch
(7 Marks)
- (b) Explain the meaning of "Capital Account Transactions" under the Foreign Exchange Management Act, 1999. State its categories and also examine whether the following transactions are permissible or not under the above act as Capital Account transactions:
 - (i) Investment by person resident in India in Foreign Securities.
 - (ii) Foreign currency loans raised in India and abroad by a person resident in India.
 - (iii) Export, import and holding of currency / currency notes.
 - (iv) Trading in transferable development rights.
 - (v) Investment in a Nidhi Company.
(7 Marks)
- (c) (i) An arrangement has been made among the Cotton producers that the cotton produced by them will not be sold to mills below a certain price. The arrangement was in writing but it was not intended to be enforced by legal proceeding. Examine whether the above arrangement can be considered as an agreement within the meaning of section 2(b) of the Competition Act, 2002.
(3 Marks)
- (ii) The Central Government has formed the opinion that Mr. CBM (A member of the Competition Commission of India) has abused his position which may be prejudicial to public interest as a member of the commission. Examine the powers of the Central Government in this regard.
(4 Marks)

Answer

- (a) As per Section 2(u) of the Foreign Exchange Management Act, 1999, 'person' includes the following:

A Company

Any agency, office or branch owned by a 'person'

Further, Section 2(v) defines a 'person resident in India' as to include: any person or body corporate registered or incorporated in India, an office, branch or agency in India owned or controlled by a person resident outside India. And an office, branch or agency outside India owned or controlled by a person resident in India.

Considering the provisions of the two sections, the residential status is as follows:

- (i) NNM Ltd. as well as the New York branch of NNM Ltd. is a 'person'. Therefore, the residential status under FEMA shall be determined for each of them separately. NNM Ltd. is incorporated in India. Therefore, it is a 'person resident in India'. NNM Ltd. (a person resident in India) has established a branch outside India. Therefore, the New York branch of NNM Ltd. falls under the clause 'an office', branch or agency outside India owned or controlled by a person resident in India and so the New York branch is a 'person resident in India'.
- (ii) DDI Ltd. as well as Kanpur branch of DDI Ltd is a 'person'. Their residential status is determined as follows:
 - (a) DDI Ltd (a foreign company) does not fall under any of the clauses of the definition of a 'person resident in India'. Therefore, DDI Ltd. is a 'person resident outside India'.
 - (b) The Kanpur branch of DDI Ltd. is a person resident in India' since it falls under the clause 'an office, branch or agency in India owned or controlled by a person resident outside India'.
- (iii) The Singapore branch of DDI Ltd., though not owned, is controlled by the Kanpur branch. The Singapore branch is a 'person resident in India' since it falls under the clause 'an office, branch or agency outside India owned or controlled by a person resident in India'.

- (b) Meaning of Capital Account Transactions

It means a transaction which alters the assets or liabilities including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of a person resident outside India, and includes transactions referred to in sub-section (3) of Section 6 of FEMA Act, 1999. The Reserve Bank of India has framed Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000. The provisions of these regulations are as under:

Categories of Capital Account Transactions:

As per these regulations, capital account transactions may be classified under the

following heads.

- (1) Permissible capital account transactions of persons resident in India (schedule 1)
- (2) Permissible Capital transactions of persons resident outside India (schedule II).
- (3) Prohibited capital account transactions.

A person resident in India may enter into any of the following capital account transactions provided the regulations specified by the Reserve Bank of India in respect of such capital account transactions are complied with. In view of the above provisions: among five capital account transaction of question first three i.e. (i), (ii) and (iii) are permissible capital account transactions and rest two i.e., (iv) and v are prohibited capital transactions.

- (c) (i) As per Section 2(b) of Competition Act, 2002 an 'agreement' includes any arrangement or understanding or action in concert, -
- (i) Whether or not, such a arrangement or understanding or action is formal or in writing; or
 - (ii) Whether or not, such an arrangement or understanding or action is intended to be enforceable by legal proceedings.

In the given case the understanding reached among the cotton producers not to sell below a certain price shall amount to an agreement as defined under section 2(b) notwithstanding the fact that arrangement is in writing but no intended to enforced by legal proceeding.

- (ii) Section 11(2) (e) of the Competition Act, 2002 empowers the Central Government to remove by an order, a member of the Competition Commission of India from his office if such member has abused his position as to render his continuance in office prejudicial as a member of Competition Commission. However Section 11(3) of the said Act puts some restrictions on such powers of the Central Government. According to this section, in case as stated in the question, Central Government wants to remove a member of the Competition Commission from his office on the above ground, 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 on such ground. 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) M/s Earth Chemicals and Engineering Ltd. is a closely held unlisted company with a paid up share capital of Rs. 3.00 crores, since 1st April, 2001 and its net worth as on 31st March, 2007 was Rs. 5.00 crores. The net tangible assets of the company as per last three audited balance sheets as at 31st March, 2005, 2006 and 2007 were Rs. 4.00 crores, 4.50 crores and 5.00 crores respectively out of which monetary assets were less

than Rs. 50 lakhs in each of the three years. The company was incorporated in 1998 and commenced its business on 1st April, 1998 and since then it has earned good profits and it has not incurred any loss in any year in the past. The company has not declared any dividend so far. But according to the profits earned so far, the management could have declared dividends in each of the last five years. The name of the company was changed from Earth Engineering Ltd. to its present name effective from 1st October, 2006. The company wants to make a public issue of shares to raise Rs. 20.00 crores by issuing equity shares at premium. For the purpose of including the information in the prospectus. The company has prepared its accounts for 12 months ended 30th September, 2007 showing segment wise revenue, which reveals that revenue from chemical segment was more than the revenue from engineering segment. Keeping the relevant guidelines issued by SEBI into account, examine whether the company can make the desired issue of equity shares based on the facts stated above. (8 Marks)

- (b) An investor has complained to SEBI that he has not received the payment due to him from the stock broker registered with Calcutta Stock Exchange Association Ltd. The complainant has requested SEBI to take appropriate action against the stock broker. State with reference to the provisions of Securities and Exchange Board of India Act, 1992. The action that can be taken against the stock broker, the procedure to be adopted and the factors that will be taken into account of SEBI. (8 Marks)
- (c) "When two or more provisions of the same statute are repugnant to each other, the court will try to construe the provisions in such a manner, if possible, as to give effect to all". Examine the statement with reference to the provisions of sections 166 and 210 of the Companies Act, 1956 which appear to be seemingly contradictory to each other for compliance. (8 Marks)

Answer

- (a) According to para 2.2.1 of Guidelines laid down in Chapter II of the SEBI (Disclosure and Investor Protection) Guidelines, 2000, an unlisted company can make an initial public offer of equity shares if the following conditions are fulfilled:
- A. The company has net tangible assets of at least Rs. 3 crores in each of the preceding three full years (of 12 months each), of which not more than 50% is held in monetary assets. Provided that if more than 50% of the net tangible assets are held in monetary assets, the company has made firm commitments to deploy such excess monetary assets in its business / project.
 - B. The company has a track record of distributable profits in terms of section 205 of the Companies Act, 1956, for at least three out of immediately preceding five years. Provided further that extraordinarily items shall not be considered for calculating distributable profits in terms of section 205 of the Companies Act, 1956.
 - C. The company has a net worth of at least Rs. 1 crore in each of the preceding 3 full years (of 12 months each).
 - D. In case the company has changed its name within the last one year, at least 50% of

the revenue for the preceding 1 full year is earned by the company from the activity suggested by the new name; and

- E. The aggregate of the proposed issue and all previous issues made in the same financial year in terms of size (i.e. offer through offer document + firm allotment + promoter's contribution through the offer document) does not exceed five times its pre-issue net worth as per the audited balance sheet of the last financial year.

In the given question, the company has net tangible assets exceeding Rs. 3 crores in each of the preceding three years and it has monetary assets which are less than 50% thereof, the company has a track record of having distributable profits in last three out of last five years, the declaration of dividend is not essential. The company has a net worth of more than Rs. 1 crore in each of the preceding three full years. The company has changed its name by including the word "chemicals" therein and as per the information provided, the revenue earned by the company from this activity is more than 50% of the total revenue earned by it during the preceding one full year of 12 months. Finally, the issue size is Rs. 20.00 crores, which is less than five times its pre-issue net worth of Rs. 5 crores. The company is free to price their equity shares. Hence, the company can raise Rs. 20 crores through public issue of equity shares at a premium.

- (b) A stock broker registered with any recognised stock exchange is governed by the provisions of Securities and Exchange Board of India Act, 1992. Accordingly, he exposes himself to certain penalties under Section 15F of the Act, in certain circumstances. According to Section 15F (b) of the Act, if a registered stock broker fails to make payment of the amount due to the investor in the manner or within the time specified in the relevant regulations, he shall be liable for a penalty of one lac rupees for each day during which the default continues or one crore rupees whichever is less.

For the purpose of adjudging any default under Section 15F of Securities and Exchange Board of India Act, 1992 as per Section 15I of the said Act, SEBI shall appoint any of its officers not below the rank of Division Chief to be an adjudicating officer for holding the enquiry in the prescribed manner after giving the person concerned a reasonable opportunity of being heard for the purpose of imposing any penalty.

Section 15J of the said act enumerates following factors that shall have to be taken into account by the adjudicating officer while adjudging the quantum of penalty.

- (i) The amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default.
 - (ii) The amount of loss to the investor or group of investors as a result of the default.
 - (iii) The repetitive nature of the default.
- (c) The statement in question is relates to an important rule of interpretation that is 'Rule of Harmonious Construction' of a Statute. According to this rule when there is doubt about the meaning of the words of a statute, these should be understood in the sense in which they harmonise with the subject of the enactment and the object which the legislature had in view. Their meaning is found not so much in strictly grammatical or etymological

propriety of language, nor even its popular use, as in the subject or in the occasion on which they are used and the object to be attained. Where there are in an enactment two or more provisions which cannot be reconciled with each other, they should be so interpreted whichever possible as to give effect to all of them. This is what is known as the Rule of Harmonious Construction. Let us take an example: According to Section 166(i) of the Companies Act, 1956 there must be not more than fifteen months gap between two consecutive annual general meetings of a Company. Section 210 requires the Board of Directors to lay at every annual general meeting of a company a profit and loss account, which must cover the period since the preceding account and must be made up to date not earlier than the date of the meeting by more than six months. The profit and loss account is required to be accompanied by a balance sheet as at the date to which the profit and loss account is made up. For some special reasons, however, the Registrar may give an extension for not more than 3 months to hold the meeting. In such a case, the accounts must relate to a period not earlier than the date of the meeting by more than six months plus the extension period. From this, it can easily be made out that except the first annual general meeting which is subject to different rules an annual general meeting is to be held subject to the following rules:

- (i) The meeting must be held in each calendar year
- (ii) It must be held not later than 15 months (18 months if extension is granted) from the date of the previous general meeting.
- (iii) Further, it must be held within six months (or six months + extension) of the date of balance sheet.

These three requirements are cumulative and separate; failure to comply with any of them constitutes an offence. Thus even where a company may hold its annual general meeting within the time limit of 15 months (or 18 months, if extension is granted) it may still be guilty of contravention of Section 210. Therefore, to give effect to both the provisions of sections, they are to be interpreted harmoniously and in fixing the date of the annual general meeting Section 166 as well as section 210 are to be taken into account. The following illustration will make things clear:- The financial year of a company ends on 31st March each year, presumption that the annual general meeting to adopt the accounts etc. relating to the year ended on 31st March, 2006 was held on 30th September, 2006 under Section 166 (i) the next general meeting need not be held till 31st December, 2007. But the relevant accounts would be those of the year ended on 31st March, 2007 which would be more than six months before the date of meeting. Therefore, the last date for holding that meeting would be 30th September, 2007.

Question 4

- (a) Mr. X was appointed as the Managing Director of ABC Ltd. for a period of 5 years w.e.f, 1st January, 2006. Since his work was found unsatisfactory. His services were terminated from 15th August, 2007 by paying compensation for the loss of office as provided in the agreement entered into by the company. Later, the company discovered that during his tenure of office Mr. X was guilty of many corrupt practices and that he

should have been removed without payment of compensation. Advise the company whether the services of the Managing Director can be terminated without payment of compensation as provided in the agreement and whether the company can recover the amount already paid to Mr. X filing a suit. (8 Marks)

- (b) M/s FAB Electronics Ltd. (FEL) has appointed four private companies as its selling agents for sale of its white goods in the four regions of the country. A complaint has been made to the Registrar of Companies, new Delhi that the four selling agents are in fact functioning as sole selling agents and that the terms and conditions of their appointment are not in the interest of FEL. Advise FEL about the provisions of the Companies Act and the action that may be taken by the authorities under the Act.

(7 Marks)

Answer

- (a) According to Section 318 of the Companies Act, 1956 a Managing Director is entitled to be paid compensation for loss of office. However, Section 318(3) (e) provides that no compensation is payable if the director concerned has been guilty of fraud or breach of trust or of gross negligence in or gross mismanagement in the conduct of the affairs of the Company. However, in the present case, compensation amount was paid and subsequently the misconduct on the part of Mr. X was noticed by the company. In the case of Bell Vs. Lever Bros (1932) Lever Bros removed their managing director of a subsidiary by paying them compensation. It was afterwards discovered that during his tenure of office he had been guilty of so many breaches of duty and corrupt practices that he could have been removed without compensation. An action was then commenced to recover back the compensation money. It was held that Bell was not bound to refund the compensation money and to disclose any breach of his fiduciary obligation so as to give the company an opportunity to dismiss him. Thus, in normal circumstances, ABC Ltd., is entitled to terminate the services of Mr. X as Managing Director without payment of compensation as he was guilty of many corrupt practices. In the present case, however, ABC Ltd. will not be able to recover the compensation money already paid to Mr. X the Managing Director.
- (b) According to Section 294(6) of the Companies Act, 1956 where a company has more selling agents than one, by whatever name called and it appears to the Central Government that it is necessary to obtain information about the terms and conditions of appointment of such agents for the purpose of determining whether any of those selling agents are in fact working as sole selling agents. The Central Government has the power to call for such information as may be necessary to find out the correct position. On the basis of the information obtained, the Central Government may by an order declare that selling agents be the sole selling agent for the area so stated with effect from such date as may be specified in the order. From the date so specified in the order, the appointment of the sole selling agent shall be regulated by the terms and conditions as may be varied by the Central Government. It shall be the duty of the company to furnish all information and documents and refusal to do so will involve penalty which may extend upto Rs. 50,000/-. Thus it is imperative for the company to furnish all the

information and documents in its possession to the Registrar of Companies or any authority making any enquiry in this regard that the selling agents are not functioning as sole selling agents.

Question 5

- (a) The Board of Directors of XYZ Ltd. has agreed in principal to grant 'loan' worth Rs. 38 lakhs to MNC Ltd. on the basis of the following information. Advise XYZ Ltd. about the requirements to be complied with under the Companies Act, 1956 for the proposed inter-corporate loan to MNC Ltd.

(i)	Authorised share capital	Rs.	1,00,00,000	
(ii)	Issued, subscribed and paid up capital	Rs.	50,00,000	
(iii)	Free reserves	Rs.	10,00,000	(8 Marks)

- (b) M/s Flyover Constructions Ltd. has to recruit 2,000 Civil Engineers on contract basis for a period of 5 years. The company entered into an agreement with the employees that each employee will have to deposit Rs. 50,000 as security which sum will be returned on completion of 3 years of contract of service. The company wants to utilize the fund so collected in their business. Advise the company with reference to Companies Act in the matter of collection and utilisation of money received from employees as security deposit.

(7 Marks)

Answer

- (a) Inter corporate loans and investments are governed by the provisions of Section 372A of the Companies Act, 1956. As per this Section, a company can advance loans to other companies or invest in the securities, of other companies upto 60% of its paid-up capital and free reserves or upto 100% of its free reserves, whichever is more. Further no loan or investment exceeding the said limits can be made by a company unless authorised by a previous special resolution passed in this regard.

First determine whether a special resolution is required for providing loans to MNC Ltd.

This can be determined as follows:

Paid up capital XYZ Ltd. (A)	(A)	Rs. 50,00,000
Free reserves	(B)	Rs. 10,00,000
Aggregate of paid up capital and free reserves	(C)	Rs. 60,00,000
60% of aggregate of paid up capital and free reserves	(D)	Rs. 36,00,000
Higher of (B) or (D) i.e. the ceiling limit for inter-corporate loan/investment etc. without requiring company to pass Special Resolution		Rs. 36,00,000
Proposed loans to MNC Ltd.		Rs. 38,00,000

Since the proposed loan exceeds the ceiling limit a special resolution is required. XYZ Ltd. should adopt the following procedure for providing loan to MNC Ltd.

- (i) Unanimous approval of the Board by passing a resolution at a Board meeting.
- (ii) A special resolution shall be passed in the general meeting

The notice of special resolution shall state the specific limits, particulars of the company to which loan is proposed to be given, specific source of funding and other relevant details. The company shall file a copy of special with the registrar within 30 days of passing of the special resolution. If the company is listed company, it shall pass the resolution by postal ballot as prescribed under Section 192A.

- (iii) the company shall obtain the prior approval of the Public Financial Institution, if any, from whom it has taken a term loan.
- (iv) the company can provide such loan to other companies only if no default in respect of public deposits is subsisting.
- (v) the prescribed particulars shall be entered in the register maintained under Section 372A(5).

(b) Section 417 of the Companies Act, 1956 provides that

- (1) any money or security deposited with a company by any of its employee in pursuance of his contract of service with the company shall be kept or deposited by the company within fifteen days from the date of deposit.
 - (i) in a post office savings bank account, or
 - (ii) in a special account to be opened by the company for the purpose in the State Bank of India or in a scheduled bank, or
 - (iii) where the company itself is a scheduled bank, in a special account to be opened by the company for the purpose either in itself or in the State Bank of India or in any other scheduled bank.
- (2) No portion of such moneys or securities shall be utilised by the company except for the purposes agreed to in the contracts of service.
- (3) A receipt for moneys deposited with a company by its employee shall not be deemed to be security within the meaning of this section; and the moneys themselves shall accordingly be deposited as provided in sub-section (1).

So the Flyover Constructions Ltd. cannot utilize the money so collected. It will have to deposit the money in the special accounts as referred in the section.

Question 6

- (a) M/s Joel Ltd. was incorporated in London with a paid up capital of 10 million pounds. Mr. Y an Indian citizen holds 25% of the paid up capital. M/s. X Ltd. a company registered in India holds 30% of the paid up capital of Joel Ltd. M/s. Joel Ltd. has recently established a share transfer office at New Delhi. The company seeks your advice as to what formalities it should observe as a foreign company under Companies Act, 1956. State

briefly the requirements relating to filing of accounts with the Registrar of Companies by the foreign company in respect of its global business as well as Indian business.

(8 Marks)

- (b) The auditors of PQR Ltd. accepted the Certificate of the Manager, a person of acknowledge competence and high reputation, as to the value of the stock in trade. The stock was grossly overstated for several years in the balance sheets of the company. As a result of this over valuation dividends were paid out of capital. The Auditors did not examine the books of account very minutely. If they had done so and compared the amount of stock at the beginning of the year. With the purchases and sales during the year, they would have noticed the over valuation. The company subsequently went into liquidation and the auditors were sued to make good the loss caused by the wrongful payment of dividends relying on the balance sheets figures. Based on the above facts, you are required to decide. With reference to the provisions of the Companies Act, 1956 and the decided case laws, the following issues:
- (i) Whether auditors of the company will be liable for the loss caused to the company by the wrongful payment of dividends based on the Balance Sheets duly audited by the Auditors.
 - (ii) What are the statutory duties of the Auditors in this regard ?

(7 Marks)

Answer

- (a) As per section 591 (1) of the Companies Act, 1956, companies falling under the following two classes shall be known as foreign companies namely:
- (i) companies incorporated outside India which, after the commencement of this Act, establish a place of business within India, and
 - (ii) companies incorporated outside India which have, before the commencement of this Act, established a place of business within India and continue to have an established place of business within India at the commencement of this Act.

Notwithstanding anything contained in sub-section (1) of section 591, where not less than fifty percent of the paid up share capital (whether equity or preference or partly equity and partly preference) of a company incorporated outside India and having an established place of business in India, is held by one or more citizens of India or by one or more bodies corporate incorporated in India, or by one or more citizens of India and one or more bodies corporate incorporated in India, whether singly or in the aggregate, such company shall comply with such of the provisions of the Act as may be prescribed with regard to the business carried on by it in India, as if it were a company incorporated in India.

Here as more than 50% of the paid-up capital is held by an Indian citizen and an Indian company M/s Joel Ltd. shall be treated as Indian company. It shall have to comply with such provisions of the Act as may be prescribed as if it were a company incorporated in India.

Joel Ltd. has to submit the following documents with the Registrar of Companies, New Delhi within 30 days of establishment of business in India.

- (a) a certified copy of the charter, statutes, or memorandum and articles, of the company or other instrument constituting or defining the constitution of the company; and, if the instrument is not in the English language, a certified translation thereof.
- (b) the full address of the registered or principal office of the company;
- (c) a list of the directors and secretary of the company, containing the particulars mentioned in sub-section (2) of section 592.
- (d) the name and address or the names and addresses of some one or more persons resident in India, authorised to accept on behalf of the company service of process and any notices or other documents required to be served on the company; and
- (e) the full address of the office of the company in India which is to be deemed its principal place of business in India.

Section 594 provides for the requirements of accounts of a foreign company. As per this section

- (1) Every foreign company shall, in every calendar year –
 - (a) make out a balance sheet and profit and loss account in such form containing such particulars and including or having annexed or attached thereto such documents (including, in particular documents relating to every subsidiary of the foreign company) as under the provisions of this Act it would, if it had been a company within the meaning of this Act, have been required to make out and lay before the company in general meeting; and
 - (b) deliver three copies of those documents to the registrar; Provided that the Central Government may, by notification in the official gazette, direct that, in the case of any foreign company or class of foreign companies the above said requirements of clause (a) shall not apply, or shall apply subject to such exceptions and modifications as may be specified in the notification.

If any such document as is mentioned in sub-section (1) is not in the English language, there shall be annexed to it a certified translation thereof.

- (b) The answer to the problem given in question mainly relates to the duties of the auditors. Section 227 of the Companies Act, 1956 provides that the main duty of the auditor is to make a report to the members of the company on the accounts examined by him and the balance sheet and the profit and loss account of the company and on every document which is annexed to the balance sheet or profit and loss account laid before the company in general meeting. The auditor owes a duty to the members to state whether the accounts give a true and fair view of the affairs of the company at the end of the financial year and of the profit and loss account of the year.

The duty of an auditor is to give information in direct and express terms (Crichton's Oil Co. Re (1902) 2ch 86) and not merely to arouse inquiry. If he discovers that any illegal or improper payment papers to have been made, his duty will be to report to the members. The auditor occupies a fiduciary position in relation to the shareholders and in auditing the accounts maintained by the directors, he must act in the best interest of the shareholders who are in the position of beneficiaries.

But there is a limitation relating to perform the duties by the auditors. An auditor is not bound to be a detective, and to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom, but in the absence of any thing of that kind he is only bound to be reasonable cautious and careful.

The above problem is related to case of Kingston Mill Co. Re (No 2) (1896) 2 ch 279. In this case it was held that, the auditors were not liable. It is not auditor's duty to take valuation of the stocks. There are many matters in which he may rely on the honesty and accuracy of others. Further they (auditors) do not guarantee the discovery of all frauds.

Question 7

- (a) M/s. City Hospital Private Ltd. has two groups of Directors. A dispute arose between the two groups out of which one group controlled the majority of shares. A very serious situation arose in the administration of the company's affairs when the minority group ousted the lawful Board of Directors from the possession and control of the management of the company's factory and workshop. Books of account and statutory records were held by the minority group and consequently the annual accounts could not be prepared for two years. The majority group applied to the company law board for relief under sections 397 and 398 of the Companies Act. You are required to decide with reference to the provisions of the said Act, the following issues:
- (i) Can majority of shareholders apply to the Company Law Board for relief against the oppression by the minority shareholders ?
 - (ii) Whether Company Law Board can grant relief in such circumstances. (8 Marks)
- (b) Worthless Ltd. has gone into liquidation because of the inability of the company to pay its debts. During the course of winding up, a proposal was put forward by the previous management to revive the working of the company through a scheme of arrangement between the company and its creditors. As per the scheme, all the creditors have to forego fifty percent of their dues. Some of the creditors have voiced their opposition to the said scheme. The company approaches you for advice. State the steps that have to be taken by the company in this regard. (7 Marks)

Answer

- (a) (i) The case stated in the question relates to the provisions of sections 397 and 398 of

the Companies Act, 1956 with regard to remedy available to majority shareholders.

Where the majority is prevented from protecting itself by controlling the directors at general body meetings, the majority becomes an artificial minority entitled to claim protection under Sections 397 and 398 (V. Sebastian, Dr V City Hospital (Pvt.) Ltd. (1985) 57 Comp. case 453 (Ker)] Thus the remedy under Sections 397 and 398 is confined not to an oppressed minority of the shareholders alone; an oppressed majority may also apply to the Company Law Board against their oppression from the side minority shareholders. In *Sindhri Iron Foundry (Pvt.) Ltd. Re* (1963) 78 C.W.N. 118, issue and allotment of a number of shares in a company whereby an admitted majority of shareholders was reduced to a minority was struck down. While granting relief to a majority group, Mitra J observed in their case;

“If the Court (now the Company Law Board) finds that the company's interest is being seriously prejudiced by the activities of one or the other group of shareholders, that two different registered offices at two different addresses have been set up, that two rival boards are holding meetings, that the company's business property and assets have passed into hands of unauthorised persons who have taken wrongful possession and who claim to be the shareholders and directors, there is no reason why the Court (now the company Law Board) should not make appropriate orders to put an end to such matters”.

- (ii) Relief by the Company Law Board: The Company Law Board may give relief if it is of the opinion:

1. that the company's affairs are being conducted (a) in a manner prejudicial to public interest, or (b) in a manner oppressive to any member or members; 2. that the facts justify the compulsory winding up order on the ground that it is just and equitable that the company should be wound up; 3. that to wind up the company would unfairly prejudice the applicants.

On being satisfied about the above requirements, the Company Law Board may pass such order as it thinks fit with a view to bring an end to the matters complained of. This provision would help salvage an otherwise sound concern which would have been, but for this principle, forced to into winding up.

- (b) As per Section 517 of the Companies Act, 1956 any arrangement entered into between a company about to be, or in the course of being wound up and its creditors shall, subject to the right to appeal under this section, be binding on the company and on the creditors if it is sanctioned by a special resolution of the company and acceded to by three-fourths in number and value of the creditors. Any creditor or contributory may, within three weeks from the completion of the arrangement, appeal to the Court (now Tribunal) against it and the Court (now tribunal) may thereupon, as it thinks just, amend, vary, confirm or set aside the arrangement. Thus, *M/s Worthless Ltd* may enter into a scheme of arrangement with the creditors by the procedure given below:

1. The draft scheme of arrangement shall be considered and approved by the board of directors.

2. The company shall apply to the court for directions to convene the meetings of the members and creditors.
3. A general meeting of the company shall be held and the special resolution approving the scheme of arrangement shall be passed.
4. A meeting of creditors shall be held whereat the scheme shall be agreed to by $\frac{3}{4}$ in number and value of the creditors. The company shall approach the Court (Tribunal) for approval of the scheme.

On receipt of the courts (Tribunal) order, the company shall file a certified copy of the Court (Tribunal) order with the Registrar of Companies.

Question 8

- (a) Mr. X appointed as the Managing Director of XYZ Ltd. w.e.f. 1st October, 2006. The company made an application to the Central Government for approval, as the remuneration proposed to be paid to Mr. X was beyond the limits laid down in schedule XIII to the Companies Act, 1956. The company started paying remuneration from the date of appointment and continued to do so till 31st March, 2007. The Central Government did not approve the remuneration as proposed by the company and restricted the same to a lower amount. On scrutiny of the accounts, it was noticed that the company till 31st March, 2007 has paid to Mr. X, a total sum of Rs. 1.20 lakhs in excess of the remuneration sanctioned by the Central Government. Explain with reference to the provisions of the Act whether Mr. X can keep the excess remuneration. Draft a resolution for waiver of recovery of the excess remuneration so paid by the company. (8 Marks)
- (b) The articles of association of DEF Ltd. mentioned in it that Mr. X and Mr. Y will act as directors of the company from the date of incorporation. The company was incorporated on 2nd January, 2007. The articles also provided that the directors will have to obtain qualification shares within one month from the date of appointment as director. Mr. X purchased the shares of the company on 28th February, 2007 and Mr. Y purchased on 28th March, 2007 thus violating the provisions contained in the articles. Having regard to the provisions of the companies Act. Examine the validity of the appointments of Mr. X and Mr. Y as directors. (7 Marks)

Answer

- (a) According to Section 309(5A) of the Companies Act, 1956, if any director draws any remuneration in excess of the remuneration sanctioned by the Central Government, he shall refund such excess remuneration to the company. Until such excess remuneration is returned he shall hold it in trust for the company. The company shall not waive the recovery of any sum refundable to it unless permitted by the Central Government.

In the present case Mr. X cannot therefore keep remuneration drawn by him which is in excess of the remuneration sanctioned by the Central Government, the Central Government permit the waiver of recovery of excess remuneration, the company may waive the recovery of excess remuneration, and then Mr. X will have a right to retain the

excess remuneration drawn by him.

Draft resolution for waiver of recovery of the excess remuneration:

"Resolved that subject to the approval of the central Government, consent of the company be and is hereby given waiving the recovery of an amount of Rs. 120,000 paid to Mr. X the director of the company, during the period 1st October, 2006 to 31st March, 2007 being in excess of the remuneration sanctioned by the Central Government vide letter no. dated

Resolved further that an application be made to the Central Government and the company secretary be and is hereby authorised to take the necessary steps in this regard."

- (b) Without prejudice to the restrictions imposed by section 266 of the Company Act, 1956, it shall be the duty of every director who is required by the articles of the company to hold a specified share qualification and whom is not already qualified in that respect, to obtain his qualification within two months after his appointment as director vide Section 270(1).

So it becomes incumbent on the part of every director to hold qualification shares within the time specified and if he does not hold the same at the time of his appointment as director he must acquire them within two months after his appointment as director. Any provision made in the articles of the company requiring a person proposed for directorship to hold qualification shares either before appointment or within a shorter than two month after his appointment will be void.

Here the provision in the articles of association to hold shares within one month shall be void. Keeping the above provision in consideration the appointment of Mr. X will be valid as he acquired the share before the expiry of two months. As far the appointment of Mr. Y is concerned he has failed to acquire the share within two-month period. As per section of 283(1)(a) the office of director shall become vacant if he fails to obtain the shares within the time specified in section 270(1). Therefore Mr. Y shall have to vacate his office. Here the date of incorporation is taken as the date of appointment.

Question 9

- (a) Mr. Z an expert in modern agriculture practices is willing to lend his services as a director of M/s. Lord Krishna Cotton Producer Company Ltd. registered under Section 581C of the Companies Act, 1956. Advise Mr. Z as to how he can be appointed as a director including (1) The total number of directors that can be appointed (2) The tenure of the directors (3) The time limit within which the appointment should be made (4) the co-option of directors and (5) the voting powers of such co-opted directors. (8 Marks)
- (b) M/s. Info-tech Overtrading Ltd. was ordered to be wound up compulsory by an order dated 15th October, 2007 of the Delhi High Court. The official liquidator who has taken control for the assets and other records of the company has noticed the following:
- (i) The Managing Director of the company has sold certain properties belonging to the company to a private company in which his son was interested causing loss to the company to the extent of Rs. 50 lakhs. The sale took place on 10th May, 2007.

- (ii) The company created a floating charge on 1st January, 2007 in favour of a private bank for the overdraft facility to the extent of Rs. 5 crores, by hypothecating the current assets viz., stocks and book debts.

Examine what action the official liquidator can take in this matter. Having regard to the provisions of the Companies Act, 1956. (7 Marks)

Answer

- (a) According to Section 581P of the Companies Act, 1956 the members who sign the memorandum and the articles are designated as first directors and shall govern the affairs of the company until the directors are appointed at the Annual General Meeting. According to Section 581 O every producer company shall have at least five and not more than fifteen directors. The election of directors shall be conducted within 90 days from the date of registration of the producer company. In the case of Inter-State Co-operative Society the election shall be held within a period of 360 days. The period of office of a director shall be not less than one year and not exceeding 5 years as may be specified in the articles. The directors are normally elected and appointed by the members in the Annual General Meeting. The Board may also co-opt one or more expert directors as an additional directors. Such directors cannot exceed 1/5th of the total number of directors. The expert directors shall not have the right to vote in the election of Chairman but shall be eligible to be elected as Chairman if it is provided by the articles. The maximum period for which such experts are appointed as directors will be as provided in the articles of association and it cannot exceed 5 years. Thus Mr. Z can be appointed as expert director but he will not have any voting right in the election of chairman of the Board of Directors. His tenure of office can be between one to five years.

- (b) The Official Liquidator can invoke the provisions contained in Section 531 of the Companies Act, 1956 to recover the sale of assets of the company. According to Section 531, any transfer of property, movable or immovable made within 6 months before the commencement of winding up will be deemed to be a fraudulent preference and hence invalid in the eyes of law. Since in the present case, the sale of immovable property took place on 10th May, 2007 and the company went into liquidation on 15th October, 2007 i.e., within 6 months before the winding up of the company and since the sale has resulted in a loss of Rs. 50 lakhs to the company. The official liquidator will be able to succeed in proving the case under Section 531 by way of fraudulent preference as the property was sold to a private company in which the son of the ex-managing director was interested.

According to Section 534 of the Companies Act, 1956 any floating charge created within 12 months of the commencement of the winding up will be treated as invalid unless it is proved that the company immediately after the creation of charge was solvent. In the present case it may be difficult for the Bank, the charge holder to prove that the company was solvent after the creation of the floating charge. The charge holder i.e., the Bank is however, entitled to recover from the company. The amount advanced along with 5% interest. Further preferential debts under Section 530 will have priority over debts secured by a floating charge. The official liquidator may thus prove that the floating charge created by the company is invalid.

SUMMARY OF EXAMINERS' COMMENTS ON THE PERFORMANCE OF CANDIDATES

PAPER – 1 : ADVANCED ACCOUNTING

General Comments

The overall performance of the candidates, as commented by the examiners, was not satisfactory. The quality of most of the answers reflected lack of candidates' knowledge and understanding of the subject. Questions requiring practical application of Accounting Standards and Guidance Notes in real life situations have not been answered well. It is also observed that the candidates neglect the theoretical aspects of the subject; they should go through the study material carefully. A thorough practice and lots of reading of the subject is required to maintain the level of knowledge expected from the students of Final Level. The candidates must present their answers in organized manner and solutions to practical problems should be given in prescribed formats along with suitable working notes.

Specific Comments

Question 1. Holding Company Accounts: The answer to this question was satisfactorily answered by most of the candidates. Few among them erred in apportionment of reserves and profits between capital (pre-acquisition) and revenue (post-acquisition) which resulted in wrong computation of goodwill/capital reserve and minority interest. Some candidates did not prepare the consolidated balance sheet taking care of the format given under the Companies Act. Few candidates showed inadequate knowledge of AS 21 'Consolidated Financial Statements'.

Question 2. Corporate Restructuring: This part of the question was well answered by most of the candidates. Some of the candidates were not able to compute the purchase consideration and therefore, could not complete the question.

Question 3.(a) AS 6 and AS 10: Average performance was observed in this part of the question. Most of the answers reflected lack of knowledge of provisions of AS 6 and AS 10.

(b) Valuation of Goodwill: Most of the candidates attempted this question correctly. Some of the candidates erred in calculation of super profit and consequently, failed to arrive at the correct value of goodwill.

Question 4.(a) Accounting for Not-for-profit Organizations: The candidates exhibited poor knowledge on this topic. Except few, no candidate was able to give required ledger accounts in this part of the question.

(b) Value Added Statement: The answer to this question was satisfactorily answered by most of the candidates.

Question 5.(a) Cash Flow statement as per AS 3: Most of the candidates attempted this question correctly in accordance with provisions of AS 3.

(b) AS 18: The performance of the candidates, in this part of the question, was average. However, few candidates could not substantiate their answers with relevant provisions of AS 18.

(c) AS 19: The candidates exhibited poor knowledge on AS 19. Very few candidates were able to give correct value of machine to be considered by Lessee Ltd. and the interest charges of each year.

Question 6.Theory Question: Average performance was observed in this question. The comments of the examiners regarding this question were mixed varying from fairly average to poor performance. Most of the answers lacked proper presentation, good expression and clarity. Many candidates gave irrelevant answers without reading the requirements of the question. Few candidates could not write the short note on maintenance of books of account by stock brokers.

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

General Comments

General Comments: The performance of candidates has not been as expected of CA Final students. Examiners have reported a lack of understanding of basic concepts like Cost of Capital, EPS, Derivatives, Foreign Exchange fluctuations etc. Students are advised to read extensively so as to develop a thorough understanding of the above mentioned topics. This shall help them attempt the paper on correct lines.

Specific Comments:

Question 1. This was a practical part requiring candidates to decide between two alternatives regarding 'purchase' or 'lease'. Some candidates used the wrong Cost of Capital whereas a few were unable to approach the problem from the Lessor's point of view.

Question 2. (a) This practical question part required candidates to have a sound understanding of 'Acquisition' and its effect on EPS.The question was reasonably well answered by most of the candidates, however, a few were unable to compute the number of shares issued by A ltd, EPS, New market price of A ltd etc.

(b) This practical question part required candidates to compute the value of the company from the given information.Many examinees were able to correctly compute the earnings/cash flows for the two years 2005 and 2006 but could not estimate cash flows for the subsequent years , thereby arriving at the wrong answer.

Question 3. (a) This was a practical question part requiring candidates to decide upon the financial viability of a project from the information given.Most of the candidates were able to compute correctly the earnings before tax but failed to work out the problem as a whole. Many students were unable to grasp the requirements regarding transfer pricing, withholding tax and manpower cost.

(b) This practical question part required candidates to compute the price of futures contract and the prospective gain on short future position. Examiners have reported a lack of knowledge of concepts regarding future contracts, hedge ratio and future price which led to wrong answers in most of the cases.

(c) This practical question part required students to arrive at a decision regarding the possibility and benefit of a hedge for its foreign currency risk. Many students have been reported to have insufficient knowledge of the required basic concepts like hedging, selling / buying rates etc because of which they arrived at the wrong answers.

Question 4.(a) This was a practical question part requiring candidates to have a sound understanding of YTM and valuation of bonds. Most of the candidates lacked a conceptual knowledge of the above mentioned concepts and hence arrived at the wrong answers.

(b) This was a practical question part requiring students to have a clear understanding of mergers and dividend valuation models. Many candidates got the entire answer right. Generally, this question part was well attempted.

Question 5. (a) This practical question part required candidates to compute the forward rates from the given information. A majority of the candidates were unable to solve this problem correctly. In most cases they failed to work out forward rates of govt securities under different interest rates/maturity periods/current prices etc.

(b) This practical question part requiring candidates to compute the present value of stock was attempted well by most of the candidates.

(c) This theory question part required students to have a sound understanding of derivatives. Majority of the candidates were able to write a few points correctly. The performance has been reported as average and could have been better.

Question 6. (a) This theory question part required students to explain the green share option. This question part was reasonably well attempted by a majority of the candidates.

(b) This theory question part required examinees to write about double taxation agreement on GDRs. The performance of this question part has been reported to be good.

(c) This theory question part required students to have a conceptual understanding of foreign exchange market and their associated risks. A majority of the candidates performed well , however, a few gave unnecessary and irrelevant details.

(d) This practical question part required students to have a basic understanding of risk and CAPM. Very few candidates gave answers on the desired lines. The overall performance in this question part has been reported as average.

PAPER – 3 : ADVANCED AUDITING

General Comments

Performance of the Candidates, in general, was satisfactory. In Q.1(c), 1(d), 2(c), 4, and 6(a), their answers lacked the understanding of the question, its requirement and knowledge of the topics and relevant statute. Writing of some candidates was illegible.

Specific Comments

Question 1.(a) Generally well attempted by most of the candidates. Most of the candidate mentioned AS 5 but some candidates failed to identify that it was not a prior period adjustment.

(b) Average performance. Most of the candidates replied to the question in a general manner rather than highlighting the applicability of AS 16.

(c) This question is based on Guidance Note on Accounting for Credit available in respect of MAT under the IT Act, 1961. Poor performance. Candidates, in general, answered this part of the question under IT Act, 1961. Most of the answer did not cover the Institute's guidance note on credit for MAT under IT Act.

(d) This question is based on ASI 14 'Disclosure of Revenue from Sales Transactions' (Revised). Only handful candidates highlighted the requirement for disclosure of revenue for sales transactions as per ASI-14 (revised). Most of the candidates failed to understand the requirement of the question towards the exhibition of sales in the P & L account.

Question 2.(a) This question is based on section 2(2)(iv) of the Chartered Accountants Act, 1949. Well answered. Candidates in general have a good idea on the relevant provisions of the Chartered Accountants Act, 1949.

(b) Good Performance. Most of the candidates answered this question correctly.

(c) This question is based on the topic Professional Ethics (Clause 5 and 6 of Part I of Second Schedule to the CA Act, 1949). Poor performance. Most of the candidates could not answer it correctly.

(d) This question is based on the topic Professional Ethics (Clause 3 of Part II of Second Schedule). Satisfactory performance. Many of the candidates attempted this part correctly by highlighting the relevant provisions of the CA Act.

Question 3.(a) This question is based on the topic EDP Auditing. Average Performance. Some candidates discussed about the method of EDP auditing, rather than method of collecting and evaluating audit evidence under EDP auditing.

(b) This question is based on the topic Qualified Audit Report. Average Performance. Most of the candidates highlighted the circumstances under which the audit report can be qualified rather than highlighting the " features of qualified Audit Report".

Question 4.(a) This question is based on the topic Due Diligence Review of Cash Flow. Not attempted by many candidates. Even those who have answered have failed to understand the meaning of “due diligence review of cash flow” and presented a general answer on cash flow statement.

(b) This question is based on Companies (Accounting Standards) Rules, 2006. Poor Performance. Candidates failed to give the meaning of small and medium sized company as per Companies (Accounting Standards) Rules, 2006.

Question 5.(a) This question is based on CARO. Good Performance and well attempted by most of the candidates. Some of the candidates mixed internal control with internal audit and could not answer properly.

This question is based on the topic Investigation (embezzlement in cash receipts). Average performance. Most of the candidates just highlighted the need for strengthening the cash department and adequacy of internal control instead of investigation of “embezzlement in cash receipt”.

Question 6.(a) This question is based on the topic Reporting obligation of NBFCs accepting/holding public deposits. Poor performance. Most of the candidates failed to mention the special points pertaining to NBFCs and just answered general reporting requirements under section 227 of the Companies Act, 1956.

(b) This question is based on the topic audit under value added tax(VAT). Fairly good performance by most of the candidates.

Question 7.(a) This question is based on AAS 26 “ Terms of Audit Engagement”. Average performance. In many cases the answers failed to cover the important aspects in the engagement letter. Few candidates answered about the manner of appointment of auditor and compliance with the Companies Act, 1956.

(b) This question is based on Applicability of CARO. Good Performance. Most of the candidates answered this question correctly.

Question 8.(a) This question is based on Peer Review. Fairly good answered by most of the candidate.

(b) This question is based on Supplementary Audit u/s 619(4) of the Companies Act, 1956. Average performance. Some of the candidates related this to special audit.

(c) This question is based on AS 14 “Accounting for Amalgamation”. Fairly good answered by most of the candidate.

(d) This question is based on Form 3 CD of Tax Audit. Good performance.

(e) This question is based on the topic Circuit Filters as specified by SEBI. Good performance.

(f) This question is based on AAS 30 “External Confirmations”. Good performance.

PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE

General Comments

The performance in general was “average”. The following are the suggestions that candidates are to take note of

- (a) Improvement in the English Language.
- (b) Main Sections/Important case laws, if any and relevant to the answer should form part of the answer.
- (c) Devoting sufficient time for adequate preparation.
- (d) Updating the knowledge in the subject by way of amendments.
- (e) Drafting skills in respect of answers to questions based on secretarial practice.

Specific Comments

Question 1. Many of the candidates in their answer to the question on the general powers of the Board of Directors relating to selling the undertaking of the company, wrongly stated that contention of shareholders was tenable on the plea that directors were the agents of the company and shareholders and therefore usurp the powers of the directors vested in them under section 291 and 292 of the Companies Act, 1956.

Though the candidates by and large performed well, some of the candidates did not state the obligations of the recognized stock exchange to maintain books of accounts and to furnish periodical returns to SEBI under section 6 of the Securities Contracts (Regulation) Act, 1956.

The performance to sub-part (c) of the question was satisfactory. However the powers of a stock exchange to impose restrictions in respect of voting by members and appointment of proxy by amending the rules under section 7 of the SCR Act, 1956 were not clearly stated.

Question 2. The problems relating to determination of residential status of various persons under the FEMA, 1999 were solved in general and provisions of section 2(u), (v) were not stated. Meaning of Capital Account transactions was written in general. Most of the candidates did not state the meaning of the term ‘agreement’ as per the provisions of section 2(b) of the Competition Act, 2002. Further, the obligation on the Central Government to refer the case to the Supreme Court before issuing order for removal of the Member of the CCI due to allegation of abusing his position as a member was not well attempted by majority of the candidates.

Question 3. The performance to the question based on fulfilling conditions by an unlisted company for public issue of equity shares as per the SEBI (DIP) Guidelines, 2000 was poor. Further factors to be considered for adjudging the quantum of penalty under Section 15J of the SEBI Act, 1992 were not stated. The Rule of Harmonious Construction in resolving conflicts

between section 166(1) and section 210 of the Companies Act, 1956 was not properly explained.

Question 4 Disentitlement of the Managing Director to payment of compensation on the allegation that he was guilty of breach of trust or gross negligence in or gross mismanagement in the conduct of the affairs of the company were not stated clearly. Also candidates did not refer the case law on the situation i.e. Bell vs. Lever Bros (1932). Powers of the Central Government to obtain information about the terms and conditions of the sole selling agents under section 294(6) of the Companies Act, 1956 were not properly stated.

Question 5. Computation of the limit up to which loans may be advanced to or investment in securities of another company by the Board of Directors and the procedure to be followed thereon in case if the limit is being exceeded by the company were not properly stated. Further in sub-part (b) of the question relating to employee's deposits under section 417 of the Companies Act, 1956, most of the candidates did not state that such moneys from employees be treated as security deposits and how utilization of such monies under the provisions of the Act, to be done.

Question 6. The provisions of section 591, 592 and 594 of the Companies Act, 1956 were not stated correctly by most of the candidates.

Further in sub-question (b), candidates wrongly dealt with the provisions of Accounting Standards instead of referring to the provisions contained in Section 227 of the Companies Act, 1956. Some of the candidates also wrongly stated that the auditor should physically verify stock authenticity of the Manager in respect of value of closing stock and that the auditor is liable for over-valuation of stock by the management of the company.

Question 7. Remedies available to the majority of shareholders in resolving issues relating prevention of oppression and mismanagement under section 397 and 398 of the Companies Act, 1956 were not properly dealt with. Further steps to be taken by the company in a scheme or arrangement under section 517 of the Companies Act, 1956, were not brought out correctly.

Question 8. Some of the candidates were not aware of the limit of remuneration prescribed by the Central Government in respect of Managing Director. Resolution for recovery of the excess remuneration so paid by the company to the MD was also lacking in language and section content. In respect of question relating to share qualification, candidates did not specify the time limit (ie, two months) within which the director should acquire the share qualification. There were no references to the concerned sections 269, 270 and 283(1) of the Companies Act, 1956.

Question 9. Candidates were not aware of the procedure in the appointment of Directors in a Producer Company as per section 581P of the Companies Act, 1956. Similarly, the provisions of section 534 of the Companies Act, 1956 regarding floating charge by a company within 12 months of the commencement of winding up and legal consequences were not stated.

PAPER – 5 : COST MANAGEMENT

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

Working notes should form part of the answer.

Question 1

- (a) The following table gives the activities in a construction project and the time duration of each activity:

Activity	Preceding activity	Normal Time (Days)
A	—	16
B	—	20
C	A	8
D	A	10
E	B, C	6
F	D, E	12

Required:

- (i) Draw the activity network of the project.
 - (ii) Find critical path.
 - (iii) Find the total float and free-float for each activity.
- (b) A manufacturer produces three products whose cost data are as follows:

	X	Y	Z
Direct materials (Rs. / Unit)	32.00	76.00	58.50
Direct Labour:			
Deptt.	Rate / hour (Rs.)	Hours	Hours
1	2.50	18	20
2	3.00	5	7
3	2.00	10	20
Variable overheads (Rs.)	8	4.50	10.50

Fixed overheads (Rs.) 4,00,000 per annum.

The budget was prepared at a time, when market was sluggish. The budgeted quantities and selling prices are as under:

Product	Budgeted quantity (Units)	Selling Price / unit (Rs.)
X	19,500	135
Y	15,600	140
Z	15,600	200

Later, the market improved and the sales quantities could be increased by 20 per cent for product X and 25 per cent each for product Y and Z. The sales manager confirmed that the increased sales could be achieved at the prices originally budgeted. The production manager stated that the output could not be increased beyond the budgeted level due to the limitation of Direct labour hours in department 2.

Required:

- (i) Prepare a statement of budgeted profitability.
 - (ii) Set optimal product mix and calculate the optimal profit.
- (c) S Limited is engaged in manufacturing activities. It has received a request from one of its important customers to supply a product which will require conversion of material 'M', which is a non-moving item.

The following details are available:

Book value of material M	Rs. 60
Realisable value of material M	Rs. 80
Replacement cost of material M	Rs. 100

It is estimated that conversion of one unit of 'M' into one unit of the finished product will require one labour hour. At present, labour is paid at the rate of Rs. 20 per hour. Other costs are as follows:

Out-of-pocket expenses	Rs. 30 per unit
Allocated overheads	Rs. 10 per unit

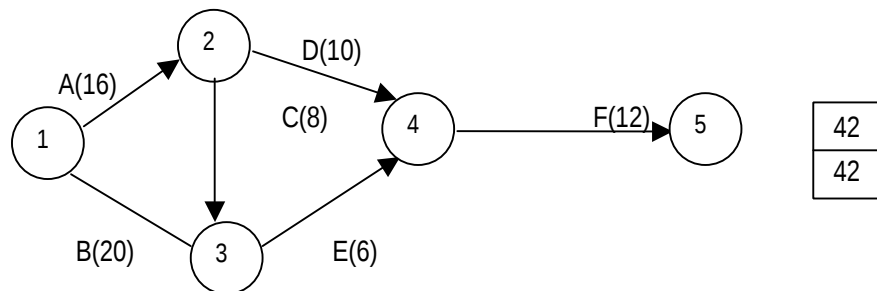
The labour will be re-deployed from other activities. It is estimated that the temporary redeployment will not result in loss of contribution. The employees to be re-deployed are permanent employees of the company.

Required:

Estimate the minimum price to be charged from the customer so that the company is not worse off by executing the order. (6 + 14 + 4 = 24 Marks)

Answer

(a) (i)



A → D → F = 16 + 10 + 12 = 38

B → E → F = 20 + 6 + 12 = 38

(ii) A – C – E – F = 16 + 8 + 6 + 12 = 42 Critical path

(iii) Total float and free float for each activity

Activity	Normal time (Days)	Earliest start	Time finish	Latest start	Time finish	Float total	Free
A	16	0	16	0	16	0	0
B	20	0	20	4	24	4	4
C	8	16	24	16	24	0	0
D	10	16	26	20	30	4	4
E	6	24	30	24	30	0	0
F	12	30	42	30	42	0	0

(b) Working Notes:

(Amount in Rupees)

	X	Y	Z
Selling price per unit (A)	135.00	140.00	200.00
Variable costs per unit			
Direct material	32.00	76.00	58.50
Direct labour			
Department 1	45.00	25.00	50.00
Department 2	15.00	12.00	21.00
Department 3	20.00	10.00	40.00
Variable overheads	<u>8.00</u>	<u>4.50</u>	<u>10.50</u>
Total variable costs (B)	<u>120.00</u>	<u>127.50</u>	<u>180.00</u>
Contribution per unit (A–B)	<u>15.00</u>	<u>12.50</u>	<u>20.00</u>

(i) Statement of budgeted profitability

	X	Y	Z
Budgeted quantity (units)	19,500	15,600	15,600
Contribution per unit (Rs.)	15.00	12.50	20.00
Total contribution (Rs.)	2,92,500	1,95,000	3,12,000

Contribution fund (Rs.)	7,99,500
Fixed overheads (Rs.)	<u>4,00,000</u>
Profit (Rs.)	<u>3,99,500</u>

(ii) Contribution per direct labour hour for Department 2

	X	Y	Z
Contribution per unit (Rs.)	15.00	12.50	20
Direct labour hours per unit	5	4	7
Contribution per labour hour	3.00	3.125	2.857
Rank	II	I	III

(iii) Total hours available in department 2

X	19,500 units × 5 = 97,500 hours
Y	15,600 units × 4 = 62,400 hours
Z	15,600 units × 7 = <u>1,09,200 hours</u>
Total	= <u>2,69,100 hours</u>

Optimal Product Mix

Product	Maximum Sales (units)	Direct labour hours available	Hours per unit	Output (units)	Hours used	Balance hours
Y	19,500	2,69,100	4	19,500	78,000	1,91,100
X	23,400	1,91,100	5	23,400	1,17,000	74,100
Z	19,500	74,100	7	10,585	74,095	5

Optimal profit (Rs.)

Contribution (Rs.)

Y	19,500 × Rs. 12.50 = Rs. 2,43,750
X	23,400 × Rs. 15 = Rs. 3,51,000
Z	10,585 × Rs. 20 = <u>Rs. 2,11,700</u>
Total Contribution	= Rs. 8,06,450
Less fixed cost	= <u>Rs. 4,00,000</u>
Profit	= <u>Rs. 4,06,450</u>

- (c) Relevant costs of producing one unit of the finished product

	Rs.
Cost of material 'M' (realisable value)	80
Cost of labour (Being sunk cost)	0
Out-of-pocket expenses	<u>30</u>
	<u>110</u>

Allocated overhead is not relevant for the decision. The customer should be charged Rs. 110 per unit.

Question 2

- (a) A company manufactures a single product, which requires two components. The company purchases one of the components from two suppliers: X Limited and Y Limited. The price quoted by X Limited is Rs. 180 per hundred units of the component and it is found that on an average 3 per cent of the total receipt from this supplier is defective. The corresponding quotation from Y Limited is Rs. 174 per hundred units, but the defective would go up to 5 per cent. If the defectives are not detected, they are utilised in production causing a damage of Rs. 180 per 100 units of the component.

The company intends to introduce a system of inspection for the components on receipt. The inspection cost is estimated at Rs. 24 per 100 units of the component. Such an inspection will be able to detect only 90 per cent of the defective components received. No payment will be made for components found to be defective in inspection.

Required:

- Advise whether inspection at the point of receipt is justified?
 - Which of the two suppliers should be asked to supply?
- (Assume total requirement is 10,000 units of the component).
- (b) What are the distinctive features of learning curve theory in manufacturing environment? Explain the learning curve ratio. (10 + 9 = 19 Marks)

Answer

- (a) Calculation of cost of per 100 units of good components:

(A)	X Ltd.	Y Ltd.
If not inspected		
Units required	10,000	10,000
Estimated defectives	300	500
	(3%)	(5%)

Cost	Rs.	Rs.
Purchase price (Rs.)	18,000	17,400
Production damage (Rs.)	<u>540</u>	<u>900</u>
Total Cost (Rs.)	<u>18,540</u>	<u>18,300</u>
Good component (units)	9,700	9,500
Cost per 100 good component (Rs.)	<u>191.13</u>	<u>192.63</u>

(B) If inspected

Defectives not detected	30	50
Defectives detected	270	450
Components paid for	9,730	9,550

Cost	Rs.	Rs.
Purchase cost	17,514	16,617
Inspection cost	2,400	2,400
Production damage	<u>54</u>	<u>90</u>
Total cost	<u>19,968</u>	<u>19,107</u>
Good components	<u>9,700</u>	<u>9,500</u>
Cost per 100 good components (Rs.)	<u>205.86</u>	<u>201.3</u>

Decision:

- (i) On the basis of the cost per 100 good component calculated at (A) and (B) above, it is concluded that inspection at the point of receipt is not justified.
 - (ii) It will be advantageous to purchase the component from X Ltd.
- (b) As the production quantity of a given item is doubled, the cost of the item decreases at a fixed rate. This phenomenon is the basic premise on which the theory of learning curve has been formulated. As the quantity produced doubles, the absolute amount of cost increase will be successively smaller but the rate of decrease will remain fixed. It occurs due to the following distinctive features of manufacturing environment:
- (i) Better tooling methods are developed and used.
 - (ii) More productive equipments are designed and used to make the product.
 - (iii) Design bugs are detected and corrected.
 - (iv) Engineering changes decrease over time.
 - (v) Earlier teething problems are overcome.

(vi) Rejections and rework tend to diminish over time.

In the initial stage of a new product or a new process, the learning effect pattern is so regular that the rate of decline established at the outset can be used to predict labour cost well in advance. The effect of experience on cost is summarized in the learning curve ratio or improvement ratio.

$$\text{Learning curve ratio} = \frac{\text{Average labour cost of first } 2N \text{ units}}{\text{Average labour cost of first } N \text{ units}}$$

For example, if the average labour cost for the first 500 units is Rs. 25 and the average labour cost for the first 1,000 units is Rs. 20, the learning curve ratio is (Rs. 20/25) or 80%. Since the average cost per unit of 1,000 units is Rs. 20, the average cost per unit of first 2,000 units is likely to be 80% of Rs. 20 or Rs. 16.

Question 3

The working results of a Software Company for two corresponding years are shown below:

	Amount (Rs. in lakhs)	
	Year 2005	Year 2006
Sales (A)	600	770
Cost of Sales:		
Direct materials	300	324
Direct wages and variable overheads	180	206
Fixed overheads	<u>80</u>	<u>150</u>
Total (B)	<u>560</u>	<u>680</u>
Profit (A – B)	<u>40</u>	<u>90</u>

In year 2006, there has been an increase in the selling price by 10 per cent. Following are the details of material consumption and utilization of direct labour hours during the two years:

	Year 2005	Year 2006
Direct material consumption (M. tons)	5,00,000	5,40,000
Direct labour hours	75,00,000	80,00,000

Required:

- Taking year 2005 as base year, analyse the variances of year 2006 and also work out the amount which each variance has contributed to change in profit.
- Find out the breakeven sales for both years.
- Calculate the percentage increase in selling price in the year 2006 that would be needed over the sale value of year 2006 to earn margin of safety of 45 per cent. (19 Marks)

Working Notes:

- (i) Budgeted sales in year 2006 = $(100/110) \times 770 = \text{Rs. } 700 \text{ lakhs}$
- (ii) Budgeted direct material cost = $(300/600) \times 700 = \text{Rs. } 350 \text{ lakhs}$
- (iii) Budgeted direct wages and variable overheads = $(180/600) \times 700 = \text{Rs. } 210 \text{ lakhs}$
- (iv) Rate per M. ton of direct material: Year 2005 = $(300/5) = \text{Rs. } 60$
: Year 2006 = $(324/5.40) = \text{Rs. } 60$
- (v) Material usage budget for the year 2006 = $(5/600) \times 700 = 5.83333 \text{ lakhs}$
- (vi) Direct labour hours budget for the year 2006 = $(75/600) \times 700 = 87.50 \text{ lakhs}$
- (vii) Direct labour and variable overheads rate per hour: Year 2005 = $(180/75) = \text{Rs. } 2.40$
Year 2006 = $(206/80) = \text{Rs. } 2.575$
- (viii) Material price variance = $(\text{Rs. } 60 - \text{Rs. } 60) \times 5,40,000 = \text{zero}$
- (ix) Material usage variance = $(5.83333 - 5.40) \times \text{Rs. } 60 = \text{Rs. } 26 \text{ lakhs (F)}$
- (x) Labour and variable overheads rate variance = $(2.40 - 2.575) \times 80 = \text{Rs. } 14 \text{ lakhs (A)}$
- (xi) Labour and variable overheads efficiency variance = $(87.50 - 80.00) \times \text{Rs. } 2.40$
= $\text{Rs. } 18 \text{ lakhs (F)}$
- (xii) Fixed overheads expenditure variance = $(150 - 80) = \text{Rs. } 70 \text{ lakhs (A)}$
- (xiii) Statement of working results of the company

	Actuals	Budget	Variance
	2006	2006	
Sales	<u>770</u>	<u>700</u>	<u>70(F)</u>
Less: Direct material	324	350	26(F)
Direct wages and variable overheads	<u>206</u>	<u>210</u>	<u>4(F)</u>
Contribution	240	140	100(F)
Less: Fixed overheads	<u>150</u>	<u>80</u>	<u>70(A)</u>
Profit	90	60	30(F)

I Reconciliation statement showing variances contribution to change in profit (Rs. in lakhs)

	Favourable	Adverse
Increase in contribution due to volume	20	—
Sales price variance	70	—
Material usage variance	26	—
Material price variance	—	—
Direct labour and variable overheads rate variance	—	14
Direct labour and variable overheads efficiency variance	18	—
Fixed overheads expenditure variance	<u>—</u>	<u>70</u>
	<u>134</u>	<u>84</u>
Total change in profit (increase)	<u>50</u>	

II Break-even point

Year 2005 : $(80/120) \times 600 = \text{Rs. } 400 \text{ lakhs}$

Year 2006 : $(150/240) \times 770 = \text{Rs. } 481.25 \text{ lakhs}$

III Required percentage increase in selling price in the year 2006 to earn a margin of safety of 45%.

Break-even sales = $(1 - 0.45)$ or 55 per cent of total sales.

Contribution at 55% sales = Fixed overheads = Rs. 150 lakhs.

Required contribution at total sales = $\text{Rs. } 150 / 0.55 = \text{Rs. } 272.73 \text{ lakhs}$

Additional contribution required = $(272.73 - 240) = \text{Rs. } 32.73 \text{ lakhs}$

Percentage increase in selling price required = $(32.73/770) \times 100 = 4.25\%$.

Question 4

- (a) A company has four zones open and four marketing managers available for assignment. The zones are not equal in sales potentials. It is estimated that a typical marketing manager operating in each zone would bring in the following Annual sales:

Zones	Rs.
East	2,40,000
West	1,92,000
North	1,44,000
South	1,20,000

The four marketing managers are also different in ability. It is estimated that working under the same conditions, their yearly sales would be proportionately as under:

Manager M	:	8
Manager N	:	7
Manager O	:	5
Manager P	:	4

Required:

If the criterion is maximum expected total sales, find the optimum assignment and the maximum sales.

- (b) "In many organisations, initiatives to introduce balanced score card failed because efforts were made to negotiate targets rather than to build consensus."

Required:

Elucidate the above statement.

(11 + 8 = 19 Marks)

Answer

- (a) Sum of the proportion = $(8 + 7 + 5 + 4) = 24$

Assuming Rs. 1,000 as one unit, the effective matrix is as follows:

Effective Matrix

Managers	Zones			
	East	West	North	South
M	$(8/24) \times 240 = 80$	$(8/24) \times 192 = 64$	$(8/24) \times 144 = 48$	$(8/24) \times 120 = 40$
N	$(7/24) \times 240 = 70$	$(7/24) \times 192 = 56$	$(7/24) \times 144 = 42$	$(7/24) \times 120 = 35$
O	$(5/24) \times 240 = 50$	$(5/24) \times 192 = 40$	$(5/24) \times 144 = 30$	$(5/24) \times 120 = 25$
P	$(4/24) \times 240 = 40$	$(4/24) \times 192 = 32$	$(4/24) \times 144 = 24$	$(4/24) \times 120 = 20$

Convert the maximization problem to minimization problem

The resultant loss matrix is as follows:

Loss Matrix

Managers	East	West	North	South
M	0	16	32	40
N	10	24	38	45
O	30	40	50	55
P	40	48	56	60

Row operation

Managers	East	West	North	South
M	0	16	32	40
N	0	14	28	35
O	0	10	20	25
P	0	8	16	20

Column operation

Managers	East	West	North	South
M	0	8	16	20
N	0	6	12	15
O	0	2	4	5
P	0	0	0	0

Managers	East	West	North	South
M	0	6	14	18
N	0	4	10	13
O	0	0	2	3
P	2	0	0	0

Managers	East	West	North	South
M	0	2	10	14
N	0	0	6	9
O	4	0	2	3
P	6	0	0	0

Managers	East	West	North	South
M	0	2	8	12
N	0	0	4	7
O	4	0	0	1
P	8	2	0	0

Assignment	Sales
	Rs.
M – East	80,000
N – West	56,000
O – North	30,000
P – South	<u>20,000</u>
	<u>1,86,000</u>

- (b) Balanced score card is a set of financial and non-financial measures relating to a company's critical success factors. It is an approach which provides information to management to assist in strategy implementation. Therefore, the components to be included in the balanced score card must flow from strategy. The targets should be measurable and must flow from strategy and corporate plan of the company. It is necessary that managers should agree to the components and targets because in absence of a consensus, managers may not commit to the targets established by the top management / the board of directors. Moreover, the functions are interdependent and results in one functional area/perspective (e.g. innovation and learning) have direct bearing on the results in other functional area / perspective (e.g. customer perspective). Therefore, it is not sufficient that individual managers agree to their targets. Successful implementation requires that the top management builds an overall consensus on the components and targets of the balanced score card. Negotiation undermines the fundamental principle that the components and targets should flow from strategy. As a result, an approach to establish targets through negotiation defeats the very purpose of balanced score card.

Question 5

- (a) "Cost can be managed only at the point of commitment and not at the point of incidence. Therefore, it is necessary to manage cost drivers to manage cost." Explain the statement with reference to structural and executional cost drivers.
- (b) Explain the main features on 'Enterprise Resource Planning.'
- (c) X Limited having an installed capacity of one lakh units of a product is currently operating at 70 per cent utilization. At current level of input prices, the F.O.B. costs per unit, taking credit for applicable export incentive workout as follows:

Capacity Utilisation	70%	80%	90%	100%
FOB cost per unit (Rs.)	97	92	87	82

The company has received three Foreign offers as under:

Source A : 5,000 units @ Rs. 55 per unit FOB

Source B : 10,000 units @ Rs. 52 per unit FOB

Source C : 10,000 units @ Rs. 51 per unit FOB

Required:

Advice the company whether it should accept any or all of the export orders.

(5 + 4 + 10 = 19 Marks)

Answer

- (a) A firm commits costs at the time of designing the product and deciding the method of production. It also commits cost at the time of deciding the delivery channel (e.g. delivery through dealers or own retail stores). Costs are incurred at the time of actual production and delivery. Therefore, no significant cost reduction can be achieved at the time when the costs are incurred. Therefore, it is said that costs can be managed at the point of commitment. Cost drivers are factors that drive consumption of resources. Therefore, management of cost drivers is essential to manage costs. Structural cost drivers are those which can be managed by effecting structural changes. Examples of structural cost drivers are scale of operation, scope of operation (i.e. degree of vertical integration), complexity, technology and experience or learning. Thus, structural cost drivers arise from the business model adopted by the company. Executional cost drivers can be managed by executive decisions, examples of executional cost drivers are capacity utilization, plant layout efficiency, product configuration and linkages with suppliers and customers. It is obvious that cost drivers can be managed only at the point of structural and operating decisions, which commit resources to various activities.
- (b) Some of the major features of "Enterprise Resource Planning" (ERP) areas follows :
- (i) ERP facilitates company-wide integrated information system covering all functional areas like manufacturing, selling and distribution, payables, receivables, inventory etc.
 - (ii) It performs core activities and increases customer services thereby augmenting the corporate image.
 - (iii) ERP bridges the information gap across organization.
 - (iv) ERP provides complete integration of systems.
 - (v) It is a solution for better project management.
 - (vi) It allows automatic induction of latest technologies like electronic fund transfer (EFT), Electronic Data Interchange (EDI), Internet, Intranet, Video Conferencing, E-commerce etc.
 - (vii) ERP eliminates most business problems like material shortage, productivity enhancements, customer service, cash management etc.
 - (viii) It provides business intelligence tools.

(c)

Statement of differential cost

Capacity	Output(Units)	FOB cost per unit (Rs.)	Total cost (Rs.)	Differential Cost (Rs.)	Differential Cost per unit (Rs.)
70%	70,000	97	67,90,000	—	—
80%	80,000	92	73,60,000	5,70,000	57
90%	90,000	87	78,30,000	4,70,000	47
100%	1,00,000	82	82,00,000	3,70,000	37

Statement showing gain or loss for various export orders

Source	Quantity (Units)	Differential Cost per unit (Rs.)	Differential Cost Total (Rs.)	Sales Revenue (Rs.)	Profit / Loss (Rs.)
A	5,000	57	2,85,000	2,75,000	–10,000
B	10,000	57 for 5,000 47 for 5,000	5,20,000	5,20,000	—
C	10,000	47 for 5,000 37 for 5,000	4,20,000	5,10,000	+90,000
Total	<u>25,000</u>		<u>12,50,000</u>	<u>13,05,000</u>	<u>+80,000</u>

If proposal A is accepted the company will suffer a loss of Rs. 10,000 with an idle capacity of 5,000 units.

If proposals A and B are accepted, the company will suffer a loss of Rs. 10,000 with an idle capacity of Rs. 5,000 units.

If the company accepts all the three proposals, it will earn profit of Rs. 80,000 with an idle capacity of 5,000 units.

Therefore, the company should accept all three proposals.

Question 6

- (a) What is the fundamental difference between Activity Based Costing System (ABC) and Traditional Costing System? Why more and more organisations in both the manufacturing and non-manufacturing industries are adopting ABC?
- (b) What is Target Costing? It is said that implementation of the target costing technique requires intensive marketing research. Explain why intensive marketing research is required to implement target costing technique. (10 + 9 = 19 Marks)

Answer

- (a) In the traditional system of assigning manufacturing overheads, overheads are first allocated and apportioned to cost centres (production and support service cost centres) and then absorbed to cost objects (e.g. products). Under ABC, overheads are first assigned to activities or activity pools (group of activities) and then they are assigned to cost objects. Thus, ABC is a refinement over the traditional costing system. Usually cost centres include a series of different activities. If different products create different demands on those activities, the traditional costing system fails to determine the product cost accurately. In that situation, it becomes necessary to use different rates for different activities or activity pools.

The following are the reasons for adoption of ABC by manufacturing and non-manufacturing industries:

- (i) Fierce competitive pressure has resulted in shrinking profit margin. ABC helps to estimate cost of individual product or service more accurately. This helps to formulate appropriate marketing / corporate strategy.
 - (ii) There is product and customer proliferation. Demand on resources by products / customers differ among product / customers. Therefore, product / customer profitability can be measured reasonably accurately, only if consumption of resources can be traced to each individual product / customer.
 - (iii) New production techniques have resulted in the increase of the proportion of support service costs in the total cost of delivering value to customers. ABC improves the accuracy of accounting for support service costs.
 - (iv) The costs associated with bad decisions have increased substantially.
 - (v) Reduction in the cost of data processing has reduced the cost of tracking resources consumption to large number of activities.
- (b) Target cost is the difference between estimated selling price of a proposed product with specified functionality and quality and the target margin. This is a cost management technique that aims to produce and sell products that will ensure the target margin. It is an integral part of the product design. While designing the product, the company needs to understand what value target customers will assign to different attributes and different aspects of quality. This requires use of techniques like value engineering and value analysis. Intensive marketing research is required to understand customer preferences and the value they assign to each attribute and quality parameter. This insight is required to be developed must before the product is introduced. The company plays within the space between the maximum attributes and quality that the company can offer and the minimum acceptable to target customers. Therefore in absence of intensive marketing research, the target costing technique cannot be used effectively.

PAPER – 6 : MANAGEMENT INFORMATION AND CONTROL SYSTEMS

Question No. 1 is compulsory. Answer any four questions
from remaining six questions.

Question 1

- (a) While performing an IS audit, the auditors should ascertain that various objectives are properly met. Briefly describe them. (5 Marks)
- (b) What are the duties of certifying authorities in respect of digital signature? (5 Marks)
- (c) Discuss any five benefits which are attained by implementing a computerised model for making decision. (5 Marks)
- (d) Briefly explain the various fact finding techniques which are used by the system analyst for determining the needs of an organization. (5 Marks)

Answer

- (a) The purpose of an IS audit is to review and evaluate the internal controls that protect the system. While performing an IS audit, auditors must ascertain that following objectives are met:
 - (i) Security provisions protect computer equipment, programs, communications and data from unauthorized access, modification or destruction.
 - (ii) Program development and acquisition is performed in accordance with management's general and specific authorisation.
 - (iii) Program modifications have the authorization and approval of management.
 - (iv) Processing of transactions, files, reports and other computer records is accurate and complete.
 - (v) Source data that is inaccurate or improperly authorized is identified and handled according to prescribed policies of management.
 - (vi) Computer data files are accurate, complete and confidential.
- (b) (i) Section [30] of Information Technology Act provides that every Certifying Authority shall follow certain procedures in respect of Digital Signature as given below:
 - (a) make use of hardware, software and procedures that are secure from intrusion and misuse;
 - (b) provide a reasonable level of reliability in its services which are reasonably suited to the performance of intended functions.
 - (c) adhere to security procedures to ensure that secrecy and privacy of the Digital Signatures are assured and
 - (d) observe such other standards as may be specified by regulations.

- (ii) Every Certifying Authority shall also ensure that every person employed by him complies with the provisions of the act, or rules, regulations or orders made thereunder.
 - (iii) A Certifying Authority must display its licence at a conspicuous place of the premises in which it carries on its business and a Certifying Authority whose licence is suspended or revoked shall immediately surrender the licence to the controller.
 - (iv) Section 34 further provides that every Certifying Authority shall disclose its Digital Signature Certificate which contains the public key corresponding to this private key used by that Certifying Authority and other relevant facts.
- (c) A computerized model may incorporate accounting, production, transportation, manufacturing and marketing operations of the company. Such models allow a decision maker to consider a large number of factors in decision-making process which was not possible in manual system. This highlights the needs to reduce skepticism that managers have toward sophisticated computerized decision-making aids. This type of model puts pertinent information into an analytical framework that aids the management decision-making process. Some of the benefits offered by a computerised model are:
- (i) Makes a fairly accurate forecast of net income for one year.
 - (ii) Prepares short-term profit plans and long-range projections.
 - (iii) Provides preplanning information in budget preparation.
 - (iv) Calculates variances between budgeted and actual results.
 - (v) Triggers revised forecasts if not proceeding in accordance with plan.
 - (vi) Acts as early warning system for monitoring activities and signaling necessary reactive plans.
 - (vii) Indicates effect on income and cash flow by following alternative investment strategies.
 - (viii) Assists in planning the addition of new facilities and a host of special studies.
 - (ix) Accomplishes all the preceding item with great speed.
- (d) Various facts finding techniques used by system analyst for determining the needs of an organization are discussed below:
- (i) Documents: Documents refer to manuals, input forms, output forms, diagrams of how the current system works, organization charts showing hierarchy of users and managers' responsibilities, job descriptions of the people who work with the current system, procedure manuals and program codes. Documents are good source of user needs and the current system.
 - (ii) Questionnaires: Users and managers are asked to complete questionnaire about the information system when the traditional system development approach is chosen. Large amount of data can be collected through properly designed questionnaire. Responses can be analysed rapidly with the help of a computer.

- (iii) Interviews: Users and managers are also interviewed to extract information in depth. The data gathered through interviews provide system developer a complete picture of the problems and opportunities. Interviewers are also useful to note user reaction first hand and probe for further information.
- (iv) Observation: Observation plays an important role in requirement analysis. Only by observing how users react to prototype of a new system, the system can be successfully developed. The analyst should visit the user site to watch how the work is taking place. Such visits often help the analyst in getting a clear picture of the users' environment and to determine why a request for a new system was submitted.

Question 2

- (a) What is "Information Security"? Why is it important in any organization? Explain briefly (10 Marks)
- (b) System analysts develop various categories of information systems to meet a variety of business needs. Discuss any three such systems briefly. (10 Marks)

Answer

- (a) Security refers to the protection of valuable assets against loss, disclosure or damage. "Information Security" covers all information. In this context, the valuable assets are the data or information recorded, processed, stored, shared, transmitted or retrieved from an electronic medium. It is protected against harm from threats leading to its loss, damage, inaccessibility, integrity or unauthorized disclosure. The protection of this unbreakable assets is achieved by deploying a layered series of technological and non-technological safeguards such as physical security measures, user identifiers, passwords, smart cards, biometrics, anti-virus, firewalls etc.

In a global information society, where information travels through cyberspace on a routine basis, the significance of information is widely accepted. In addition, information and the information system and communication that deliver the information are truly pervasive throughout organization – from the user's platform to local and wide area networks to servers to main frame computers. Organisations depend on timely, accurate, complete, valid, consistent, relevant and reliable information. Accordingly, executive management has a responsibility to ensure that the organization provides all users with a secure information systems environment. It is clear that there are not only many direct and indirect benefits from the use of information systems, there are also many risks (direct and indirect) relating to information systems. Most risks have led to a gap between the need to protect systems and the degree of protection applied. This gap is caused by various factors such as (i) widespread use of technology, (ii) interconnectivity of systems, (iii) elimination of distance, time and space etc. (iv) unevenness of technological changes, (v) Devolution of management and control, (vi) Attractiveness of conducting unconventional electronic attacks over more conventional physical attacks against organizations, and (vii) External factors such as legislative, legal, and regulatory requirements or technological developments.

Threats to information systems may arise from intentional or unintentional acts and many come from internal or external sources. The threats may emanate from, among others, technical conditions (program bugs, disk crashes), natural disasters (fires, floods), environmental conditions, human factors, unauthorized access or viruses.

Adequate measures for information security help to ensure the smooth functioning of information systems and protect the organization from loss or embarrassment caused by security failure. That is why, the organisations have started giving more and more importance towards information security.

(b) Systems analysts develop the following types of information systems to meet a variety of business needs:

- (i) Transaction processing systems
- (ii) Management information systems
- (iii) Decision support systems
- (iv) Executive information systems
- (v) Expert systems.

Three of the above categories are discussed largely below:

- (i) **Transaction Processing Systems:** These systems are aimed at expediting and improving the routine business activities that all organisations engage. Standard operating procedures, which facilitate handling of transactions, are often embedded in computer programs that control the entry of data, processing of details, search and presentation of data and information. Transaction processing systems if properly computerized, provide speed and accuracy and can be programmed to follow routines without any variance.
- (ii) **Management Information Systems (MIS):** Transaction processing systems are operations oriented. In contrast, MIS assist managers in decision making and problem solving. They use results produced by the transaction processing systems, but they may also use other information. In any organization, decisions must be made on many issues that recur regularly and require a certain amount of information. Because the decision making process is well understood, the manager can identify the information that will be needed for the purpose. In turn, the information systems can be developed so that reports are prepared regularly to support these recurring decisions.
- (iii) **Decision Support Systems:** Not all decisions are of a recurring nature. Some occur only once or recur infrequently. Decision support systems (DSS) are aimed at assisting managers who are faced with unique (non-recurring) decision problems. In well structured situations, it is possible to identify information needs in advance, but in an unstructured environment, it becomes difficult to do so. As information is acquired, the manager may realize that additional information is required. In such cases, it is impossible to pre-design system report formats and contents. A DSS must, therefore, have greater flexibility than other information systems. Finally, we can say that DSS is of much more use when business are of an unstructured or

semi-structured in nature. A decision support system is an integrated piece of software incorporating data base, model base and user interface. While the decision-support system can be of use at the tactical level, it is the strategic level that could make best use of it.

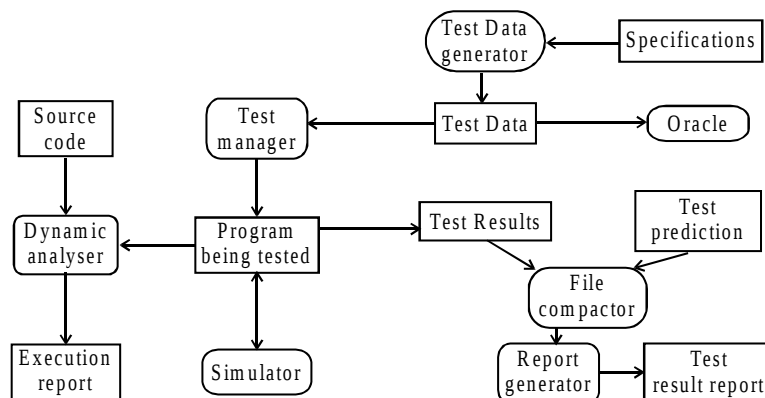
Question 3

- (a) Explain with the help of a diagram the various tools which are included in a testing workbench. (10 Marks)
- (b) What do you understand by Material Inventory Control System? Draw the information flow diagram for designing computerized material inventory control system. (10 Marks)

Answer

- (a) Testing workbenches are open systems which evolve to suit the needs of the system being tested. The tools which might be included in a testing work benches are:
- Test Manager:** It manages the running and reporting of program tests. This involves keeping track of test data, expected results, program facilities tested and so on.
 - Test data generator:** It generates test data for the program to be tested. This may be accomplished by selecting data from a database or by using patterns to generate random data of the correct form.
 - Oracle:** It generates predictions of expected results.
 - File compactor:** It compares the results of program tests with previous test results and reports differences between them.
 - Report generator:** It provides report definition and generation facilities for test results.
 - Dynamic analyzer:** It adds code to a program to count the number of times each statement has been executed.
 - Simulators:** Different kinds of simulators such as target simulators, user interface simulators, I/O simulators are available for simulation.

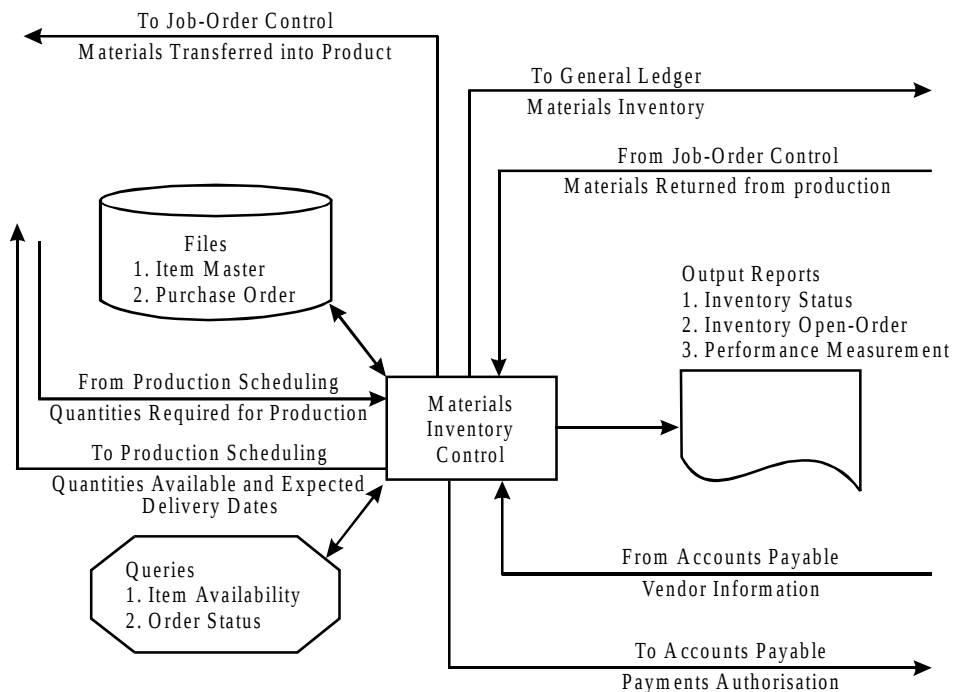
A typical testing layout is shown below:



- (b) The materials inventory control system is the point at which materials enter the manufacturing accounting systems. This system controls inventory and minimizes the costs of purchasing and holding of inventory shortage. Therefore, it needs the following information to function:

- ◆ The timing of purchases.
- ◆ Whether materials received meet specifications and have been properly costed.
- ◆ The status of inventory on hand.
- ◆ The status of unfilled orders.
- ◆ Anticipated demand.

The figure given below depicts the flow of information to and from the materials inventory system. One of the major functions is to maintain a subsidiary ledger with accounts for each item in the inventory. This ledger should balance in total to the materials inventory control account contained in the general ledger.



Question 4

- (a) Explain briefly various activities that should be completed for successful conversion of an existing system to the new information system. (10 Marks)
- (b) Discuss the various activities which are part of the system development life cycle. (5 Marks)

- (c) State the standards that should be followed while designing graphical output. (5 Marks)

Answer

- (a) Various activities which should be completed for successful conversion of an existing system to the new information system are classified as follows:

- (i) Procedure conversion
- (ii) File conversion
- (iii) System conversion
- (iv) Scheduling personnel and equipment
- (v) Alternative plans in cast of equipment failure.

These are discussed briefly below:

- (i) Procedure conversion: Operating procedures should be completely documented for the new system. This applies to both computer-operations and functional area operations. Before any parallel or conversion activities can start, operating procedures must be clearly spelled out for personnel in the functional areas undergoing changes. Information on input, data files, methods, procedures, output and internal controls must be presented in clear, concise and understandable terms for the average reader. Written operating procedures must be supplemented by oral communication during the training sessions on the system change. Once the new system is completely operational, the system implementation group should discuss with all supervisory personnel about their respective areas. As with every new installation, minor adjustments should be expected. All supervisory personnel should freely discuss with the systems development team members so that necessary changes can be initiated as conditions change. Thus proper machinery for making changes must be put in place.
- (ii) File Conversion: Because large files of information must be converted from one medium to another, this phase should be started long before programming and testing are completed. The cost and related problems of file conversion are significant whether they involve on-line files or off-line files. If the existing system is operating on a computer but of different configuration, the formats of the present computer files are generally unacceptable for the new system. Besides the need to provide a compatible format, there are several other reasons for file conversion. Data may be required to put on magnetic disk or other mass storage device to construct an on-line common database.
- (iii) System conversion: After on-line and off-line files have been converted and the reliability of the new system has been confirmed for a functional area, daily processing can be shifted from the existing information system to the new one. A cut-off point is established so that database and other data requirements can be updated to the cut-off point. All transactions initiated after this time are processed on the new system. System development team members should be present to

assist and to answer any questions that might develop. Consideration should be given to operating the old system for some more time to permit checking and balancing the total results of both the systems. The old system can be dropped as soon as the data processing group is satisfied with new system's performance.

- (iv) **Scheduling personnel and equipment:** Scheduling data processing operations of a new information system for the first time is a difficult task for the system manager. As users become more familiar with the new system, the job becomes more routine. Before the newly designed project is complete, it is often necessary to schedule the new equipment. Schedules should be set up by the system manager in conjunction with departmental managers of operational units serviced by the equipment. The master schedule for next month should provide sufficient computer time to handle all required processing. Just as the equipment must be scheduled for its maximum utilization, so must be personnel who operate the equipment. It is essential that each person follow the methods and procedures set forth by the MIS section.
 - (v) **Alternative plans in case of equipment failure:** Alternative processing plans must be implemented in case of equipment failure. Who or what caused the failure is not as important in case of equipment failure as the fact that the system is down. Priorities must be given to those jobs which are critical to an organization, such as billing, payroll and inventory. Critical jobs can be performed manually until the equipment is set right. Documentation of alternative plans is the responsibility of the computer section and should be fully covered by the organisation's systems and procedures manual.
- (b) The system development life cycle consists of the following activities:
- (i) Preliminary investigation
 - (ii) Requirement analysis or systems analysis
 - (iii) Design of the system
 - (iv) Development of software
 - (v) Systems testing
 - (vi) Implementation and maintenance.

Each of these activities is discussed below briefly:

- (i) **Preliminary investigation:** A preliminary investigation is undertaken when users come across a problem or opportunity and submit a formal request for a new system to the MIS department. This activity consists of three parts: request clarification, feasibility study and request approval.
- (ii) **Requirement analysis or systems analysis:** If, after studying the results of preliminary investigation, management decides to continue the development process, the needs of the users are studied. Analysts work closely with employees and managers of the organization for determining information requirements of the users. After gathering the details of information through several fact finding

techniques and tools, the analysts study the present system to identify its problems and shortcomings and identify the features, which the new system should include to satisfy the new or changed user application environment. This step is also referred to as "systems analysis".

- (iii) Design of the system: During system design, the user requirements that arise from analyzing the user applications environment are incorporated into a new system design. The design of an information system produces the details that state how a system will meet the requirements identified above. The analyst designs various reports, data entry procedures, inputs, files and database.
 - (iv) Development of software: After the system design details are resolved, such resources needs as specific type of hardware, software and services are determined. Subsequently, choices are made regarding which products to buy or lease from which vendors. Software can be purchased from this market or it can be developed within the organization also. The choice depends on many factors such as time, cost and availability of programs.
 - (v) Systems testing: Before the information system is finally used, it must be tested. Systems testing is done experimentally to ensure that the software does not fail i.e. it will run according to its specifications and in the way users expect. Special test data are input for processing and results examined. If it is found satisfactory, it is eventually tested with actual data from the current system.
 - (vi) Implementation and maintenance: After the system is found to be fit, it is implemented with the actual data. Hardware is installed and users are trained on the new system. The results of the development efforts are reviewed to ensure that the new system satisfies users requirements. After implementation, the system is maintained; it is modified to adapt to changing users' and business needs so that the system can be useful to the organization for a longer period.
- (c) The system analyst must determine the purpose of the graph, the kind of data that need to be analysed, its audience and the effects on the audience of different kinds of graphical outputs.
- ◆ Graphic output also contains text, the design of which is an important aspect. Each graphic report should include a title and the date of preparation.
 - ◆ For a series, page numbers should also be included. Labels can increase the accuracy with which people read data in the graphic form. However, placement of the label affects readability.
 - ◆ Consistent spacing in all labels and using a common family of type styles maximizes readability.
 - ◆ All vertical and horizontal axes should be proportional. The use of all capital letters in long words, titles or footnotes impedes readability and should be avoided. Abbreviations should not be used.

Question 5

- (a) Briefly discuss any five program design tools. (10 Marks)
- (b) State and explain the four back up and recovery features necessary in a DBMS.(5 Marks)
- (c) Briefly explain five categories of Computer frauds based on the data processing model. (5 Marks)

Answer

- (a) Five program design tools are discussed below:
 - (i) Program Flow Chart: Program flow chart is among the most common program design tools. Flow chart depicts the logical steps through which a computer program must proceed when solving a problem. Often it does not provide a broad view of how the program is organized. Also, sometimes it is difficult for programmers to translate a program flow chart directly into a structured code.
 - (ii) Pseudo Code: When reviewing the work done by a program designer, users may also need to review narrative descriptions of a program logic. Pseudo-code, like program flow charts, also represents program logic. However, instead of using graphical symbols and flow lines, pseudo-code presents program logic in English – like statements. Pseudo-code is generally preferred by programmers over flow charts because it represents program code more closely. Many users also find pseudo code more understandable than program flow charts. Pseudo-code is particularly useful when designing transaction processing and information – retrieval programs.
 - (iii) Structure Chart: Structure Chart which looks similar to corporate organization chart is useful for organising problems. The structure chart organizes each of the program tasks into well-defined modules. The higher level modules represent control portion of the program; the lowest level modules do the actual task of the program. It does not give any detail of the actual program logic and the order in which various tasks are performed. Instead they show how all the logical functions of the program fit together as a whole.
 - (iv) 4GL Tools: Fourth generation languages provide a way out to remove the obstacles of the above three design tools. These tools ensure that the work done with them is consistent with the other work performed by the system team. The automation of manual task and internal consistency checks are two reasons due to which productivity gains result from using 4GL tools.
 - (v) Object oriented programming and design tools: These tools provide a means of enhancing programmer productivity and of reducing the application backlogs common in many organisations. It results in a model that describes objects, classes and their relationships to one another. It is often taken from DFD. In fact, every input and output screen, every process and data store found in a fully decomposed DFD may be a candidate of an object in an object – oriented design.

- (b) The four backup and recovery features necessary in a DBMS are discussed below:
- (i) Database backup: The backup features makes a periodic backup of the entire database. This is an automatic procedure that should be performed at least once a day. The backup copy should be stored in a secure remote area.
 - (ii) Transaction log: This feature provides an audit trail of all processed transactions. It lists transactions in a transactions log file and records the resulting changes to the database in a separate database change log.
 - (iii) Checkpoint feature: The checkpoint facility suspends all data processing while the system reconciles the transaction log and the database change log against the database. At this point the system is in a "quiet state". Checkpoints occur automatically several times an hour. If a failure occurs, it is usually possible to restart the processing from the last check point. Thus, only a few minutes of transaction processing must be repeated.
 - (iv) Recovery Module: The recovery module uses the logs and backup files to restart the system after a failure.
- (c) Various studies have examined frauds to determine the type of assets stolen and the approaches used by employees to commit computer frauds. One way to categorise computer fraud is to use the data processing model. Based on this model, five categories of computer frauds are:
- (i) Input: The simplest and most common way to commit a fraud is to alter computer input, it requires little, if any, computer skills. Instead, perpetrators need only to understand how the system operates so that they can cover their tracks. Collusive fraud, disbursement frauds, payroll and receipt frauds are examples of computer frauds committed through computer input.
 - (ii) Processor: Computer fraud can be committed through unauthorized system use, including the theft of computer time and services. For example, some companies do not allow their employees to use company computers to keep personal or outside business records. Violating this policy would constitute a fraud. Similarly, employee goofing is also considered to be computer fraud.
 - (iii) Computer instructions: Computer fraud can be accomplished by tampering with the software that processes company data. This may involve modifying the software, making illegal copies of software or using it in an unauthorized manner. It might also involve developing a software program or module to carry out an unauthorized activity. This approach to computer fraud used to be one of the least common, because it requires a specialized knowledge of computer programming that is beyond the scope of most users.
 - (iv) Data: Computer fraud can be perpetrated by altering or damaging a company's data file or by copying, using them without authorization. There have been numerous instances of data files being scrambled, altered or destroyed by some selfish employees.

- (v) Output: Computer fraud can be carried out by stealing or misusing system output. System output is usually displayed on monitors or printed on paper. Unless properly safeguarded, monitor and printer output is subject to pry eyes and unauthorized copying.

Question 6

- (a) What is Enterprise Resource Planning? Briefly describe its benefits. (10 Marks)
- (b) State the steps involved in selection of a Computer System. (5 Marks)
- (c) Briefly explain the principles to guide the design of measures and indicators to be included in EIS. (5 Marks)

Answer

- (a) An Enterprise resource planning system is a fully integrated business management system covering functional areas of an enterprise like Logistics, Production, Finance, Accounting and Human Resources. It organizes and integrates operation processes and information flows to make optimum use of resources such as men, material, money and machine.

Enterprise resource planning promises one database, one application, and one user interface for the entire enterprise, where once disparate systems ruled manufacturing, distribution, finance and sales. Taking information from every function, it is a tool that assists employees and managers to plan, monitor and control the entire business.

The following are some of the benefits they achieved by implementing the ERP packages:

- ◆ Gives Accounts Payable personnel increased control of invoicing and payment processing and thereby boosting their productivity and eliminating their reliance on computer personnel for these operations.
- ◆ Reduces paper documents by providing on-line formats for quickly entering and retrieving information.
- ◆ Improves timeliness of information by permitting posting daily instead of monthly.
- ◆ Provides greater accuracy of information with detailed content, better presentation, satisfactory for the auditors.
- ◆ Improved cost control.
- ◆ Faster response and follow-up on customers.
- ◆ More efficient cash collection, say, material reduction in delay in payments by customers.
- ◆ Better monitoring and quicker resolution of queries.
- ◆ Enables quick response to change in business operations and market conditions.
- ◆ Helps to achieve competitive advantage by improving its business processes.

- ◆ Improves supply-demand linkage with remote locations and branches in different countries.
- ◆ Provides a unified customer database usable by all applications.
- ◆ Improves International operations by supporting a variety of tax structures, invoicing schemes, multiple currencies, multiple period accounting and languages.
- ◆ Improves information access and management throughout the enterprise.
- ◆ Provides solution for problems like Y2K and Single Monetary Unit (SMU) or Euro Currency.

(b) Steps involved in selection of a computer system:

- ◆ Prepare the design specifications.
- ◆ Prepare and distribute an RFP (Request for proposal) to selected computer vendors.
- ◆ On the basis of analysis of proposals, eliminate vendors whose proposals are inferior.
- ◆ Have vendors present their proposals.
- ◆ Conduct further analysis of the proposals.
- ◆ Contact present users of the proposed system.
- ◆ Conduct equipment benchmark tests.
- ◆ Select the equipment.

(c) Various principles to be followed while designing EIS are:

- (i) EIS measures must be easy to understand and collect. An EIS should not add substantially to the workload of managers or staff.
- (ii) EIS measures must be based on a balanced view of the organisation's objectives.
- (iii) Performance indicators in an EIS must reflect everyone's contribution in a fair and consistent way. Indicators should be as independent as possible from variables outside the control of managers.
- (iv) EIS measures must encourage management and staff to share ownership of the organisation's objectives. Performance indicators must promote both team-work and friendly competition. Measures will be meaningful for all staff; people must feel that they as individuals, can contribute to improving the performance of the organization.
- (v) EIS information must be available to everyone in the organization. The objective is to provide everyone with useful information about the organisation's performance. Confidential information should not be part of the EIS.
- (vi) EIS measures must evolve to meet the changing needs of the organization.

Question 7

Write short notes on the following:

- (a) Objectives of Information Technology Act, 2000.
- (b) Review areas of an IS Auditor.
- (c) Process Integration.
- (d) End user development approach in system development. (4 × 5 = 20 Marks)

Answer

- (a) Objectives of Information Technology Act, 2000 are:
 - (1) To grant legal recognition for transactions carried out by means of electronic data interchange and other means of electronic communication in place of paper based communication methods.
 - (2) To give legal recognition to Digital Signature for authentication of any information or matter which requires authentication under any law.
 - (3) To facilitate electronic filing of documents with Government departments.
 - (4) To facilitate electronic storage of data.
 - (5) To facilitate and give legal sanction to electronic fund transfers between banks and financial institutions.
 - (6) To give legal recognition for keeping books of account by bankers in electronic form.
 - (7) To amend the Indian Penal Code, the Indian Evidence Act, 1872, the Bankers' Book Evidence Act, 1891 and the Reserve Bank of India Act, 1934.
- (b) The IS auditors may focus on following review areas:
 - (1) Computerised systems and applications: The auditor should verify that systems and applications are appropriate to the users' needs, efficient and adequately controlled to ensure valid, reliable, timely and secure input, processing and output at current and projected levels of system activity.
 - (2) Information Processing Facilities: This facility must be controlled to ensure timely, accurate and efficient processing of applications under normal and potentially disruptive conditions.
 - (3) Systems Development: An IS auditor should ensure that systems under development meet the objectives of the organization, satisfy user requirements and provide efficient, accurate and cost effective systems and applications. The auditor should also ensure that these systems are written, tested and installed in accordance with generally accepted standards for systems development.
 - (4) Management of Information Systems: MIS must develop an organizational structure and procedures to ensure a controlled and efficient environment for

information processing. This plan should also specify the computers and peripheral equipments required to support all functions in an economic and timely manner.

- (5) Client/Server, Telecommunications and Intranets: In a client/server environment, all applications that can be dedicated to a user are put on the client. All resources that need to be shared are put on the server. Auditors must ensure that controls are in place on the client as well as on the server and on the network. Auditors must provide the same level of control assurance in an Internet/Intranet environment as in a client/server environment, with special emphasis on TCP/IP and HTTP.
- (c) Process integration: It means that the CASE system has embedded knowledge about the process activities, their phasing, their constraints and the tools needed to support their activities. The CASE system participates in the scheduling of these activities and in checking that the required activity reference is maintained. Process integration requires that the CASE system maintains a mould of the software process and uses this mould to drive the process activities. In a sense, activities and deliverable are identified, a coordination strategy defined and the tools required to support activities are specified. All of this is embedded in the mould and a process interpreter then extracts this mould to drive the software process.
- (d) End User development approach: With the increasing availability of low-cost technology, end user development is becoming popular. Here it is the end user and not the computer professional who is responsible for systems development activities. The number and nature of systems development activities followed by the end user often differ from those found in formal approaches. There are some risks involved. Enforcing standards and policies is unlikely to be carried out to the same degree as in other approaches. The end-user will not have the experience of an analyst in completing an accurate specification of system requirements. Hence, there would be a reduction in the quality assurance and stability of the system. As departments would choose their own software and hardware, an increase in unrelated and incompatible systems would result. Also difficulties in accessing could arise for users trying to access a central system.

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

PAPER – 7 : DIRECT TAXES

Answer all questions

Question 1

HSP, a partnership firm engaged in the business of running a heritage hotel approved by the competent authority provides the following information relating to the year ended on 31.3.2007:

- (a) Net profit as per P & L account of Rs.200 lacs was arrived at after charge of the following:
 - (i) Depreciation on hotel building having W.D.V. on 1.4.2006 of Rs.500 lacs was charged by treating the same as plant and machinery.
 - (ii) Expenses of Rs.1,00,000 incurred for the purpose of promoting family planning among its employees.
 - (iii) Payment of Rs.50,000 for an advertisement published in the souvenir released on 15th August by Bhartiya Janta Party.
 - (iv) Compensation of Rs.1,00,000 paid to the suppliers of automatic kitchen appliances because of termination of the contract after receipt of 50% of appliances.
 - (v) Wines and liquor imported in F.Y. 2005-06 for Rs.20 lacs and were available in the stock on 1.4.2006 for Rs.5 lacs were confiscated by the Govt. authority and therefore were written off.
 - (vi) Expenses of Rs.20 lacs incurred on replacement of carpets in the foyer, lounge and bar.
- (b) Out of amount credited to the reserve created under section 80HHD(1) in the F.Y. 2001-02, an amount of Rs.15 lacs could not be utilised for the purposes as per section 80HHD(4) till 31.3.2007.
- (c) Amount of Rs.4 lacs equal to U.K. £5000 was remitted and paid to a travel agent resident of U.K. as commission for the booking of international tourists in the hotel. Tax at source was not deducted out of such payment.
- (d) Amount of Rs.40,000 each was paid in cash to the suppliers of vegetables, milk products and eggs on 11.2.07 because of suspension of banking operations due to strike of bank employees.
- (e) Amount of Rs.5 lacs written off in the F.Y. 2004-05 as irrecoverable from a travel agent; an amount of Rs.2 lacs out of it was recovered on 13.3.07 and credited to a reserve account.

Compute the income chargeable to tax for A.Y. 2007-08 and give reasons in brief for treatment given to each of the items. (14 Marks)

Answer

Computation of taxable income of M/s. HSP for the A.Y.2007-08

Particulars	Amount in Rs.
Income from business and profession	
Net profit as per profit and loss account	2,00,00,000
Add : Items charged in profit and loss account which are not allowable	
Excess depreciation on building @ 5%(i.e. 15% - 10%) on Rs.500 lakh	25,00,000
Expenses on promoting family planning amongst the employees	1,00,000
Advertisement in souvenir of a political party	50,000
Compensation to a supplier of kitchen appliances	1,00,000
	27,50,000
Add : Recovery of bad debts credited in reserve but chargeable under section 41 (4)	2,00,000
Total Income	
	2,29,50,000

Reasons for treatment given to each of the items specified :-

- (1) Hotel building does not constitute plant and machinery and therefore, depreciation chargeable thereon is 10%. However, depreciation has been charged in the profit and loss account at the rate applicable to plant and machinery i.e. @ 15%. Accordingly, the excess depreciation charged in the profit and loss account @ 5% (15%-10%) has to be added to income.
- (2) Expenses on promoting family planning amongst employees is allowable under section 36(1)(ix) only to a company assessee. In this case, since the assessee is a firm, such expenses are not allowable and therefore, the same has to be added back.
- (3) Advertisement of any nature given in a magazine / souvenir published by a political party is not allowable as per section 37(2B).
- (4) Compensation paid for breach of a contract for supply of a capital asset is in the nature of capital expenditure as held by the Supreme Court in case of Swadeshi Cotton Mills Co. Ltd. vs. CIT (1967) 63 ITR 65. Accordingly, the same will be disallowed and added back to income.
- (5) The Apex Court in case of Dr. T.A. Quereshi vs CIT (2006) 287 ITR 0547 observed that loss of stock-in-trade has to be considered as a trading loss. Explanation to section 37(1) is not relevant here since it is not a case of business expenditure but one of business loss. Business loss is allowable on ordinary commercial principles.

Therefore, since wine and liquor formed part of stock-in-trade of the firm, confiscation of the same has to be allowed as a business loss.

- (6) The expenditure incurred on replacement of carpets by a hotel are in the nature of expenses incurred for the purposes of business and are allowable as revenue expenses under section 37(1).
- (7) The amount credited in a reserve under section 80HHD(1) is to be utilized for the purposes as specified in section 80HHD(4) within a period of 5 years next following the previous year in which the amount was credited to the reserve i.e. by 31.3.2007. The assessee had failed to utilize the same in 5 years and therefore as per the provisions of section 80HHD(5)(b) the same is deemed to be the profits of the year immediately following the period of 5 years i.e. P.Y.2007-08 and shall be chargeable to tax in the A.Y. 2008-09. Therefore, for the current assessment year (i.e. A.Y.2007-08), there would be no adjustment.
- (8) The payment to a non-resident outside India without deduction of tax at source is an allowable expense as per CBDT Circular No.786 dated 7.2.2000, as there is no income accruing or arising to the non-resident in India.
- (9) The cash payments made totaling Rs.1,20,000 on the day when bank employees were on strike is an exception as per rule 6DD(k) and clarification of CBDT as per letter No.142(14)/70 dated 28/9/1970. Therefore, disallowance under section 40A(3) is not attracted.
- (10) The recovery of a debt which was earlier written off under section 36(1)(vii) and was allowed as deduction is chargeable to tax under section 41(4) in the year of such recovery. Accordingly, such amount has to be added to income despite the fact that the same was credited by the firm in a reserve account.

Question 2

- (a) Anush Motors Ltd., an Indian company declared income of Rs.300 crores computed in accordance with Chapter IV-D but before making any adjustments in respect of the following transactions for the year ended on 31.3.2007:
 - (i) 10,000 cars sold to Rida Ltd. which holds 30% shares in Anush Motors Ltd. at a price which is less by \$ 200 each car than the price charged from Shingto Ltd.
 - (ii) Royalty of \$ 1,20,00,000 was paid to Kyoto Ltd. for use of technical know-how in the manufacturing of car. However, Kyoto Ltd. had provided the same know-how to another Indian company for \$ 90,00,000.
 - (iii) Loan of Euro 1000 crores carrying interest @ 10% p.a. advanced by Dorf Ltd., a German company, was outstanding on 31.3.2007. The total book value of assets of Anush Motors Ltd. on the date was Rs.90,000 crores. The said German company had also advanced a loan of similar amount to another Indian company @ 9% p.a. Total interest paid for the year was EURO 100 crores.

Explain in brief the provisions of the Act affecting all these transactions and compute the income of the company chargeable to tax for A.Y.2007-08 keeping in mind that the value of 1\$ and of 1 EURO was Rs.50 and Rs.55, respectively, throughout the year. (7 Marks)

- (b) Simran Pharma Ltd., a manufacturer of drugs and pharma products, provides the following information relating to payments made to its marketing manager in the year 2006-07:

- Salary @ Rs. 20,000 p.m.
- Motor-cycle purchased for Rs.45,000 in June, 2006 was given free of cost.
- Conveyance allowance of Rs.5,000 p.m. which was allowed to him as exempt under section 10(14).
- Tickets worth Rs.4,000 for a cricket match between India and England.
- Reimbursement of medical expenses actually incurred by him of Rs.17,500.

The company asks you to compute the amount of:

- (a) income chargeable to tax in the hands of marketing manager; and
- (b) payments covered under fringe benefits, amount chargeable to FBT and the amount of such tax thereon. (6 Marks)

Answer

- (a) Any income arising from an international transaction, where two or more "associated enterprises" enter into a mutual agreement or arrangement, shall be computed having regard to arm's length price as per the provisions of Chapter X of the Act.

Section 92A defines an "associated enterprise" and sub-section (2) of this section speaks of the situations when the two enterprises shall be deemed to associated enterprises. Applying the provisions of section 92A(2)(a) to (m) to the given facts, it is clear that "Anush Motors Ltd." is associated with :-

- (i) Rida Ltd. as per section 92A(2)(a), because this company holds shares carrying more than 26% of the voting power in Anush Motors Ltd.;
- (ii) Kyoto Ltd. as per section 92A(2)(g), since this company is the sole owner of the technology used by Anush Motors Ltd. in its manufacturing process;
- (iii) Dorf Ltd. as per section 92A(2)(c), since this company has financed an amount which is more than 51% of the book value of total assets of Anush Motors Ltd.

The transactions entered into by Anush Motors Ltd. with different companies are, therefore, to be adjusted accordingly to work out the income chargeable to tax for the A.Y. 2007-08.

Income of Anush Motors Ltd. as computed under Chapter IV-D, Rs.300 crore
prior to adjustments as per Chapter – X

Add: Difference on account of adjustment in the value of international transactions:

(i)	Difference in price of car @ \$ 200 each for 10,000 cars (\$ 200 x 10,000 x 50)	Rs.10 crore
(ii)	Difference for excess payment of royalty of \$ 30,00,000 (\$ 30,00,000 x 50) [See Note below]	Rs.15 crore
(iii)	Difference for excess interest paid on loan of EURO 1000 crores (55*1000*1/100)	<u>Rs.550 crore</u>
	Total Income	<u>Rs.875 crore</u>

Note – The difference for excess payment of royalty has been added back presuming that the manufacture of cars by Anush Motors Ltd. is wholly dependent on the use of know-how owned by Kyoto Ltd.

- (b) Simran Pharma Ltd., a manufacturer of drugs and pharma products, is an employer as per section 115W(a)(i) for the charge of tax on fringe benefits provided to its employees. The total income chargeable to tax in the hands of the employee and fringe benefits chargeable to tax in the hands of the company are calculated as follows -

Particulars	Income of Marketing Manager (Rs.)	Value of Fringe Benefits (Rs.)
- Salary	2,40,000	-
- Free Motor cycle	45,000	-
- Conveyance allowance exempt under section 10(14) for employee	-	60,000
- Free ticket of a cricket match	-	4,000
- Reimbursement of medical expenses	2,500	15,000
(Reimbursement up to Rs.15,000 is exempt in the hands of the employee. Such amount is chargeable as fringe benefit in the hands of the employer).		
Total	<u>2,87,500</u>	<u>79,000</u>

- (a) Income chargeable to tax in the hands of Marketing Manager is Rs.2,87,500

- (b) The fringe benefits chargeable to tax in the hands of the company are -

(i)	Conveyance @ 5% (5% of 60,000)	Rs.3,000
(ii)	Others @20% [20% of 19,000 (4,000 + 15,000)]	<u>Rs.3,800</u>
	Total	<u>Rs.6,800</u>
	Tax on FBT @30% of 6,800/-	Rs.2,040
	Surcharge @ 10%	<u>Rs. 204</u>

	Rs.2,244
Education cess @ 2%	<u>45</u>
FBT payable by the company	<u>Rs.2,289</u>

Question 3

- (a) XYZ Ltd., engaged in the business of manufacturing of industrial cables, imported a car on 26.2.2001 from Japan which costed in total of Rs.53,00,000. The car was used from 1.3.01 continuously for the purposes of its business by the company. The Assessing Officer, in the month of June 2007, while completing assessment under section 143(3) of the Act for A.Y. 2005-06, noted that the company had claimed depreciation @ 25% since assessment year 2001-02 on this car in the block of assets. Therefore, he issued notices under section 148 read with section 147 for A.Y. 2001-02 to 2005-06.

Examine the validity of the action of the Assessing Officer in the context of the provisions of the Act. (4 Marks)

- (b) "Easy Call Ltd.", to provide telecom services in Mumbai, obtained a licence on 11.4.2004 for a period of 10 years ending on 31.3.2014 against a fee of Rs.27 lacs to be paid in 3 installments of Rs.10 lacs, 9 lacs and 8 lacs by April, 2004, April, 2005 and April, 2006 respectively. Explain, how the payment made for licence fee shall be dealt with under the Income-tax Act, 1961 and work out the amount, if any, deductible in this respect out of income chargeable to tax for A.Y. 2007-08 and subsequent years. (5 Marks)
- (c) Smt. Kanti engaged in the business of growing, curing, roasting and grounding of coffee after mixing chicory had a total income of Rs.3,25,000 from this business which was her only source of income during the year ended on 31.3.07. She consults you to have an opinion whether she is required to file return of income for the Asst. Year 2007-08 as per provisions of section 139(1) of the Act. (3 Marks)
- (d) An amount of Rs.5 lacs was paid on 17.3.07 to the parents of Amit by the Government of Maharashtra as a compensation to the aggrieved family whose only son Amit lost his life in Mumbai local train serial bomb blasts.

Explain with reasons, is the amount of compensation received chargeable to tax in A.Y. 2007-08? (3 Marks)

Answer

- (a) Depreciation is not admissible under section 32 on imported car acquired between 1.3.75 and 31.3.01. The car, imported by the company on 26.2.01 and used for the purposes of its business with effect from 1.3.01, was a vehicle acquired before the period ended on 31.3.01, thereby not qualifying for the claim of depreciation. Therefore, the depreciation charged by the company on this car for the assessment year 2001-02 and subsequent assessment years is not allowable.

The wrong claim of depreciation is a valid reason for taking action under section 148 read with section 147 for the assessment years 2001-02 to 2005-06, because income to

that extent chargeable to tax has escaped assessment as per Explanation 2(c)(iv) of section 147.

The issuance of notice under section 148 for five assessment years is also valid, since as per the requirement of section 149(1)(b), the income chargeable to tax which has escaped assessment amounts to more than Rs.1 lakh during each of these assessment years on account of depreciation charged on the imported car being in excess of Rs.1 lakh for each of these assessment years.

- (b) The payment made for acquiring the licence to operate telecom services in Mumbai shall be subject to deduction as per the scheme in section 35ABB. As per section 35ABB, any amount actually paid for obtaining licence to operate telecommunication services shall be allowed as deduction in equal installments during the number of years for which the license is in force. If the payment is made before the commencement of business, the deduction shall be allowed beginning with the year of commencement of business. In any other case, it will be allowed commencing from the year of payment. Deduction shall be allowed up to the year in which the license shall cease to be in force.

The amount of deduction available for A.Y. 2007-08 is Rs.3 lakh as worked out below:-

(1)	(2)	(3)	(4) = (3)/(2)
Previous year of payment	Unexpired period of license	Installment paid (Rs.)	Deduction in respect of each installment (Rs.)
2004-05	10 years	10,00,000	1,00,000
2005-06	9 years	9,00,000	1,00,000
2006-07	8 years	<u>8,00,000</u>	<u>1,00,000</u>
		<u>27,00,000</u>	<u>3,00,000</u>

The deduction under section 35ABB for assessment year 2007-08 onwards till A.Y. 2014-15 will be Rs.3 lakh each year.

Note – It is assumed that the company has commenced business during the P.Y.2004-05.

- (c) The clarification regarding filing of return of income by the coffee growers being individuals covered by Rule 7B of the Income tax Rules, 1962 is given in Circular No.10/2006 dated 16.10.06. According to this Circular, an individual deriving income from growing, curing, roasting and grounding of coffee with or without mixing chicory, would not be required to file the return of income if the aggregate of 40% of his or her income from growing, curing, roasting and grounding of coffee with or without mixing chicory and income under all other sources liable to tax in accordance with the provisions of this Act, is equal to or less than the basic exemption limit prescribed in the First Schedule of the Finance Act of the relevant year.

In this case, Smt. Kanti has a total income of Rs.3,25,000 from this business, which was her only source of income for P.Y.2006-07. 40% of her total income works out to Rs.1,30,000, which is less than the basic exemption limit of Rs.1,35,000 in respect of

resident women assesses. Therefore, Smt. Kanti is not required to file a return of income for the A.Y.2007-08 as per the provisions of section 139(1).

- (d) Section 10(10BC) defines disaster to mean a catastrophe, mishap, calamity or grave occurrence in any area, arising from natural or man made causes, or by accident or negligence. It should have the effect of causing substantial loss of life or human suffering or damage to, and destruction of, property, or damage to, or degradation of, environment. It should be of such a nature or magnitude as to be beyond the coping capacity of the community of the affected area. If, for this reason, a compensation is paid by the Central Government or by a State Government or by a local authority, then the same will be exempt from tax. Accordingly, the amount of Rs.5 lakh received by the parents of deceased Amit from the Government of Maharashtra for the disaster because of Mumbai local train serial bomb blasts, is exempt under section 10(10BC).

Question 4

- (a) A piece of land owned by Mr. Mishra located on Jaipur-Delhi highway was acquired by NHAI in the F.Y.2003-04, but the award ordered in F.Y. 2004-05 was paid in the F.Y. 2006-07. This land was purchased by him on 2.4.1977 for Rs.1,000. The fair market value of the land as on 1.4.1981 was Rs.900. Compensation paid was Rs.5 lacs.

The other piece of land located in Chennai purchased in April, 2003 for Rs.25 lacs was also sold by him in February, 2007 for Rs.35 lacs, but sale deed thereof could not be executed by 31.3.2007. The value for the purpose of stamp duty applied by the stamp valuation authority was Rs.38 lacs.

Compute the income chargeable to tax arising as a result of these transactions in the A.Y.2007-08. The CILs for the F.Y.2003-04, 2004-05 and 2006-07 are 463, 480 and 519 respectively. (6 Marks)

- (b) "NEPTUNE" is a shipliner, used in carrying passengers and cargo, owned by M/s Thomas & Thomas of U.K. The ship carried the passengers and cargo in June, 2006 from Singapore to Mumbai and vice versa and collected charges thereof amounting to Rs.200 lacs. It left Mumbai port on 15.6.06 for its journey to Korea. No other journey to India was undertaken by any of the vessels of the company during the year ended on 31.3.07. The non-resident company had authorized its Indian agent to comply with the income tax provisions.

You are consulted by the company to explain about the procedure as to return of income to be filed and the period within which the assessment thereof will be completed by the Assessing Officer. (4 Marks)

- (c) Raja Ltd., made a provision on 31.3.02 of Rs.85,500 against a bill of supplier of raw material by charging the amount to profit and loss account and claimed deduction thereof while computing the income chargeable to tax for A.Y. 2002-03. The amount of Rs.40,000 not paid to the party till 31.3.06 was paid in cash on 11.6.06. The Assessing Officer issued show cause notice to the company to rectify the computation of income for the A.Y. 2002-03 on account of payment made in cash on 11.6.06.

Can the Assessing Officer do so?

(4 Marks)

Answer

(a) Computation of taxable income of Mr. Mishra for A.Y.2007-08

Particulars	Rs.
Capital Gains	
(A) Long-term capital gain derived from transfer of land on Jaipur-Delhi highway acquired by NHAI in F.Y. 2003-04 for which award was paid in F.Y. 2006-07 is chargeable to tax in A.Y.2007-08 [See Note (i) below]	
Sale consideration i.e. compensation paid	5,00,000
Less: Indexed cost of acquisition [See Note (ii) below]	
$\frac{(1000 \times 463)}{100}$	4,630
	4,95,370
(B) Sale of land at Chennai in February 2007 [See Note (iii) below]	
Full value of consideration as per section 50C [See Note (iv) below]	38,00,000
Less: Indexed cost of acquisition	
$\frac{(25,00,000 \times 519)}{463}$	28,02,376
	9,97,624

Total income chargeable to tax arising as a result of these transactions in the A.Y.2007-08 is = Rs.14,92,994 (i.e. Rs.4,95,370 +Rs.9,97,624).

Notes:

- The capital gains arising on compulsory acquisition shall be charged to tax in the year in which the compensation is first received as per section 45(5)(a).
- The option of fair market value as on 1.4.81 is not exercised by the assessee since the fair market value is lower than the cost.
463 is the cost inflation index of F.Y.2003-04 i.e. the year in which the property was compulsorily acquired.
- The execution of sale deed is not compulsory for the purpose of charge of capital gain because the transfer of right enabling enjoyment of immovable property gives rise to charge of capital gains as held by the Kerala High Court in the case of CIT v. C.F. Thomas (2006) 284 ITR 557.

- (iv) As per section 50C, the value applied by the stamp valuation authority is deemed to be the full value of consideration received or accruing as a result of such transfer, since such value is higher than the sale consideration of Rs.35 lakh.
- (b) M/s. Thomas & Thomas of U.K shall be required to file the return of income in India for the journey of its ship before it leaves for onward journey to Korea.

However, as per the proviso to section 172(3), where the Assessing Officer is satisfied that it is not possible for the master of the ship to furnish the return before the departure of the ship from the port, and if satisfactory arrangements have been made for filing of return and payment of tax by the authorised agent in India, he may permit filing of return within 30 days of departure of the ship i.e. before 15.7.2006.

Section 172(4A) provides a time limit of 9 months for completion of assessment in such cases. The period of 9 months is reckoned from the end of the financial year in which the return under section 172(3) is furnished. However, in respect of returns filed on or before 1.4.2007, assessments are required to be completed on or before 31.12.2008.

- (c) The proviso to section 40A(3) provides that where an allowance has been made in the assessment for any year in respect of any liability for any expenditure incurred by the assessee and subsequently, during any previous year, the assessee makes any payment in respect of such liability in a sum exceeding Rs.20,000 otherwise than by an account payee cheque drawn on a bank or by an account payee bank draft, the allowance originally made shall be deemed to have been wrongly made and the Assessing Officer may recompute the total income of the assessee for the previous year in which such liability was incurred by making necessary amendment.

The proviso to section 40A(3) is attracted in this case since the company has made a cash payment of Rs.40,000 in respect of a liability incurred and allowed in A.Y.2002-03. Accordingly, Rs.8000/-, being 20% of Rs.40,000, will be added in the computation of income for the A.Y.2002-03.

The action of the Assessing Officer to issue show cause notice to rectify the computation of income for the A.Y.2002-03 is, therefore, correct.

Question 5

- (a) The business premises of Ram Bharose Ltd. and the residence of two of its directors at Delhi were searched under section 132 of the Act by the DDI, Delhi. The search was concluded on 9.8.2007 and following were also seized besides other papers and records:
 - (i) Papers found in the drawer of an accountant relating to Shri Krishna Ltd., Mumbai indicating details of various business transactions. However, Ram Bharose Ltd. is not having any direct or indirect connection of any nature with these transactions and Shri Krishna Ltd., Mumbai and its directors.
 - (ii) Jewellery worth Rs. 5 lacs from the bed room of one of the director, which was claimed by him to be of his married daughter.

- (iii) Papers recording certain transactions of income and expenses having direct nexus with the business of the company for the period from 16.4.04 to date of search. It was admitted by the director that the transactions recorded in such papers have not been incorporated in the books.

You are required to answer on the basis of aforesaid and the provisions of Act, following questions:

- (a) What action the DDI shall be taking in respect of the seized papers relating to Shri Krishna Ltd., Mumbai?
 - (b) Whether the contention raised by the director as to jewellery found from his bed-room will be acceptable?
 - (c) What presumption shall be drawn in respect of the papers which indicate transactions not recorded in the books?
 - (d) Proceedings for how many years shall now be taken up and within which time limit the assessment thereof be completed by the Assessing Officer?
 - (e) Can the company move an application for settlement of case as per Chapter XIX-A of the Act? (11 Marks)
- (b) An individual resident in India, having income earned outside India in a country with which no agreement under section 90 exists, asks you to explain whether the credit of the tax paid on the income in that country will be allowed to him in India. (4 Marks)

Answer

- (a) (a) The authorised officer being DDI, Delhi is not having any jurisdiction over Shri Krishna Ltd., Mumbai, and therefore as per section 132(9A), the papers seized relating to this company shall be handed over by him to the Assessing Officer having jurisdiction over Shri Krishna Ltd., Mumbai within a period of 60 days from the date on which the last of the authorisations for search was executed for taking further necessary action thereon.
- (b) The contention raised by the Director will not be acceptable because as per the provisions of sub-section (4A)(i) of section 132, where any books of account, other documents, money, bullion, jewellery or other valuables are found in the possession or control of any person in the course of search, then, in respect thereof, it may be presumed that the same belong or belongs to that person.
- (c) As per section 132(4A), the presumptions in respect of the papers, indicating transactions not recorded in the books but having direct nexus with the business of the company, are that the same belong to the company, contents of such papers are true and the handwriting in which the same are written is/are of the persons(s) whose premises have been searched.
- (d) The search was conducted after 31.05.2003 and therefore, as per provisions of section 153A, the Assessing Officer will issue notices to the company to furnish the return of income in respect of each assessment year falling within six assessment

years immediately preceding the assessment year relevant to the previous year in which the search is conducted. Therefore, notices for A.Y. 2002-03 to 2007-08 shall be issued by the Assessing Officer.

The assessment for six assessment years shall be completed (as per provisions of section 153B(1)(a) read with proviso) within a period of 21 months from the end of the financial year in which the last of the authorisation for search was executed. Therefore, the assessment for the six assessment years shall be required to be completed by the Assessing Officer by 31.12.2009 as the search was concluded on 9.08.2007.

- (e) With effect from 1.6.2007, the definition of a case as per section 245A(b) has been amended to restrict the cases eligible to appear before the Settlement Commission. Accordingly, no proceedings, except the original assessment proceedings should be pending at the time of making an application to Settlement Commission. Therefore, an application cannot be made to the Settlement Commission where search has been initiated under section 132 followed by assessment under section 153A.
- (b) The assessee is a resident in India and accordingly, the income accruing or arising to him globally is chargeable to tax in India. However, section 91 specifies that if a person resident in India has paid tax in any country with which no agreement under section 90 exists, then, for the purpose of relief or avoidance of double taxation, a deduction is allowed from the Indian income-tax payable by him, of a sum calculated on such doubly taxed income at Indian rate of tax or the rate of tax of such country, whichever is lower, or at the Indian rate of tax if both rates are equal. Accordingly, the assessee shall not be given any credit of the tax paid on the income in other country, but shall be allowed a deduction from the Indian income-tax payable by him as per the scheme of section 91.

Question 6

- (a) Prakash, a member in two AOPs, namely, "AOP & Co." and "Prakash & Akash", provides the following details of his income for the year ended on 31.3.2007:
 - (a) "AOP & Co.", assessed at normal rates of tax, had credited in his account, amount of Rs.96,000 as interest on capital, Rs.96,000 as salary and Rs.20,000 as share of profit.
 - (b) A house property located at Jaipur was purchased on 1.7.2001 with the borrowed capital in "Prakash & Akash" jointly shared equally and occupied by both of them for self residential purposes. Total interest paid for the year 2006-07 on the borrowed capital was Rs.1,60,000.

Compute the income and the tax liability thereon for the A.Y. 2007-08 and support your answer with brief reasons and the provisions of the Act. (6 Marks)

- (b) What is the quantum of penalty that could be levied in each of the following cases:
 - (i) Failure to get books of accounts audited as required under section 44AB of the Income-tax Act within the time prescribed under the Act.

- (ii) Failure to get books of accounts audited in response to the notice issued under section 142(2A) of the Income-tax Act.
- (iii) Failure to furnish audit report as required under section 92E of the Income-tax Act.

(3 Marks)

Answer

- (a) Mr. Prakash is a member in two AOPs, namely, AOP & Co. and Prakash & Akash. Though Prakash & Akash is an AOP, the income from the house property will not be assessed as income of the AOP, but will be included in the hands of the individual members as per section 26, since the share of each member is definite and ascertainable. Hence, Prakash's share of income from house property would be assessed in his individual hands.

Since AOP & Co., has been taxed at normal rates of tax, Mr. Prakash's share income from the AOP (i.e. salary, interest on capital and his share of profit) would be included in his total income. Mr. Prakash, however, would be entitled to a relief under section 86 in respect of this income which has been included in his total income but on which tax has already been paid by the AOP. As per section 110, the relief shall be allowed at the average rate of tax calculated on the total income inclusive of such income.

Hence, the tax liability in the hands of Mr. Prakash would be as under:-

Particulars	Rs.	Rs.
Annual Value ($\frac{1}{2}$ share in house property used for own residence)	Nil	
Less: Interest on loan [$\frac{1}{2}$ share in Rs.1,60,000] – Since the loan is borrowed on or after 1.4.1999 and is used for acquiring property within 3 years, deduction would be available upto a maximum of Rs.1,50,000. This limit of Rs.1,50,000 applies for each member separately.	80,000	
Loss from house property		(-) 80,000
Share income from AOP & Co.		
- Interest on capital	96,000	
- Salary	96,000	
- Share of profit	20,000	
		2,12,000
Total Income		1,32,000

Tax on total income	3,200
Less: Rebate under section 86 read with section 110	
- Average rate of tax	
(Rs.3,200/Rs.1,32,000 x 100) = 2.424%	
- Rebate available	
(Rs.2,12,000 x 2.424%)	5,139
restricted to tax on total income	3,200
Tax liability	<u>Nil</u>

(b) The penalty that could be levied in each case is:-

- (i) Failure to get books of accounts audited as required under section 44AB of the Income-tax Act - a sum equal to $\frac{1}{2}\%$ of the total sales, turnover or gross receipts, as the case may be, in business, or of the gross receipts in profession, in such previous year or years, or a sum of Rs.1,00,000, whichever is less [Section 271B].
- (ii) Failure to get books of accounts audited in response to the notice issued under section 142(2A) – a sum of Rs.10,000 [Section 271(1)].
- (iii) Failure to furnish audit report under section 92E of the Income-tax Act - a sum of Rs.1,00,000 [Section 271BA].

Question 7

Examine and state, in the context of provisions of the Act, as to correctness of the following actions of the Income-tax authorities or of others:

- (i) A trust created for charitable purposes also derived income by letting out halls for functions. The Director of Income-tax (Exemptions) cancelled the registration on the ground that the trust was carrying on commercial activity. (3 Marks)
- (ii) The Assessing Officer issued notices under section 133 to four banks requiring particulars relating to a customer in a specific format duly verified in a prescribed manner. One of the banks refused to part with the information on the ground that the letter did not specify about any proceeding pending against the said customer under the Income-tax Act. (3 Marks)
- (iii) Mr. Siddharth was a partner in a firm, representing his HUF, holding 25% of the share in the firm. His wife Vineeta, a house lady, was admitted in her individual capacity in the firm for 25% share. She was paid remuneration which has been proposed by the Assessing Officer to be clubbed in the hands of Siddharth-HUF by invoking section 64 of the Act. (4 Marks)

Answer

- (i) Section 12AA(3) empowers the Commissioner to cancel the registration if he is satisfied that the activities of such trust or institution are not genuine or are not being carried out in accordance with the objects of the trust or institution.

The Karnataka High Court, in *Sanjeevamma Hanumanthe Gowda Charitable Trust v. Director of Income-tax (Exemptions)*(2006) 285 ITR 327 (Karn.), observed, that for the purpose of registration under section 12AA, it is necessary for the authorities to satisfy themselves that the activities of the trust or institution are genuine and that the income derived from the trust property is applied to charitable or religious purpose. It is not necessary to go into the nature of the activity by which the income was derived by the trust.

In the case of a trust which derived income by letting out halls for functions, there is no evidence to show that the activity was not genuine or was not for the objects of the trust. The action of Director of Income-tax (Exemptions) is, thus, not correct.

- (ii) It is not necessary that any proceeding should be pending against the customer for the purpose of invoking section 133(6) of the Income-tax Act. It is with a view to collecting information that power is given to an Assessing Officer under section 133(6) to issue notice requiring a banking company to furnish information in respect of such points or matters as may be useful or relevant to any enquiry or proceeding under the Act. The second proviso to section 133(6) makes it clear that such information can be sought for even when no proceeding under the Act is pending; such power can be exercised even in case of an enquiry, the only safeguard being that before this power can be invoked by the Assessing Officer, the approval of the Director or the Commissioner, as the case may be, has to be obtained [*Karnataka Bank Ltd. vs. Secretary, Government of India* (2002) 255 ITR 508(SC)].

The action of the Assessing Officer in this case is, therefore, correct assuming that he has obtained the prior approval of the Director or the Commissioner, as the case may be.

- (iii) As per section 64(1)(ii) of the Income-tax Act, in computing the total income of any "individual", the remuneration paid to spouse by a firm in which the individual has substantial interest shall be liable for clubbing. In the present case, Mr. Siddharth is not a partner in his individual capacity, but a partner in representative capacity.

The Supreme Court has, in the case of *CIT vs. Om Prakash* (1996) 217 ITR 785, held that an individual can be a partner in a partnership firm in his individual capacity or in the capacity of the karta of a Hindu undivided family or, for that matter, in any other capacity, e.g., as a trustee. Where a person is a partner as the karta of a Hindu undivided family, the capacity in which he is a partner in the partnership firm is relevant as between him and the other members of the Hindu undivided family. The income the karta receives as a partner is not his individual income; it is the income of the Hindu undivided family and he receives it on behalf of the Hindu undivided family. It is for this reason that the income of the wife arising from her membership of the partnership firm, is held not includible in the income of the Hindu undivided family since the total income of the Hindu undivided

family is not the total income of the individual (husband). For section 64(1) to get attracted, it is necessary that the spouse should be a partner in a partnership firm in his individual capacity. It is not attracted where he is a partner as the karta of the Hindu undivided family to which his wife belongs.

The action of the Assessing Officer in this case is, therefore, not correct.

Question 8

- (a) Mr. Rajpal gives the particulars of various assets held by him on 31.3.2007 and requests you to compute his net wealth by explaining in brief that why the same was dealt with like that :
- (i) Jewellery gifted to wife from time to time in total of Rs.1 lac and were available with her on the valuation date having market value of Rs.5 lacs.
 - (ii) A flat in Mumbai purchased under instalment scheme in 1986 for Rs.6 lacs and used for own residence since then. The market value of it was Rs.20 lacs on 31.3.2007 and installment of Rs.1 lac was also outstanding.
 - (iii) He is a qualified engineer and was in possession of instruments used for his professional activity. The value of all such instruments was Rs.1 lac.
 - (iv) Urban land purchased for Rs.2 lacs in August 2004 located at Jaipur, in the name of his son who is suffering from a disability specified under section 80U. The age of his son on 31.3.2007 was 10 years and value of land was Rs.5 lacs.
 - (v) House located in NOIDA shown in his wealth-tax return for A.Y.2006-07 at Rs.40 lacs was sold on 20.3.07 for Rs.45 lacs, but the sale deed thereof was executed on 3.4.07. (5 Marks)
- (b) Examine the correctness of the statement that "All types of land held by an assessee on the valuation date are treated as 'Urban land' under the Wealth-tax Act." (5 Marks)

Answer

- (a) Computation of Net Wealth of Mr. Rajpal on 31.3.2007

Particulars of asset with reason for chargeability	Amount (Rs.)
1. Under section 4(1)(a)(i) read with Rule 18 of Schedule III, the fair market value of gifted jewellery on the valuation date will be included in the wealth of Mr. Rajpal.	5,00,000
2. The flat at Mumbai used by the assessee for his own residence is exempt under section 5(vi) and accordingly, the liability of outstanding installment is not deductible.	Nil
3. Professional instruments held on the valuation date used for the purpose of profession are not assets for the purpose of levy of wealth-tax.	Nil

4. Urban land is an asset by virtue of section 2(ea)(v). However, since the same is in the name of his minor son who suffers from a disability specified under section 80U, the clubbing provisions are not applicable as per section 4(1)(a)(ii).	Nil
5. The property at Noida was sold during the year and is, therefore, not an asset of the assessee but is an asset of the beneficial owner, since ownership of the property passes on sale of the property and execution of sale deed only confirms the act of the parties.	Nil
Net Wealth	<u>5,00,000</u>

- (b) Urban land is an “asset” as per section 2(ea)(v) of the Wealth Tax Act and it means (i) land situated in any area comprised within the jurisdiction of a municipality or cantonment board and which has a population of not less than 10,000 according to the last preceding census; (ii) land situated in any area not being more than 8 kms from the local limits of any municipality or cantonment board.

However, in spite of fulfilling the above conditions, the following are not treated as urban land:-

- (i) land on which construction of a building is not permissible under any law for the time being in force in the area in which such land is situated;
- (ii) land occupied by any building which has been constructed with the approval of the appropriate authority;
- (iii) unused land held by the assessee for industrial purposes for a period of 2 years from the date of its acquisition by him; and
- (iv) any land held by the assessee as stock-in-trade for a period of 10 years from the date of its acquisition by him.

Therefore, all types of land held by an assessee on the valuation date may not be treated as urban land under the Wealth-tax Act.

Hence, the statement is not correct.

The suggested answers for Indirect Taxes (Paper 8) are based on the provisions as amended by the Finance Act, 2006 and Notifications/Circulars issued up to 30.04.2007 which are relevant for November 2007 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 provisions of the Central Excise Act, 1944:
- (i) Manufacture and processing
 - (ii) Dutiability of site related activities
 - (iii) Labelling and branding activities (2 x 2 = 4 Marks)
- (b) Explain briefly the meaning of “Trade parlance test” in matters relating to classification under the Central Excise Tariff Act, 1985. (4 Marks)
- (c) Discuss the validity or otherwise of the following statements with brief reasons:
- (i) An assessee would lose the benefit to pay duty in monthly instalments if he has made a default in payment of duty by the due date and the same is discharged beyond a period of 30 days from the due date in terms of rule 8 of the Central Excise Rules, 2002.
 - (ii) Excise duty is payable on intermediate goods, manufactured by factory A which are removed without payment of duties of excise for use in the manufacture of subject goods, namely machines, in factory B of a Large Tax Payer Unit under rule 12BB of the Central Excise Rules, 2002. (2 x 3 = 6 Marks)
- (d) Answer briefly in the context of refund of CENVAT credit under rule 5 of the CENVAT Credit Rules, 2004, the following:
- (i) Under what circumstances will the benefit under the Rule be available for inputs or input services? (3 Marks)
 - (ii) How is the manufacturer or provider of output service allowed to utilize the CENVAT credit in respect of the inputs or input services? (3 Marks)

Answer

- (a) (i) Manufacture involves a series of processes, whereas a process is one of the activities undertaken for manufacture of a product from input materials. Manufacture is the cumulative effect of various processes to which raw materials are subjected and each step towards the finished product would constitute

processing in relation to manufacture.

- (ii) Excise duty is a levy on movable goods and not on immovable property. Excise duty is chargeable when, at site, there emerges movable goods, during the course of fabrication or bringing into being of immovable property, in the form of buildings, plant etc. In other words, if movable goods such as fabricated parts, structures, equipments are brought into being and they are thereafter mounted or fixed on civil foundations so as to complete the construction, excise duty will be chargeable on such movable goods, notwithstanding that the final products are items of immovable property.

On the other hand, if the site work is carried out on top of a civil foundation and such parts, structures etc. are erected piece by piece on such foundation, no movable goods are brought into being and hence no duty is chargeable on such activities.

- (iii) An unlabelled or a labelled product is normally treated in commercial parlance as the one and the same and consequently mere labelling of fully manufactured products does not constitute manufacture in law. However, the legislature has specifically provided in section 2(f)(iii) of the Central Excise Act, 1944 that in respect of goods specified in the Third Schedule of the Central Excise Act, 1944, labelling or re-labelling inter alia amounts to manufacture. As regards branding, it has been held in numerous decisions that this would not amount to manufacture.

- (b) According to the Trade Parlane test, if a product is not defined in the Schedules and Section Notes and Chapter Notes of the Central Excise Tariff Act, 1985, then it should be classified according to its popular meaning or meaning attached to it by those dealing with it i.e., in its commercial sense. However, where the Tariff headings itself uses highly scientific or technical terms, goods should be classified in scientific or technical sense.

The Supreme Court in *Akbar Badruddin Jiwani v. CC* [1990] 47 ELT 161 has held that the said doctrine of commercial nomenclature and trade understanding should be departed from in a case where the statutory context in which the Tariff entry appears, requires such a departure.

- (c) (i) Sub-rule (3A) of rule 8 of the Central Excise Rules, 2002 provides that if an assessee defaults in payment of duty beyond 30 days from the due date then he shall pay excise duty for each consignment at the time of removal, without utilizing the CENVAT credit. He shall continue to pay duty consignment-wise (from PLA) till the date he pays the outstanding amount including interest thereon. In the event of any failure, it shall be deemed that such goods have been cleared without payment of duty and the consequences and penalties as provided shall follow.

Hence, the given statement is valid.

- (ii) As per rule 12BB of the Central Excise Rules, 2002, the given statement would be valid in all cases where:

- (i) the machines are not exported under bond or letter of undertaking within 6

months from the date of receipt of the intermediate goods in the recipient premises (factory B), or

- (ii) the machines are removed without payment of duty, or
- (iii) the machines are removed by paying appropriate excise duties beyond a period of 6 months, or
- (iv) any duty of excise is payable on intermediate goods and the said duty is not payable on machines.

However, the statement would be invalid in cases not covered by points (i) to (iv) mentioned above.

- (d) (i) The benefit under rule 5 of the CENVAT Credit Rules, 2004 for inputs or input services would be available when the same are used:
 - (a) in the manufacture of final product which is cleared for export under Bond or Letter of Undertaking (LUT), or
 - (b) in the manufacture of intermediate product cleared for export; or
 - (c) in providing output service which is exported.
- (ii) The CENVAT credit in respect of the input or input services shall be allowed to be utilized by the manufacturer or provider of output service towards payment of:
 - (a) duty of excise on any final product cleared for home consumption or for export on payment of duty; or
 - (b) service tax on output service.

Where for any reason such adjustment is not possible, the manufacturer or the provider of output service shall be allowed refund of such amount subject to such safeguards, conditions and limitations, as may be specified, by the Central Government, by notification.

Question 2

- (a) M/s. KE Ltd. manufactured elastics with brand name of M/s. XYZ Ltd., who in turn used these elastics in the manufacture of other excisable goods. These elastics were never sold in the open market. The general public only received the manufactured excisable goods. M/s. KE Ltd. claimed the exemption based on value of clearances (SSI) in terms of Notification No. 8/2003-C.E. dated 01.03.2003 on the ground that they did not use the brand name on the final product and that the brand name was used only in respect of the goods meant for captive consumption. This claim was disputed by the Excise Department on the basis that it is immaterial that the ultimate customer got only the final product as the use of the brand name on elastics, even if not sold in the open market, would convey to the customer that the elastics had connection with the owner of the brand name. Briefly discuss whether the stand of the Department is valid in law?

(5 Marks)

- (b) With reference to the CENVAT Credit Rules, 2004, discuss briefly whether the following statements are correct or not:
- (i) CENVAT credit cannot be taken on the inputs lying in stock on the date when the final product becomes dutiable because the said product was initially exempt.
 - (ii) CENVAT credit of duties of excise on inputs can be availed on the basis of an invoice, while credit of service tax paid on input services can be availed only upon payment of the full invoice value including service tax.
 - (iii) In case of transfer of ownership of the factory by way of sale along with inputs and capital goods, the unutilized input credit shall lapse. (3 x 2 = 6 Marks)
- (c) Briefly answer with reference to the provisions of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 whether in the following cases any notional interest on the advance received is includible in the value for purpose of assessment:
- (i) An assessee sells his goods against full advance payment to X. He also sell such goods to Y without any advance payment at the same price per unit.
 - (ii) A, the assessee manufactures and supplies certain goods as per design and specification of B. A takes 50% of the price as advance against these goods and there is no sale of such goods to any other buyer. (2 x 2 = 4 Marks)

Answer

- (a) The facts of the given case are identical to the case of Kohinoor Elastics Pvt. Ltd. v. CCEx. [2005] 188 ELT 3 (SC). In the instant case, the Supreme Court has observed that as per the small scale exemption notification, the benefit of small scale exemption is available only in respect of those goods which do not bear a brand/trade name of another person. However, the notification does not provide that exemption shall be lost only for those goods (bearing the brand name of other person) which are sold in the market or those goods which reach the customers without any change in form. Therefore, the Apex Court has held that goods manufactured for captive consumption would not be any exception and the exemption would not be available if brand name of another person is used on them.

Hence, in the given case the Department's stand is valid in law and M/s. KE Ltd. will not be entitled for the small scale exemption in respect of the elastics (meant for captive consumption) bearing the brand name of M/s. XYZ Ltd.

- (b) (i) False. Manufacturer of final products shall be allowed to take CENVAT credit of the duty paid on-
- inputs lying in the stock or
 - inputs in process or
 - inputs contained in the final products lying in stock
- on the date on which such final product cease to be exempted goods [Rule 3(2)].

- (ii) True. Credit of service tax paid on input services can be availed only after the recipient of input service makes payment of input services and the service tax payable on it, as shown in the invoice [Rule 4(7)].

However, in case of excise duty, credit is available as soon as the goods are received in the factory. The reason for such different treatment is that the input supplier can clear the inputs from his factory only after paying the applicable duty irrespective of the time at which he receives the payment against the invoice, whereas the input service provider pays the service tax only after he realizes the payment for taxable services as the service tax is due upon realization only.

Note: If the recipient of input service settles the bill on a value less than the invoice value, service tax payable shall also be reduced proportionately and the assessee would be eligible to avail the reduced CENVAT credit.

- (iii) False. The manufacturer shall be allowed to transfer the credit lying unutilized provided the transfer takes place with specific provision for transfer of liabilities of such factory [Rule 10(1)] and the said inputs and capital goods are duly accounted for to the satisfaction of the Deputy/Assistant Commissioner of Central Excise [Rule 10(3)].

Note: It is also possible to answer as 'True' if it is assumed that there is no specific provision of transfer of the liabilities of such factory or the inputs and the capital goods have not been accounted for to the satisfaction of the Deputy/Assistant Commissioner of Central Excise.

- (c) Explanation 2 to rule 6 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 provides that where any advance payment from the buyer is received against delivery of excisable goods, no notional interest on such advance shall be added to the value unless the central excise officer has evidence to the effect that the advance received has influenced the fixation of price of the goods by way of charging a lesser price or by offering of a special discount to the buyer who has made the advance deposit.
- (i) No notional interest on the advance received by the assessee is includible in the transaction value in the present case as same price is also charged from Y (another buyer) who has not given the advance deposit.
- (ii) Notional interest would be includible only if there is evidence available with the central excise officer that advance has resulted in lowering of prices. In the absence of any such evidence, no notional interest on the advance received shall be added to the transaction value.

Question 3

- (a) M/s PQR Ltd. were granted a refund by the Appellate Authority under the Central Excise Act, 1944. The jurisdictional Assistant Commissioner of Central Excise has issued a notice under section 11A of the Central Excise Act, 1944 demanding the amount of

refund on the ground that such a refund is erroneous. Briefly discuss whether the action taken by the Assistant Commissioner of Central Excise is valid in law. (4 Marks)

- (b) Answer briefly with reference to rule 21 of the Central Excise Rules, 2002 (regarding remission of duty and destruction of goods) the following:
- (i) The circumstances under which remission of duty may be ordered;
 - (ii) The manner of destruction. (2 x 2 = 4 Marks)
- (c) Briefly explain the procedure for removal of goods by an hundred percent export oriented unit for domestic tariff area. (4 Marks)
- (d) Write a brief note on “electronic maintenance of records and preparation of returns and documents” under the Central Excise Rules, 2002. (3 Marks)

Answer

- (a) The facts of the given case are similar to the case of *Dynamite Technologies Ltd. v. Union of India* 2005 (186) ELT 277 (Kar.) wherein the High Court has held that where refund arises only as a consequence of an order/direction issued by the Appellate Authority, as a quasi judicial functionary, any recovery of amount could only be made if the order is again modified further in appeal proceedings and not otherwise. The High Court observed that even in such an event the amount could be recovered only as a consequential action and not otherwise. The High Court stated that the show cause notice in the said case was unnecessary and not within the scope of the power under section 11A of the Central Excise Act, 1944. The expression “whether or not” in section 11A could not be extended to the case of short levy/non-levy or erroneous refund granted as a result of appellate proceedings.

Therefore, in view of the above-mentioned judgement the action taken by the Assistant Commissioner is not valid in law.

- (b) (i) Rule 21 of the Central Excise Rules, 2002 provides that where it is shown to the satisfaction of the Central Excise Officer that goods have been lost or destroyed by natural causes or by unavoidable accident or claimed by the manufacturer as unfit for consumption or for marketing, at any time before removal, he may remit the duty payable on such goods subject to such conditions as may be imposed by him.
- (ii) The goods intended and presented before the proper officer must be destroyed in such a manner that they become irretrievable as excisable commodity. The actual method of destruction will depend upon the nature of the goods to be destroyed. For example matches, cotton, rayon and woolen fabrics, papers, cigar and cheroots may be destroyed by fire. Electric bulb and batteries may be destroyed by crushing into bits and scraps. Vegetable oils and vegetable products may be destroyed by mixing earth or kerosene and dumping into pits. Whatever method of destruction is adopted, the officer supervising the destruction will satisfy himself that the destroyed goods cannot be marketed.

- (c) Rule 17 of the Central Excise Rules, 2002 provides that where any goods are removed from a 100% EOU to domestic tariff area, such removal shall be made under an invoice in the procedure prescribed under Rule 11. Further, removal shall be made only after payment of appropriate duty by debiting the account current maintained for this purpose or by utilizing the CENVAT credit.

Such unit is required to maintain appropriate accounts related to production in the prescribed form giving the following details:-

- (i) description of goods
- (ii) quantity removed
- (iii) duty paid

Such unit is further required to submit a monthly return in the specified Form (ER-2) in respect of excisable goods manufactured in, and receipt of inputs and capital goods in, the unit. The return is to be submitted to the Superintendent of Central Excise within ten days from the close of the month to which the return relates.

- (d) Any person may electronically maintain or generate all or any of the records or returns, invoices and other documents prescribed under the rules made under the Central Excise Act using a computer, in an electronically readable format. The Department will maintain a record to the effect that records are maintained electronically. The records can be kept on any electronic media and besides this print outs may also be kept where required.

The records together with back-ups in electronic or other form should be preserved for a period of 5 years counted from the first day of the financial year following the financial year to which they relate. The person who maintains electronic records will have to produce the relevant records in hard copy and/or in an electronic readable format, policy and procedure manuals, instructions to record the flow of transactions through the accounting system from the stage of initiation to the closure and storage to the central excise officer or audit party deputed by the Commissioner or the Comptroller and Auditor General of India. An audit trail and inter-linkages including the source document and financial accounts record layout, data dictionary and explanation for the codes used and total number of records in each field along with sample copies of documents will also have to be produced when required. Changes made in the systems adopted by the assessee should be informed to the Department.

In case there is misuse of this facility or if the information required is not made available then the Assistant/Deputy Commissioner of Central Excise may withdraw the facility after giving a reasonable opportunity of being heard to the person.

Question 4

- (a) Section 35C(2) of the Central Excise Act, 1944 provides that the Appellate Tribunal, may at any time within six months of the date of the order, with a view to rectifying any mistake apparent from the record, amend any order passed by it. Briefly illustrate with two examples as to what would constitute "mistake apparent from the record" for the purpose of this provision. (5 Marks)

- (b) Briefly explain the provisions under the Central Excise Act, 1944 relating to special audit in cases where credit of duty availed or utilized is not within the normal limits. (4 Marks)
- (c) Write a brief note on the following with reference to the Central Excise Act, 1944 and the rules made thereunder:
 - (i) Cancellation of export documents
 - (ii) Bond to be executed by 100% EOU for obtaining indigenous goods without payment of duty
 - (iii) Execution of bond by Government undertaking. (3 x 2 = 6 Marks)

Answer

- (a) Two illustrations of mistakes apparent on the face of the record:-
 - (i) Failure to take into consideration the material evidence, which is present on record, would amount to a mistake apparent on the face of the record. The Tribunal has jurisdiction to correct such a mistake in exercise of its powers under section 35C(2) of the Central Excise Act, 1944 [CCEx. v. Bharat Bijlee Ltd. 2006 (198) ELT 489 (SC)].
 - (ii) When a decision rendered by the Apex Court is not considered, non-consideration of such binding precedent constitutes an error apparent on the face of the record. Even in the context of decisions of the Apex Court and the jurisdictional High Courts rendered after the order of the Tribunal, there would be a case of error apparent on the face of the record on the reasoning that the superior court declared the law as it always was. The binding decision of the Apex Court would cover even the period prior to the inception of such law during which the orders contrary to such ratio of the subsequent decision were passed, thus giving rise to an error apparent on the face of the record. Therefore, rectification of such an error within the period permissible by the statute is required to be effected [Hindustan Lever Ltd. v. CCEx. 2006 (202) ELT 177 (Tri.-LB)].

Other mistakes apparent on the face of the record, which can be rectified by the Tribunal in terms of section 35C(2), can be typographical error, calculation mistakes, point raised in appeal but not considered, retrospective amendments in the statute etc.
- (b) Section 14AA of the Central Excise Act, 1944 states that the Commissioner of Central Excise may call for an audit if he has reason to believe that the credit of duty availed of or utilized by a manufacturer of any excisable goods:
 - (a) is not within the normal limits having regard to the nature of excisable goods produced or manufactured, the type of inputs used and other relevant factors as he may deem appropriate;
 - (b) has been availed of or utilized by reason of fraud, collusion or any willful misstatement or suppression of facts.

The Commissioner shall direct such manufacturer to get the accounts of his factory, depot, office, distributor or any other place, as may be specified by him, audited by a Cost Accountant nominated by him. The Cost Accountant has to submit the duly signed and certified audit report within the period specified by the central excise officer. The report should include any other particulars as are required by such officer. This audit shall be in addition to any other audit under any other law for the time being in force.

The manufacturer shall be given an opportunity of being heard in respect of any material gathered on the basis of the audit and proposed to be utilized in any proceeding under the Act.

- (c) (i) If the excisable goods cleared under A.R.E.-1 are not exported for any reason and the exporter intends to divert the goods for home consumption, he may request the Bond/Letter of Undertaking accepting authority in writing to allow cancellation of application and diversion of goods for consumption in India. He will be permitted to do so if he pays the duty as specified in the application along with interest on such duty from the date of removal for export from the factory till date of payment. Since the duty has been assessed once, there will not be any need for reassessment. After the duty is discharged, the exporter may take credit in his running bond account on the basis of letter of permission, invoice and TR 6 challans.

If the exporter after clearing the goods without payment of duty intends to change the destination and cancel the original documents and issue fresh ones, the same may be done under permission and authentication by the bond/LUT accepting authority.

- (ii) In the case of 100% EOU obtaining indigenous goods without payment of duty under a notification issued under section 5A of the Central Excise Act, 1944, acceptance of surety bond instead of bank guarantee is permissible. EOUs may continue to execute bond in the format given in Form B 17. While executing the combined B 17 bond, security to the extent of 5% of the value of bond in the form of bank guarantee or cash deposit or any other mode of security may be accepted in lieu of surety.
- (iii) The Central Board of Excise and Customs has decided that every undertaking owned and managed directly through any Ministry, Directorate or Directorates of Central Government is exempt from execution of any bond. A State Government is exempt from furnishing any security or surety for bond, where the execution of such bond, or, as the case may be furnishing of security or surety is required under the rules.

An undertaking owned or controlled by the Central Government or State Government does not include any undertaking belonging to corporation owned or controlled by the Central Government or State Government and established by or under a Central or State Act, or any undertaking belonging to a Government Company within the meaning of section 617 of the Companies Act.

Question 5

- (a) Discuss briefly the validity of the following statement with reference to the powers of the Central Excise Department to launch prosecution proceedings under section 9 and section 9AA of the Central Excise Act, 1944:
- “Confiscation and penalty in departmental adjudication and prosecution in criminal proceedings are independent and do not amount to double jeopardy.” (4 Marks)
- (b) Write a brief note on the procedure for warehousing of excisable goods removed from a factory or warehouse with reference to rule 20 of the Central Excise Rules, 2002. (4 Marks)
- (c) State briefly the procedure to be followed by the Authority for Advance Ruling under section 23D of the Central Excise Act, 1944 on the receipt of an application. (4 Marks)
- (d) Write a brief note on the duty of excise not levied or short levied as a result of general practice that is notified as not recoverable under section 11C of the Central Excise Act, 1944. (3 Marks)

Answer

- (a) Besides the departmental adjudication, prosecution may also be launched under section 9 of the Central Excise Act, 1944 for offences under section 9(1) of the Act. As per the provisions of section 9AA, prosecution may be launched against any person, director, manager, secretary or other officers of the company or partner/ proprietor of the firm, who is responsible for the conduct of the business of the company/firm and is found guilty of the offences under the Central Excise Act. Section 9 of the Central Excise Act provides for prosecution of offences in a court of law and provides a minimum imprisonment of six months which can extend to a period of seven years in certain cases.
- Prosecution proceedings in a court of law are generally initiated after departmental adjudication of an offence has been completed. However, prosecution may be launched even where adjudication is not complete. Prosecution is launched in all cases where there is sufficient evidence to prove fraudulent intention. The Chief Commissioner of Central Excise or the Director General of Central Excise Intelligence has the power to sanction prosecution. Thus, confiscation and penalty in departmental proceedings and prosecution in criminal proceedings are independent.
- (b) Rule 20 of the Central Excise Rules, 2002 prescribes the following procedure for warehousing of excisable goods removed from a factory or a warehouse:
- The consignor (i.e. manufacturer or registered person of the warehouse) shall prepare an application for removal of goods from a factory or a warehouse to another warehouse in quadruplicate in the specified form.
 - The consignor shall prepare the invoice in the manner prescribed in Rule 11.
 - The original, duplicate and triplicate application and the duplicate invoice shall be sent to the warehouse of the destination.

- (iv) The consignor shall send the quadruplicate copy to the Superintendent-in-charge having jurisdiction over his factory or warehouse within 24 hours of removal of the consignment.
 - (v) On arrival of the goods at the destination, the consignee (i.e., the registered person of the warehouse who receives the excisable goods from the factory or a warehouse) shall verify the goods with the copies of the application within 24 hours. The consignee shall send the original application to the Superintendent-in-charge, of his warehouse, the duplicate to the consignor and retain the triplicate for his records.
 - (vi) The Superintendent-in-charge of the consignee shall countersign the application received by him and forward the same to the Superintendent-in-charge of the consignor.
 - (vii) The consignor shall retain the duplicate application duly endorsed by the consignee for his record.
- (c) Section 23D of the Central Excise Act, 1944 prescribes the following procedure to be followed by the Authority for Advance Ruling on receipt of an application:
- (i) On receipt of the application for advance ruling, the Authority shall forward a copy to the relevant Commissioner.
 - (ii) The Authority has the sole discretion to accept or reject the application. However a hearing has to be given before rejection. Application is liable to be rejected in the following cases:-
 - (a) where the question raised in the application is already pending before any Central Excise Officer, Appellate Tribunal or any Court.
 - (b) where the question raised is the same as in a matter already decided by any Appellate Tribunal or Court.
 - (iii) The Authority shall pass an order admitting or rejecting the application. A copy of such order should be given to the applicant and the Department.
 - (iv) The Authority can further examine any material placed before it after admission of the application.
 - (v) The Authority should pronounce the final order within 90 days of the receipt of the application.
 - (vi) Copies of the order have to be given to the applicant and the Commissioner.
- (d) Sometimes goods liable to central excise duty may not be charged to duty on account of generally prevalent practice. They may also be subjected to a lower rate of duty than the applicable rate. In such cases, the Central Government has the power to direct by notification that such not-levied excise duty or short levied excise duty shall not be required to be paid in respect of such goods.

When such a notification in respect of such goods is issued, the whole of the excise duty (in case of non-levy) or excess excise duty (in case of short-levy) which would not have been paid if the said notification had been in force, shall be dealt with in accordance with the provisions of section 11B(2) relating to refunds.

The person claiming refund of such duty or the excess duty has to make an application to the Assistant/Deputy Commissioner of Central Excise in the prescribed form before the expiry of six months from the date of issue of the said notification.

PART B

Question 6

- (a) Explain briefly with reference to the provisions of the Customs Act, 1962 any two of the following:

- (i) "Import" and "Importer"
- (ii) Meaning of "Assessment"
- (iii) "Clearance for home consumption" and "Clearance for warehousing"

(2 x 2 = 4 Marks)

- (b) XYZ ice cream company imported cone containers made from printed aluminium foils which according to the assessee were classifiable under Chapter 76: "Aluminium and Articles thereof" in section XV of the first schedule to the Customs Tariff Act, 1975. According to the Revenue, these were classifiable under Chapter 48: "Paper and Paperboard; articles of paperpulp, of paper or paperboard". The revenue's view was that where composite goods are made of different components and cannot be classified by reference to Rule 2 of the Interpretative Rules, then the classification has to be according to the principles contained in Rule 3. The classification has to be as if the goods consists of the material or components which give them their essential character. Since the contents of the material in this case was 70.7% paper, that was the essential component of the cone containers for ice cream and merit classification under Chapter 48.

The chapter notes to Chapter 48 read as follows:

Notes :

- 1.
2. This chapter does not cover;
 - (a)
 -
 - (n) metal foil backed with paper or paper board (Section XV)

Discuss briefly whether the action proposed by the Revenue is correct is law. (4 Marks)

- (c) Examine the validity of the following statements with reference to the Customs Act, 1962 giving brief reasons. (Answer any three):

- (i) Service charges paid to canalizing agent are not includible in the assessable value of imports.
 - (ii) Design and engineering charges are includible in the assessable value of the imported goods only if the goods imported are specifically manufactured on the basis of the design and engineering specifications provided by the importer.
 - (iii) Inspection charges are not includible in the assessable value of the imported goods if contract does not specify for certification by an independent agency.
 - (iv) Goods exempt from basic customs duty would automatically be exempt from additional duty of customs. (3 x 2 = 6 Marks)
- (d) (i) With reference to section 125 of the Customs Act, 1962 briefly explain the following:
- (a) Option to pay fine in lieu of confiscation.
 - (b) Whether this fine once paid could be claimed as a refund if the importer decides to abandon the goods? (2 x 2 = 4 Marks)
- (ii) Briefly explain the provisions of Section 89 of the Customs Act, 1962 with regard to supply of ship stores. (2 Marks)

Answer

- (a) (i) The term import under section 2(23) of the Customs Act, 1962 refers to bringing into India from a place outside India. Import of goods into India commences when the goods enter the territorial waters of India, but gets completed only when the goods become part of the mass of goods within the country.
- As per section 2(26) of the Customs Act, 1962 importer, in relation to any goods at any time between their importation and the time when they are cleared for home consumption, includes any owner or any person holding himself out to be the importer.
- (ii) In the context of customs duty, the term assessment means quantification of the amount of duty payable. The process of assessment involves determining:
- (i) the quantity and total value of the consignment
 - (ii) the proper tariff classification of the goods
 - (iii) the appropriate rate of duty after all abatements
 - (iv) whether the goods are to be cleared for home consumption or for warehousing.
- (iii) Clearance for home consumption implies that the customs duty on the imported goods has been discharged and goods are cleared for utilization. Clearance for warehousing implies that the goods may, instead of being cleared for home consumption, be deposited in a warehouse and cleared later. When the goods are deposited in a warehouse the collection of duty is deferred till the time such goods are cleared for home consumption. However, the importer has to execute a bond up to a sum equal to twice the amount of duty assessed on the goods at the time of import.

- (b) In the given case, the Chapter Note 2(n) specifically excludes metal foil backed with paper or paperboard from the purview of Chapter 48. The aluminium cone foil containers made up of 70.7% paper cannot be included under Chapter 48 by mere reference to the title of the Chapter 48: "Paper and Paperboard; articles of paper pulp, of paper or paperboard". The contention of the Revenue that the Chapter Note will not apply because of Rule 3(b) of the Interpretative Rules, is not correct as it has been specifically provided in Rule 1 of the Interpretative Rules that "the titles of sections and Chapters are provided for ease of reference only; for legal purposes classification shall be determined according to the terms of the headings and any relative section or Chapter Notes and, provided such headings or Notes do not otherwise require, according to the provisions hereinafter contained".

Therefore, only if there is no specific Chapter Note requiring otherwise, the subsequent rules i.e., rule 2 onwards, including rule 3(b) of the Rules for Interpretation, can be invoked. However, in the present case, Chapter 48 – Note – 2(n) is very specific leaving no option to resort to Rule 3(b).

The argument that the Interpretative Rules override the Chapter Note is not acceptable in view of the specific enumeration that the rules do not have any other purpose other than ease of reference.

Hence, the Revenue's contention that the cone containers should be classified under Chapter 48 is not correct.

- (c) (i) The statement is not correct. Since the canalizing agent is not the agent of the importer nor does he represent the importer abroad, purchases by canalizing agency from foreign seller and subsequent sale by it to Indian importer are independent of each other. Hence, the commission or service charges paid to the canalizing agent are includible in the assessable value as these cannot be termed as buying commission [Hyderabad Industries Ltd. v. UOI 2000 (115) ELT 593 (SC)].
- (ii) The Supreme Court in the case of TISCO Ltd. v. CCEx. & Cus. 2000 (116) ELT 422 (SC) has held that design and engineering charges paid for use during construction, erection, assembly etc. of imported goods, being relatable to post import activity, are not includible in the value. Thus, the design and engineering charges which relate to pre-importation activity are only includible in the value. Since, in this case the design and engineering charges are paid for manufacturing the imported product, i.e., they relate to pre-importation activity, the same are includible in the value. Thus, the statement is correct.

Note: With effect from 10.10.2007, new Customs Valuation (Determination of Value of Imported Goods) Rules, 2007 have been notified under section 14 as amended by the Finance Act, 2007. Explanation to rule 10(1) of the said rules clarifies that the royalty, licence fee or any other payment for using a process shall be added to the price actually paid or payable, notwithstanding the fact that such goods may be subjected to the said process after their importation if such payments are related to imported goods and are a condition of the sale of imported goods.

- (iii) The statement is correct. Where there is no requirement in the contract for independent inspection and the inspection is carried out by foreign supplier on his own and is not required for the purpose of fulfilling the condition of the contract, then such charges incurred on inspection are not includible in assessable value [Bombay Dyeing & Mfg. v. CC 1997 (90) ELT 276 (SC)].
 - (iv) The statement is not correct. Exemption from basic customs duty would not mean exemption from additional duty. When goods are exempted from basic customs duty in terms of section 12 of the Customs Act, 1962 it would not mean that they are exempted from additional duty of customs also, as basic customs duty is leviable by virtue of section 12 of the Customs Act, 1962 while additional customs duty is leviable under section 3 of the Customs Tariff Act, 1975 [Kaur Sarin Traders v. Union of India 2006 (199) ELT 224 (Pat.)].
- (d) (i) (a) Section 125 of the Customs Act empowers a customs officer adjudging the confiscation to give an option to the owner of the goods or where such owner is not known, the person from whose custody such goods have been seized to pay fine in lieu of confiscation. The provisions in this regard are as follows:
- (i) In case of prohibited goods, the proper officer may give an option to pay fine in lieu of confiscation.
 - (ii) In case of other goods, the proper officer shall give an option of payment of fine, in lieu of confiscation.
- The amount of such fine cannot exceed the market price of the goods confiscated, less import duty paid (in the case of imported goods) thereon. Also, the assessee shall be liable to pay any duty and charges payable in respect of such goods.
- (b) In the case of Purfina Chemicals Pvt. Ltd. v. CEGAT Madras 2004 (167) ELT 145 (Mad.) the High Court has observed that the provisions of section 125 give the importer an option to either allow the goods to be confiscated or pay redemption fine in lieu of confiscation. Hence, the redemption fine becomes liable only in lieu of confiscation.
- The High Court has held that where the importer has abandoned the goods, the scope for confiscation comes to an end. Hence, the redemption fine, if already paid becomes liable to be refunded.
- (ii) Section 89 of the Customs Act, 1962 covers the case of indigenous goods, which are supplied to a vessel as ship stores. Goods produced or manufactured in India and required as stores on a foreign going vessel or aircraft may be exported free of duty in such quantities as the proper officer may determine having regard to the size of the vessel or the aircraft, the number of passengers and the crew and the length of voyage or journey on which the vessel or aircraft is about to depart. In other words, the duty free supply of ship stores should be reasonable and not in commercial quantities.

Question 7

- (a) M/s. HIL imports copper concentrate from different suppliers. At the time of import, the seller issues a provisional invoice and the goods are provisionally assessed under section 18 of the Customs Act, 1962 based on the invoice. When the final invoice is raised, based on the price prevalent in the London Metal Exchange on a predetermined date based on the covenant in the contract between the buyer and seller, the assessments are finalized on such invoices. M/s HIL had filed two refund claims arising out of the finalization of the bills of entry by the authorities on 01.03.2006 and on 15.03.2006. With effect from 13.07.2006 (Presidential assent on 13.07.2006) section 18 of the Customs Act, 1962 was amended with the insertion of certain provisions in terms of which it became necessary for the assessee to prove that they had not passed on the amount to their customers. Based on this amendment, the department has rejected the refund claims. Discuss in the light of decided case law, if any, whether the action of the department is correct in law? (5 Marks)
- (b) M/s. RIL Ltd. claimed duty drawback in respect of its export products. Over 97% of the inputs by weight of the product were procured indigenously and were not excisable. All Industry Rates under the Customs and Central Excise Duties Drawback Rules, 1995 were fixed taking into account the incidence of customs duty on imported inputs. Explain briefly with reference to Rule 3(1)(ii) of the said rules whether the claim of M/s. RIL will merit consideration by the authorities. (4 Marks)
- (c) In the context of section 65 of the Customs Act, 1962 dealing with waste or refuse arising during the manufacturing operations or other processes done in the warehouse:
- (i) Examine the validity of the following statement with brief reasons:
 "If finished products are cleared for home consumption on payment of appropriate import duty of customs, then appropriate duty of customs should be levied on the imported goods content in the waste or refuse." (3 Marks)
 - (ii) Explain briefly the "relevant date" for determination of rate of duty leviable on the imported material content in the waste or refuse. (3 Marks)

Answer

- (a) The Supreme Court in *M/s Oriental Exports v. Commissioner of Customs New Delhi* (2006) 200 ELT A/138 (SC) has held that bar of unjust enrichment does not apply in case of refund arising out of finalization of provisional assessment. However, with effect from 13.07.2006, the Taxation Laws Amendment Act has amended section 18 (dealing with provisional assessment) so as to incorporate the principle of unjust enrichment in case of refund arising out of finalization of provisional assessment.

In the instant case, the finalization of the bills of entry has taken place on 01.03.2006 and on 15.03.2006. However, the amendment, by which the provisions of unjust enrichment are incorporated in section 18, has come into effect from 13.07.2006 (Presidential assent on 13.7.2006). Thus, bills of entries have been finalized before the said amendment has become effective. The issue under consideration is whether the said provision will have

retrospective operation so as to enforce this amendment even in respect of bills of entry assessed prior to 13.07.2006. Prior to 13.07.2006, in order to claim refund arising out of finalization of provisional assessment, it was not necessary to prove that incidence of duty has not been passed on to the customers. The said requirement has been inserted in section 18 with effect from 13.07.2006. Thus, the assessments finalized by the authorities prior to 13.07.2006 would be governed by the provisions of section 18 as it stood during the relevant period. However, the assessments finalized by the authorities after 13.07.2006 and refund claim arising out of the same would be governed by the provisions as are incorporated on 13.07.2006.

Therefore in the instant case, the assessee M/s HIL will not be required to adduce proof that in respect of the bills of entry finalized on 01.03.2006 and 15.03.2006 they have not passed on the incidence of such duty to their customers.

- (b) Clause (ii) of second proviso to rule 3 of the Customs and Central Excise Duties Drawback Rules, 1995 inter alia provides that no drawback shall be allowed if the exported goods have been produced or manufactured using imported materials or excisable materials on which duties have not been paid.

In the given case, there was no duty incidence on 97% of the inputs of the export product except the duty incidence on remaining 3% of the inputs, which was insignificant. All Industry Rates fixed for particular export products are applicable to all exporters who export the same. However, in a case where there is clear evidence, as in the present one, that the inputs of such export products have not suffered any duty, no drawback can be claimed. Same view was expressed by the Tribunal in the case of Rubfila International Ltd. v. CCus. Cochin 2005 (190) ELT 485 (Tri.-Bang.).

Note: Circular No. 19/2005 Cus. dated 21.03.2005 clarifies that All Industry Rates of Duty Drawback shall be allowed on export goods manufactured partly of non-duty paid inputs. However, in the given case the said Circular shall not apply as almost whole of the inputs have not suffered duty at all.

- (c) (i) Section 65(2)(b) of the Customs Act, 1962 deals with the question whether import duty should be levied on imported goods content in the waste and scrap when finished products are cleared for home consumption. The said section lays down that if the finished products are cleared for home consumption on payment of appropriate duty of customs, then appropriate duty of customs should be levied on the imported goods content in the waste or refuse.
- (ii) The relevant date for determination of rate of duty leviable on the imported material content in the waste or refuse shall be decided as per the provisions of section 15(1) of the Customs Act, 1962. In the given case, the goods are not:-
- (a) cleared for home consumption on a bill of entry filed under section 46; or
 - (b) cleared from the warehouse, where the date of filing bill of entry for home consumption is relevant. Hence, in this case the third alternative namely the "date of payment of duty" under section 15(1)(c) shall apply.

Thus, in collecting the import duty on the imported material content in the waste or refuse, the rate of duty prevalent on the date of payment of duty shall apply.

Question 8

- (a) Briefly explain the salient features of the Customs Act, 1962 relating to Special Economic Zones. (5 Marks)
- (b) Explain briefly the provisions of section 28(1A) of the Customs Act, 1962 in respect of a person who voluntarily deposits full duty demanded along with interest and applicable penalty. (5 Marks)
- (c) Write a brief note on the provisions of section 28BA of the Customs Act, 1962 regarding property that may be attached provisionally to protect the interest of revenue in certain cases. (5 Marks)

Answer

- (a) The main features of Special Economic Zones (SEZ) are as follows:
 - (i) SEZ may be set up in the public, private or joint sector or by the State Government as notified by the Ministry of Commerce and Industry. The provisions of Chapter XA of the Customs Act, 1962 relating to SEZ are applicable to goods admitted to a SEZ. The Central Government may make rules regarding the requirements relating to goods or class of goods admissible to SEZ.
 - (ii) Any goods imported directly from outside India or procured from within India shall be authorized for admission to the SEZ. Goods admitted to SEZ are exempt from duties of customs subject to certain conditions.
 - (iii) Any goods admitted to SEZ from DTA shall be chargeable to export duties at such rates as are leviable on such goods when exported, subject to any rules made in this behalf. Any goods removed from the SEZ to DTA shall be chargeable to the duties of customs including antidumping, countervailing and safeguard duties as leviable on such goods when imported.
 - (iv) SEZ could be set up for manufacturing goods, rendering of services, production, processing, assembling, trading, repair, re-making, re-conditioning and re-engineering, making of gold, silver and other articles of precious metals and jewellery.
 - (v) It shall be under the administrative control of the Development Commissioner. All activities in the SEZ, unless otherwise specified, shall be carried out through self certification procedure.
 - (vi) Goods going into SEZ from DTA shall be treated as deemed exports. At the same time, goods coming from SEZ to DTA shall be treated as import of goods.

Note: The Finance Act, 2007 has omitted Chapter XA of the Customs Act, 1962 which contains the provisions relating to Special Economic Zones in view of the operationalisation of the Special Economic Zones, Act 2005.

- (b) With effect from 13.07.2006, the Taxation Laws Amendment Act, 2006 has inserted sub-section (1A) in section 28.

Section 28(1) prescribes the condition and time limit within which a show cause notice has to be served for recovery of customs duties. The new sub-section (1A) of section 28 provides an option to the importer or the exporter or the agent or employee of the importer or exporter to whom a notice has been served by the proper officer for short/non levy or non charging or short payment of interest or erroneous refund of duty and interest by reason of fraud, collusion or any willful mis-statement or suppression of facts.

Such a person may pay the duty in full or in part as may be accepted by him including the interest payable thereon under section 28AB and penalty equal to 25% of the duty specified within 30 days of the receipt of the notice.

Where duty is paid in full together with the interest and penalty under sub-section (1A), the proceedings in respect of such persons to whom notices have been issued shall be deemed to have been concluded in respect of the matters stated therein. Where the duty has been paid in part along with interest and penalty, the proper officer shall determine the amount of duty or interest which will not exceed the amount partly due from such person.

- (c) With effect from 13.07.2006, the Taxation Laws (Amendment) Act, 2006 has inserted a new section 28BA in the Customs Act, 1962. Section 28BA provides that during the pendency of any proceeding under section 28 or section 28B, the proper officer may provisionally attach any property belonging to the person on whom notice has been served under section 28(1) or section 28B(2), in accordance with section 142 of the Customs Act and the Rules made thereunder. This action requires prior approval of the Commissioner of Customs and must be necessary for protecting the interest of Revenue.

Such an attachment could be effected for a period of 6 months which shall commence from the date of the order of the Commissioner permitting such provisional attachment. This period may be extended by the Chief Commissioner of Customs by such further period or periods as may be determined by him. The reasons for such extension should be recorded in writing and the total period should not exceed 2 years.

If an application for the settlement of the case is made under section 127B, the period commencing from the date on which such an application is made and ending with the date on which order under section 127C(1) is made shall be excluded from the period of 2 years mentioned above.

PART C

Question 9

- (a) Service Tax (Determination of Value) Rules, 2006 (Valuation Rules) and Taxation of Services (Provided from Outside India and Received in India) Rules, 2006 (Import Rules) came into force from 19.4.2006.

Answer the following with reference to the said Rules:

- (i) Expenditure or costs incurred by the service provider as a “Pure agent” of the recipient of service shall be excluded from the value of the taxable service. Who is a “pure agent” under the Valuation rules?
 - (ii) What is the value of taxable service in the case of service provided from outside India under the Valuation Rules?
 - (iii) What are the three categories of taxable services specified in Rule 3 of the Import Rules? (3 x 2 = 6 Marks)
- (b) Answer the following with reference to the Finance Act, 1994 and the rules made thereunder relating to service tax:
- (i) Intimation regarding change in details furnished by an assessee in Form ST-1.
 - (ii) Cancellation of registration certificate.
 - (iii) Adjustment of excess amount paid towards service tax liability for the subsequent period. (3 x 1 = 3 Marks)
- (c) Answer any three of the following with reference to the Finance Act, 1994 as amended relating to applicability of service tax:
- (i) Manpower recruitment agency services in respect of staff not contractually employed by the recipient of service but who come under his direction.
 - (ii) Business support services in the context of “outsourced services”.
 - (iii) Construction of roads, airports, railways, bridges, tunnels in the context of “site preparation and clearance, excavation, earth moving and demolition services”.
 - (iv) Clearing and forwarding agent’s services. (3 x 2 = 6 Marks)

Answer

- (a) (i) Explanation 1 to rule 5 of the Valuation Rules provides that “pure agent” means a person who—
- (a) enters into a contractual agreement with the recipient of service to act as his pure agent to incur expenditure or costs in the course of providing taxable service;
 - (b) neither intends to hold nor holds any title to the goods or services so procured or provided as pure agent of the recipient of service;
 - (c) does not use such goods or services so procured; and
 - (d) receives only the actual amount incurred to procure such goods or services.
- (ii) Rule 7 of the Valuation Rules provides that the value of taxable service received under section 66A (i.e., the services which are provided from outside India and received in India) of the Finance Act, 1994 shall be such amount as is equal to the

actual consideration charged for the services provided or to be provided. Rule 7(2) provides that the value of the taxable services partly performed in India and specified in Rule 3(ii) of the Import Rules shall be the total consideration paid by the recipient for such services including the value of service partly performed outside India.

(iii) The three categories of taxable services are:

- ◆ When the immovable property in respect of which the service is provided or to be provided is located in India [Rule 3(i) of Import Rules]
- ◆ When the service is performed in India [Rule 3(ii) of Import Rules]
- ◆ When the service is received by a recipient located in India for use in relation to business or commerce [Rule 3(iii) of Import Rules].

(b) (i) As per rule 4(5A) of the Service Tax Rules, 1994, change in any information or details furnished by an assessee in Form ST-1 at the time of obtaining registration or any additional information or detail intended to be furnished should be intimated in writing by the assessee to the jurisdictional Assistant/ Deputy Commissioner of Central Excise. Such intimation should be made within a period of 30 days of such change.

Further, the assessee would be required to submit a self-certified copy of the registration certificate while intimating any such change and the amended registration certificate shall be issued after canceling the original registration certificate issued earlier.

(ii) As per rule 4(7) of the Service Tax Rules, 1994, every assessee who is registered and ceases to provide taxable service shall surrender his registration certificate to the Superintendent of Central Excise immediately. Sub-rule (8) of rule 4 provides that on receipt of such certificate the Superintendent of Central Excise shall ensure that the assessee has paid all moneys due to the Central Government under the provisions of Act/Rules/Notifications and thereupon cancel the registration certificate.

(iii) Rule 6(3) of the Service Tax Rules, 1994 allows an assessee to adjust the excess service tax paid by him in respect of the services not wholly or partially rendered by him for any reason against the service tax liability for the subsequent period if the value of the services and service tax thereon is refunded to the person from whom it was received.

Further, rule 6(4A) of the Service Tax Rules, 1994 provides that where an assessee has paid to the credit of Central Government any amount in excess of the amount required to be paid towards service tax liability for a month or quarter, as the case may be, the assessee may adjust such excess amount paid by him against his service tax liability for the succeeding month or quarter, as the case may be. However, such adjustment of excess amount paid shall be subject to certain conditions specified in sub-rule (4B).

- (c) (i) As per section 65(105)(k) of the Finance Act, 1994, the scope of taxable service in relation to recruitment or supply of manpower includes any service provided or to be provided to a client by a manpower recruitment or supply agency in relation to the recruitment or supply of manpower, temporarily or otherwise in any manner.

In the instant case, the manpower recruitment agency is supplying manpower on a temporary basis as the staff is not contractually employed by the recipient. Since, the scope of taxable service includes temporary supply of manpower, the service in the instant case shall be liable to service tax. Further, the CBEC vide MF (DR) Letter F.No. B1/6/2005 TRU dated 27.07.2005 has also clarified that such service would be covered within the purview of service tax.

- (ii) Business entities outsource a number of services for use in business or commerce. These services include transaction processing, routine administration or accountancy, customer relationship management and tele-marketing. There are also business entities which provide infrastructural support such as providing instant offices along with secretarial assistance known as “Business Centre Services”. All such outsourced services are liable to service tax under business support services. Definition of support services of business or commerce gives indicative list of outsourced services [MF (DR) Letter DOF No. 334/4/2006 TRU dated 28.02.2006].
- (iii) Site formation and clearance, excavation and earthmoving and demolition and such other activities provided to any person by any other person in the course of construction of inter alia roads, airports, railways, bridges, tunnels are exempt from the whole of the service tax leviable thereon vide Notification No. 17/2005 ST dated 07.06.2005.
- (iv) As per section 65(25) of the Finance Act, 1994, clearing and forwarding agent means any person who is engaged in providing any service either directly or indirectly, connected with clearing and forwarding operations in any manner to any other person and includes a consignment agent.

The functions of a clearing and forwarding agent include receiving of goods from the factories of the principal, warehousing the goods, arranging the dispatch of the goods, maintenance of records etc. and preparation of invoices.

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 up to the mark. It is important for students to understand the various concepts relating to both traditional and modern cost management. A proper knowledge of such concepts will help students approach the examination confidently. Students are advised to read extensively various reference books prescribed by the Board of Studies and try understanding the reasons behind the introduction of modern concepts in favour of certain established traditional procedures.

Specific Comments

Question 1. (a) This was a practical part requiring candidates to draw an activity network and identify the critical path. Most of the candidates attempted this question part on the right lines; however, a few were unable to compute the total and free float correctly.

(b) This was a practical part requiring students to have a clear knowledge of concepts regarding the application of marginal costing concepts for decision making purposes. Most of the students attempted this question part with correct answers.

(c) This practical question part required students to have conceptual understanding of relevant costs. Examiners have noticed a lack of knowledge of basic concepts underlying relevancy because of which a majority of the candidates got the answers wrong.

Question 2. (a) This practical question part required candidates to understand a brief scenario which provided them with two alternatives from which a decision had to be made regarding raw material purchases. Most of the students were unable to correctly comprehend and understand the scenario and hence arrived at the wrong answers.

(b) This theory part required candidates to explain the distinctive features of learning curve in a manufacturing environment. Most of the candidates provided incomplete and vague answers.

Question 3. This was a practical question part requiring candidates to have a sound understanding of standard and marginal costing. Most of the answers did not contain the reconciliation statement and the %age increase in selling price. Many students computed incorrectly the standards for 2006 and hence got the variances wrong.

Question 4. (a) This was a practical question part requiring candidates to determine the optimum assignment for maximising sales. Most of the students attempted this question part on the desired lines.

(b) This was a theory part requiring students to have a clear understanding of balanced scorecard. Examiners have reported a lack of understanding of this important concept which resulted in incorrect and incomplete answers.

Question 5. (a) This was a theory question part requiring candidates to explain the concept of cost management with reference to executional and structural cost drivers. Examiners have reported a lack of clear understanding of this important concept because of which most of the answers were attempted poorly.

(b) This theory question part required candidates to write about the main features of ERP. Many of the candidates gave irrelevant answers with a few restricting the answer to the definition of ERP.

(c) This practical question part required students to have a sound understanding of differential costs and its application in decision making. Very few students provided the right answer to this question part. Most of the candidates exhibited poor knowledge of incremental, relevant and differential concepts thereby arriving at wrong answers.

Question 6. (a) This theory question part required students to explain the fundamental differences between traditional and ABC concepts. Most of the students gave irrelevant answers reflecting a lack of knowledge of concepts.

(b) This theory question part required examinees to write about Target Costing and its relationship with marketing research. The majority of candidates gave satisfactory answers; however, a few misunderstood Target Costing as a simple technique/tool for cost determination.

PAPER – 6: MANAGEMENT INFORMATION AND CONTROL SYSTEMS

General Comments

Candidates failed to perform as per the expectation due to lack of adequate preparation, understanding of the questions and proper presentation of the answers. The candidates answered the questions on the basis of their general knowledge. They are advised to go through the study material thoroughly and take examination more seriously and with sincerity in order to perform well. It is also recommended that candidates should avoid unnecessary details while giving answers to the question.

Specific Comments:

Question 1. (a) Most of the candidates failed to explain the responsibility that the IS Auditor is having for establishing control objectives to reduce the risk in Information Security Audit. Candidates wrote answers without understanding the basic concept of Information Security environment.

(b) Most of the candidates did not cover all the points in respect to the Section 30 of Information Technology Act, though the performance was below average.

(c) More than average number of candidates could not answer properly. Hence, the performance was average.

(d) Less than average number of the candidates answered wrong. The candidates need to understand the relevance of the system analysis and design in business environment.

Question 2. (a) Answered by most of the candidates with average performance.

(b) The question asked was straight forward. Hence, well answered by almost all the candidates.

Question 3. (a) Answered by few candidates with poor performance. Various aspects of test work bench under CASE work benches were not explained properly, although the question asked was straight forward.

(b) The question was asked based on the organisations' inventory control system in general but only few candidates attempted, rest skipped the question as they were required to give practical diagram.

Question 4. (a) Average performance by majority of the candidates. Many candidates mixed up the activities for successful conversion with conversion strategies.

(b) Satisfactory performance by majority of the examinees.

(c) Most of the candidates answered in general and not technical terms. Also they did not cover the salient features of the question. Hence, the performance was not satisfactory.

Question 5. (a) Most of the candidates answered wrongly. They were confused with CASE tools and system development tools, covered irrelevant points in the answer. Hence, the performance was not satisfactory.

(b) Only some of the candidates wrote the answer correctly and others were not able to understand the basic concept of DBMS, covering security (backup and recovery) features. Hence, the performance was poor.

(c) Most of the candidates were not able to understand as well as explain the concept of frauds in computer system. Instead of giving the categories of computer frauds, definitions of computer frauds were given. Hence, performance was not satisfactory.

Question 6. (a) Satisfactory performance by the average number of the candidates. Candidates were required to understand the difference between the features, characteristics and the benefits of ERP.

(b) Most of the candidates wrote correct answer. The performance was good.

(c) Vague answers were given by the candidates. Instead of giving guiding principal in EIS, only description of EIS was given. Hence, performance was not at all satisfactory.

Question 7. (a) Satisfactory performance by the majority of the candidates.

(b) Mostly all candidates wrote well and secured good marks.

(c) Many candidates were confused with business process integration, that was wrong. Performance was below average.

(d) Answered by most of the candidates with average performance.

PAPER – 7 : DIRECT TAXES

General Comments

Most candidates do not possess the required expert knowledge in income-tax. The substance of legal provisions was not present in their answers. Their answers were vague and based on surmises and conjectures. Lengthy answers dealing with irrelevant points were common. Many candidates have not given proper notes in support of their answers. The presentation of answers was also very poor in many cases. Other deficiencies were very poor handwriting, poor English, lack of expression and spelling and grammatical mistakes.

Specific Comments

Question 1.(i) For the purpose of working out the excess depreciation debited to profit & loss account, many candidates have wrongly taken the rate of depreciation on plant and machinery as 20% instead of 15%. Further, some candidates have wrongly taken the rate of building as 5% instead of 10% for the purpose of computing the excess depreciation charged.

(ii) Some of the candidates were not aware that the expenses on promoting family planning amongst employees is allowable under section 36(1)(ix) only to company assesses and not to firms.

(iii) Most of the candidates were not aware of the decision of Supreme Court holding that compensation paid for the breach of contract for supply of capital asset is in the nature of capital expenditure.

(iv) Only a very few candidates were aware of the decision of the Apex Court in the case of Dr. T.A. Quereshi v. CIT (2006) 287 ITR 0547 holding that Explanation to section 37(1) is not relevant in the case of business loss.

Question 2 . (a) Though income chargeable to tax has been arrived at correctly, the reasons for the additions made have not been explained correctly.

(b) Some of the candidates have wrongly treated free motor cycle as a fringe benefit chargeable to tax in the hands of the employer. A few candidates have wrongly treated reimbursement of medical expenses up to Rs.15,000 as salary and the balance Rs.2,500 as a fringe benefit.

Question 3.(a) Most candidates were not aware that depreciation is not admissible under section 32 on imported car acquired between 1.3.75 and 31.3.01.

(b) Some of the candidates have wrongly answered that payment of licence fee has to be treated as capital expenditure and depreciation is allowable on the same.

(c) A few candidates were not aware of the clarification regarding filing of return of income by the coffee growers given vide circular No.10/2006 dated 16.10.2006. Some candidates have stated that "Nil" return has to be filed, though the assessee does not have taxable income.

Question 4.(a) Many candidates were not aware that execution of sale deed is not compulsory for the purpose of charge of capital gains. Some candidates have wrongly taken the fair market value as on 1.4.81, even though the same is lower than the cost of acquisition.

(b) Some of the candidates were not aware of the provisions of section 172(3) and were therefore, not able to answer the question correctly.

(c) A few candidates have simply stated that the Assessing Officer can issue show cause notice to the company to rectify the computation of income without giving proper reasons for the same.

Question 5. (a)(a) Some candidates have wrongly stated that the papers relating to Sri Krishna Ltd. should be handed over to Sri Krishna Ltd.

(a)(d) Some candidates have wrongly stated that the time limit for completion of assessments is 4 years.

(b) Very few candidates were aware of the provisions of section 91 providing for deduction from the Indian income-tax payable by a person resident in India, of tax paid in any country with which no agreement under section 90 exists.

Question 6. (a) Many candidates were not aware of the rebate available under section 86 read with section 110.

(b) Only a very few candidates could state the correct quantum of penalty leviable in each of the cases.

Question 7.(ii) Most candidates were not aware of the provisions of section 133(6) and were, therefore, not able to answer the question correctly.

(iii) Very few candidates were aware that for section 64(1)(ii) to get attracted, it is necessary that the spouse should be a partner in a partnership firm in his individual capacity.

Question 8. (a) A few candidates have wrongly included the amount of Rs.1 lakh in the net wealth instead of Rs.5 lakh, being the market value of jewellery on valuation date. Some candidates have wrongly included the value of house located in Noida in the wealth of Mr. Rajpal, though it was sold by him on 20.3.07.

(b) Some of the candidates could not correctly explain the meaning of Urban land as per the provisions of section 2(ea)(v) of the Wealth-tax Act.

PAPER – 8 : INDIRECT TAXES

General comments

The candidates showed marked tendency to write general answers instead of referring to actual provisions in a concise and to the point manner. The answers were vague, lengthy and not up to the point. Candidates lacked in-depth study of the subject. Further, the presentation of answers was not up to the mark. Candidates are advised to carefully study the latest case laws and the latest amendments made in the Acts (relevant for the particular exams).

Specific comments

Question 1.(a) (iii) Provisions in respect of labelling and branding activities were not clear to many candidates.

(c)(ii) This question was based on a recent amendment relating to the concession available to large tax paying units. Majority of the answers were not satisfactory thereby indicating that the candidates have not been updating their knowledge.

(d) Provisions of rule 5 of the CENVAT Credit Rules, 2004 were not clear to many candidates as the answers were not up to the mark.

Question 2.(b)(iii) As per rule 10 of the CENVAT Credit Rules, 2004 in case of transfer of ownership of the factory by way of sale along with inputs and capital goods, a manufacturer is allowed to transfer the credit lying unutilized provided the transfer takes place with specific provision for transfer of liabilities of such factory and the inputs and capital goods are duly accounted for to the satisfaction of the Deputy or Assistant Commissioner of Central Excise. However, many candidates failed to mention the conditions of the transfer of liabilities and recording of inputs and capital goods to the satisfaction of the Deputy or Assistant Commissioner of Central Excise.

(c) Majority of the candidates correctly concluded in part (i) that since there is no influence on the price, notional interest is not includible. However, in part (ii), they wrongly stated that since it is the only sale transaction, price is influenced and notional interest should be added.

Question 3.(a) Considerable number of candidates had no idea of application of section 11A of the Central Excise Act, 1944 vis-a-vis orders of the Appellate authority. Many of them wrongly concluded that the Assistant Commissioner of Central Excise was empowered to issue a notice under section 11A demanding the amount of refund erroneously given by the Appellate Authority.

(c) The procedure relating to removal of goods by a 100% EOU to DTA prescribed under rule 17 of the Central Excise Rules, 2002 has not been understood by many candidates.

(d) Most of the candidates failed to explain the manner in which records can be maintained electronically.

Question 4.(a) Most of the candidates wrongly concluded that mistake in interpretation of section notes, circular, notification etc. were "mistakes apparent from the record".

(b) Few of the candidates failed to explain the reasons as to why a special audit can be called for and how the same should be conducted.

Question 5.(a) Many candidates wrongly concluded that the process of confiscation and penalty in departmental adjudication and prosecution in criminal proceedings are not independent but inter-linked.

(c) Many candidates failed to explain the correct procedure to be followed by the Authority for Advance Ruling on receipt of an application.

(d) Very few candidates were able to correctly explain the provisions of section 11C of the Central Excise Act, 1944.

Question 6.(b) Many candidates wrongly concluded that the Interpretative Rules would apply and the goods would be classified in accordance with Rule 3.

(d)(i)(b) Few candidates wrongly explained that once the fine is paid, the same can never be refunded.

Question 7.(a) It was not clear to many candidates that, unless specifically provided, an amendment cannot have retrospective operation.

Question 8.(a) Some of the candidates instead of explaining the provisions of Customs Act, 1962 in respect of Special Economic Zones, wrongly explained the provisions of Income Tax Act relating to Special Economic Zones.

(b) & (c) Only a handful of the candidates had clear knowledge of the two newly introduced sections viz. 28(1A) and 28 BA of the Customs Act, 1962.

Question 9.(a) (iii) Instead of explaining the three categories of taxable services specified in rule 3 of the Import Rules, many candidates wrongly explained three different taxable services like courier services, clearing and forwarding agent's services etc.

(c)(i) Most of the candidates wrongly explained that service tax would not be applicable on manpower recruitment agency services' in respect of staff not contractually employed by the recipient of services but who come under its direction.