

SUGGESTED ANSWERS

FINAL COURSE

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BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

PAPER – 1 : ADVANCED ACCOUNTING

Answer all questions.

Working notes should form part of the answer.

Question 1

The Balance Sheet of Munna Ltd. on 31st March, 2005 is as under:

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
<i>Authorised, issued equity share capital</i>		<i>Goodwill</i>	<i>2,00,000</i>
<i>20,000 shares of Rs. 100 each</i>	<i>20,00,000</i>	<i>Plant and machinery</i>	<i>18,00,000</i>
<i>10,000 preference shares (7%) of</i>		<i>Stock</i>	<i>3,00,000</i>
<i>Rs. 100 each</i>	<i>10,00,000</i>	<i>Debtors</i>	<i>7,50,000</i>
<i>Sundry creditors</i>	<i>7,00,000</i>	<i>Preliminary expenses</i>	<i>1,00,000</i>
<i>Bank overdraft</i>	<i>3,00,000</i>	<i>Cash</i>	<i>1,50,000</i>
		<i>Profit and loss account</i>	<i><u>7,00,000</u></i>
	<i><u>40,00,000</u></i>		<i><u>40,00,000</u></i>

Two years' preference dividends are in arrears. The company had bad time during the last two years and hopes for better business in future, earning profit and paying dividend provided the capital base is reduced.

An internal reconstruction scheme as follows was agreed to by all concerned:

- (i) Creditors agreed to forego 50% of the claim.*
- (ii) Preference shareholders withdrew arrear dividend claim. They also agreed to lower their capital claim by 20% by reducing nominal value in consideration of 9% dividend effective after reorganization in case equity shareholders' loss exceed 50% on the application of the scheme.*
- (iii) Bank agreed to convert overdraft into term loan to the extent required for making current ratio equal to 2 : 1.*
- (iv) Revalued figure for plant and machinery was accepted as Rs. 15,00,000.*
- (v) Debtors to the extent of Rs. 4,00,000 were considered good.*
- (vi) Equity shares shall be exchanged for the same number of equity shares at a revised denomination as required after the reorganisation.*

Show:

- (a) Total loss to be borne by the equity and preference shareholders for the reorganization;*
- (b) Share of loss to the individual classes of shareholders;*
- (c) New structure of share capital after reorganization;*
- (d) Working capital of the reorganized Company; and*
- (e) A proforma balance sheet after reorganization.*

(16 marks)

Answer**(a) Loss to be borne by Equity and Preference Shareholders**

	Rs.
Profit and loss account (debit balance)	7,00,000
Preliminary expenses	1,00,000
Goodwill	2,00,000
Plant and machinery (Rs. 18,00,000 – Rs. 15,00,000)	3,00,000
Debtors (Rs. 7,50,000 – Rs. 4,00,000)	<u>3,50,000</u>
Amount to be written off	16,50,000
Less: 50% of sundry creditors	<u>3,50,000</u>
Total loss to be borne by the equity and preference shareholders*	<u>13,00,000</u>

(b) Share of loss to preference shareholders and equity shareholders

Total loss of Rs. 13,00,000 being more than 50% of equity share capital i.e. Rs.10,00,000.

Preference shareholders' share of loss = 20% of Rs. 10,00,000 = Rs. 2,00,000

Equity shareholders' share of loss (Rs. 13,00,000 – Rs. 2,00,000) = Rs. 11,00,000

Total loss Rs. 13,00,000

(c) New structure of share capital after reorganisation

Equity shares:	Rs.
20,000 equity shares of Rs. 45 each, fully paid up (Rs. 20,00,000 – Rs. 11,00,000)	9,00,000
Preference shares:	
10,000, 9% preference shares of Rs. 80 each, fully paid up (Rs. 10,00,000 – Rs. 2,00,000)	<u>8,00,000</u>
	<u>17,00,000</u>

(d) Working capital of the reorganized company

Current Assets:	Rs.	Rs.
Stock		3,00,000
Debtors		4,00,000
Cash		<u>1,50,000</u>
		<u>8,50,000</u>
Less: Current liabilities:		

* Two years' preference dividend (arrears) have been ignored in the computation of loss to be borne by equity and preference shareholders.

Creditors	3,50,000	
Bank overdraft **	<u>75,000</u>	<u>4,25,000</u>
Working capital		<u>4,25,000</u>

(e) Balance Sheet of Munna Ltd. (and reduced)
as on 31st March, 2005

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
<i>Share Capital Authorised (issued and paid up)</i>		<i>Fixed Assets</i>	
20,000 equity shares of Rs. 45 each	9,00,000	Plant and Machinery	15,00,000
10,000, 9% preference shares of Rs. 80 each	8,00,000	<i>Current Assets</i>	
<i>Unsecured loan</i>		Stock	3,00,000
Term loan with Bank	2,25,000	Debtors	4,00,000
<i>Current liabilities</i>		Cash	1,50,000
Bank overdraft	75,000		
Creditors	<u>3,50,000</u>		
	<u>23,50,000</u>		<u>23,50,000</u>

Question 2

Travels & Tours Ltd. has two divisions – 'Inland' and 'International'. The Balance Sheet as at 31st December, 2004 was as under:

	<i>Inland</i> <i>(Rs. crores)</i>	<i>International</i> <i>(Rs. crores)</i>	<i>Total</i> <i>(Rs. crores)</i>
<i>Fixed Assets:</i>			
Cost	600	600	1,200
Depreciation	<u>500</u>	<u>200</u>	<u>700</u>
W.D.V. (written down value)	100	400	500
<i>Net Current Assets:</i>			
Current assets	400	300	700
Less: Current liabilities	<u>200</u>	<u>200</u>	<u>400</u>
	<u>200</u>	<u>100</u>	<u>300</u>
<i>Total</i>	<u>300</u>	<u>500</u>	<u>800</u>
<i>Financed by:</i>			
<i>Loan funds:</i>			
	—	100	100

** Current ratio shall be 2 : 1, i.e. total current liabilities shall be 50% of Rs. 8,50,000 (i.e. Rs. 3,00,000 + 4,00,000 + 1,50,000) = Rs. 4,25,000. Therefore, Bank overdraft = Rs. 75,000 (Rs. 4,25,000 less creditors Rs. 3,50,000).

(Secured by a charge on fixed assets)

Own Funds:

Equity capital (fully paid up Rs. 10 shares)

50

Reserves and surplus

650

?

?

700

Total

300

500

800

It is decided to form a new company 'IT Ltd.' for international tourism to take over the assets and liabilities of international division.

Accordingly 'IT Ltd.' was formed to takeover at Balance Sheet figures the assets and liabilities of international division. 'IT Ltd.' is to allot 5 crore equity shares of Rs. 10 each in the company to the members of 'Travels & Tours Ltd.' in full settlement of the consideration. The members of 'Travels & Tours Ltd.' are therefore to become members of 'IT Ltd.' as well without having to make any further investment.

- (a) You are asked to pass journal entries in relation to the above in the books of 'Travels & Tours Ltd.' and also in 'IT Ltd.'. Also show the Balance Sheets of both the companies as on 1st January, 2005 showing corresponding figures, before the reconstruction also.
- (b) The directors of both the companies ask you to find out the net asset value of equity shares pre and post-demerger.
- (c) Comment on the impact of demerger on "shareholders wealth". (16 marks)

Answer

(a) Journal of Travels & Tours Ltd.

		(Rs. in crores)	
Particulars		Dr.	Cr.
		Rs.	Rs.
Current liabilities account	Dr.	200	
Loan fund (secured) account	Dr.	100	
Provision for depreciation account	Dr.	200	
Loss on reconstruction account (Balancing figure)	Dr.	400	
To Fixed assets account			600
To Current assets account			300

(Being the assets and liabilities of International division taken out of the books on transfer of the division to IT Ltd.; the consideration being allotment to the members of the company of one equity share of Rs. 10 each of that company at par for every share held in the company vide scheme of reorganisation)*

* Any other alternative set of entries may be given with the same net effect on various accounts.

Journal of IT Ltd.

		(Rs. in crores)	
		Dr.	Cr.
		Rs.	Rs.
Fixed assets account (600 – 200)	Dr.	400	
Current assets account	Dr.	300	
To Current liabilities account			200
To Loan funds (secured) account			100
To Equity share capital account			50
To Capital reserve account			350
(Being the assets and liabilities of International division of Travels & Tours Ltd. taken over by IT Ltd. and allotment of 5 crore equity shares of Rs. 10 each at par as fully paid up to the members of Travels & Tours Ltd.)			

Travels & Tours Ltd.
Balance Sheet as on 1st January, 2005

		(Rs. in crores)	
		After reconstruction	Before reconstruction
I.	SOURCES OF FUNDS		
(1)	Shareholders' Funds		
(a)	Capital	50	50
(b)	Reserves and Surplus (Schedule A)	<u>250</u>	<u>650</u>
		300	700
(2)	Loans Funds		
Secured Loans		<u>—</u>	<u>100</u>
	Total	<u>300</u>	<u>800</u>
II.	APPLICATION OF FUNDS		
(1)	Fixed Assets		
(a)	Gross Block	600	1,200
(b)	Less: Depreciation	<u>500</u>	<u>700</u>
(c)	Net block	100	500
(2)	Investments	—	—
(3)	Current Assets	400	700
Less: Current liabilities		<u>200</u>	<u>400</u>
Net current assets		<u>200</u>	<u>300</u>
	Total	<u>300</u>	<u>800</u>

Schedule to Balance Sheet

		(Rs. in crores)
	After reconstruction	Before reconstruction
A. Reserves and surplus	650	650
Less: Loss on reconstruction	<u>400</u>	<u>—</u>
	<u>250</u>	<u>650</u>

Note to Accounts: Consequent to reconstruction of the company and transfer of international division of Travels & Tours Ltd. to newly incorporated Company IT Ltd., the members of the company have been allotted 5 crore equity shares of Rs. 10 each at par of 'IT Ltd.'

IT Ltd.**Balance Sheet as on January 1, 2005**

		(Rs. in crores)
I. SOURCES OF FUNDS		
(1) Shareholder's Funds		
(a) Capital (Schedule A)	50	
(b) Reserves and Surplus	<u>350</u>	400
(2) Loans Funds		
Secured Loans		<u>100</u>
	Total	<u>500</u>
II. APPLICATION OF FUNDS		
(1) Fixed Assets		400
(2) Investments		—
(3) Current Assets	300	
Less: Current Liabilities	<u>200</u>	
Net current assets		<u>100</u>
	Total	<u>500</u>

Schedule to Balance Sheet

	(Rs. in crores)
A. Share Capital:	
Issued and paid up capital:	
5 crore equity shares of Rs. 10 each fully paid up	50
(All the above equity shares have been issued for consideration other than cash to the members of Travels and Tours Ltd. on takeover of International division.)	

(b) Net Asset Value of an equity share

	Pre-Demerger	Post-Demerger
Travels & Tours Ltd.	Rs. 700 crores 5 crore shares = Rs. 140	Rs. 300 crores 5 crore shares = Rs. 60
IT Ltd.	—	Rs. 400 crores 5 crore shares = Rs. 80

- (c) Demerger into two companies has no impact on 'net asset value' of shareholding. Pre-demerger, it was Rs. 140 per share. After demerger, it is Rs. 60 + Rs. 80 = Rs. 140 per original share.

It is only the yield valuation that is expected to change because of separate focussing on two distinct businesses whereby profitability is likely to improve on account of de-merger.

Question 3

The Balance Sheets of Football Ltd. and its subsidiary Hockey Ltd. as on 31st March, 2005 are as under:

Liabilities	Football Ltd. Rs.	Hockey Ltd. Rs.	Assets	Football Ltd. Rs.	Hockey Ltd. Rs.
Equity shares of Rs. 10 each	48,00,000	20,00,000	Goodwill	4,50,000	3,00,000
10% Preference shares of Rs. 10 each	7,00,000	3,80,000	Plant and machinery	12,00,000	5,00,000
General reserve	5,50,000	4,20,000	Motor vehicles	9,50,000	7,50,000
Profit and loss account	10,00,000	6,00,000	Furniture and fittings	6,50,000	4,00,000
Bank overdraft	1,20,000	70,000	Investments	26,00,000	4,50,000
Sundry creditors	4,30,000	4,80,000	Stock	4,50,000	7,20,000
Bills payable	—	1,60,000	Cash at bank	2,25,000	2,10,000
			Debtors	9,30,000	7,80,000
			Bills receivable	1,45,000	—
	<u>76,00,000</u>	<u>41,10,000</u>		<u>76,00,000</u>	<u>41,10,000</u>

Details of acquisition of shares by Football Ltd. are as under:

Nature of shares	No. of shares acquired	Date of acquisition	Cost of acquisition Rs.
Preference shares	14,250	1.4.2002	3,10,000
Equity shares	80,000	1.4.2003	9,50,000
Equity shares	70,000	1.4.2004	8,00,000

Other information:

- (i) On 1.4.2004 profit and loss account and general reserve of Hockey Ltd. had credit balances of Rs. 3,00,000 and Rs. 2,00,000 respectively.
- (ii) Dividend @ 10% was paid by Hockey Ltd. for the year 2003-2004 out of its profit and loss account balance as on 1.4.2004. Football Ltd. credited its share of dividend to its profit and loss account.
- (iii) Hockey Ltd. allotted bonus shares out of general reserve at the rate of 1 share for every 10 shares held. Accounting thereof has not yet been made.
- (iv) Bills receivable of Football Ltd. were drawn upon Hockey Ltd.
- (v) During the year 2004-2005 Football Ltd. purchased goods from Hockey Ltd. for Rs. 1,00,000 at a sale price of Rs. 1,20,000. 40% of these goods remained unsold at close of the year.
- (vi) On 1.4.2004 motor vehicles of Hockey Ltd. were overvalued by Rs. 1,00,000. Applicable depreciation rate is 20%.
- (vii) Dividends recommended for the year 2004-2005 in the holding and the subsidiary companies are 15% and 10% respectively.

Prepare consolidated Balance Sheet as on 31st March, 2005.

(16 marks)

Answer

Consolidated Balance Sheet of Football Ltd. and its subsidiary Hockey Ltd. as on 31st March, 2005

Liabilities	Amount		Assets	Amount	
	Rs.	Rs.		Rs.	Rs.
Share Capital			Fixed Assets		
Authorised, Issued and paid up capital		—	Goodwill		
4,80,000 equity shares of Rs. 10 each		48,00,000	Football Ltd.	4,50,000	
70,000 10% preference shares of Rs. 10 each		7,00,000	Hockey Ltd.	<u>3,00,000</u>	
Minority Interest (W.N. 3)		9,86,750		7,50,000	
Reserves and Surplus			Add: Goodwill on consolidation (W.N. 2)	<u>1,97,500</u>	9,47,500
General reserve (W.N. 5)		7,15,000	Plant and Machinery		
Profit and loss account (W.N. 4)		5,07,750	Football Ltd.	12,00,000	
Current Liabilities and Provisions			Hockey Ltd.	<u>5,00,000</u>	17,00,000
Bank Overdraft			Motor Vehicles		
Football Ltd.	1,20,000		Football Ltd.	9,50,000	
Hockey Ltd.	<u>70,000</u>	1,90,000	Hockey Ltd.		
			(7,50,000 – 1,00,000 + 20,000)	<u>6,70,000</u>	16,20,000

Sundry Creditors			Furniture & Fittings		
Football Ltd.	4,30,000		Football Ltd.	6,50,000	
Hockey Ltd.	<u>4,80,000</u>	9,10,000	Hockey Ltd.	<u>4,00,000</u>	10,50,000
Bills payable			Investments		
Hockey Ltd.	1,60,000		Football Ltd.		
Less: Mutual debt	<u>1,45,000</u>	15,000	(26,00,000 – 20,60,000)	5,40,000	
Proposed Dividend			Hockey Ltd.	<u>4,50,000</u>	9,90,000
Equity	7,20,000		<i>Current assets, loans</i>		
Preference	<u>70,000</u>	7,90,000	<i>and advances</i>		
			<i>Current assets</i>		
			Stock		
			Football Ltd.	4,50,000	
			Hockey Ltd.	<u>7,20,000</u>	
				11,70,000	
			Less: Unrealised profit	<u>8,000</u>	11,62,000
			Debtors		
			Football Ltd.	9,30,000	
			Hockey Ltd.	<u>7,80,000</u>	17,10,000
			Cash at Bank		
			Football Ltd.	2,25,000	
			Hockey Ltd.	<u>2,10,000</u>	4,35,000
			<i>Loans and advances</i>		
			Bills receivable		
			Football Ltd.	1,45,000	
			Less: Mutual Debt	<u>1,45,000</u>	<u>Nil</u>
		<u>96,14,500</u>			<u>96,14,500</u>

Working Notes:**(1) Analysis of Profits of Hockey Ltd.**

		<i>Capital Profits</i>	<i>Revenue Reserve</i>	<i>Revenue Profit</i>
	Rs.	Rs.	Rs.	Rs.
(a) General Reserve as on 1.4.2004	2,00,000			
Less: Bonus issue (1/10 of Rs. 20,00,000)	<u>2,00,000</u>	—	—	
(b) Addition to General Reserve during 2004-2005 (Rs. 4,20,000 – Rs. 2,00,000)			2,20,000	
(c) Profit and Loss Account balance as on 1.4.2004	3,00,000			
Less: Dividend paid for the year 2003-2004	<u>2,00,000</u>	1,00,000		

(d) Profit for the year 2004-2005 (Rs. 6,00,000 – Rs. 1,00,000)		5,00,000
(e) Adjustment for over valuation of motor vehicles	(1,00,000)	
(f) Adjustment of revenue profit due to overcharged depreciation (20% on Rs. 1,00,000)		20,000
(g) Preference dividend for the year 2004-2005 @ 10%		<u>(38,000)</u>
	<u>—</u>	<u>2,20,000</u>
Football Ltd.'s share (3/4)		1,65,000
Minority Interest (1/4)		<u>55,000</u>
		<u>2,20,000</u>
		<u>4,82,000</u>
(2) Cost of Control	Rs.	Rs.
Cost of investments in Hockey Ltd.		20,60,000
Less: Paid up value of equity shares (including bonus shares)	16,50,000	
[80,000 + 70,000 + (10% of 1,50,000)] × Rs. 10		
Paid-up value of preference shares	1,42,500	
Pre-acquisition dividend*	<u>70,000</u>	<u>18,62,500</u>
Cost of control/Goodwill		<u>1,97,500</u>
(3) Minority Interest		
Equity share capital [Rs. 5,00,000 + Rs. 50,000 (Bonus)]		5,50,000
Preference share capital (Rs. 3,80,000 – Rs. 1,42,500)		2,37,500
Share of revenue reserve		55,000
Share of revenue profit		1,20,500
Proposed preference dividend		<u>23,750</u>
		<u>9,86,750</u>
(4) Profit and Loss Account – Football Ltd.		
Balance		10,00,000
Share in profit of Hockey Ltd.		3,61,500
Share in proposed preference dividend of Hockey Ltd.		<u>14,250</u>
		13,75,750

* The dividend on 70,000 shares only (acquired on 1.4.2004) is a pre-acquisition dividend.

Less: Pre-acquisition dividend credited to profit and loss account	70,000	
Unrealised profit on stock (40% of Rs.20,000)	8,000	
Proposed equity dividend	7,20,000	
Proposed preference dividend	<u>70,000</u>	<u>8,68,000</u>
		<u>5,07,750</u>

(5) **General reserve – Football Ltd.**

Balance	5,50,000	
Add: Share in Hockey Ltd.	<u>1,65,000</u>	
		<u>7,15,000</u>

Note: No information has been given in the question regarding date of bonus issue by Hockey. It is also not mentioned whether the bonus shares are issued from pre-acquisition general reserve or post-acquisition general reserve. The above solution is given on the basis that Hockey Ltd. allotted bonus shares out of pre-acquisition general reserve.

Question 4

- (a) Prepare a segmental report for publication in Diversifiers Ltd. from the following details of the company's three divisions and the head office:

	Rs.('000)
<i>Forging Shop Division</i>	
Sales to Bright Bar Division	4,575
Other Domestic Sales	90
Export Sales	<u>6,135</u>
	<u>10,800</u>
<i>Bright Bar Division</i>	
Sales to Fitting Division	45
Export Sales to Rwanda	<u>300</u>
	<u>345</u>
<i>Fitting Division</i>	
Export Sales to Maldives	<u>270</u>

Particulars	Head Office	Forging Shop Division	Bright Bar Division	Fitting Division
	Rs. ('000)	Rs. ('000)	Rs. ('000)	Rs. ('000)
Pre-tax operating result		240	30	(12)
Head office cost reallocated		72	36	36
Interest costs		6	8	2
Fixed assets	75	300	60	180
Net current assets	72	180	60	135
Long-term liabilities	57	30	15	180

(b) An equipment is leased for 3 years and its useful life is 5 years. Both the cost and the fair value of the equipment are Rs. 3,00,000. The amount will be paid in 3 instalments and at the termination of lease lessor will get back the equipment. The unguaranteed residual value at the end of 3 years is Rs. 40,000. The (internal rate of return) IRR of the investment is 10%. The present value of annuity factor of Re. 1 due at the end of 3rd year at 10% IRR is 2.4868. The present value of Re. 1 due at the end of 3rd year at 10% rate of interest is 0.7513.

(i) State with reason whether the lease constitutes finance lease.

(ii) Calculate unearned finance income.

(c) Intelligent Corporation (I-Corp.) is dealing in seasonal products. The quarterly sales pattern of the product is given below:

Quarter I	II	III	IV
Ending 31st March	30th June	30th September	31st December
-	-	-	-*

For the First quarter ending 31st March, 2005, I-Corp. gives you the following information:

	Rs. crores
Sales	50
Salary and other expenses	30
Advertisement expenses (routine)	02
Administrative and selling expenses	08

While preparing interim financial report for the first quarter 'I-Corp.' wants to defer Rs. 21 crores expenditure to third quarter on the argument that third quarter is having more

* There may be some percentage of sales given herein.

sales, therefore third quarter should be debited by higher expenditure, considering the seasonal nature of business. The expenditures are uniform throughout all quarters.

Calculate the result of first quarter as per AS 25 and comment on the company's view.

- (d) Top & Top Limited has set up its business in a designated backward area which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment. Having fulfilled all the conditions under the scheme, the company on its investment of Rs. 50 crore in capital assets, received Rs. 10 crore from the Government in January, 2005 (accounting period being 2004-2005). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 2005.

Keeping in view the relevant Accounting Standard, discuss whether this action is justified or not. (8 + 4 + 4 + 4 = 20 marks)

Answer

(a)	Diversifiers Ltd. Segmental Report				(Rs. '000)
Particulars	Divisions				Consolidated Total
	Forging shop	Bright Bar	Fitting	Inter Segment Eliminations	
Segment revenue					
Sales:					
Domestic	90	—	—	—	90
Export	<u>6,135</u>	<u>300</u>	<u>270</u>	<u>—</u>	<u>6,705</u>
External Sales	6,225	300	270	—	6,795
Inter-segment sales	<u>4,575</u>	<u>45</u>	<u>—</u>	<u>4,620</u>	<u>—</u>
Total revenue	<u>10,800</u>	<u>345</u>	<u>270</u>	<u>4,620</u>	<u>6,795</u>
Segment result (given)	240	30	(12)		258
Head office expenses					<u>(144)</u>
Operating profit					114
Interest expense					<u>(16)</u>
Profit before tax					<u>98</u>
Information in relation to assets and liabilities:					
Fixed assets	300	60	180	—	540

Net current assets	<u>180</u>	<u>60</u>	<u>135</u>	<u>—</u>	<u>375</u>
Segment assets	<u>480</u>	<u>120</u>	<u>315</u>	<u>—</u>	<u>915</u>
Unallocated corporate assets (75 + 72)	—	—	—	—	<u>147</u>
Total assets					<u>1,062</u>
Segment liabilities	30	15	180	—	225
Unallocated corporate liabilities					<u>57</u>
Total liabilities					<u>282</u>

Sales Revenue by Geographical Market

	Home Sales	Export Sales (by forging shop division)	Export to Rwanda	Export to Maldives	(Rs. '000) Consolidated Total
External sales	90	6,135	300	270	6,795

(b) (i) Present value of residual value = Rs. 40,000 × 0.7513 = Rs. 30,052

Present value of lease payments = Rs. 3,00,000 – Rs. 30,052 = Rs. 2,69,948.

The present value of lease payments being 89.98% $\left(\frac{2,69,948}{3,00,000} \times 100 \right)$ of the fair value, i.e. being a substantial portion thereof, the lease constitutes a finance lease.

(ii) Calculation of unearned finance income

	Rs.
Gross investment in the lease [(Rs.1,08,552* × 3) + Rs. 40,000]	3,65,656
Less: Cost of the equipment	<u>3,00,000</u>
Unearned finance income	<u>65,656</u>

Note: - In the above solution, annual lease payment has been determined on the basis that the present value of lease payments plus residual value is equal to the fair value (cost) of the asset.

* Annual lease payments = $\frac{\text{Rs. } 2,69,948}{2.4868} = \text{Rs. } 1,08,552$ (approx.)

(c)

**Result of the first quarter
ended 31st March, 2005**

		<i>(Rs. in crores)</i>
Turnover		50
Add: Other Income		<u>Nil</u>
Total		50
Less: Change in inventories	Nil	
Salaries and other cost	30	
Administrative and selling expenses (8 + 2)	<u>10</u>	<u>40</u>
Profit		<u>10</u>

As per AS 25 on Interim Financial Reporting, the income and expense should be recognised when they are earned and incurred respectively. As per para 38 of AS 25, the costs should be anticipated or deferred only when

- (i) it is appropriate to anticipate that type of cost at the end of the financial year, and
- (ii) costs are incurred unevenly during the financial year of an enterprise.

Therefore, the argument given by I-Corp relating to deferment of Rs. 21 crores is not tenable as expenditures are uniform through out all quarters.

- (d) As per para 10 of AS 12 'Accounting for Government Grants', where the government grants are of the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

In the given case, the subsidy received is neither in relation to specific fixed asset nor in relation to revenue. Thus it is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs. The correct treatment is to credit the subsidy to capital reserve. Therefore, the accounting treatment followed by the company is not proper.

Question 5

The following Balance Sheet of X Ltd. is given:

X Ltd.

Balance Sheet as on 31st March, 2005

Liabilities	Rs.	Assets	Rs.
5,000 shares of Rs. 100 each fully paid	50,00,000	Goodwill	4,00,000
Bank overdraft	18,60,000	Land and building at cost	32,00,000
Creditors	21,10,000	Plant and machinery at cost	28,00,000
Provision for taxation	5,10,000	Stock	32,00,000
Profit and Loss Appropriation A/c	<u>21,20,000</u>	Debtors considered good	20,00,000
	<u>1,16,00,000</u>		<u>1,16,00,000</u>

In 1986 when the company commenced operation the paid up capital was same. The Loss/Profit for each of the last 5 years was – years 2000-2001 – Loss (Rs. 5,50,000); 2001-2002 Rs. 9,82,000; 2002-2003 Rs. 11,70,000; 2003-2004 Rs. 14,50,000; 2004-2005 Rs. 17,00,000;

Although income-tax has so far been paid @ 40% and the above profits have been arrived at on the basis of such tax rate, it has been decided that with effect from the year 2004-2005 the Income-tax rate of 45% should be taken into consideration. 10% dividend in 2001-2002 and 2002-2003 and 15% dividend in 2003-2004 and 2004-2005 have been paid. Market price of shares of the company on 31st March, 2005 is Rs. 125. With effect from 1st April, 2005 Managing Director's remuneration has been approved by the Government to be Rs. 8,00,000 in place of Rs. 6,00,000. The company has been able to secure a contract for supply of materials at advantageous prices. The advantage has been valued at Rs. 4,00,000 per annum for the next five years.

Ascertain goodwill at 3 year's purchase of super profit (for calculation of future maintainable profit weighted average is to be taken). (16 marks)

Answer

(i)	Future Maintainable Profit		
	Year	Profit (P) Rs.	Product (PW) Rs.
	2001-2002	9,82,000	9,82,000
	2002-2003	11,70,000	23,40,000
	2003-2004	14,50,000	43,50,000
	2004-2005	17,00,000	<u>68,00,000</u>
		<u>10</u>	<u>1,44,72,000</u>

Weighted average annual profit (after tax) = $\frac{\sum PW}{\sum W} = \text{Rs. } \frac{1,44,72,000}{10}$	<u>14,47,200</u>
Weighted average annual profit before tax $\left(\text{Rs. } 14,47,200 \times \frac{100}{60} \right)$	24,12,000
Less: Increase in Managing Director's remuneration	<u>2,00,000</u>
	22,12,000
Add: Saving in cost of materials	<u>4,00,000</u>
	26,12,000
Less: Taxation @ 45%	<u>11,75,400</u>
Future maintainable profit	<u>14,36,600</u>

(ii)

Average Capital Employed

	Rs.	Rs.
Assets:		
Land and Buildings		32,00,000
Plant and Machinery		28,00,000
Stock		32,00,000
Sundry Debtors		<u>20,00,000</u>
		1,12,00,000
Less: Outside liabilities:		
Bank overdraft	18,60,000	
Creditors	21,10,000	
Provision for taxation	<u>5,10,000</u>	<u>44,80,000</u>
Capital employed at the end of the year		67,20,000
Add: Dividend @ 15% paid during the year		<u>7,50,000</u>
		74,70,000
Less: Half of the profit (after tax) for the year i.e.		
Rs. 17,00,000 $\times \frac{1}{2}$		<u>8,50,000</u>
Average capital employed		<u>66,20,000</u>

(iii)

Normal Profit

$$\text{Average dividend for the last 4 years} \left(\frac{10 + 10 + 15 + 15}{4} \right) = 12.5\%$$

Market price of share Rs. 125

$$\text{Normal rate of return} = \frac{12.5}{125} \times 100 = 10\%$$

Normal profit (10% of Rs. 66,20,000) = Rs. 6,62,000

(iv) Valuation of goodwill

	Rs.
Future maintainable profit	14,36,600
Less: Normal profit	<u>6,62,000</u>
Super profit	<u>7,74,600</u>
Goodwill at 3 years' purchase of super profits (Rs. 7,74,600 × 3)	<u>23,23,800</u>

Question 6

- (a) Give an account of the growing scope of human capital reporting.
- (b) Briefly discuss methods of valuation of intangible assets.
- (c) In order to enhance the level of disclosure by the listed companies, SEBI has amended clause 32 of the listing agreement. After amendment what disclosures are required?
- (d) After the HAVOC caused by TSUNAMI, a group of companies undertakes during the period from January, 2005 to March, 2005 various commercial activities, having granted considerable subsidy, along the related coast line. The management intends to highlight the results of such activities while publishing financial statements for the year 2004-2005. What is the scope? (4 × 4 = 16 marks)

Answer

- (a) Of late there is a growing trend of shift from the traditional focus on financial reporting of quantifiable resources (which can be measured in monetary terms) to a more comprehensive approach of reporting under which human resources are also considered as measurable assets. Having followed the methods of accounting of fixed assets, one can take into account the employee-related costs like cost of recruitment, training and orientation of employees, for the purpose of capitalization and then the appropriate portion thereof can be amortised each year over the estimated years of effect of such costs.

The relevance of human resource information lies in the fact that it concerns organizational changes in the firm's human resources. The ratio of human to non-human capital indicates the degree of labour intensity of an organization. Comparison of the specific values of human capital based on the organisation's scales of wages and salaries with the general industry standards, can be a good source of information to the management. There is no standard human capital reporting format as employment reporting is relatively a new form of reporting. Usually, the report inter alia contains data pertaining to employee numbers, employment and training policies, collective bargaining arrangements, industrial disputes, pension and pay arrangement and disabled employee numbers.

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

- (b) Valuation of intangible assets is a complex exercise, as the non-physical form of intangible assets pose the difficulty of identifying the future economic benefits that the enterprise can expect to derive from them. There are three main approaches for valuing intangible assets:
- (1) *Cost approach*: In cost approach, historical expenditure incurred in developing the asset is aggregated. Cost is measured by purchase price, where the asset has been acquired recently.
 - (2) *Market value approach*: In comparable market value approach, intangible assets are valued with reference to transactions involving similar assets that have cropped up recently in similar markets. This approach is possible when there is an active market in which arm's length transactions have occurred recently involving comparable intangible assets and adequate information of terms of transactions is available.
 - (3) *Economic value approach*: This approach is based on the cash flows or earnings attributable to those assets and the capitalization thereof, at an appropriate discount rate or multiple. Some of the key parameters used in this approach are projected revenues, projected earnings, discount rate, rate of return etc. The information required can be derived from either internal sources, external sources or both. Under this approach, the valuer has to identify cash flows or earnings directly associated with the intangible assets like the cash flows arising from the exploitation of a patent or copyright, licensing of an intangible asset etc. This approach can be put to practice only if cash flows arising from the intangible assets are identifiable from the management accounts and budgets, forecasts or plans of the company. In most situations of valuation of intangible assets, the economic based approach is used, because of the uniqueness of intangible assets and the lack of comparable market data for the use of market value approach.
- (c) After SEBI's amendment of Clause 32 of Listing Agreement, the following disclosures are required:
- (a) In case the company has changed its name consequent upon the going in for a new line of business including software business during any period after 1st January, 1998, the company will disclose the turnover and income etc. from such new activities in the annual reports for a period of 3 years from the date of change of name of the company.
 - (b) The company will give a cash flow statement prepared as per AS 3 presented under indirect method and will attach this cash flow statement to the balance sheet and the profit and loss account of the company.

- (c) The company shall mandatorily publish consolidated financial statements in the annual report in addition to the individual financial statement. The consolidated financial statement shall be audited by the statutory auditors and submitted to the stock exchange.
- (d) The company shall make disclosures in compliance with the accounting standard on "Related Party Disclosures" in the annual reports.
- (d) Corporate social reporting is information communicate with respect to discharge of social responsibilities of corporate entity. Through 'Corporate Social Report' the corporate enterprises disclose the manner in which they are discharging their social responsibilities. More specifically, it is addressed to the public or society at large, although it can be squarely used by other user groups also.

In the given case, the group of companies has positively contributed to the social cause and the commercial activities undertaken by them come under the purview of corporate social reporting. Normally, such information is not required to be given mandatorily in the financial report due to the lack of any generally accepted standard of social responsibility for business entities. However, everyone agrees that all business entities should be socially responsible but how the individual entity weighs its priorities of social responsibility depends on the personal choice or preference of the group of persons in the management of an enterprise.

The group of companies (referred in the question) can voluntarily highlight the results of various commercial activities, undertaken by them along the related coast line through a 'note to accounts' while publishing financial statements for the year ended 2004-2005. Infact bringing out the results of such Tsunami relief activities in the Tsunami affected areas may imbibe a sense of social responsibility among other entities through 'Corporate Social Report'.

Suggested Answers: May 2005

Final Course : Group 1

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

*Question No. 1 is compulsory. Answer any **four** questions from the rest. Figures in the margin indicate marks allotted to each questions.*

Working notes should form part of the answer.

Question 1

ABC Ltd. is considering a proposal to acquire a machine costing Rs. 1,10,000 payable Rs. 10,000 down and balance payable in 10 annual equal instalments at the end of each year inclusive of interest chargeable at 15%. Another option before it is to acquire the asset on a lease rental of Rs. 15,000 per annum payable at the end of each year for 10 years. The following information is also available.

- (i) Terminal Scrap value of Rs. 20,000 is realizable, if the asset is purchased.*
- (ii) The company provides 10% depreciation on straight line method on the original cost.*
- (iii) Income tax rate is 50%.*

You are required to compute the analyse cash flows and to advise as to which option is better. (20 marks)

Answer

Option I : To buy the asset:

In this option the firm has to pay Rs. 10,000 down and the balance Rs. 1,00,000 together with interest @ 15% is payable in 10 annual equal instalments. The instalment amount may be calculated by dividing Rs. 1,00,000 by the PVAF for 10 years at 15% i.e.

$$\text{Annual repayment} = \text{Rs. } 1,00,000 / 5.0188 = \text{Rs. } 19,925$$

The cash flows of the borrowing and purchase option may be computed as follows:

Year	Instalment	Interest	Repayment	Balance
	Rs.	Rs.	Rs.	Rs.
1	19,925	15,000	4,925	95,075
2	19,925	14,261	5,664	89,411
3	19,925	13,412	6,513	82,898
4	19,925	12,435	7,490	75,408
5	19,925	11,311	8,614	66,794
6	19,925	10,019	9,906	56,888
7	19,925	8,533	11,392	45,496
8	19,925	6,824	13,101	32,395

9	19,925	4,859	15,066	17,329
10	19,925	2,596*	17,329	—

* Difference between the outstanding balance and the last instalment (i.e. Rs. 19,925 – Rs. 17,329 = Rs. 2,596)

Year	Instalment	Interest	Depreciation	Tax Shield 50% (2 + 3)	Net CF (1-4)	PVF	PV
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Rs.	Rs.	Rs.	Rs.	Rs.		Rs.
0	10,000	—	—	—	—	1.000	10,000
1	19,925	15,000	11,000	13,000	6,925	.870	6,025
2	19,925	14,261	11,000	12,631	7,294	.756	5,514
3	19,925	13,412	11,000	12,206	7,719	.658	5,079
4	19,925	12,435	11,000	11,718	8,207	.572	4,694
5	19,925	11,311	11,000	11,156	8,769	.497	4,358
6	19,925	10,019	11,000	10,510	9,415	.432	4,067
7	19,925	8,533	11,000	9,767	10,158	.376	3,819
8	19,925	6,824	11,000	8,912	11,013	.327	3,601
9	19,925	4,859	11,000	7,930	11,995	.284	3,407
10	19,925	2,596	11,000	6,798	13,127	.247	<u>3,242</u>
	Present value of total outflows						—53,806
10	Salvage value (after tax)		10,000	—	—	.247	<u>+2,470</u>
	Net present value of outflows						<u>—51,336</u>

It may be noted that (i) depreciation of Rs. 11,000 has been provided for all the 10 years. This is 10% of the original cost of Rs. 1,10,000. (ii) The asset is fully depreciated during its life of 10 years, therefore, the book value at the end of 10th year would be zero. As the asset is having a salvage value of Rs. 20,000, this would be capital gain and presuming it to be taxable at the normal rate of 50%, the net cash inflow on account of salvage value would be Rs. 10,000 only. This is further discounted to find out the present value of this inflow.

Option II – Evaluation of Lease Option:

In case the asset is acquired on lease, there is a lease rent of Rs. 15,000 payable at the end of next 10 years. This lease rental is tax deductible, therefore, the net cash outflow would be only Rs. 7,500 (after tax). The PVAF for 10 years @ 15% is 5.0188. So, the present value of annuity of Rs. 7,500 is

Present value of annuity of outflow = Rs. $7,500 \times 5.0188$ = Rs. 37,641.

Advice:

If the firm opts to buy the asset, the present value of outflow comes to Rs. 51,336; and in case of lease option, the present value of outflows comes to Rs. 37,641. Hence, the firm should opt for the lease option. In this way, the firm will be able to reduce its costs by Rs. 13,695 i.e. Rs. 51,336 – Rs. 37,641. This may also be referred to as Net Benefit of Leasing.

Note: Students may also discount cash flows under both alternatives at after tax cost i.e. 15% $(1 - 05) = 7.5\%$. Discounting will not have any impact on this decision since any discount factor will lead to pv of lease to be less than that of pv of debt).

Question 2

- (a) XYZ Ltd. is considering merger with ABC Ltd. XYZ Ltd.'s shares are currently traded at Rs. 25. it has 2,00,000 shares outstanding and its earning after taxes (EAT) amount to Rs. 4,00,000. ABC Ltd. has 1,00,000 shares outstanding; its current market price is Rs. 12.50 and its EAT is Rs. 1,00,000. The merger will be effected by means of a stock swap (exchange). ABC Ltd. has agreed to a plan under which XYZ Ltd. will offer the current market value of ABC Ltd.'s shares.
- What is the pre-merger earnings per share (EPS) and P/E ratios of both the companies?
 - If ABC Ltd.'s P/E ratio is 8, what is its current market price? What is the exchange ratio? What will XYZ Ltd.'s post merger EPS be?
 - What must the exchange ratio be for XYZ Ltd.'s pre-merger and post-merger EPS to be the same?
- (b) A Company pays a dividend of Rs. 2.00 per share with a growth rate of 7%. The risk free rate is 9% and the market rate of return is 13%. The Company has a beta factor of 1.50. However, due to a decision of the Finance Manager, beta is likely to increase to 1.75. Find out the present as well as the likely value of the share after the decision.
- (c) RBI sold a 91 day T-bill of face value of Rs. 100 at an yield of 6%. What was the issue price?
- (d) Explain the term "Offer for Sale". (8 + 6 + 2 + 4 = 20 marks)

Answer

(a)	Merger and EPS	
	XYZ	ABC
Company	Rs.	Rs.
Market price of equity shares	25.00	12.50

No. of equity shares outstanding	2,00,000	1,00,000
Earning after tax	4,00,000	1,00,000

$$(i) \quad EPS = Rs. \frac{4,00,000}{2,00,000 \text{ shares}}, \frac{Rs. 1,00,000}{1,00,000 \text{ shares}} = \quad 2.00 \quad 1.00$$

$$P/E \text{ ratio} = Rs. 25/2, 12.50/1 \quad 12.5 \quad 12.5$$

- (ii) (a) If ABC Ltd. P/E ratio is 8, its current market price will be Rs. 8 only (8×1).
- (b) Then the exchange ratio will be $8/25$ i.e. $32/100$. For every 100 shares of ABC, 32 shares of XYZ will be issued ($1,00,000 \times 32/100 = 32,000$ shares of XYZ will be issued to all the shareholders of ABC Ltd.
- (c) Post merger EPS of XYZ Ltd. = Total earning/Total shares = $5,00,000/2,32,000$ equity shares = Rs. 2.16.
- (iii) Total earnings Rs. 5,00,000/EPS Rs. 2 = 2,50,000 equity shares i.e. 50,000 shares of XYZ will have to be issued to the shareholders of ABC i.e. one share of XYZ will be issued for every two shares held by ABC shareholders.

Then pre-merger and post-merger EPS of XYZ will be same as follows:

Pre-merger EPS of XYZ	Rs. 2.00
Post-merger EPS of XYZ	Rs. $5,00,000/2,50,000$ equity shares = Rs. 2.00

- (b) In order to find out the value of a share with constant growth model, the value of K_e should be ascertained with the help of 'CAPM' model as follows:

$$K_e = R_f + \beta (K_m - R_f)$$

Where,

- K_e = Cost of equity
 R_f = Risk free rate of return
 β = Portfolio Beta i.e. market sensitivity index
 K_m = Expected return on market portfolio

By substituting the figures, we get

$$K_e = 0.09 + 1.5 (0.13 - 0.09)$$

$$= 0.15 \text{ or } 15\%$$

and the value of the share as per constant growth model is

$$P_0 = \frac{D_1}{(K_e - g)}$$

Where,

P_0 = Price of a share

D_1 = Dividend at the end of the year 1

K_e = Cost of equity

G = growth

$$P_0 = \frac{2.00}{(k_e - g)}$$

$$P_0 = \frac{2.00}{0.15 - 0.07}$$

$$= \text{Rs. } 25.0$$

However, if the decision of finance manager is implemented, the beta (β) factor is likely to increase to 1.75 therefore, K_e would be

$$K_e = R_f + \beta (K_m - R_f)$$

$$= 0.09 + 1.75 (0.13 - 0.09)$$

$$= 0.16 \text{ or } 16\%$$

The value of share is

$$P_0 = \frac{D_1}{(k_e - g)}$$

$$P_0 = \frac{2.00}{0.16 - 0.07}$$

$$= \text{Rs. } 22.22$$

(c) Let the issue price be X

By the terms of the issue of the T-bills.

$$6\% = \frac{100 - x}{x} \times \frac{365}{91} \times 100$$

$$6\% = \frac{6 \times 91 \times x}{36,500} = (100 - x)$$

$$= 0.01496 x = 100 - x$$

$$x = \frac{100}{1.01496} = \text{Rs. } 98.53$$

(d) Offer for sale is also known as bought out deal (BOD). It is a new method of offering equity shares, debentures etc., to the public. In this method, instead of dealing directly

with the public, a company offers the shares/debentures through a sponsor. The sponsor may be a commercial bank, merchant banker, an institution or an individual. It is a type of wholesale of equities by a company. A company allots shares to a sponsor at an agreed price between the company and sponsor. The sponsor then passes the consideration money to the company and in turn gets the shares duly transferred to him. After a specified period as agreed between the company and sponsor, the shares are issued to the public by the sponsor with a premium. After the public offering, the sponsor gets the shares listed in one or more stock exchanges. The holding cost of such shares by the sponsor may be reimbursed by the company or the sponsor may get the profit by issue of shares to the public at premium.

Thus, it enables the company to raise the funds easily and immediately. As per SEBI guidelines, no listed company can go for BOD. A privately held company or an unlisted company can only go for BOD. A small or medium size company which needs money urgently chooses to BOD. It is a low cost method of raising funds. The cost of public issue is around 8% in India. But this method lacks transparency. There will be scope for misuse also. Besides this, it is expensive like the public issue method. One of the most serious short coming of this method is that the securities are sold to the investing public usually at a premium. The margin thus between the amount received by the company and the price paid by the public does not become additional funds of the company, but it is pocketed by the issuing houses or the existing shareholders.

Question 3

(a) A firm has projected the following cash flows from a project under evaluation:

Year	Rs. lakhs
0	(70)
1	30
2	40
3	30

The above cash flows have been made at expected prices after recognizing inflation. The firm's cost of capital is 10%. The expected annual rate of inflation is 5%.

Show how the viability of the project is to be evaluated.

(b) Write a note about the functions of merchant bankers.

(c) The following figures are collected from the annual report of XYZ Ltd.:

	Rs.
Net Profit	30 lakhs
Outstanding 12% preference shares	100 lakhs
No. of equity shares	3 lakhs
Return on Investment	20%

What should be the approximate dividend pay-out ratio so as to keep the share price at Rs. 42 by using Walter model? (8 + 6 + 6 = 20 marks)

Answer

- (a) It is stated that the cash flows have been adjusted for inflation; hence they are “nominal”. The cost of capital or discount rate is “real”. In order to be compatible, the cash flows should be converted into “real flow”. This is done as below:

Year	Nominal cash flows	Adjusted Inflation* factor	Real cash flows	PVF @ 10%	PV of cash flows
0	(70)	–	(70)	1.000	(70)
1	30	0.952	28.56	0.909	25.96
2	40	0.907	36.28	0.826	29.97
3	30	0.864	25.92	0.751	19.47
				Total	75.40
				Less: Cash out flow	<u>70.00</u>
				NPV (+)	<u>5.40</u>

* $1/1.05$; $1/(1.05)^2$; $1/(1.05)^3$;

with positive NPV, the project is financially viable.

Alternatively, instead of converting cash flows into real terms, the discount rate can be converted into nominal rate. Result will be the same.

An alternative solution is presented herewith

Alternative solution:

Year	Nominal cash flows	PVF @ 10% adjusted by the inflation factor i.e. 5%*	PV of cash flows
0	(70)	1.000	(70)
1	30	0.866	25.98
2	40	0.749	29.96
3	30	0.649	<u>19.47</u>
		Cash inflow	75.41
		Less: Cash out flow	<u>70.00</u>
		Net present value	<u>5.41</u>

$$* \frac{0.909}{1.05} = 0.866, \frac{0.826}{1.1025} = 0.749, \frac{0.751}{1.1576} = 0.649$$

with positive NPV, the project is financially viable.

(b) Functions of Merchant Bankers:

The basic function of merchant banker or investment banker is marketing of corporate and other securities. In the process, he performs a number of services concerning various aspects of marketing, viz., origination, underwriting, and distribution, of securities. During the regime of erstwhile Controller of Capital Issues in India, when new issues were priced at a significant discount to their market prices, the merchant banker's job was limited to ensuring press coverage and dispatching subscription forms to every corner of the country. Now, merchant bankers are designing innovative instruments and perform a number of other services both for the issuing companies as well as the investors. The activities or services performed by merchant bankers, in India, today include:

1. Project promotion services.
2. Project finance.
3. Management and marketing of new issues.
4. Underwriting of new issues.
5. Syndication of credit.
6. Leasing services.
7. Corporate advisory services.
8. Providing venture capital.
9. Operating mutual funds and off shore funds.
10. Investment management or portfolio management services.
11. Bought out deals.
12. Providing assistance for technical and financial collaborations and joint ventures.
13. Management of and dealing in commercial paper.
14. Investment services for non-resident Indians.

(c)

Rs. in lakhs

Net Profit	30
Less: Preference dividend	12
Earning for equity shareholders	18
Therefore earning per share	18/3 = Rs. 6.00

Cost of capital i.e. (k_e)

(Assumed) 16%

Let, the dividend pay out ratio be X and so the share price will be:

$$P = \frac{D}{K_e} + \frac{r(E-D)}{K_e}$$

Here $D = 6x$; $E = \text{Rs. } 6$; $r = 0.20$ and $K_e = 0.16$ and $P = \text{Rs. } 42$

$$\text{Hence Rs. } 42 = \frac{6x}{0.16} + \frac{0.2(6-6x)}{0.16 \times 0.16}$$

$$\text{or Rs. } 42 = 37.50X + 46.875(1-x)$$

$$= 9.375x = 4.875$$

$$x = 0.52$$

So, the required dividend payout ratio will be = 52%

Question 4

- (a) On January 28, 2005 an importer customer requested a bank to remit Singapore Dollar (SGD) 25,00,000 under an irrevocable LC. However, due to bank strikes, the bank could effect the remittance only on February 4, 2005. The interbank market rates were as follows:

	January, 28	February 4
Bombay US\$1	= Rs. 45.85/45.90	45.91/45.97
London Pound 1	= US\$ 1.7840/1.7850	1.7765/1.7775
Pound 1	= SGD 3.1575/3.1590	3.1380/3.1390

The bank wishes to retain an exchange margin of 0.125%. How much does the customer stand to gain or lose due to the delay?

(Calculate rate in multiples of .0001)

- (b) Ram buys 10,000 shares of X Ltd. at Rs. 22 and obtains a complete hedge of shorting 400 Nifties at Rs. 1,100 each. He closes out his position at the closing price of the next day at which point the share of X Ltd. has dropped 2% and the nifty future has dropped 1.5%. What is the overall profit/loss of this set of transaction?
- (c) Write a brief note about regulation of NBFCs in India. (8 + 4 + 8 = 20 marks)

Answer

- (a) On January 28, 2005 the importer customer requested to remit SGD 25 lakhs.

To consider sell rate for the bank:

US \$ = Rs. 45.90

Pound 1 = US\$ 1.7850

Pound 1 = SGD 3.1575

Therefore, SGD 1 = $\frac{\text{Rs. } 45.90 \times 1.7850}{\text{SGD } 3.1575}$

SGD 1 = Rs. 25.9482

Add: Exchange margin (0.125%) Rs. 0.0324

Rs. 25.9806

On February 4, 2005 the rates are

US \$ = Rs. 45.97

Pound 1 = US\$ 1.7775

Pound 1 = SGD 3.1380

Therefore, SGD 1 = $\frac{\text{Rs. } 45.97 \times 1.7775}{\text{SGD } 3.1380}$

SGD 1 = Rs. 26.0394

Add: Exchange margin (0.125%) Rs. 0.0325

Rs. 26.0719

Hence, loss to the importer

= SGD 25,00,000 (Rs.26.0719 – Rs.25.9806)

= Rs. 2,28,250

(b) Particulars	Rate	Amount (Rs.)		Amount (Rs.)	
10,000 shares – Buy	Rs. 22	2,20,000	2%	4,400	Loss
400 Nifties – short	Rs. 1,100	4,40,000	1.5%	6,600	Gain
				2,200	Net gain

- (c) (a) (i) **Meaning of NBFC's:** An NBFC is a company or an institution basically engaged in acceptance of deposits under different schemes and to invest these monies in any manner. NBFC may be registered as a Company under Companies Act, 1956, or may be other form of organization. The Reserve Bank of India Act defines an NBFC as (1) a financial institution which is a company. (ii) a non-banking institution which is a company having its principal business the receiving of deposits under any scheme or lending in any

manner (iii) such other non-banking institution as the RBI may specify with the approval of Central Government. Non-banking financial companies, normally, provides supplementary finance to the corporate sector. For the purpose of growing economy the role of NBFC's is important. The finance and related services is the major activity of NBFC's.

(ii) By implication any non-banking financial institution engaged in deposits and lending activities is called NBFC. On the basis of types of activities, NBFCs may be consisting of

- (i) Loan Companies
- (ii) Investment companies.
- (iii) Hire purchase finance companies.
- (iv) Equipment leasing companies.
- (v) Mutual benefit finance companies.
- (vi) Housing finance companies.
- (vii) Miscellaneous finance companies.
- (viii) Other and residuary finance companies
- (ix) Chit fund companies

The RBI regulates the activities of NBFCs through the following sets of directions:

- (i) NBFC acceptance of public deposits (Reserve Bank of India) directions, 1998.
- (ii) NBFC prudential norms (Reserve Bank of India) directions, 1998.
- (iii) NBFC Auditors Report (Reserve Bank of India) directions, 1998.
- (iv) NBFC (Reserve Bank of India) directions, 1987.
- (v) Miscellaneous Non-Banking Companies (Reserve Bank of India) directions, 1977.

The RBI has amended the NBFCs' regulations from time to time so that NBFCs grow on sound and healthy lines and to protect the interest of NBFC depositors.

(iii) Regulation of NBFCs – RBI Act

The RBI Act regulates different types of NBFCs under the provisions of Chapter III – B & Chapter C.

Silent features of Chapter III – B

The two compulsory prerequisites as per Chapter III–B are

- (a) The NBFC should obtain a certificate of registration.

(b) It must have NOF (Net Operating Funds) of Rs. 200 lacs.

These two requirements are cumulative.

Computation of NOF (Net Operating Funds) will be as follows

NOF is defined in the Section 45, I-A of the Act. The basis of computation is the latest Balance Sheet of the Company. Following items are considered for NOF.

1. Paid up equity capital and free reserves.
2. Accumulated losses, deferred revenues expenditure and intangible assets.
3. Investment in shares of subsidiaries, companies in the same group and other NBFCs.
4. Book value of Debentures, bonds made in subsidiaries or companies in the same group.
5. Deposit with subsidiaries and companies in the same group.

The calculation of NOF is

$$X = 1 + 2$$

$$Y = 3 + 4 + 5.$$

If 10% of Y exceeds the X then excess to be find out.

The NOF of the NBFC will be X – the excess amount.

Procedure for obtaining registration.

Application must be in the form prescribed by RBI and should be submitted to the Regional Office of the RBI.

Processing of application by RBI.

RBI ensures capacity of the NBFC to meet the creditors claim in full, general character of the management and the capital structure. The activity of NBFC shall not be prejudicial to the operation and consolidation of the financial sector and also shall not be prejudicial to the public interest.

Cancellation of registration.

Registration can be cancelled under section 44IA (6) wherein certain conditions are prescribed under the section such as

- Non-compliance of directions issued by the RBI.
- Fails to maintain accounts in accordance with any law or order issued by RBI.
- Failed to submit or offer for inspection its books of accounts or other relevant documents when demanded by RBI.

- Failed to comply with any conditions specified by RBI while granting certificate of registration.

Procedure for cancellation of registration

NBFC should be given a reasonable opportunity of being heard. NBFC must generally be given an opportunity by RBI for taking necessary steps to comply with the conditions, except in cases where RBI is of the opinion that the delay in canceling the certificate of registration shall be prejudicial to public interest or to the interest of the depositors of the NBFC.

Appellate Remedy

The NBFC can prefer and appeal to Central Government within 30 days from the date on which the cancellation order was communicated to it. If no appeal has been prescribed then the decision of RBI shall be final.

Question 5

- (a) Project X and Project Y are under the evaluation of XY Co. The estimated cash flows and their probabilities are as below:

Project X : Investment (year 0) Rs. 70 lakhs

Probability weights	0.30	0.40	0.30
Years	Rs. lakhs	Rs. lakhs	Rs. lakhs
1	30	50	65
2	30	40	55
3	30	40	45

Project Y : Investment (year 0) Rs. 80 lakhs.

Probability weighted	Annual cash flows through life
	Rs. lakhs
0.20	40
0.50	45
0.30	50

- (a) Which project is better based on NPV, criterion with a discount rate of 10%?
- (b) Compute the standard deviation of the present value distribution and analyse the inherent risk of the projects.
- (b) A share of Tension-free Economy Ltd. is currently quoted at, a price earning ratio of 7.5 times. The retained earning per share being 37.5% is Rs. 3 per share. Compute:
- The company's cost of equity, if investors expect annual growth rate of 12%.
 - If anticipated growth rate is 13% p.a., calculate the indicated market price, with

same cost of capital.

- (3) If the company's cost of capital is 18% and anticipated growth rate is 15% p.a., calculate the market price per share, assuming other conditions remain the same.

(12 + 8 = 20 marks)

Answer

(a) Calculation of NPV xy Co.:

	Project X	Cash flow	PVF	PV
Year				
1	$(30 \times 0.3) + (50 \times 0.4) + (65 \times 0.3)$	48.5	0.909	44.09
2	$(30 \times 0.3) + (40 \times 0.4) + (55 \times 0.3)$	41.5	0.826	34.28
3	$(30 \times 0.3) + (40 \times 0.4) + (45 \times 0.3)$	38.5	0.751	<u>28.91</u>
				<u>107.28</u>
		NPV: $(107.28 - 70.00) =$		(+) <u>37.28</u>
Project Y				
1-3	$(40 \times 0.2) + (45 \times 0.5) + (50 \times 0.3)$	45.5	2.486	<u>113.11</u>
		NPV $(113.11 - 80.00)$		(+) <u>33.11</u>

(b) Calculation of Standard deviation

		σ
Project X		
Year		
1	$\sqrt{((30 - 48.5)^2 + (50 - 48.5)^2 + (65 - 48.5)^2)}$	24.83
2	$\sqrt{((30 - 41.5)^2 + (40 - 41.5)^2 + (55 - 41.5)^2)}$	17.80
3	$\sqrt{((30 - 38.5)^2 + (40 - 38.5)^2 + (45 - 38.5)^2)}$	10.81
Project Y		
	$\sqrt{(40 - 45.5)^2 + (45 - 45.5)^2 + (50 - 45.5)^2}$	7.12

As per Hillier's model

$$\sigma^2 = \sum_{t=0}^n (1+r)^{-2t} \sigma^2$$

Hence

Project X

$$\text{Year} \quad (1+r)^{-2t} \quad \sigma^2$$

0	1.00	4,900	4,900
1	0.83	617	512
2	0.69	317	219
3	0.56	117	<u>66</u>
			<u>5,697</u>

$$\text{Standard deviation} = \sqrt{5,697} = 75.48$$

Project Y

Year			
0	1.00	6,400	6,400
1	0.83	51	42
2	0.69	51	35
3	0.56	51	<u>29</u>
			<u>6,506</u>

$$\text{Standard deviation} = \sqrt{6,506} = 80.66$$

Analysis:

Project X is recommended because of higher NPV and lower standard deviation (risk of variability)

(b) 1. Calculation of cost of capital

Retained earnings	37.5%	Rs. 3 per share
Dividend*	62.5%	Rs. 5 per share
EPS	100.0%	Rs. 8 per share

P/E ratio 7.5 times

Market price is Rs. $7.5 \times 8 = \text{Rs. } 60$ per share

Cost of equity capital = (Dividend/price $\times 100$) + growth %

$$= (5/60 \times 100) + 12\% = 20.33\%.$$

$$* \left(\frac{\text{Rs. } 3}{37.5} \times 62.5 = \text{Rs. } 5 \right)$$

2. Market price = Dividend/(cost of equity capital % – growth rate %) = $5/(20.33\% - 13\%) = 5/7.33\% = \text{Rs. } 68.21$ per share.

3. Market price = Dividend/(cost of equity capital % – growth rate %) = $5/(18\% - 15\%) = 5/3\% = \text{Rs. } 166.66$ per share.

Question 6

(a) The following information is provided relating to the acquiring company Efficient Ltd. and the target Company Healthy Ltd.

	<i>Efficient Ltd.</i>	<i>Healthy Ltd.</i>
No. of shares (F.V. Rs. 10 each)	10.00 lakhs	7.5 lakhs
Market capitalization	500.00 lakhs	750.00 lakhs
P/E ratio (times)	10.00	5.00
Reserves and Surplus	300.00 lakhs	165.00 lakhs
Promoter's Holding (No. of shares)	4.75 lakhs	5.00 lakhs

Board of Directors of both the Companies have decided to give a fair deal to the shareholders and accordingly for swap ratio the weights are decided as 40%, 25% and 35% respectively for Earning, Book Value and Market Price of share of each company:

- (i) Calculate the swap ratio and also calculate Promoter's holding % after acquisition.
 - (ii) What is the EPS of Efficient Ltd. after acquisition of Healthy Ltd.?
 - (iii) What is the expected market price per share and market capitalization of Efficient Ltd. after acquisition, assuming P/E ratio of Firm Efficient Ltd. remains unchanged.
 - (iv) Calculate free float market capitalization of the merged firm.
- (b) (i) Who can be appointed as Asset Management Company (AMC)?
- (ii) Write the conditions to be fulfilled by an AMC.
- (iii) What are the obligations of AMC?
- (c) Write short notes on the following:
1. Debt Securitisation.
 2. Stock Lending Scheme – its meaning, advantages and risk involved.

(12 + 4 + 4 = 20 marks)

Answer

(a)	Swap Ratio	Efficient Ltd.	Healthy Ltd.
Market capitalisation		500 lakhs	750 lakhs
No. of shares		10 lakhs	7.5 lakhs
Market Price per share		Rs. 50	Rs. 100
P/E ratio		10	5
EPS		Rs. 5	Rs. 20
Profit		Rs. 50 lakh	Rs. 150 lakh
Share capital		Rs. 100 lakh	Rs. 75 lakh
Reserves and surplus		Rs. 300 lakh	Rs. 165 lakh
Total		Rs. 400 lakh	Rs. 240 lakh
Book Value per share		Rs. 40	Rs. 32

(i) **Calculation of Swap Ratio**

EPS	1 : 4 i.e.	$4.0 \times 40\%$	1.6
Book value	1 : 0.8 i.e.	$0.8 \times 25\%$	0.2
Market price	1 : 2 i.e.	$2.0 \times 35\%$	0.7
		Total	2.5

Swap ratio is for every one share of Healthy Ltd., to issue 2.5 shares of Efficient Ltd. Hence, total no. of shares to be issued $7.5 \text{ lakh} \times 2.5 = 18.75 \text{ lakh shares}$

Promoter's holding = $4.75 \text{ lakh shares} + (5 \times 2.5 = 12.5 \text{ lakh shares}) = 17.25 \text{ lakh}$
i.e. Promoter's holding % is $(17.25 \text{ lakh} / 28.75 \text{ lakh}) \times 100 = 60\%$.

Calculation of EPS, Market price, Market capitalization and free float market capitalisation

- (ii) Total No. of shares $10 \text{ lakh} + 18.75 \text{ lakh} = 28.75 \text{ lakh}$
 Total capital $100 \text{ lakh} + 187.5 \text{ lakh} = \text{Rs. } 287.5 \text{ lakh}$
 EPS
$$\frac{\text{Total profit}}{\text{No. of shares}} = \frac{50 \text{ lakh} + 150 \text{ lakh}}{28.75 \text{ lakh}} = \frac{200}{28.75}$$

 $= \text{Rs. } 6.956$
- (iii) Expected market price $\text{EPS } 6.956 \times \text{P/E } 10 = \text{Rs. } 69.56$
 Market capitalization $= \text{Rs. } 69.56 \text{ per share} \times 28.75 \text{ lakh shares}$
 $= \text{Rs. } 1,999.85 \text{ lakh}$
- (iv) Free float of market capitalization $= \text{Rs. } 69.56 \text{ per share} \times (28.75 \text{ lakh} \times 40\%)$
 $= \text{Rs. } 799.94 \text{ lakh}$

(b) (i) **Asset Management Company (AMC):** A company formed and registered under Companies Act 1956 and which has obtained the approval of SEBI to function as an asset management company may be appointed by the sponsor of the mutual fund as AMC.

(ii) The following conditions should be fulfilled by an AMC

- (1) Any director of the asset management company shall not hold the place of a director in another asset management company unless such person is independent director referred to in clause (d) of sub-regulation (1) of regulation 21 of the Regulations and the approval of the Board of asset management company of which such person is a director, has been obtained.
- (2) The asset management company shall forthwith inform SEBI of any material change in the information or particulars previously furnished which have a

bearing on the approval granted by SEBI.

- (a) No appointment of a director of an asset management company shall be made without the prior approval of the trustees.
- (b) The asset management company undertakes to comply with SEBI (Mutual Funds) Regulations, 1996.
- (c) No change in controlling interest of the asset management company shall be made unless prior approval of the trustees and SEBI is obtained.
 - (i) a written communication about the proposed change is sent to each unit holder and an advertisement is given in one English Daily newspaper having nation wide circulation and in a newspaper published in the language of the region where the head office of the mutual fund is situated.
 - (ii) The unit holders are given an option to exit at the prevailing Net Asset Value without any exit load.
 - (iii) The asset management company shall furnish such information and documents to the trustees as and when required by the trustees.
- (iii) Obligations of the AMC:
 - (1) The AMC shall manage the affairs of the mutual funds and operate the schemes of such fund.
 - (2) The AMC shall take all reasonable steps and exercise due diligence to ensure that the investment of the mutual funds pertaining to any scheme is not contrary to the provisions of SEBI Regulations and the trust deed of the mutual fund.

(c) (1) Debt Securitisation:

Debt securitisation is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this assets pool market securities can be issued. The process can be classified in the following three functions.

1. *The origination function:* A borrower seeks a loan from finance company, bank or housing company. On the basis of credit worthiness repayment schedule is structured over the life of the loan.
2. *The pooling function:* Similar loans or receivables are clubbed together to create an underlying pool of assets. This pool is transferred in favour of a SPV (Special Purpose Vehicle), which acts as a trustee for the investor. Once, the assets are transferred they are held in the organizers portfolios.
3. *The securitisation function:* It is the SPV's job to structure and issue the securities on the basis of asset pool. The securities carry coupon and an expected maturity, which can be asset based or mortgage based. These are

generally sold to investors through merchant bankers. The investors interested in this type of securities are generally institutional investors like mutual fund, insurance companies etc. The originator usually keeps the spread.

Generally, the process of securitisation is without recourse i.e. the investor bears the credit risk of default and the issuer is under an obligation to pay to investors only if the cash flows are received by issuer from the collateral.

(2) Stock Lending Scheme:

Stock lending means transfer of security. The legal title is temporarily transferred from a lender to a borrower. The lender retains all the benefits of ownership, except voting power/rights. The borrower is entitled to utilize the securities as required but is liable to the lender for all benefits such as dividends, rights etc. The basic purpose of stock borrower is to cover the short sales i.e. selling the shares without possessing them. SEBI has introduced scheme for securities lending and borrowing in 1997.

Advantages:

- (1) Lenders to get return (as lending charges) from it, instead of keeping it idle.
- (2) Borrower uses it to avoid settlement failure and loss due to auction.
- (3) From the view-point of market this facilitates timely settlement, increase in settlement, reduce market volatility and improves liquidity.
- (4) This prohibits fictitious bull run.

The borrower has to deposit the collateral securities, which could be cash, bank guarantees, government securities or certificates of deposits or other securities, with the approved intermediary. In case, the borrower fails to return the securities, he will be declared a defaulter and the approved intermediary will liquidate the collateral deposited with it.

In the event of default, the approved intermediary is liable for making good the loss caused to the lender.

The borrower cannot discharge his liabilities of returning the equivalent securities through payment in cash or kind.

National Securities Clearing Corporation Ltd. (NSCCL), Stock Holding Corporation of India (SHCIL), Deutsche Bank, Reliance Capital etc. are the registered and approved intermediaries for the purpose of stock lending scheme. NSCCL proposes to offer a number of schemes, including the Automated Lending and Borrowing Mechanism (ALBM), automatic borrowing for settlement failures and case by case borrowing.

Suggested Answers : Final Examination : May, 2005

PAPER – 3 : ADVANCED AUDITING

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

Question 1

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

- (a) *The Managing Director of the Company has committed a "Teeming and Lading" Fraud. The amount involved has been however subsequently after the year end deposited in the company. (4 marks)*
- (b) *P Pvt. Ltd. was amalgamated with PQR Ltd. with effect from 1st April, 2004. As per the scheme of amalgamation approved by the High Court, the amalgamation was to be accounted by the "Pooling of Interests Method". The scheme further provided that the balance in Revaluation Reserve of P Pvt. Ltd. as on 31st March, 2004 was to be treated as a General Reserve on amalgamation. During the financial year 2004-05, PQR Ltd. issued bonus shares out of General Reserves (which included the amount of revaluation reserve of P Pvt. Ltd.). (5 marks)*
- (c) *B Pvt. Ltd., implements a Voluntary Retirement Scheme (VRS) for its employees. It follows a policy of amortising the expenditure over 10 years. As at 1st April, 2004, the unamortised VRS expenditure was Rs. 15 lakhs. During the year 2004-05, it incurred further Rs. 12 lakhs as VRS. For the year ended 31st March, 2005, the company proposes to revise the period of amortisation to 5 years. It also proposes to follow the revised period for the opening balance. (5 marks)*
- (d) *The accountant of C Ltd. has requested you, not to send balance confirmations to a particular group of debtors since the said balances are under dispute and the matter is pending in the Court. (4 marks)*

Answer

- (a) **Fraud Committed by Managing Director:** The Managing Director of the company has committed a "Teeming and Lading" fraud. The fact that the amount involved has been subsequently deposited after the year end is not important because the auditor is required to perform his responsibilities as laid down in AAS 4, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements". First of all, as per AAS 4, the auditor need to perform procedures whether the financial statements are materially misstated. Because an instance of fraud cannot be considered as an isolated occurrence and it becomes important for the auditor to perform audit procedures and revise the audit risk assessment. Secondly, the auditor need to consider the impact of fraud on financial statements and its disclosure in the audit report. Thirdly, the auditor should communicate the matter to the Chairman and Board of Directors. Finally, in view of the fact that the fraud has been committed at the highest level of management, it affects the reliability of audit evidence previously obtained since there is

a genuine doubt about representations of management. Finally, the auditor shall have to report under CARO, 2003 indicating the nature and amount involved in respect of fraud noticed during the year.

- (b) **Amalgamation and Revaluation Reserve:** As per AS 14, "Accounting for Amalgamations" if the amalgamation is in the nature of merger and the 'Pooling of Interest Method' is followed, the identity of the reserves is preserved and it appears in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. In the instant case, P Pvt. Ltd is amalgamated with PQR Ltd. and the amalgamation is in the nature of merger. Accordingly, Revaluation Reserves of P Pvt. Ltd. would have normally continued to remain so in PQR Ltd. However, since the scheme mentions that Revaluation Reserve is to be treated as General Reserves, the scheme will override AS 14. AS 14, "Accounting for Amalgamations", also requires that in case of any approved scheme of amalgamation if the treatment in accounting is not as per the AS, a specific disclosure of the same will have to be made alongwith the financial effect on the financial statements due to such deviation. The statutory auditor will accordingly have to ensure that the company complies with the requirements regarding treatment of reserves and other related disclosure requirements or he may be required to modify his report.
- (c) **Expenditure on Voluntary Retirement Scheme:** AS 26, "Intangible Assets", deals with expenditure incurred on intangible items by all enterprises, except amongst others, is not applicable to expenditure in respect of termination benefits. As per the standard, termination benefits are employee benefits payable as a result of either an enterprises' decision to terminate an employee's employment before the normal retirement date; or an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement). Accordingly, Voluntary Retirement Scheme (VRS) is one form of termination benefit and hence AS 26 principles are not applicable. The same has to be, therefore, accounted as per general accepted accounting practices. Accordingly, VRS expenditure would have to be written off / amortised over a reasonable period. In fact, the change of the accounting policy followed by the company to reduce the amortisation period to 5 years for the entire VRS expenditure including opening balance seems appropriate and reasonable. The auditor, however, has to examine that the requirements of AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" and impact of change in accounting policy is also disclosed as per AS 1, "Disclosure of Accounting Policies".
- (d) **External Confirmation Requests:** AAS 30, "External Confirmations", establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. It requires that the auditor should employ external confirmation procedures in consultation with the management. The auditor may come across certain situations in which the management may request him not to seek external confirmation from certain parties because of dispute with the debtors, etc. The management, for example, might make such a request on the grounds that due to a dispute with the particular debtor, the request for confirmation might aggravate the sensitive negotiations between the entity and the debtor. In such cases, when an auditor agrees to management's request not to seek external confirmation regarding a

particular debtor, the auditor should consider validity of grounds for such a request and assess management's integrity and obtain evidence to support the same. The auditor should also ask the management to submit its request in a written form, detailing therein the reasons for such a request. The auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should document the reasons for acceding to the management's request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter. While considering the validity of request, in case the auditor reaches at a conclusion that the same was not valid, he may appropriately modify the report.

Question 2

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

- (a) *L, a chartered accountant did not maintain books of account for his professional earnings on the ground that his income is less than the limits prescribed u/s 44AA of the Income Tax Act, 1961. (5 marks)*
- (b) *M/s. ABC, a firm of Chartered Accountants has taken a loan for acquiring computers, from a company whose Managing Directors' son is an Articled Trainee with A, a partner of M/s ABC. (4 marks)*
- (c) *M/s XYZ, a firm of Chartered Accountants created a website "www.xyzindia.com". The website besides containing details of the firm and bio-data of the partners also contains the photographs of all the partners of the firm. (5 marks)*
- (d) *Z, a Chartered Accountant, certifies a financial forecast of his client which was forwarded to the client's bank based on which the bank sanctioned a loan to the client. (4 marks)*

Answer

- (a) **Maintenance of Books of Account:** Under Clause (ii) of Part II of Second Schedule to the Chartered Accountants Act, 1949, the Institute has specified that if a chartered accountant in practice or the firm of Chartered Accountants of which he is a partner fails to maintain and keep in respect of his/its professional practice, proper books of account including the Cash Book and Ledger, he is deemed to be guilty of professional misconduct. Accordingly, it does not matter whether section 44AA of the Income Tax Act, 1961 applies or not. Hence, Mr. L is guilty of professional misconduct.
- (b) **Loan from a Company:** As per Clause (i) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant is deemed to be guilty of professional misconduct if he contravenes any of the provisions of Chartered Accountants Act, 1949 or Regulations made thereunder. Regulation 47 of the Chartered Accountant's Regulations, 1988 prohibits a member from accepting any premiums or loans or any deposit in any form from an articled clerk directly or indirectly. However, M/s ABC has taken loan from a company whose Managing Director happens to be father of articled clerk with Mr. A, a partner of M/s ABC. In this case, the articled trainee has no direct

interest in that company. There has been a case wherein a chartered accountant was held guilty of professional misconduct because he took a loan from a firm in which the articled clerk and his father were both interested. But, in this case as per the facts, the articled trainee has no direct interest in the company. However, if relationship, direct or indirect, can be established in view of relationship of articled trainee with MD of the company, Mr. A of M/s ABC would be held liable for professional misconduct. Thus, M/s ABC would be guilty of professional misconduct under this clause if it is proved that the loan was related to the engagement of the articled clerk.

- (c) **Hosting Details on Website:** As per detailed guidelines of the ICAI laid down in Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant or the firm can create its own website using any format subject to guidelines. However, the website should be so designed that it does not solicit clients or professional work and should not amount to direct or indirect advertisement. The guidelines of the ICAI to allow a firm to put up the details of the firm, bio-data of partners and display of a passport size photograph. In the case of M/s XYZ, all the guidelines seem to have been complied and there appears to be no violation of the Chartered Accountants Act, 1949 and its Regulations.
- (d) **Certification of Financial Forecast:** Under Clause (3) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice is deemed to be guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast. Accuracy does not refer to arithmetical accuracy. All forecasts are estimates based on certain assumptions duly evaluated on a consideration of various relevant factors and cannot be ascertained with accuracy. The Guidance Note on Accountants Report on Profit Forecasts and/or Financial forecasts considered the implications of this clause and made it clear that the chartered accountant can participate in the preparation of profit or financial forecasts and review them. But, first of all, he should clearly indicate in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and, secondly, he should not vouch for the accuracy of the forecasts. In the instant case, Mr. Shankar is deemed to be guilty as it appears that he has certified the financial forecast without taking adequate safeguards.

Question 3

Answer the following:

- (a) *Enumerate, in brief, the important aspects to be evaluated by the external auditor in determining the efficiency and extent of reliance to be placed on the work and function of an Internal Auditor.* (6 marks)
- (b) *While compiling the financial statements of a concern, you observed that the input information supplied by the concern is incomplete, incorrect and few of the Accounting Standards have not been followed. Describe, in brief, the procedure you will follow in the above.* (5 marks)

- (c) *You have been appointed the sole statutory auditor of a company where you were one of the joint auditors in the immediately preceding year. The concerned joint auditor has not been reappointed. What are the various steps you would take to ascertain the compliance of the requirements of the Companies Act, 1956 before accepting the audit?* (5 marks)

Answer

- (a) Evaluation of Internal Audit Function:** The external auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor. As per AAS 7 "Relying Upon the Work of an Internal Auditor", the important aspects to be considered by external auditor are:

- (i) *Organisational Status:* An important aspect is whether the audit is being carried out by outside agency or by departmental team. Another related aspect is level in the organisation to whom the report is addressed and whether he is free to communicate with the external auditor.
- (ii) *Scope of Function:* Nature and depth of coverage of the internal audit and to what extent the management considers and where appropriate, act upon the recommendations of the internal auditor.
- (iii) *Technical competence:* Internal audit work is performed by persons having adequate technical training and proficiency. Professional qualification and experience of the persons carrying out internal audit function also need to be considered.
- (iv) *Due Professional care:* It should be ascertained that the internal audit appears to be properly planned, supervised, reviewed and documented. Existence of proper internal audit manual, programmes and working papers will lead to the establishment of due professional care.

The external auditor should document his evaluation and conclusion of all the above factors.

- (b) Compilation of Financial Information:** According to AAS 31 "Engagements to Compile Financial Information", an accountant would normally have to rely upon the management for information to compile the financial statements in a compilation engagement. If in the course of compilation of financial statements, it is observed that the information supplied by the entity is incorrect, incomplete or otherwise unsatisfactory, the accountant should perform following procedures:

- (i) Make any enquiries of management to assess the reliability and completeness of the information provided;
- (ii) Assess internal controls prevailing in the entity; and
- (iii) Verify any matters or explanations.

The accountant may also request the management to provide additional information. This may be asked in the form of management representation letter. If the management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for such withdrawal.

If one or more accounting standards are not complied with, the same should be brought to the notice of the management and if the same is not rectified by the management, the accountant should include the same in notes to the accounts and the compilation report to the management.

- (c) **Compliance with Requirements of Companies Act, 1956:** When one of the joint auditors of the previous year is appointed as the sole auditor for the next year, it is similar to new re-appointment of one of the retiring joint auditors. The provisions of section 225 of the Companies Act, 1956, relating to non-reappointment of the other person also need to be considered. The following points should be taken into account:
- (i) Special notice u/s 225(1) was duly received by the company from a member at least 14 days before AGM containing a proposal for appointing a sole auditor expressly.
 - (ii) Verify notice sent to all the members at least 7 days before the AGM. [u/s 190(2)]
 - (iii) Verify that special notice has been sent to retiring auditor forthwith. [u/s 225(2)]
 - (iii) Any representation received from the retiring auditor was sent to the members [u/s 225(3)].
 - (iv) Verify from the minutes whether the representation received from the retiring joint auditor was considered at the AGM.
 - (v) Examine that proposed resolution was properly passed.
 - (vi) Ensure that provisions of section 224(2) are complied fully.
 - (vii) Ascertain special resolution u/s 224A, if any, is passed accordingly.
 - (viii) Obtain a certified copy of the relevant minutes of AGM and a written communication of the appointment within 7 days.

Question 4

- (a) *A Pvt. Ltd. is incorporated on 1st July, 2004. During the year ended 31st March, 2005, it had issued shares (fully paid up) of Rs. 40 lakhs, had borrowed Rs. 7.5 lakhs each from 2 financial institutions and its turnover (Net of excise Rs. 50 lakhs which is credited to a separate account) is Rs.475 lakhs. Will Companies Auditors Report Order, 2003 (CARO) be applicable to A Pvt. Ltd.? (4 marks)*
- (b) *As the statutory auditor of B Ltd. to whom CARO, 2003 is applicable, how would you report in the following situations?*
- (i) *The company has stood guarantee to its sister concern, whose financial condition was not healthy for a sum of Rs. 20 lakhs borrowed from a bank.*

- (ii) *Physical verification of only 50% (in value) of items of inventory has been conducted by the company. The balance 50% will be conducted in next year due to lack of time and resources.*
- (iii) *Accumulated losses of the company are 50.9% of its net worth and it is incurring continuous cash losses since last 2 years.* (4 × 3 = 12 marks)

Answer

- (a) The Companies (Auditor's Report) Order (CARO), 2003, exempts private limited companies from its application which fulfils all the following conditions:

- (i) the paid up capital and reserves are Rs.50 lakhs or less;
- (ii) it has not accepted any public deposits;
- (ii) it has no outstanding loan of Rs.10 lakhs or more from any bank or financial institution; and
- (iii) its turnover does not exceed Rs.5 crores.

In the case of M/s A Pvt. Ltd., its paid-up capital is less than Rs.50 lakhs, turnover is less than Rs. 5 crores since excise duty is not taken into account if it is credited separately to excise duty account; and, it is also implied from the facts that it has not accepted any public deposits. However, it fails to fulfil condition relating to outstanding loan because as per the Statement on CARO, 2003, issued by the Institute requires that the amount of outstanding loan taken from bank/financial institution have to be considered on a cumulative basis. M/s A Pvt. Ltd. has total borrowings of Rs. 15 lakhs and thus fails to satisfy all conditions and accordingly CARO, 2003 will be applicable.

- (b) (i) Para 4(xv) of CARO, 2003 requires the auditor to state in his report whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and condition whereof are prejudicial to the interests of the company. The auditor should examine the Memorandum of Association to determine whether the company has the power to give guarantee. The auditor should also examine the minute book and register of guarantee to ascertain whether guarantee has been issued under the sanction of competent authority. The auditor should also verify compliance with requirements of sections 295 and 372A of the Companies Act, 1956. It should also be ensured that the guarantee given is shown as contingent liability.

In determining whether the guarantee is prejudicial to the interest of the company, the auditor should consider financial standing of the party, nature of security offered, etc. In this case, since financial condition of the company on behalf of whom guarantee is given is not so good, the auditor may consider expressing an opinion that the terms and conditions on which the company has given guarantees for loans taken by the sister concern, i.e., M/s B Ltd., is prejudicial to the interests of the company.

- (ii) Para 4(ii)(a) of CARO, 2003 requires the auditor to state in his report whether physical verification of inventory has been conducted at reasonable interval by the management. Physical verification of inventory is the responsibility of the management which should verify all material items at least once in a year and more often in appropriate cases. The auditor in order to satisfy himself about verification at reasonable intervals should examine the adequacy of evidence and record of verification. In the given case, the above requirement of CARO, 2003 has not been fulfilled as such and the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable. He may consider the impact on financial statement and report accordingly.
- (iii) Para 4(x) of CARO, 2003 requires the auditor to state in his report in respect of a company which is in existence for more than 5 years from the date of registration:
- (a) whether the accumulated losses at the end of the year are more than 50% of its net worth; and
 - (b) whether it has incurred cash losses during the current year and the immediately preceding financial year.

In the instant case, since the company is covered by the above requirements, there are symptoms of potential sickness and, thus, auditor should report the same. It is, however, to be assumed that the company is in existence for more than 5 years.

(Note: Students may note that the CARO, 2003 has been amended by the Companies (Auditor's Report) (Amendment) Order, 2004 which is effective for all audit reports issued on or after November 25, 2004. While answering this question, the position as contained in the original CARO, 2003 has been considered.)

Question 5

Answer the following:

- (a) *In determining whether to use Computer Assisted Auditing Techniques (CAATs), what are the factors that a statutory auditor has to consider?* (6 marks)
- (b) *"In an audit of an insurance company, the Receipts and Payments Account is also subjected to audit". Comment on this statement in brief.* (6 marks)
- (c) *What are the exceptions to the general rule of treating advances as Non-performing Assets (NPAs)?* (4 marks)

Answer

- (a) **Consideration of Factors in Use of CAATs:** In determining whether to use CAATs, the auditor should consider the following factors:
- (i) *Availability of sufficient IT knowledge and expertise:* It is essential that members of the audit team should possess sufficient knowledge and experience to plan, execute and use the results of CAAT. The audit team should have sufficient knowledge to

plan, execute and use the results of the particular CAAT adopted.

- (ii) *Availability of CAATs and suitable computer facilities and data in suitable format:* The auditor may plan to use other computer facilities when the use of CAATs on an entity's computer is uneconomical or impractical, for example, because of an incompatibility between the auditor's package programme and entity's computer.
- (iii) *Impracticability of manual tests due to lack of evidence:* Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve, amounts of data that would overwhelm any manual procedure.
- (iv) *Impact on effectiveness and efficiency in extracting a data:* It includes selection of samples, applying analytical procedures, time involved in application of CAAT, etc.
- (v) Time constraints in certain data, such as transaction details, are often kept for a short time and may not be available in machine-readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.

- (b) Audit of Receipts and Payments Account:** Section 11(1A) of the Insurance Act, 1938 provides that every insurer, in respect of insurance business transacted by him and in respect of his shareholders' funds, should prepare at the end of each financial year, a Balance Sheet, a Profit and Loss Account, a separate account of receipts and payments and a Revenue Account in accordance with the Regulations made by the IRDA. Since receipts and payments account has been made a part of financial statements of an insurer, it is implied that the receipts and payments account is also required to be audited.

The IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002 require that the auditor of an insurance company should:

- (i) report whether the receipts and payments account of the insurer is in agreement with the books of account and returns;
- (ii) express an opinion as to whether the receipts and payments account has been prepared in accordance with the provisions of the relevant statutes; and
- (iii) express an opinion whether the receipts and payments account give a true and fair view of the receipts and payments of the insurer for the financial year/period under audit.

It may hence be said that auditor is required to audit the Receipts and Payments Account of the insurer and also express an opinion on the same.

- (c) Non-performing Assets:** RBI has laid down norms for classification of assets and provisioning norms for NPAs. However, certain exceptions to these norms are discussed below:

- (i) Temporary deficiencies, e.g., non availability of current drawing power due to non-

receipt of latest stock statement, temporary delay in renewals of limits on due date, etc.

- (ii) *Natural Calamities*: Where, in the wake of natural calamities, short-term agricultural loans are converted into term loans or there is rescheduling of repayment period or fresh short-term loans are sanctioned, the term loan as well as fresh short term loan may be treated as current dues and need not be classified as NPA.
- (iii) *Facilities Backed by Central Government Guarantees*: Credit facilities backed by guarantee of the Central Government though overdue should be treated as NPA only when the government repudiates its guarantee when invoked (this exemption is only for the purpose of asset classification and provisioning and not for the purpose of recognition of income).
- (iv) Advances to “On Lending” arrangements are also exempted under this category.

Question 6

Answer the following:

- (a) As an internal auditor for a large manufacturing concern, you are asked to verify whether there are adequate records for identification and value of Plant and Machinery, tools and dies and whether any of these items have become obsolescent and not in use. Draft a suitable audit programme for the above. (10 marks)
- (b) When can a company be said to have ‘Not maintained’ proper books of account? What is the role of the statutory auditor for the same? (6 marks)

Answer

- (a) The Internal Audit Programme in connection with Plant and Machinery and Tools and dies may be on the following lines:
 - (i) *Internal Control Aspects*: The following may be incorporated in the audit programme to check the internal control aspects:
 - (a) Maintaining separate register for hired assets, leased asset and jointly owned assets.
 - (b) Maintaining register of fixed asset and reconciling to physical inspection of fixed asset and to nominal ledger.
 - (c) All movements of assets are accurately recorded.
 - (d) Authorisation be obtained for –
 - (i) a declaring a fixed asset scrapped.
 - (ii) selling a fixed asset.
 - (e) Check whether additions to fixed asset register are verified and checked by authorised person.

- (f) Proper recording of all additions and disposal.
 - (g) Examining procedure for the purchase of new fixed assets, including written authority, work order, voucher and other relevant evidence.
 - (h) Regular review of adequate security arrangements.
 - (i) Periodic inspection of assets is done or not.
 - (j) Regular review of insurance cover requirements over fixed assets.
 - (ii) *Assets Register*: To review the registers and records of plant, machinery, etc. showing clearly the date of purchase of assets, cost price, location, depreciation charged, etc.
 - (iii) *Cost Report and Journal Register*: To review the cost relating to each plant and machinery and to verify items which have been capitalised.
 - (iv) *Code Register*: To see that each item of plant and machinery has been given a distinct code number to facilitate identification and verify the maintenance of Code Register.
 - (v) *Physical Verification*: To see physical verification has been conducted at frequent intervals.
 - (vi) *Movement Register*: To verify (a) whether a Movement Register for movable equipments and (b) log books in case of vehicles, etc. are being maintained properly.
 - (vii) *Assets Disposal Register*: To review whether assets have been disposed off after proper technical and financial advice and sales/disposal/retirement, etc. of these assets are governed by authorisation, sales memos or other appropriate documents.
 - (viii) *Spare Parts Register*: To examine the maintenance of a separate register of tools, spare parts for each plant and machinery.
 - (ix) *Review of Maintenance*: To scrutinise the programme for an actual periodical servicing and overhauling of machines and to examine the extent of utilisation of maintenance department services.
 - (x) *Review of Obsolescence*: To scrutinise whether expert's opinion have been obtained from time to time to ensure purchase of technically most useful efficient and advanced machinery after a thorough study.
 - (xi) *Review of R&D*: To review R&D activity and ascertain the extent of its relevance to the operations of the organisation, maintenance of machinery efficiency and prevention of early obsolescence.
- (b) Section 209(1) of the Companies Act, 1956 requires that every company shall keep proper books of account with respect to the following items:

- (i) all sums of money received and expended by the company and the matters in respect of which the receipts and expenditure take place;
- (ii) all sales and purchases of goods by the company;
- (iii) the assets and liabilities of the company; and
- (iv) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilisation of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particulars in the books of account.

Proper books of account shall not be deemed to be kept if such books of accounts are not kept on accrual basis of accounting and according to double entry system of accounting.

In case proper books of account are not kept, the auditor is required to specifically refer to violation of the Companies Act, 1956 in the auditor's report and shall also state that in his opinion proper books of account as required by law have not been kept by the company so far as appears from his examination of those books and, he has to further give either qualified opinion or disclaimer of opinion.

Further, the books also have to be maintained under accrual system. If the statutory auditor finds the books not maintained accordingly, he will have to modify his report.

Question 7

Comment on the following:

- (a) *A company has a branch office which recorded a turnover of Rs. 1,90,000 in the financial year 2004-05. No audit of the branch has been carried out. The statutory auditor of the company has made no reference of the above branch in his report. The total turnover of the company is Rs.10 crores for the year 2004-05.* (6 marks)
- (b) *Obtaining audit evidence in performing compliance and substantive procedures.*

(10 marks)

Answer

- (a) Section 228 of the Companies Act, 1956 requires that the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. So, normally speaking, the audit of branch office has to be carried out unless the company has obtained exemption under the Companies (Branch Audit Exemptions) Rules, 1961 formulated u/s 228(4), having regard to quantum of activity. The Rules provide for the exemption of a branch office of a company carrying on manufacturing, processing or trading activity from the provisions of section 228, if the average quantum of activity of the branch does not

exceed rupees two lakh or two per cent of the average of the total turnover and the earnings from other sources of the company as a whole, whichever is higher. Since in the instance case, no such exemption has been obtained and accordingly, the company is liable. The auditor is also required to mention this fact in the audit report and deal appropriately.

(b) Obtaining Audit Evidence: In performing compliance and substantive procedures, the auditor may obtain audit evidence by following methods:

(i) **Inspection:** It consists of examining various records, documents and tangible assets. Examination of these records and assets provides evidence of varying degree of reliability depending upon their nature, source and effectiveness of internal control over their processing. Inspection of tangible assets provides reliable evidence regarding their existence. Four major categories of documentary evidence, which provide different degree of reliability are:

- (a) documentary evidence originating from and held by third parties;
- (b) documentary evidence originating from third party and held by entity;
- (c) documentary evidence originating from the entity and held by third parties;
- (d) documentary evidence originating from and held by the entity.

Inspection of tangible assets is one of the methods to obtain reliable evidence with respect to their existence but not necessarily as to their ownership or value.

(ii) **Observation:** It consists of witnessing a process or procedure being performed by others. Observation of physical verification of inventories by the auditor will help in gathering reliable evidence as to their existence, physical condition and control.

(iii) **Inquiry and confirmation:** Inquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence.

Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor requests confirmation of receivables by direct communication with debtors.

(iv) **Computation:** It consists of checking the arithmetical accuracy of source documents and accounting records and doing calculation to arrive at facts and figures.

(v) **Analytical review:** It consists of studying significant ratios and trends and investigating unusual fluctuations in results.

Question 8

Write short notes on any **four**:

- (a) *Walk Through Tests*
- (b) *Vostro and Nostro Accounts*
- (c) *Special Report by auditor to Registrar of Cooperative Societies*
- (d) *Factors relevant in evaluation of Inherent Risk*
- (e) *Preliminary Report under Peer Review*
- (f) *Margins (Under Stock Exchange Trading Regulations)* (4 × 4 = 16 marks)

Answer

- (a) **Walk Through Tests:** A walk-through is a procedure in which an auditor traces a transaction from its initiation through the company's information systems to the point when it is reflected in the financial reports. The auditor should perform one walk-through, at a minimum, for each major class of transactions. A walk-through provides evidence to confirm that the auditor understands (1) the process flow of transactions, (2) the design of identified controls for internal control components, including those related to preventing and detecting fraud, and (3) whether all points in the process have been identified at which misstatements related to relevant financial statement assertion could occur. Walk-throughs also provide evidence to evaluate the effectiveness of the controls' design and confirm that the controls have been placed in operation.

When performing a walk-through, the auditor should:

- (i) Be sure that the walk-through encompasses the complete process (initiation, authorisation, recording, processing, and reporting) for each significant process identified, including controls intended to address fraud risk.
- (ii) Ask the entity's personnel, at each of key stage in the process, about their understanding of what the company's prescribed procedures require.
- (iii) Determine whether processing procedures are performed as expected on a timely basis, and look for any exceptions to prescribed procedures and controls.
- (iv) Evaluate the quality of evidence provided and perform procedures that produce a level of evidence consistent with the auditor's objectives. The auditor should follow the whole process, using the same documents and technology that company staff use, asking questions of different personnel at each significant stage, and asking follow-up questions to identify any abuse of controls or fraud indicators.

Once a walk-through is performed, the auditor may carry forward the documentation, noting updates, unless significant changes make preparation of new documentation more efficient. If such significant changes occur in the process flow of transactions or supporting computer applications, the auditor should evaluate the nature of the changes

and the effect on related accounts. The auditor should determine whether it is necessary to walk through transactions that were processed both before and after the change.

- (b) **Vostro and Nostro Accounts:** Bank's maintain stocks of foreign currencies in the form of Bank Accounts with their overseas branches/correspondents. Such foreign currency accounts maintained by Indian banks at other overseas centres is designated by it as "Nostro Account". For example all banks in India would be maintaining a US Dollar Account with their New York office/branch/correspondents, such account would be designated by the Indian office as Nostro Account. "Vostro Account" is the opposite of Nostro accounts. Here a foreign bank in another country maintains stocks of Indian rupees with their Indian branch/correspondent/local bank. Such Indian Rupee Accounts are designated as a Vostro Account. For example a German Bank might maintain a Vostro Account in rupees in terms with Indian Bank. While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of Nostro Accounts with the respective minor account. The amount in the Nostro account is stock of foreign currency in the form of bank accounts with the overseas branches and correspondents. Unreconciled Nostro Accounts, on an examination, may reveal unauthorized payments from the foreign currency account, unauthorized withdrawals, and unauthorized debit to minor account. The auditor should also evaluate the internal control with regard to inward/ outward messages. The inward/ outward messages should be properly authenticated and discrepancies noticed, should be properly dealt with, in the books of accounts.

The auditor should also verify whether prescribed procedure in relation to inter bank confirmation in the Vostro account is followed or not. In case balance confirmation certificate have been received but the same have not been reconciled, or where confirmation has not been received the same should be reported, in respect of each Vostro Account.

- (c) **Special Report by Auditor to Registrar of Co-operative Societies:** During the course of audit of co-operative societies, if the auditor notices that there are some serious irregularities in the working of the society he may draw specific attention to these matters by a special report. In the following cases, a special report may become necessary:
- i) Personal profiteering by members of managing committee in the transaction of the society, which are ultimately detrimental to the interest of the society.
 - ii) Detection of fraud relating to expenses, purchases, property and stores of the society.
 - iii) Mis-management and decision against co-operative principles.
 - iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups and deliberate negligence about the recovery, thereof and cases of reckless advancing without adequate security and credit worthiness of the party.
- (d) **Relevant Factors in evaluation of inherent risk:** While developing an overall audit plan, the auditor is required to assess inherent risk at financial statement level and is

then required to relate his assessment to material account balances and the class of transactions. To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Normally an auditor evaluates inherent risk by assessing factors such as integrity of the management, experience and knowledge of the management, turnover of key management personnel, circumstances which may motivate the management to misstate the financial statement when its financial performance is not satisfactory, nature of entity's business prone to rapid technological obsolescence dealing with large number of related parties, etc.

- (e) **Preliminary Report Under Peer Review:** In the process of peer review, at the end of the on-site review, the reviewer would send a preliminary report to the practice unit before making any report to the Board on the areas in case systems and procedures of the practice unit reviewed have been found to be deficient or where non-compliance with reference to any other matter has been noticed by the reviewer during the course of review. The reviewer has to take care that the report does not contain name of any individual practice unit. However no preliminary report is required if no deficiency or non-compliance is observed. In preparing the report, he should assess the conclusion drawn from the review that indicates deficiency. The report is addressed to the practice unit. The report should also contain a paragraph that discusses the scope of the review. Limitations on the scope of review, if any, with fact thereof should also be communicated in the report. The report should be prepared on the letterhead of the reviewer with date, signature, and membership number and code number allotted to the reviewer.
- (f) **Margins:** Margin refers to deposit made by members with the stock exchange authorities. There can be wide fluctuations at the time of settlement in the prices of securities since the closing rate of the earlier settlement. In order to restrict excessive speculation and also to safeguard the interest of the investors, members are required to keep certain deposits with the stock exchange. The members are required to collect the margin from their clients and deposit the same with clearing house. Margin is intended to protect the members by providing them with funds to cover anticipated fluctuations in prices of securities, particularly, if the client delays or is unable to meet his commitments. It also helps prevent excessive speculation, as clients would be required to invest some funds and not indulge in speculations without adequate resource. Different type of margins which a member is normally required to deposit are: Gross exposure margin, Mark to market margin, Volatility margin, 'Additional Volatility margin, Special margin and Ad-hoc margin etc. These margins are required to be paid on due dates at stipulated time as decided by the exchange or clearing house of the exchange. The members are required to compute margin payable for all the securities traded by them.

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) *The Annual General Meeting of M/s Robertson Ltd., for laying the Annual Accounts thereat for the year ended 31st March, 2004 was not held, as the accounts were not ready. In this context:*
- (i) *Advise the company regarding compliance of the provisions of Section 220 of the Companies Act, 1956 for filing of copies of Annual Accounts with the Registrar of Companies.*
 - (ii) *Will it make any difference in case the Annual Accounts were duly laid before the AGM held on 27th September, 2004 but the same were not adopted by the shareholders?* (5 Marks)
- (b) *Working of City Stock Exchange Association Ltd., is not being carried on by its Governing Board in public interest. On receipt of representations from various Investors and Investors' Association, the Central Government is thinking to withdraw the recognition granted to the said Stock Exchange. You are required to state the circumstances and procedure for withdrawal of such recognition as per the provisions of Securities Contracts (Regulation) Act, 1956 in this regard. Also state the effect of such withdrawal on the contracts outstanding on the date of withdrawal.* (5 Marks)
- (c) *Delhi Stock Exchange has refused to grant listing of the shares of ABC Limited but the Exchange has not disclosed any reason therefore. The company wants to challenge the decision of the Stock Exchange in the Civil Court.*

Advise the company pursuant to relevant provisions of the Securities Contracts (Regulation) Act, 1956. (5 Marks)

Answer

- (a) Under section 220(1) of the Companies Act, 1956, after the balance sheet and profit and loss account have been laid before the AGM, three copies thereof be filed with the Registrar of Companies, within 30 days from the date on which the Accounts were laid at the AGM. Where the AGM for any year has not been held, the Accounts shall be filed with the Registrar of Companies within 30 days from the latest date when the AGM ought to have been held in accordance with the provisions of the Act, namely, sections 166 and 210 of the Act. Under section 220(2), it is also provided that if AGM does not adopt the Annual Accounts or if the AGM for any year is not held, a statement of that fact and of the reasons shall be annexed to the accounts filed with the Registrar of Companies.

Accordingly,

- (i) In the present case though AGM was not held, it ought to be held by 30.9.2004

under sections 166/210 of the Act. Thus, the balance sheet and profit and loss account for the year ended 31.3.2004 be filed with the Registrar of Companies by 29.10.2004 along with a statement that AGM was not held by 30.9.2004 as the accounts were not ready.

- (ii) Since the AGM has been held in time on 27.9.2004, the balance sheet and profit and loss account as at 31.3.2004 be filed with the Registrar of Companies by 26.10.2004. A statement be also annexed to the balance sheet that the accounts were not adopted at the AGM held on 27.9.2004 giving reasons therefor.
- (b) Section 5 of the Securities Contracts (Regulation) Act, 1956 empowers the Central Government to withdraw the recognition granted to a Stock Exchange. The circumstances and procedure to be followed for withdrawal of such recognition is stated below:
- (i) If, considering the interest of the trade or the public interest, the Central Government is of the opinion that the recognition granted to a stock exchange should be withdrawn, the Central Government shall serve a written notice of the governing body of the stock exchange.
 - (ii) The said notice shall specify the reasons for the proposed withdrawal of the recognition.
 - (iii) The governing body of the stock exchange shall be afforded an opportunity of being heard by the Central Government.
 - (iv) Even after hearing the governing body, the Central Government is satisfied that the recognition granted to the stock exchange should be withdrawn, the Central Government may, by way of a notification in the Official Gazette, withdraw the recognition granted to the stock exchange.

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

- (c) Under section 22A of the Securities Contracts (Regulation) Act, 1956 where a recognised Stock Exchange refuses to list the securities of any public company, the company shall be entitled to be furnished with reasons for such refusal. If aggrieved, the company may appeal to the Securities Appellate Tribunal:
- (i) within 15 days from the date on which the reasons for such refusal are furnished to it, or
 - (ii) where the Stock Exchange has omitted or failed to dispose of within the time specified in section 73(1A) of the Companies Act, 1956 (i.e., before the expiry of ten weeks from the date of closing of the subscription list as per prospectus) within 15 days from the expiry of the specified time or within such further period not exceeding one month as Securities Appellate Tribunal may allow.

In terms of section 22E of the Act, Civil Court has no jurisdiction to entertain any suit in respect of this matter.

The company may be advised accordingly.

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) *MKP Limited, an Indian company having its Registered Office at Mumbai, India established a branch at New York U.S.A. on 1st April, 2004.*
 - (ii) *WIP Ltd., a company incorporated and registered in London established a branch at Chandigarh in India on 1st April, 2004.*
 - (iii) *WIP Ltd.'s Singapore branch which is controlled by its Chandigarh branch.*
- (7 Marks)
- (b) *Mr. F, an Indian National desires to obtain foreign exchange for the following purposes:*
- (i) *Payment of US \$10,000 as commission on exports under Rupee State Credit Route.*
 - (ii) *US \$ 30,000 for a business trip to U.K.*
 - (iii) *Remittance of US \$ 2,00,000 for payment as prize money to the winning team in a Hockey Tournament to be held in Australia.*
- Advise him, if he can get the Foreign Exchange and under what conditions.* (7 Marks)
- (c) *Mr. MKP was a member of the Competition Commission of India. He ceased to be such member on 31st March, 2005. Thereafter, he was offered the post of Executive Director with appropriate remuneration and perquisites in the following organisations to join his duties on and from 1st July, 2005:*
- (i) *HLL Ltd., a private sector public limited company, whose case was disposed off by the Competition Commission under the provisions of the Competition Act, 2002 in the month of February, 2005.*
 - (ii) *Life Insurance Corporation of India.*
- You are required to state with relevant provisions of the Competition Act, 2002 the option available to Mr. MKP in respect of accepting the above offers.* (7 Marks)

Answer

- (a) (i) As per provisions of section 2(v)(ii) of the Foreign Exchange Management Act, 1999 (FEMA) any person or body corporate registered or incorporated in India is a "Person resident in India". As per section 2(v) of the said Act the term "person" includes a company. Section 2(v)(iv) of the said Act states that an office, branch or agency outside India owned or controlled by a person resident in India is a "Person

resident in India”.

In the light of the above provisions of FEMA, the residential status of the New York branch of MKP Ltd is that of a “Person resident in India” from the date of its establishment since it is owned by a person, i.e., a company, resident in India.

- (ii) As per provisions of section 2(v)(iii) of the Foreign Exchange Management Act, 1999 (FEMA) an office, branch or agency in India owned or controlled by a person resident outside India is a “Person resident in India”. Section 2(w) of the said Act states that a person who is not resident in India is a “Person resident outside India”.

On application of the above provisions of FEMA, it can be concluded that WIP Ltd. is a “Person resident outside India” and since it owns a branch in Chandigarh, India, the residential status of the said Chandigarh branch is that of a “Person resident in India” from the date of its establishment.

- (iii) As per provisions of section 2(v)(iv) of the Foreign Exchange Management Act, 1999 (FEMA) an office, branch or agency outside India owned or controlled by a person resident in India is a “Person resident in India”. Here, the Singapore branch of WIP Ltd. is controlled by its Chandigarh branch which is a “Person resident in India”. Therefore, the residential status of the Singapore branch of WIP Ltd. shall be that of a “Person resident in India”.
- (b) Under provisions of section 5 of the Foreign Exchange Management Act, 1999 certain Rules have been made for drawal of Foreign Exchange for Current Account transactions. As per these Rules, Foreign Exchange for some of the Current Account transactions is prohibited. As regards some other Current Account transactions, Foreign Exchange can be drawn with prior permission of the Central Government while in case of some Current Account transactions, prior permission of Reserve Bank of India is required:
- (i) In respect of item No. (i), i.e., payment of commission on exports under Rupee State Credit Route, such payment is prohibited and the same is included in First Schedule to the Foreign Exchange Management (Current Account Transactions) Rules, 2000.
 - (ii) Foreign Exchange for business trip upto US\$ 25,000 can be obtained by any person. If a person wants to exceed this limit, then prior permission of Reserve Bank of India is required as per Third Schedule to the Foreign Exchange Management (Current Account Transactions) Rules, 2000. In respect of item (ii), since the amount involved is more than US \$ 25,000, Mr. F can obtain the foreign exchange after getting the permission of Reserve Bank of India.
 - (iii) The type of payment as envisaged in item No.(iii) is covered under Second Schedule to the Foreign Exchange Management (Current Account Transactions) Rules, 2000 and for remitting of prize money exceeding US\$ 1,00,000 for sports activity abroad other than International, National or State level body will require the prior permission of the Central Government. (Ministry of Human Resource Development – Department of Youth Affairs and Sports). Since the amount involved in item No. (iii) of the question is more than US\$ 1,00,000 and Mr. F is not an International, National or State level body, he has to obtain the permission of the

Central Government before remitting the prize money of US\$ 2,00,000.

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

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

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

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

However, since Life Insurance Corporation of India is a Corporation established under the Central Act, the above restriction does not apply and Mr. MKP can accept the offer to join as the Executive Director of the said corporation with effect from 1st July, 2005.

Question 3

Answer any **two** of the following:

- (a) As on 31st December, 2004, following information and figures are noticed from the Annual Accounts for the year ended 31st March, 2004 of SKP Ltd., a Company listed with The Stock Exchange, Mumbai:
- (i) Authorised Share Capital Rs.20.00 Crores comprising of 2 Crore Equity Shares of Rs.10 each.
 - (ii) Paid up Share Capital Rs.9.00 Crores comprising of 80 lac Equity Shares of Rs.10 each fully paid up and 20 lac Equity Shares of Rs.10 each called and paid up to Rs.5 each. The total paid up capital is paid up in cash.
 - (iii) Securities Premium Account Rs.20.00 Crores.
 - (iv) 5 lac Fully Convertible Debentures of Rs.100 each. These debentures are due for conversion on 31st March, 2005 in full into fully paid Equity Shares of Rs.10 each in the ratio of one Debenture: two Equity Shares.
 - (v) General Reserve Rs.30.00 Crores.
 - (vi) Fixed Assets Revaluation Reserve Rs.10.00 Crores.
 - (vii) Outstanding Liabilities in respect of Bonus to Employees and Workers Rs.25.00 lacs.

(viii) Outstanding Liabilities in respect of Interest payable on Public Deposits comprising of Fixed Deposits from general public Rs.15.00 lacs.

Following other information is gathered from the books of account and other records of the said Company for the period upto 31st December, 2004:

- (a) The partly paid shares were made fully paid prior to 30th September, 2004.
- (b) Bonus to employees and workers was paid on 15th September, 2004.
- (c) Interest on Public Deposits was outstanding on 31st December, 2004.

The Directors of SKP Ltd. wants to issue Bonus Shares on or after 1st April, 2005 in the ratio of 1:1. Advise the Directors on the matter with reference to the guidelines issued by Securities and Exchange Board of India on Bonus Issue. (8 Marks)

- (b) Excel Ltd., a public limited company listed with The Stock Exchange, Mumbai, wants to make issue of equity shares on preferential basis pursuant to a scheme approved under Corporate Debt Restructuring framework specified by Reserve Bank of India to various persons as may be selected by the Board of Director of the Company. Following information relevant to the preferential issue is available:

- (i) Total No. of equity shares to be issued: 50 Lac equity shares of Rs.10 each out of which 30 lac equity shares will be allotted on 30th June, 2005 as fully paid up and balance 20 lac equity shares shall be allotted on the same date but paid up to Rs.5 each and balance Rs.5 shall be called upon at a later date and shall be paid up on 30th November, 2005.
- (ii) Out of the proposed allottees some persons are holding their shares in Excel Ltd. in physical form and not in dematerialized form and some persons had sold their entire shareholding in Excel Ltd. in January, 2005.
- (iii) The meeting of general body of shareholders for approving the preferential issue was held on 15th March, 2005.

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

- (i) What would be the lock-in period for the shares allotted on preferential basis?
- (ii) Who are the persons not entitled for allotment of shares on preferential basis? (8 Marks)

- (c) (i) Explain the rule of 'ejusdem generis' with regard to interpretation of statutes. (4 Marks)

- (ii) Sunrise Industries Ltd. has paid Rs.1,00,000 to a political party as its contribution to fight elections. Can it do so under the provisions of the Companies Act, 1956? (4 Marks)

Will it make any difference if the company has advertised its products in the monthly magazine published by the political party?

Answer

(a) According to Guidelines issued by securities and Exchange Board of India on Bonus issue, a listed Company proposing to issue bonus shares has to comply with the following:

- (a) Pending the conversion of Fully Convertible Debentures (FCDs)/Partly Convertible Debentures (PCDs), the Company cannot issue shares by way of bonus unless similar benefit is extended to the holders of FCDs/PCDs through reservation of shares and the shares so reserved may be issued at the time of conversion of FCDs/PCDs on the same terms on which the bonus issues were made.
- (b) The bonus issue is made out of free reserve built out of genuine profits or securities premium collected in cash only.
- (c) Fixed Assets Revaluation Reserves are not capitalised for the purpose of bonus issue.
- (d) The bonus issue is not made in lieu of dividend.
- (e) The bonus issue can be made only after any partly paid shares are made fully paid.
- (f) The Company should not have defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption.
- (g) The Company should have sufficient reasons to believe that it has not defaulted in respect of the payment of statutory dues like contribution to P.F., gratuity and bonus to employees etc.
- (h) The Board of Directors' proposal to make bonus issue is implemented within six months from the date of approval by the Board of Directors and the same can not be revoked.
- (i) The bonus issue must be permitted by the Articles of Association and if the Articles of Association does not contain such a clause, then first the same should be suitably amended.
- (j) If Authorised Capital is not sufficient to accommodate the post bonus issue paid up capital, the capital clause of the Memorandum of Association should be suitably amended.
- (k) A compliance certificate by the company duly countersigned by the statutory auditor or company secretary in practice is to be submitted to SEBI.

Based on the above mentioned Guidelines of SEBI, the Board of Directors is advised as follows:

- (a) Check the Articles of Association whether it allows the issue of bonus shares. If not, the Articles of Association should be amended to include the relevant clause.
- (b) The Paid up Share Capital of the Company as on 31st March, 2004 was Rs.9.00 Crores and after the partly paid shares were made fully paid, the paid up share

capital became Rs.10.00 Crores. Moreover, after the conversion of 5 lac FCDs, the paid up capital will increase by 10 lac shares of Rs.10/- each, that means the paid up capital shall become 11.00 Crores as on 31st March, 2005. The Directors want to make bonus issue in the ratio of 1:1. Therefore, the post bonus issue paid up capital shall become Rs.22.00 Crores. But the Authorised Share Capital is only Rs.20.00 Crores, hence, the Directors are required to take steps to increase the authorised capital to at least Rs.22.00 Crores.

- (c) The Company is having sufficient amount in General Reserve and Securities Premium Account and the Directors can use from any/both of these accounts for bonus issue. But they should not utilise any amount from the Fixed Assets Revaluation Reserve.
 - (d) Since the Bonus to employees and workers have been paid within the time allowed by the Payment of Bonus Act, the requirement of the SEBI Guidelines have been fulfilled.
 - (e) The default in paying the interest on fixed deposits should be rectified by paying the necessary amount as provided in the Companies (Acceptance of Deposit Rules) 1975.
 - (f) The Directors should pass necessary resolution in the meeting of Board of Directors and take further steps to issue the bonus shares within six months from the passing of such resolution.
 - (g) After the issue of bonus shares, the company should forward a compliance certificate duly counter signed by its statutory auditor or a company secretary in practice to SEBI.
- (b) (i) **Lock-in Period:**

As per Guidelines issued by SEBI [Para 13.3.1(e)], the lock-in-period in respect of the shares issued on preferential basis pursuant to a scheme approved under Corporate Debt Restructuring framework specified by Reserve Bank of India, shall commence from the date of allotment and shall continue for a period of one year in case of fully paid up shares. In the case of allotment of partly paid shares, the lock-in period shall commence from the date of allotment and continue for a period of one year from the date when shares become fully paid up.

In view of the above guidelines of SEBI, the lock-in period for 30 lac shares to be allotted as fully paid up shall commence from 30th June, 2005 and shall continue for one year from that date. In case of 20 lac shares allotted as partly paid up on 30th June, 2005 and to be made fully paid up on 30th November, 2005, the lock-in period shall commence from 30th June, 2005 and shall continue till one year from 30th November, 2005, the date on which the same were made fully paid up.

- (ii) **Non-eligibility for preference shares:**

As per Guidelines issued by SEBI [Para 13.3.1(f)], where any shares are issued on preferential basis, any person who does not hold his entire shareholding in the issuing

company in dematerialised form shall not be entitled for the preferential allotment of shares. Para 13.3.1(h) of the said guidelines disentitles any persons from receiving shares in a preferential issue, if such person has sold his shares in the issuing company during the six months period prior to the relevant date.

In view of the above guidelines, the persons who are holding the shares in Excel Ltd. in physical form and not in dematerialised form and the persons who have sold their shares in the said company in January, 2005 being falling within the period of six months prior to the relevant date, are not entitled to receive the shares in the preferential issue.

Relevant date for this purpose means the date thirty days prior to the date on which the meeting of general body of shareholders is held under section 81(1A) of the Companies Act, 1956 to consider the proposed issue. (Para 13.1.1.1).

(c) (i) The term 'ejusdem generis' means 'of the same kind or species'. This rule can be explained as follows:

(a) Where any Act enumerates different subjects, general words following specific words are to be construed with reference to the words that precede them. Those general words are to be taken as applying to things of the same kind as the specific words previously mentioned, unless there is something to show that a wider sense was intended. Thus, this rule means that where specific words are used and after them some general words are used the general words would take their colour from the specific words used earlier.

Where there was prohibition on importation of arms, ammunition or gun - powder or any other goods', the words 'any other goods' will be construed as referring to goods similar to 'arms, ammunition or gun powder – A.G. Brown (1920)/KB. 773.

(b) If the particular words used exhaust the whole genus (category), then the general words are to be construed as covering a larger genus.

(c) This rule applies only where the specific words are of the same nature. When they are of different categories than the meaning of the general words following these specific words remains unaffected. The general words then would not take colour from the earlier specific words.

Courts have discretion whether to apply this rule in a particular case or not. For example, the 'just and equitable' clause under Section 433 of the Companies Act is held to be not restricted by the first five situations in which the court may wind up a company.

(ii) Under section 293A of the Companies Act, 1956, a company may contribute any amount not exceeding 5% of its average net profits during 3 immediately preceding financial years, to any political party or for any political purpose. For the purpose, Board may pass a resolution in this behalf and the amount contributed and the name of the party be disclosed in the Profit and Loss Account of the company.

However, a Government company is prohibited to make any such political contribution.

Sunrise Industries Ltd. may contribute the amount of Rs.1 lakh subject to the above restrictions provided it has been in existence for more than three years.

As per section 293A(3)(b) of the Act, the amount of expenditure incurred on advertisement in any publication (being a publication in the nature of a souvenir, brochure, tract, pamphlet or the like) by a political party shall also be deemed to be a contribution to a political party. Publication of advertisement of the products of the company in the monthly magazine of the political party will be covered by the general words 'or the like and will also be deemed to be a contribution to the political party for the purposes of section 293A of the Act.

Question 4

- (a) *A majority of the Board of Directors of M/s Bulk Drugs Ltd. have reasons to believe that some of the business activities carried on in the name of the company are prima facie against the interests of the company and its members. They want the matter to be referred to Central Government in the form of an application for appointment of an Inspector to reach to the bottom of the matter and unveil the truth. In this connection you are required to:*
- (i) *State the steps required to be taken with reference to the provisions of the Companies Act, 1956.*
 - (ii) *Draft an application to be made to the Central Government. (8 Marks)*
- (b) (i) *M/s LMN Limited has been running in losses and has defaulted payment to its creditors. On 1.8.2004, the company mortgaged its plant and machinery to Mr. Patel, a close friend of the managing director of the company, against payment of his dues of Rs.10 lakhs payable by the company. The other creditors were left in lurch. In the meantime, Mr. Raman (who was not paid by the company for supply of raw material of the value of Rs.50,000) presented a petition for winding up the company before the High Court on 31.12.2004. The company was ordered to be wound up by the court on 30.4.2005. The Official Liquidator wants to declare the transaction of mortgage with Mr. Patel as invalid. Will he succeed? (4 Marks)*
- (ii) *M/s Iqbal Sons Ltd. issued shares of the nominal value of Rs.10 per share, out of which Rs.5 was payable on application and balance Rs.5 was payable on call. The call money was invited by the Board of Directors but some shareholders, including a non-executive director, failed to pay the same within the prescribed period. Explain the status of Director who defaulted in paying call money. (3 Marks)*

Answer

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

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

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

- (i) the business of the company is being conducted with intent to defraud the creditors, members or any other person
- (ii) the person concerned in the formation of the company or the management of its affairs has been guilty of fraud, misfeasance or misconduct towards the company or its members.
- (iii) the members have not been given all the information with respect to its affairs. (Central Government can on its own order investigation even if there is no order from the Company Law Board).

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

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

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

DRAFT APPLICATION

BULK DRUGS LTD.

(Address)

Dated _____

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

Sir,

At an Extra ordinary General Meeting of the shareholders of the company held

on____(date)_____ at the registered office of the company, the members have unanimously passed the following Special Resolution:

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

1. Granting of Interest-free Loans to certain parties
2. Purchase of Raw materials without complying with the procedure laid down by the Drug Controller.”

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

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

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

Yours faithfully,

For BULK DRUGS LTD.

Secretary

- (b) (i) Under Section 531 of the Companies Act, 1956, any transfer of property, movable or immovable, execution or other act relating to the property made against the company within six months before the commencement of its winding up would be deemed to be a fraudulent preference and shall be invalid.

In the present case, the date of commencement of winding up of the company is 31.12.2004, being the date of presentation of winding up petition. The assets were transferred by way of mortgage on 1.8.2004 i.e., within 6 months. The liquidator may take steps to declare it invalid as the dominant motive of the company was to prefer one creditor to other creditors.

- (ii) **Status of Defaulting Director**

Under section 283(1)(f) of the Companies Act, 1956, if a director fails to pay all in respect of shares held by him within 6 months from date fixed for the payment of call, his office shall become vacant by operation of law. These provisions will apply to the company's director who defaulted in payment of call money.

In view of this provision, the non-executive director shall be deemed to have vacated his office if he has failed to pay the call amount within six months from the last date fixed for the payment of the call, unless the Central Government has by

notification in the official gazette removed the disqualification incurred by such failure.

Question 5

- (a) Mr. BPK was appointed as the sole selling agent of M/s KMP Ltd. with effect from 1st January, 2002 for a period of five years. Mr. BPK earned his remuneration as follows during the years 2002 to 2004:

Year	Amount of remuneration
2002	Rs.4,41,000
2003	Rs.6,32,000
2004	Rs.7,45,000

On and from 1st January, 2005, the sole selling agency agreement was terminated by M/s KMP Ltd. You are required to calculate the amount of compensation payable by the said company to Mr. BPK under the provisions of the Companies Act, 1956.

What would be your answer in a case where the said M/s KMP Ltd. was amalgamated with another company with effect from 1st January, 2005 and Mr. BPK refused to act as the sole selling agent of the amalgamated company after amalgamation. (8 Marks)

- (b) (i) Define the expression "Accounting Standards" within the meaning of Companies Act, 1956.
- (ii) XYZ Limited did not prepare its Balance Sheet as at 31st March, 2005 and the Profit & Loss Account for the year ended on that date in conformity with some of the mandatory Accounting Standards issued by the Institute of Chartered Accountants of India. You are required to state with reference to the provisions of the Companies Act, 1956, the responsibilities of directors and statutory auditor of the company in this regard. (7 Marks)

Answer

- (a) As per provisions of section 294A(2) of the Companies Act, 1956, any compensation payable by a company to its sold selling agent for premature loss of office shall not exceed the remuneration which he would have earned if he would have been in office for the unexpired residue of his term, or for three years, which ever is shorter, calculated on the basis of the average remuneration actually earned by him during a period of three years immediately preceding the date on which his office ceased or was terminated, or where he held his office for a period lesser than three years, then average remuneration actually earned by him during such lesser period.

Based on the above provision of the Companies Act, 1956, Mr. BPK is entitled to compensation for the unexpired residue of his term, i.e., for two years since it is shorter than three years. Such compensation shall be calculated on the basis of average remuneration received by him during the years 2002 to 2004. On the basis of figures given in the question, the amount of compensation shall be as follows:

Year	Amount of remuneration (Rs.)
2002	4,41,000/-
2003	6,32,000/-
2004	<u>7,45,000/-</u>
Total Remuneration	<u>18,18,000/-</u>
Average Remuneration per annum	<u>6,06,000/-</u>
Compensation payable to Mr. BPK for two years	<u>12,12,000/-</u>

As per provisions of section 294A(1) of the Companies Act, 1956, where the sole selling agent resigns his office in view of amalgamation with any other company and he is appointed as sole selling agent after such amalgamation, then he is not entitled to any compensation and the company is also prohibited from paying any compensation to the sole selling agent. Thus, in second case, Mr. BPK shall not be entitled to any compensation for premature loss of office since he himself has refused to act as the sole selling agent after amalgamation.

- (b) (i) As per sub-section (3C) of section 211 of the Companies Act, 1956, the expression "accounting standards" means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949 as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under sub-section (1) of section 210A of the said Act.

Proviso to the said sub-section states that the standards of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the accounting standards are prescribed by the Central Government under this sub-section.

- (ii) Sub-section (3A) of the said section states that every profit and loss account and balance sheet of the company shall comply with the accounting standards.

Sub-section (3B) states that where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely:

- (a) the deviation from the accounting standards;
- (b) the reasons for such deviation; and
- (c) the financial effect, if any, arising due to such deviation.

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

- (a) the managing director or manager of the company, if any.

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

In view of the above provisions of the Companies Act, 1956, the managing director/directors have a responsibility to ensure that in case of non-compliance of any mandatory Accounting Standard, proper disclosure is made in the profit & loss account and the balance sheet. However, it is open to the managing director/directors to prove that a competent and reliable person has been charged with the duty of seeing that the provisions of section 211 were complied with and such a person was in a position to discharge that duty. [Proviso 1 to section 211(7)].

Moreover, the Board of Directors is also required under section 217 of the Companies Act, 1956 to include a Directors' Responsibility Statement indicating therein that in the preparation of the annual accounts, the applicable accounting standards have been followed along with proper explanation relating to material departures. This provision makes it obligatory for the directors to ensure that the annual accounts are prepared in accordance with the accounting standards.

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

Question 6

- (a) (i) *A two year old Producer Company registered under Section 581C of the Companies Act, 1956 wants to donate some amount. The Chief Executive of the Producer Company has approached you to advise him as to how and for what purposes the donation can be made by such company. Also state the monetary restrictions, if any, laid down in the Companies Act, 1956 on making donations by a Producer Company. You are informed that as per the Profit & Loss account of the Producer Company for its last accounting year, net profit was Rs.20.00 lacs.*
- (ii) *Is it obligatory for every producer company to appoint a whole time secretary under the provisions of the Companies Act, 1956?* (8 Marks)
- (b) *Amar Textiles Ltd. is a company engaged in manufacture of fabrics. The Company has investments in shares of other bodies corporate including 70% shares in Amar Cotton Co. Ltd. and it has also advanced loans to other bodies corporate. The aggregate of all the investments made and loans granted by Amar Textiles Ltd. exceeds 60% of its paid up share capital and free reserves and also exceeds 100% of its free reserves. In course of its business requirements, Amar Textiles Ltd. has obtained a term loan from Industrial Development Bank of India (a public financial institution within the meaning of Section 4A of the Companies Act, 1956) and the same is still subsisting. Now the Company wants to increase its holding from 70% to 80% of the equity share capital in Amar Cotton Co. Ltd. by purchase of additional 10% shares from other existing shareholders.*

State the legal requirements to be complied with by Amar Textiles Ltd. under the provisions of the Companies Act, 1956 to give effect to the above proposal.

Will your answer be different if Amar Textiles Ltd. would have defaulted in payment of matured fixed deposits accepted by it from the public? (7 Marks)

Answer

- (a) (i) As per provisions of section 581 ZH of the Companies Act, 1956, a Producer Company may, by special resolution, make donation or subscription to any institution or individual for the following purposes:-

(a) For promoting the social and economic welfare of Producer Members or Producers or general public; or

(b) For promoting the mutual assistance principles.

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

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

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

- (ii) Under section 581X of the Companies Act, 1956 every Producer Company having an average turnover exceeding Rs.5 crores in each of three consecutive financial years shall have a whole time secretary who is a member of ICSI.

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

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

In the present case, Amar Textiles Ltd., obtained a term loan from Industrial Development Bank of India (IDBI) which is a public financial institution within the

meaning of section 4A of the Companies Act, 1956 and therefore the provisions of section 372A(2) are attracted and such loan is still subsisting. The company is required to obtain prior approval of IDBI for making any further investment.

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

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

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

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

Question 7

- (a) Advise M/s Super Specialities Ltd. in respect of the following proposals under consideration of its Board of Directors:
- (i) Appointment of Managing Director who is more than 70 years of age;
 - (ii) Payment of commission of 4% of the net profits per annum to the ordinary directors of the company;
 - (iii) Payment of remuneration to an ordinary director for rendering professional services; and
 - (iv) Payment of remuneration of Rs.40,000 per month to the whole time director of the company running in loss and having an effective capital of Rs.95.00 lacs. (8 Marks)
- (b) 60% shares of Indo-French Ltd. are held by French Group and balance by an Indian Group. As per Articles of Association of the company both groups had equal managerial powers. The relationship between the two groups soured and the operations of the company reached a deadlock. The Indian Group approached the Company Law Board for action against the French Group for oppression. Based on these facts, you are required to decide, with reference to the provisions of the Companies Act, 1956 and/or the decided case laws, the following issues:
- (i) Whether the contention of oppression against the French Group by the Indian Group is tenable?
 - (ii) What are the powers of the Company Law Board in this regard? (7 Marks)

Answer

- (a) (i) Under Schedule XIII, Part I, Paragraph (c) of the Companies Act, 1956, a person shall be eligible for appointment as Managing Director who has attained the age of

70 years where his appointment is approved by a Special resolution passed by the company in the general meeting. In that case, approval of the Central Government is not required.

- (ii) Under Section 309(4)(b) of the Companies Act, 1956 ordinary directors may be paid commission if the company by special resolution authorise such payment not exceeding 1% of net profit, if the company has MD/WTD/Manager or upto 3% of the net profits in any other case. Further, under section 309(7) of the Act, Special resolution shall not remain in force for a period of more than 5 years at a time.

Second proviso to section 309(4) states that a company in general meeting may, with the approval of the Central Government, authorise the payment of such remuneration at a rate exceeding one per cent or, as the case may be, three per cent of its net profits.

Thus, in the present case, commission of 4% of net profits of the company per annum can only be paid to the ordinary directors with the approval of the Central Government

- (iii) Under proviso to section 309(1) of the Act, any remuneration for services rendered to any director in any other capacity shall not be so included if-
 - (a) the services rendered are of a professional nature, and
 - (b) in the opinion of the Central Government, the director possesses the requisite qualification for the practice of the profession.

In that case, approval of the Central Government will not be required for payment of any remuneration to the concerned director.

- (iv) In terms of section II of Part II of Schedule XIII of the Act, approval of the Central Government is not required for payment of monthly remuneration upto Rs.75,000/- in case of a company with effective capital of less than Rs.1 crore and having no profit or its profits are inadequate, to its managerial persons, provided -
 - (1) the payment of remuneration is approved by the Remuneration Committee;
 - (2) the company has not defaulted in repayment of its debts, including public deposits or debentures or interest payable thereon for a continuous period of 30 days in the preceding year before the date of such appointment.

Thus, in the given case, the company may pay the remuneration of Rs.40,000 P.M. to its WTD without approval of the Central Government subject to the above restrictions.

- (b) (i) Section 397 of the Companies Act, 1956 deals with the remedy in a situation when the affairs of the company are being conducted in a manner oppressive to a shareholder or shareholders. This means that some of the shareholders must be in such a position that they can be oppressed by other shareholders or the management. In the present case as given in the question, both the Indian Group and the French Group are equally strong and none is able to oppress the other.

The situation stated in the question is a deadlock but it can not be termed as oppression. Since it is not a case of winding up of the company, the relief under the said section 397 is not available to the Indian Group [*Gnanasambandam v. Tamil Nadu Transporters (Coimbatore) P. Ltd. (1971) 41 Comp. Cas. 26*]. In view of the position discussed, the contention of the Indian Group is not tenable.

- (ii) The powers of the Company Law Board under the provisions of section 397 of the Companies Act, 1956 are discretionary in character. Apart from the general powers envisaged therein, the Company Law Board under section 402(b) of the said Act, may order the purchase of the shares of one group by the other group. In the case of *Yashovardhan Saboo v. Groz Beckert Saboo Ltd. 1993 1 Comp. L.J. 20*, the presiding officer ordered the foreign group to buy out the shares of the minority group at the fair price with necessary permission under the laws governing the foreign exchange. But in case where there is a deadlock and the matters are not sorted out by any other means, an order for winding up of the company may also be made under the just and equitable clause by the Court hearing petition under section 397/398. [*Kishan Kumar Ahuja v. Suresh Kumar Ahuja*]. Thus, if the Indian Group or the French Group fail to buy out the shares of the other group, the Company Law Board may order the winding up of the company in accordance with the provisions of the Companies Act, 1956.

NOTE: Powers of the Company Law Board has been transferred to the Tribunal by the Companies (Second Amendment) Act, 2002 and assented by the President of India on 13.1.2003. This will take effect from the date of full enforcement. Till then, powers being currently exercised by the Company Law Board shall continue to be exercised.

Question 8

- (a) What do you understand by Corporate Governance? Explain, how the provisions of the Companies Act, 1956 relating to Audit Committee will help in achieving some of the objectives of Corporate Governance. (8 Marks)
- (b) Mr. KMP: is director of XLS Ltd. He intends to construct a residential building for his own use. The cost of construction is estimated at Rs.1.50 Crores which Mr. KMP proposes to finance partly from his own sources to the tune of Rs.60 Lacs and the balance Rs.90 Lacs from housing loan to be obtained from a housing finance company. For the purpose of obtaining the loan, he has approached the housing finance company which has in principle agreed to grant the loan, but has put a condition. The condition put by the housing finance company is that the Company XLS Ltd. of which Mr. KMP is a director should provide the guarantee for repayment of the loan and interest as per the terms of the proposed agreement for granting the loan to Mr. KMP. You are required to advice Mr. KMP on the matter keeping in view the relevant provisions of the Companies Act, 1956. (7 Marks)

Answer**(a) CORPORATE GOVERNANCE**

The vast amount of literature available on the subject ensures that there exist innumerable definitions of corporate governance. To get a fair view on the subject it would be prudent to give a narrow as well as a broad definition of corporate governance.

In a narrow sense, corporate governance involves a set of relationships amongst the company's management, its board of directors, its shareholders, its auditors and other stakeholders. These relationships, which involve various rules and incentives, provide the structure through which the objectives of the company are set, and the means of attaining these objectives as well as monitoring performance are determined. Thus, the key aspects of good corporate governance include transparency of corporate structures and operations, the accountability of managers and the boards to shareholders, and corporate responsibility towards stakeholders.

In a broader sense, however, good corporate governance, the extent to which companies are run in an open and honest manner, is important for overall market confidence, the efficiency of capital allocation, the growth and development of countries' industrial bases, and ultimately the nations' overall wealth and welfare.

AUDIT COMMITTEE

For better corporate governance, the concept of Audit Committee for companies was introduced by section 292A of the Companies Act, 1956. Every public company having paid up capital of not less than Rs.5.00 Crores must have an Audit Committee.

The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee [Section 292A(5)].

As per section 292A(6) of the said Act, the function of the Audit Committee includes the following:

- (a) The Audit Committee should discuss with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors.
- (b) The Audit Committee should review half yearly and annual financial statements before submission to the Board.
- (c) The Audit Committee should ensure compliance of internal control systems.

The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary. [Section 292A(7)].

The recommendations of the Audit Committee on any matter relating to financial management including the audit report, shall be binding on the Board and if the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefore and communicate such reasons to the shareholders. [Section 292A(8) & (9)].

The above provisions of law relating to powers and functions of the Audit Committee relating to financial statements will help in achieving one of the objectives of corporate governance, i.e., accountability and avoidance of poor financial reporting. It also ensures that the companies are managed in clean and transparent manner.

- (b) According to the provisions of section 295 of the Companies Act, 1956, no company shall make any loan or given any guarantee or provide any security in connection with a loan made by any other person to any director of the lending company less the previous approval of the Central Government is obtained in this respect.

In view of the above provisions of the law Mr. KMP is required to approach XLS Ltd. intimating the company the full details of the loan transaction and the condition imposed by the housing finance company. After receipt of the relevant details and information the company, namely, XLS Ltd. is required to make an application to the Central Government for obtaining the approval under section 295 of the Companies Act, 1956. On receipt of the approval of the Central Government, XLS Ltd. can provide the guarantee to housing finance company in respect of the loan proposed to be granted to Mr. KMP.

The company XLS Ltd. is also required to pass a Board Resolution as required by section 292 of the Companies Act, 1956 and also a special resolution in terms of section 372A if the facts of the case so require.

Question 9

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

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

- (b) (i) *Board of Directors of DBM Limited held a board meeting on 2nd May, 2005 at its registered office. You are required to state the salient points to be taken into account while drafting the minutes of the said board meeting.*
- (ii) *Draft a board resolution for appointment of Mr. Paul as the Managing Director of DBM Limited passed in the above stated board meeting.*
(7 Marks)

Answer

- (a) As per provisions of section 297 of the Companies Act, 1956, when a Company enters into a contract in which some of the directors are interested, then consent of the Board of Directors of the Company is required to be obtained. In the present case since the Managing Director of LMB is interested in the contract for the purchase of machines and equipments because of his son's partnership in the supplier firm, the same should be

approved by the board of directors of the company.

Proviso to section 297(1) states that in the case of a company having a paid-up share capital of not less than rupees one crore, no such contract shall be entered into except with the previous approval of the Central Government. Since the paid up capital of LMB Ltd. is Rs.5.00 Crores the company is required to take prior approval of the Central Government.

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

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

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

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

present and the capacity in which present, e.g., name of the person chairing the meeting, names of the directors and secretary identifying them as director or secretary, names of persons in attendance like solicitor, auditor, internal auditor etc. The minutes should also contain the subject of leave of absence granted, if any, to any of the board members.

- (d) Content of the meeting giving serial number of the minute, brief subject heading, full terms of the resolution adopted including the statistical details, if any.
 - (e) Names of the directors dissenting or not concurring with any resolution passed at the board meeting.
 - (f) Reference about interested directors abstaining from voting is also required to be stated in the minutes.
 - (g) Chairman's signature and date of verification of minutes as correct.
- (ii) Resolution passed at the meeting of Board of Directors of DBM Limited held at its registered office situated at.....On 2nd May, 2005 at.....AM.

"RESOLVED subject to the approval by the shareholders in a general meeting and pursuant to provisions of section 198, 309, 310, Schedule XIII and other applicable provisions of the Companies Act, 1956 that Mr. Paul be and is hereby appointed as the Managing Director of the Company with effect from 1st June, 2005 for a period of five years on a remuneration approved by the Remuneration Committee as enumerated below:

(1) Salary: Rs. _____ per month.

(2) Perquisites, Benefits & Facilities: _____.

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

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

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

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

PAPER - 5 : COST MANAGEMENT

Question 1

- (a) Define Total Quality Management? What are the six Cs for successful implementation of TQM ?
- (b) What steps are involved in value chain analysis approach for assessing competitive advantages?
- (c) Carlon Ltd. makes and sells a single product; the unit specifications are as follows:

Direct Materials X	:	8 sq. metre at Rs 40 per square metre
Machine Time	:	0.6 Running hours
Machine cost per gross hour	:	Rs. 400
Selling price	:	Rs. 1,000

Carlon Ltd. requires to fulfil orders for 5,000 product units per period. There are no stock of product units at the beginning or end of the period under review. The stock level of material X remains unchanged throughout the period.

Carlon Ltd. is planning to implement a Quality Management Programme (QPM). The following additional information regarding costs and revenues are given as of now and after implementation of Quality Management Programme.

Before the implementation of QMP	After the implementation
1. 5% of incoming material from suppliers scrapped due to poor receipt and storage organisation.	1. Reduced to 3%.
2. 4% of material X input to the machine process is wasted due to processing problems.	2. Reduced to 2.5%
3. Inspection and storage of Material X costs Re. 1 per square metre purchased.	3. No change in the unit rate
4. Inspection during the production cycle, calibration checks on inspection equipment vendor rating and other checks cost Rs. 2,50,000 per period	4. Reduction of 40% of the existing cost.
5. Production Qty. is increased to allow for the downgrading of 12.5% of the production units at the final inspection stage. Down graded units are sold as seconds at a discount of 30% of the standard selling price.	5. Reduction to 7.5%

- | | |
|---|---|
| <p>6. Production Quantity is increased to allow for return from customers (these are replaced free of charge) due to specification failure and account for 5% of units actually delivered to customer.</p> <p>7. Product liability and other claims by customers is estimated at 3% of sales revenue from standard product sale.</p> <p>8. Machine idle time is 20% of Gross machine hrs used (i.e. running hour = 80% of gross/hrs.).</p> <p>9. Sundry costs of Administration, Selling and Distribution total – Rs. 6,00,000 per period.</p> <p>10. Prevention programme costs Rs. 2,00,000</p> | <p>6. Reduction to 2.5%</p> <p>7. Reduction to 1%.</p> <p>8. Reduction to 12.5%.</p> <p>9. Reduction by 10% of the existing.</p> <p>10. Increase to Rs. 6,00,000.</p> |
|---|---|

The Total Quality Management Programme will have a reduction in Machine Run Time required per product unit to 0.5 hr.

Required:

- (a) *Prepare summaries showing the calculation of (i) Total production units (pre inspection), (ii) Purchase of Materials X (square metres), (iii) Gross Machine Hours.*
- (b) *In each case, the figures are required for the situation both before and after the implementation of the Quality Management Programme so that orders for 5,000 product units can be fulfilled.*
- (b) *Prepare Profit and Loss Account for Carlon Ltd. for the period showing the profit earned both before and after the implementation of the Total Quality Programme.*

Answer

- (a) The total quality management is a set of concepts and tools for getting all employees focused on continuous improvement in the eyes of the customer. Quality is an important aspect of world-class manufacturing. The success of Japanese companies is grass rooted in their long-term commitment to improvement of quality. A world class manufacturing approach demands that the quality must be designed into product and the production process, rather than an attempt to remove poor quality by inspection. This means that the objectives of quality assurance in a world- class-manufacturing environment, is not just reject defective product, but to systematically investigate the cause of defects so that they can be gradually eliminated. Though the goal is zero defect, the methodology is one of continuous improvement.

Six Cs of TQM

- (i) Commitment - If a TQM culture is to be developed, so that quality improvement becomes normal part of everyone's job, a clear commitment, from the top must be provided. Without this all else fails.
 - (ii) Culture - Training lies at the centre of effecting a change -in culture and attitudes. Negative perceptions must be changed to encourage individual contributions.
 - (iii) Continuous improvement - TQM is a process, not a program, necessitating that we are committed in the long term to the never ending search for ways to do the job better.
 - (iv) Co-operation: The on-the-job experience of all employees must be fully utilized and their involvement and co-operation sought in the development of improvement strategies and associated performance measures.
 - (v) Customer focus: Perfect service with zero defects in all that is acceptable at either internal or external levels.
 - (vi) Control: Documentation, procedures and awareness of current best practice are essential if TQM implementations are to function appropriately The need for control mechanisms is frequently overlooked, in practice.
- (b) Most corporations define their mission as one of creating products and services. In contrast, the other companies are acutely aware of the strategic importance of individual activities within their value chain, They are concentrating on those activities that allow them to capture maximum value for their customers and themselves.

These firms use the value chain analysis approach to better understand which segments, distribution channels, price points. product differentiation. selling prepositions and value chain configuration will yield them the greatest competitive advantage.

The way the value chain approach helps these organizations to assess competitive advantage includes the use of following steps of analysis.

- (i) **Internal cost analysis** - to determine the sources of profitability and the relative cost positions of internal value creating processes;
- (ii) **Internal differentiation analysis** - to understand the sources of differentiation with internal value-creating process; and
- (iii) **Vertical linkage analysis** - to understand the relationships and associated costs among external suppliers and customers in order to maximize the value delivered to customers and to minimize the cost.

The value chain approach used for assessing competitive advantages is an integral part of the strategic planning process. Like strategic planning, value chain analysis is a continuous process of gathering, evaluating and communicating information for business decision-making.

(c) (a)

	Existing		After TQM Programme
i. Total production units (Preinspection)			
Total sales requirements	5,000		5,000
Specification losses 5%	250	2.5%	125
	5,250		5,125
Downgrading at inspection	750		416
$\frac{12.5}{87.5} \times 5,250$		$\frac{7.5}{92.5} \times 5,125$	
Total units before inspection	6,000		5,541
ii Purchase of material 'X'(Sq Mtr)			
Material required to meet pre inspection production requirement $6,000 \times 8$ SqMtr	48,000 SqMtr	$5,541 \times 8$ SqMtr	44,328 SqMtr
Processing loss $\frac{4}{96} \times 48,000$	2,000		1,137
		$\frac{2.5}{97.5} \times 44,328$	
Input to the process	50,000		45,465
Scrapped material $\frac{5}{95} \times 50,000$	2,632		1,406
		$\frac{3}{97} \times 45,465$	
Total purchases	52,632		46,871
iii Gross Machine Hours			
Initial requirements $6,000 \times 0.6$	3,600	$5,541 \times 0.5$	2,771
Idle time $\frac{20}{80} \times 3,600$	900	$\frac{12.5}{87.5} \times 2,771$	396
Gross time	4,500		3,167

(b)		Profit and loss statement	
	Rs		Rs
Sales revenue 5,000 Units× Rs 1,000	50,00,000		50,00,000
Sales downgraded 750 Units×Rs 700	5,25,000	416 Units × Rs 700	2,91,200
	55,25,000		52,91,200
Costs:			
Material 52,632 Sq Mtr ×Rs 40	21,05,280	46,871Sq Mtr × Rs 40	18,74,840
Inspection and storage costs 52,632 Sq Mtr ×Re 1	52,632	46,871Sq Mtr × Re 1	46,871
Machine cost 4,500 Hrs × Rs 400	18,00,000	3,167 Hrs× Rs 400	12,66,800
Inspection and other cost	2,50,000	2,50,000 × 60%	1,50,000
Product liability (3% × 50,00,000)	1,50,000	1% × 50,00,000	50,000
Sundry cost of selling, distribution and administration.	6,00,000	6,00,000 × 90%	5,40,000
Preventive programme cost	2,00,000		6,00,000
	51,57,912		45,28,511
Net profit	3,67,088		7,62,689

Question 2

- (a) *C Preserves produces Jams, Marmalade and Preserves. All the products are produced in a similar fashion; the fruits are cooked at low temperature in a vacuum process and then blended with glucose syrup with added citric acid and pectin to help setting.*

Margins are tight and the firm operates, a system of standard costing for each batch of Jam.

The standard cost data for a batch of raspberry jam are

<i>Fruits extract</i>	<i>400 kgs @ Rs. 16 per kg.</i>
<i>Glucose syrup</i>	<i>700 kgs @ Rs. 10 per kg.</i>
<i>Pectin</i>	<i>99 kgs. @ 33.2 per kg.</i>
<i>Citric acid</i>	<i>1 kg at Rs. 200 per kg.</i>
<i>Labour</i>	<i>18 hours @ Rs. 32.50 per hour.</i>
<i>Standard processing loss 3%.</i>	

The climate conditions proved disastrous for the raspberry crop. As a consequence, normal prices in the trade were Rs. 19 per kg for fruits abstract although good buying could achieve some savings. The impact of exchange rates for imported sugar plus the minimum price fixed for sugarcane, caused the price of syrup to increase by 20%.

The retail results for the batch were –

Fruit extract	428 kgs at Rs. 18 per kg.
Glucose syrup	742 kgs at Rs. 12 per kg.
Pectin	125 kgs at Rs 32.8 per kg.
Citric acid	1 kg at Rs. 95 per kg.
Labour	20 hrs. at Rs. 30 per hour.

Actual output was 1,164 kgs of raspberry jam.

You are required to:

- (i) Calculate the ingredients planning variances that are deemed uncontrollable.
 - (ii) Calculate the ingredients operating variances that are deemed controllable.
 - (iii) Calculate the mixture and yield variances.
 - (iv) Calculate the total variances for the batch.
- (b) "Balanced score card and performance measurement system endeavours to create a blend of strategic measures, outcomes and drive measures and internal and external measures". Discuss the statement and explain the major components of a balanced score card.
- (c) Explain clearly the terms Resource Smoothing and Resource Levelling.

Answer

(a) Details of original and revised standards and actual achieved

	Original standards		Revised standards		Actual	
Fruit	400 Kgs × Rs16	Rs6,400	400 Kgs × Rs 19	Rs7,600	428 Kgs × Rs 18	Rs7,704
Glucose	700 Kgs × Rs10	Rs7,000	700 Kgs × Rs12	Rs 8,400	742 Kgs × Rs 12	Rs 8,904
Pectin	99 Kgs × Rs 33.2	Rs 3286.8	99 Kgs × Rs 33.2	Rs 3286.8	125Kgs × Rs 32.8	Rs 4,100
Citric acid	1 Kg × Rs 200	Rs 200	1 Kg × Rs 200	Rs 200	1 Kg × Rs 95	Rs 95
	1,200 kgs	Rs16,886.8	1,200 kgs	Rs19,486.8	1,296 kgs	Rs20,803
Labour		Rs 585.0		Rs 585.0		Rs 600
	1,200 kgs	17,471.8	1,200 kgs	20,071.8	1,296 kgs	21,403
Loss	36 kgs		36kgs		132	
	1,164kgs	Rs 17,471.8	1,164kgs	Rs 20,071.8	1,164 Kgs	Rs 21,403

(i) Planning variances

* Fruit extract (6,400 less 7,600)	Rs 1,200(Adverse)
Glucose syrup (7,000 less 8,400)	Rs1,400(Adverse)
Total	Rs 2,600(Adverse)

* (Std qty × Std price less Std qty × Revised Std price)

(ii) Ingredients operating variances

Total (19,486.8 less 20,803) = Rs 1,316.2(Adverse)

Ingredients Price variance

(Revised Material Price – Actual Material Price) × (Actual Qty Consumed)

		Variance in Rs
Fruit extract	(19 – 18) × 428	428(F)
Glucose syrup		Nil
Pectin	(33.2 – 32.8) × 125	50(F)
Citric acid	(200 – 95) × 1	105(F)
		583(F)

Usage variance

(Std Qty on Actual Production less Actual Qty on Actual Production) × Revised Std Price/Unit

	Rs	Variance in Rs
Fruit extract	(400 – 428) × 19	532(A)
Glucose syrup	(700 – 742) × 12	504(A)
Pectin	(99 – 125) × 33.2	863.2(A)
Citric acid		Nil
		1,899.2(A)

(iii) Mix Variance

(Actual usage in std mix less Actual usage in actual mix) × std price

		Variance in Rs
Fruit extract	(432 – 428) × 19	76(F)
Glucose syrup	(756 – 742) × 12	168 (F)
Pectin	(106.92 – 125) × 33.2	600.3(A)
Citric acid	(1.08 – 1) × 200	16(F)
		340.3 (A)

Yield variance

$$\begin{aligned}
 & (\text{Actual yield} - \text{Std yield from actual output}) \times \text{Std cost per unit of output} \\
 & = (1,164 - 1,296 \times 0.97) \times \frac{19486.8}{1164} = 1,558.9(\text{A})
 \end{aligned}$$

Labour operating variance

$$585 - 600 = 15(\text{A})$$

- (iv) Total variance = Planning variance + Usage Variance + Price Variance + labour operating Variance.

$$\text{Or Total Variance} = (2,600) + (1,899.2) + 583 + (15) = 3931.2 (\text{A}).$$

- (b) The balanced score card translates an organization's mission and strategy into a comprehensive set of performance measures that provides the framework for implementing its strategy. The balanced score card does not focus solely on achieving financial objectives. It is an approach, which provides information to management to assist in strategic policy formulation and achievement. It emphasizes the need to provide the user with a set of information, which addresses all relevant areas of performance in an objective and unbiased manner. As a management tool it helps companies to assess overall performance, improve operational processes and enables management to develop better plans for improvements.

Major components of a balanced scorecard - The components of balanced score cards varies form business to business. A well designed balanced scorecard combines financial measures of post performance with measures of firm's drivers of future performance. The specific objectives and measures of an organization-balanced scorecard can be derived from the firm's vision and strategy. Generally, balanced score card has the following four perspectives from which a company's activity can be evaluated.

- (i) **Financial perspective:** Financial perspective measures the results that the organization delivers to its stakeholders. The measures are: operating income, revenue growth, revenues from new products, gross margin percentage, cost reduction in key areas, economic value added, return on investment.
- (ii) **Customer perspective:** The customer perspective considers the business through the eyes of customers, measuring and rejecting upon customer satisfaction.
The measures are: - market share. customer satisfaction, customer retention percentage, time taken to fulfil customer's requests.
- (iii) **Internal business perspective:** The internal perspective focuses attention on the performance of the key internal processes, which drive the business such as innovative process, operation process and post-sales services.
- (iv) **Learning & growth perspective:** The measure are:- employee education & skills levels, employee turnover ratio, information system availability, percentage of

employee suggestion implemented etc.

- (c) **Resource Smoothing:** It is a network technique used for smoothening peak resource requirement during different periods of the project network. Under this technique the total project duration is maintained at the minimum level. The resources required for completing different activities of project are smoothened by utilising floats available on non-critical activities. These non-critical activities having floats are rescheduled or shifted so that a uniform demand on resources is achieved. The constraint is on the project duration time.

Resource Levelling: It is also a network technique used for reducing the requirement of particular resource due to its paucity. It utilizes the large floats available on non-critical activities of the project and thus cuts down the demand on the resources.

In resource levelling, the maximum demand of a resource should not exceed the available limit at any point of time. To achieve this, non-critical activities are rescheduled by utilising their floats. It may lead to enlarging the completion time of the project. The constraint here is on the limit of the resource availability.

Question 3

- (a) *During the last 20 years, KL Ltd's manufacturing operation has become increasingly automated with Computer-controlled robots replacing operators. KL currently manufactures over 100 products of varying levels of design complexity. A single plant wise overhead absorption rate, based on direct labour hours, is used to absorb overhead costs.*

In the quarter ended March, KL's manufacturing overhead costs were:

	(Rs. '000)
Equipment operation expenses	125
Equipment maintenance expense	25
Wages paid to technicians	85
Wages paid to Store men	35
Wages paid to despatch staff	40
	310

During the quarter, the company reviewed the Cost Accounting System and concluded that absorbing overhead costs to individual products on a labour hour absorption basis is meaningless. Overhead costs should be attributed to products using an Activity Based Costing (ABC) system and the following was identified as the most significant activities:

- (i) *Receiving component consignments from suppliers*
- (ii) *Setting up equipment for production runs*
- (iii) *Quality inspections*

- (iv) Despatching goods as per customer's orders.

It was further observed that in the short-term KL's overheads are 40% fixed and 60% variable. Approximately, half the variable overheads vary in relating to direct labour hours worked and half vary in relation to the number of quality inspections.

Equipment operation and maintenance expenses are apportioned as:

- Component stores 15% , manufacturing 70% and goods dispatch 15%

Technician's wages are apportioned as :

- Equipment maintenance 30% , set up equipment for production runs 40% and quality inspections 30%

During the quarter :

- a total of 2000 direct labour hours were worked (paid at Rs. 12 per hr.)
- 980 components consignments were received from suppliers
- 1020 production runs were set up
- 640 quality inspections were carried out
- 420 orders were dispatched to customers.

KL's production during the quarter included components R, S and T. The following information is available:

	Component R	Component S	Component T
Direct labour Hrs worked	25	480	50
Direct Material	Rs. 1,200	Rs. 2,900	Rs. 1,800
Component Consignments Recd.	42	24	28
Production runs	16	18	12
Quality Inspections	10	8	18
Orders (goods) despatched	22	85	46
Quantity produced	560	12,800	2,400

Required:

- Calculate the unit cost of R, S and T components, using KL's existing cost accounting system.
 - Explain how an ABC system would be developed using the information given. Calculate the unit cost of components R, S and T using ABC system.
- (b) An electronics firm which has developed a new type of fire-alarm system has been asked to quote for a prospective contract. The customer requires separate price quotations for each of the following possible orders:

Order	Number of fire-alarm systems
First	100
Second	60
Third	40

The firm estimates the following cost per unit for the first order:

Direct materials	Rs. 500
Direct labour	
Deptt. A (Highly automatic) 20 hours at Rs. 10 per hour	
Deptt. B (Skilled labour) 40 hours at Rs. 15 per hour	
Variable overheads	20% of direct labour
Fixed overheads absorbed:	
Deptt. A	Rs. 8 per hour
Deptt. B	Rs. 5 per hour

Determine a price per unit for each of the three orders, assuming the firm uses a mark up of 25% on total costs and allows for an 80% learning curve. Extract from 80% Learning curve table:

X	1.0	1.3	1.4	1.5	1.6	1.7	1.8	1.9	2.0
Y%	100.0	91.7	89.5	87.6	86.1	84.4	83.0	81.5	80.0

X represents the cumulative total volume produced to date expressed as a multiple of the initial order.

Y is the learning curve factor, for a given X value, expressed as a percentage of the cost of the initial order.

Answer

- (a) (1) Single factory direct labour hour overhead rate = $\frac{\text{Rs } 3,10,000}{2,000} = \text{Rs } 155$ per direct labour hour

Computation of unit cost (existing system)

	R (Rs)	S(Rs)	T(Rs)
Direct labour cost @ Rs 12 per hour	300	5,760	600
Direct material	1,200	2,900	1,800

Overheads(direct labour hours × Rs 155 per hour	3,875	74,400	7,750
	5,375	83,060	10,150
Quantity Produced (No)	560	12,800	2,400
Cost per unit	9.60	6.49	4.23

(2) ABC system involves the following stages,

1. Identifying the major activities that take place in an organisation.
2. Creating a cost pool /cost centre for each activity
3. Determining the cost driver for each activity
4. Assigning the cost of activities to cost objects (e.g. products, components, customers etc)

The most significant activities have been identified e.g. receiving components consignments from suppliers, setting up equipment for production runs, quality inspections, and despatching orders to customers. The following shows the assignment of the costs to these activities,

	(Rs ,000)				
	<i>Receiving supplies</i>	<i>Set ups</i>	<i>Quality inspection</i>	<i>Despatch</i>	<i>Total</i>
Equipment operation expenses	18.75	87.50		18.75	125
Maintenance	3.75	17.50		3.75	25
Technicians wages initially allocated to Maintenance(30% of Rs 85,000= Rs 25,500 and then reallocated on same basis on maintenance)	3.83	17.85		3.82	25.5
Balance of technicians wages allocated to set ups and quality inspections		34.00	25.50		59.50
Stores wages - Receiving	35				35
Despatch wages - Despatch				40	40
	61.33	156.85	25.50	66.32	310

Note : Equipment operation expenses and Maintenance allocated on the basis 15%,70% and 15% as specified in the question.

The next stage is to identify the cost drivers for each activity and establish cost

driver rates by dividing the activity costs by a measure of cost driver usage for the period. The calculations are as follows :-

$$\text{Receiving supplies } \left(\frac{\text{Rs } 61,330}{980} \right) = \text{Rs } 62.58 \text{ per component.}$$

$$\text{Performing set ups } \left(\frac{1,56,850}{1,020} \right) = \text{Rs } 153.77 \text{ per set up}$$

$$\text{Despatching goods } \left(\frac{66,320}{420} \right) = \text{Rs } 157.93 \text{ per despatch}$$

$$\text{Quality inspection } \left(\frac{25,500}{640} \right) = \text{Rs } 39.84 \text{ per quality inspection}$$

Finally, costs are assigned to components based on their cost driver usage. The assignments are as follows,

	<i>R (Rs)</i>	<i>S(Rs)</i>	<i>T(Rs)</i>
Direct labour	300	5,760	600
Direct materials	1,200	2,900	1,800
Receiving supplies	2,628.36	1,501.92	1,752.24
Performing set ups	2,460.32	2,767.86	1,845.24
Quality inspections	398.40	318.72	717.12
Despatching goods	3,474.46	13,424.05	7,264.78
Total costs	10,461.54	26,672.55	13,979.38
No of units produced	560	12,800	2,400
Cost per unit	18.682	2.08	5.82

For components, the overhead costs have been assigned as follows,

(Component R)

Receiving supplies (42 receipts at Rs 62.58)

Performing set ups (16 production runs at Rs 153.77)

Quality inspections (10 at Rs 39.84)

Despatching goods (22 at Rs 157.93).

(b) (i) Price per unit for first order of 100 units

	<i>Rs</i>	<i>Rs</i>
Direct material		500.00
Direct labour	Dept A 20 Hrs @ 10 = 200	800.00

	Dept B 40 Hrs @ 15 = 600	
Variable Overhead	20% of Rs 800	160.00
Fixed Overhead	Dept A 20 Hrs @ 8 = 160	360.00
	Dept B 40 Hrs @ 5 = 200	
Total cost		1,820.00
Profit 25%		455.00
Selling price per unit		2,275.00

(ii) Price per unit for second order of 60 units

Learning will be applicable only in department B.

Cumulative output becomes 100 units + 60 units = 160 units i.e. 1.6 times for which learning is 86.1 % from the tables.

Therefore Total Hrs for 160 units = 160 units $\times$ 40 $\times$.861 = 5,510.4 Hrs

Therefore Hrs for 60 units = Hrs for 160 units less Hrs for 100 units

Or 5510.4 less 40 $\times$ 100 = 1510.4 Hrs

Therefore Hrs per unit = $\frac{1510.4}{60} = 25.17$

Calculation of selling price per unit

		Rs
Direct materials		500.00
Direct labour	Dept A 20 Hrs @ 10 = 200	577.55
	Dept B 25.17 Hrs @ 15 = 377.55	
Variable Overhead	20% of 577.55	115.51
Fixed Overhead	Dept A 20 Hrs @8= 160	285.85
	Dept B 25.17 Hrs @5=125.85	
Total cost		1,478.91
Profit 25%		369.73
Selling price per unit		1,848.64

(iii) Price per unit for third order of 40 units

Cumulative output becomes 100 + 60 + 40 = 200 units i.e. 2 times for which learning is 80% from the table

Total Hrs for 200 units = 200 $\times$ 40 $\times$.80 = 6,400 Hrs

Hrs for 40 units = Hrs for 200 units less Hrs for 160 units

Or 6,400 less 5510.4 = 889.6 Hrs

$$\text{Therefore Hrs per unit} = \frac{889.6}{40} = 22.24$$

Calculation of selling price per unit

		Rs
Direct materials		500.00
Direct labour	Dept A 20 Hrs @ 10 = 200.00	533.60
	Dept B 22.24 @ 15 = 333.60	
Variable Overhead	20% of 533.60	106.72
Fixed Overhead	Dept A 20 Hrs @ 8 = 160	271.20
	Dept B 22.24 Hrs @ 5 = 111.20	
Total cost		1,411.52
Profit 25%		352.88
Selling price per unit		1,764.40

Question 4

- (a) "The diverse use of routinely recorded cost data give rise to a fundamental danger information prepared for one purpose can be grossly misleading in another context".

Discuss to what extent the above statement is valid and explain your conclusion.

- (b) Explain different types of Competitive pricing ?

- (c) R Ltd. has spare capacity in two of its manufacturing departments – Department 4 and Department 5. A five-day week of 40 hours is worked, but there is only enough internal work for 3 days per week so that 2 days per week (16 hours) could be available in each department. R Ltd. has sold this time to another manufacturer, but there is some concern about the profitability of this work.

The accountant has prepared a table giving the hourly operating cost in each department. The summarised figures are as follows:

	Department 4	Department 5
	Rs.	Rs.
Power costs	40	60
Labour costs	40	20
Overhead costs	40	40
	<u>120</u>	<u>120</u>

The labour is paid on a time basis and there is no charge in the weekly wage bill whether or not the plant is working at full capacity. The overhead figures are based on firm's current overhead absorption rates (fixed and variable) when the departments are operating at 90% of full capacity (assume a 50 week year). The budgeted fixed overhead attributed to department 4 is Rs. 36,000 p.a. and that for Deptt. 5 Rs. 50,400 p.a.

As a short term measure the company has been selling processing time to another

manufacturer @ Rs. 70 per hour in either departments. The customer is willing to continue this arrangement and to purchase any spare time available, but R Ltd. is considering the introduction of a new product on a minor scale to absorb the spare capacity.

Each unit of the new product would require 45 minutes in Deptt. 4 and 20 minutes in Deptt. 5. The variable cost of the required input material is Rs. 10 per unit. The market study indicated as follows:

- (i) with a selling price of Rs. 100, the demand would be 1,500 units p.a.
- (ii) with a selling price of Rs. 110, the demand would be 1,000 units p.a.
- (iii) with a selling price of Rs. 120, the demand would be 500 units p.a.

You are required to calculate the best weekly programme for the spare time in the two manufacturing departments, to determine the best price to charge for the new product and to quantify the weekly gain that this programme and price should yield.

Answer

- (a) A database should be maintained with costs appropriately coded and classified so that relevant cost information can be extracted to help managers make better decisions. Future costs rather than past costs are required for decision making. Therefore costs extracted from the data base should be adjusted to make it relevant for that purpose. For example, consider a situation where a company is negotiating a contract for the sale of one of its products with a customer in an overseas country which is not part of the normal market. If the company has temporary excess capacity and the contract is for 100 units for the month only, then the direct labour cost will remain the same irrespective of whether the contract is undertaken or not. The direct labour cost will therefore be irrelevant. Let us now assume that the contract is for 100 units per month for three years and the company has excess capacity. For long term decisions, direct labour will be relevant cost because if the contract is not undertaken, direct labour can be deployed or made redundant Undertaking the contract will result in additional labour costs.
- (b) Where a company sets its price mainly on the consideration of what its competitors are charging, its pricing under such situation is called competitive pricing. Two types of competitive pricing are:
 - (i) **Going rate Pricing** - under this method, the firm tries to keep its price at the average level charged by the industry. Such pricing is useful where it is difficult to measure costs. Adoption of such pricing will not only yield fair return but would be least disruptive for industry's harmony. Under highly competitive conditions in homogenous product market (such as food, raw materials and textiles) the company has no pricing decision to make.
 - (ii) **Sealed bid pricing** - Competitive pricing is adopted in situations where firms compete for jobs on the basis of bids. The bid is the firms offer price, and it is a prime example of pricing based on the expectations of how competitors will price

rather than on a rigid relation based on the concerns own costs or demand. The objective of the firm in bidding situation is to get the contract and therefore it tries to set its prices lower than the other bidding firms.

- (c) The relevant cost of producing the new product is the variable cost plus the lost contribution from selling the processing time to another manufacturer. It is given that, the main product will absorb 3 days per week.

Calculation of variable overhead rates

	Dept. 4	Dept. 5
Normal Hrs.per annum (0.9×40 hr×50 wks)	1,800 hrs	1,800hrs
Fixed O.H. rate/hr. (Rs.)	20 (36,000/1,800)	28(50,400/1800)
Total O.H. rate/hr (given) (Rs.)	40	40
Thus variable OH rate/hr (Rs.)	20	12

The variable costs per hour are:

Department 4 : Power Cost Rs 40 + Variable Cost Rs 20 = Rs 60

Department 5 : Power Cost Rs 60 + Variable Cost Rs 12 = Rs 72

Note: labour costs are fixed (given).

If the new product is not developed, dept. 4 shall sell unused processing time at Rs. 70 per hour. It is not profitable for Dept. 5 to sell processing time at Rs. 70 per hour since the variable costs is more at Rs. 72. Therefore the relevant cost per processing hour are

Dept. 4 Rs. 70 (Rs. 60 variable cost + Rs. 10 lost contribution for selling processing time)

Dept. 5 Rs. 72

Relevant cost for producing the new product

	Rs
Direct Material (Given)	10.00
Dept. 4, variable operating cost (0.75 hr ×Rs. 70)	52.50
Dept. 5 variable operating cost (0.33 hr. × Rs. 72)	24.00
Relevant cost	86.50

Additional contribution for various selling prices/demand levels

	Rs.	Rs.	Rs.
Selling price per unit	100	110	120
Restricted demand (Units)	* 1067	1000	500

Relevant cost (Rs)	86.50	86.50	86.50
Contribution (Rs)	13.50	23.50	33.50
Total Contribution (Rs)	14,404.50	23,500	16,750

$$* \text{ Dept 4 } (800 \text{ Hrs} \times \frac{4}{3}) = 1,067 \text{ units}$$

$$* \text{ Dept. 5 } (800 \text{ Hrs} \times 3) = 2400 \text{ units}$$

Hence selling 1000 units @ Rs. 110 per unit will achieve optimum contribution.

Computation of spare time for production of 1,000 units pa

	Department 4	Department 5
Time required per unit (Hours)	$\frac{3}{4}$	$\frac{1}{3}$
Total time for producing 1,000 units (Hours)	750	334
Time available (Hours)	800	800
Spare time (Hours)	50	466
Spare time per week (Hours)	1	9.32

Therefore Dept 4 can sell 1 hr. per week at Rs. 70 per hour.

It is not profitable to sell spare capacity of 9.32 hrs. / week at the existing rate of Rs. 70 per hour.

Weekly gain from this programme

	Rs.
Selling price	110
<i>Variable cost</i>	
Direct materials	10
Dept. 4 variable operating cost 0.75×60	45
Dept. 5 variable operating cost 0.33×72	24
	79
Contribution / unit	31
Weekly sale	20 units
Additional contribution / week	620
Plus contribution of selling 1 hr (selling price – variable cost = $70 - 60$)	10
Total contribution	630

Without the new product the weekly contribution 16 hours × Rs. 10 per hr	160
Additional gain for introducing the new product	470

Question 5

- (a) "Because a single budget system is normally used to serve several purposes, there is a danger that they may conflict with each other". Do you agree? Discuss.
- (b) AB Cycles Ltd. has 2 divisions, A and B which manufacture bicycle. Division A produces bicycle frame and Division B assembles rest of the bicycle on the frame. There is a market for sub-assembly and the final product. Each division has been treated as a profit centre. The transfer price has been set at the long-run average market price. The following data are available to each division:

Estimated selling price of final product	Rs. 3,000 p.u.
Long run average market price of sub-assembly	Rs. 2,000 p.u.
Incremental cost of completing sub-assembly in division B	Rs. 1,500 p.u.
Incremental cost in Division A	Rs. 1,200 p.u.

Required:

- (i) If Division A's maximum capacity is 1,000 p.m. and sales to the intermediate are now 800 units, should 200 units be transferred to B on long-term average price basis.
- (ii) What would be the transfer price, if manager of Division B should be kept motivated?
- (iii) If outside market increases to 1,000 units, should Division A continue to transfer 200 units to Division B or sell entire production to outside market?
- (c) Determine the selling price per unit to earn a return of 12% net on capital employed (net of Tax @ 40%).

The cost of production and sales of 80,000 units per annum are:

Material	Rs. 4,80,000	Labour	Rs. 1,60,000
Variable overhead	Rs. 3,20,000	Fixed overhead	Rs. 5,00,000

The fixed portion of capital employed is Rs. 12 lacs and the varying portion is 50% of sales turnover.

Answer

- (a) A single budget system may be conflicting in planning and motivation, and planning and performance evaluation roles as below:
- (i) Planning and motivation roles – Demanding budgets that may not be achieved may be appropriate to motivate maximum performance but they are unsuitable for

planning purposes. For these, a budget should be a set based on easier targets that are expected to be met.

- (ii) Planning and performance evaluation roles – For planning purposes budgets are set in advance of the budget period based on an anticipated set of circumstances or environment. Performance evaluation should be based on a comparison of active performance with an adjusted budget to reflect the circumstance under which managers actually operated.

- (b) (i) In this case there are two options available –

(a)	Sell at the sub assembly stage (after completion of Div. A) @ Rs. 2000/-	
	Incremental cost in Div. A	Rs 1,200/-
	Contribution	Rs 800/-
(b)	Sell at the final product stage	Rs. 3,000
	Cost at Div. A and Div. B Rs(1200+1500)	Rs 2,700
	Contribution	Rs 300

Therefore it is profitable to sell at the subassembly stage because of higher contribution, provided there is a market.

Hence, if there is market at intermediate stage, first priority is to sell intermediary (sub assembly). Therefore, 800 units should be sold as sale of intermediary.

The balance capacity available of $(1000 - 800) = 200$ units should be transferred to B and B should complete the assembly and sell as final product, since the company can earn Rs. 300 per unit for each unit of such sale.

- (ii) If B Div. receives the subassembly at market price of Rs. 2,000, plus its own incremental cost of Rs. 1,500 will give total cost of Rs. 3,500, thereby yielding a loss of Rs. $3500 - 3000 = \text{Rs. } 500$ per unit, whereas the company makes a profit of Rs. 300 per unit.

In order to keep the manager of Div. B motivated, the profit earned of Rs. 300 per unit should be shared between A and B. Hence transfer price will be variable cost of Div. A + 50% of profit earned in the final product = $1200 + 150 = \text{Rs. } 1,350$

- (iii) Both Div. A and the Company make higher contribution by selling to intermediate market. If the market demand increases to 1,000 units, the full quantity should be sold outside as intermediary and nothing should be transferred to Div. B.

- (c) Return of 12% net (after tax of 40%) on capital employed is equivalent to $12\% \div (1 - 0.4) = 20\%$ (gross) on capital employed.

Let selling price per unit to be 'x'

Since Total sales = Total cost + profit

$$\text{i.e. } 80,000x = 14,60,000 + 20\% (12,00,000 + 0.5 \times 80,000x)$$

$$\text{or, } 80,000x = 14,60,00 + 2,40,000 + 8,000x$$

$$\text{or, } 72,000x = 17,00,000$$

$$\text{or, } 'x' = \frac{17,00,000}{72,000} = \text{Rs. } 23.61$$

Hence selling price per unit will be Rs. 23.61

Question 6

- (a) Explain which features of the Service organisations may create problems for the application of activity-based costing.
- (b) A company manufactures two products A and B, involving three departments – Machining, Fabrication and Assembly. The process time, profit/unit and total capacity of each department is given in the following table:

	Machining (Hours)	Fabrication (Hours)	Assembly (Hours)	Profit (Rs).
A	1	5	3	80
B	2	4	1	100
Capacity	720	1,800	900	

Set up Linear Programming Problem to maximise profit. What will be the product Mix at Maximum profit level ?

- (c) A product comprised of 10 activities whose normal time and cost are given as follows:

Activity	Normal Time (days)	Normal cost
1-2	3	50
2-3	3	5
2-4	7	70
2-5	9	120
3-5	5	42
4-5	0	0
5-6	6	54
6-7	4	67
6-8	13	130
7-8	10	166

Indirect cost Rs. 9 per day.

- (i) Draw the network and identify the critical path.

- (ii) What are the project duration and associated cost ?
 (iii) Find out the total float associated with each activity.

Answer

(a) The following may create problem for adoption of ABC system in service organisation –

- (i) Facility sustaining costs (such as property, rents etc.) represent a significant portion of total costs and may only be avoidable if the organisation ceases business. It may be impossible to establish appropriate cost drivers.
 (ii) It is often difficult to define products where they are of intangible nature. Cost objects can therefore be difficult to specify.
 (iii) Many service organisations have not previously had a costing system and much of the information required to set up a ABC system will be non-existent. Therefore introduction of ABC may be expensive.

- (b) Maximize $z = 80x + 100y$ subject to
- $$\begin{aligned} x + 2y &\leq 720 \\ 5x + 4y &\leq 1800 \\ 3x + y &\leq 900 \\ x \geq 0, y &\geq 0 \end{aligned}$$
- where $x = \text{No. of units of A}$
 $y = \text{No. of units of B}$

By the addition of slack variables s_1, s_2 and s_3 the inequalities can be converted into equations. The problem thus become

$$\begin{aligned} z = 80x + 100y \text{ subject to } & x + 2y + s_1 = 720 \\ & 5x + 4y + s_2 = 1800 \\ & 3x + y + s_3 = 900 \end{aligned}$$

$$\text{and } x \geq 0, \quad y \geq 0, \quad s_1 \geq 0, \quad s_2 \geq 0, \quad s_3 \geq 0$$

Table I

	Profit/unit	Qty.	80 X	100 Y	0 S ₁	0 S ₂	0 S ₃	
S ₁	0	720	1	2	1	0	0	$\frac{720}{2} = 360$
S ₂	0	1800	5	4	0	1	0	$\frac{1800}{4} = 450$
S ₃	0	900	3	1	0	0	1	$\frac{900}{1} = 900$
Net evaluation row			80	100	0	0	0	

$$1800 - 720 \times 4/2 = 360$$

$$5 - 1 \times 2 = 3$$

$$4 - 2 \times 2 = 0$$

$$0 - 1 \times 2 = -2$$

$$1 - 0 \times 2 = 1$$

$$0 - 0 \times 2 = 0$$

$$900 - 720 \times 1/2 = 540$$

$$3 - 1 \times 1/2 = 5/2$$

$$1 - 2 \times 1/2 = 0$$

$$0 - 1 \times 1/2 = -1/2$$

$$0 - 0 \times 1/2 = 0$$

$$1 - 0 \times 1/2 = 1$$

Table 2:

			80	100	0	0	0	
Program	Profit/unit	Qty.	X	Y	S ₁	S ₂	S ₃	
Y	100	360	1/2	1	1/2	0	0	360 ÷ 1/2 = 720
S2	0	360	3	0	-2	1	0	360 ÷ 3 = 120
S3	0	540	5/2	0	-1/2	0	1	540 ÷ 5/2 = 216
Net evaluation row			30	0	-50	0	0	

$360 - 360 \times 1/6 = 300$	$540 - 360 \times 5/6 = 240$
$1/2 - 3 \times 1/6 = 0$	$5/2 - 3 \times 5/6 = 0$
$1 - 0 \times 1/6 = 1$	$0 - 0 \times 5/6 = 0$
$1/2 - 2 \times 1/6 = 5/6$	$-1/2 - 2 \times 5/6 = 7/6$
$0 - 1 \times 1/6 = -1/6$	$0 - 1 \times 5/6 = -5/6$
$0 - 0 \times 1/6 = 0$	$1 - 0 \times 5/6 = 1$

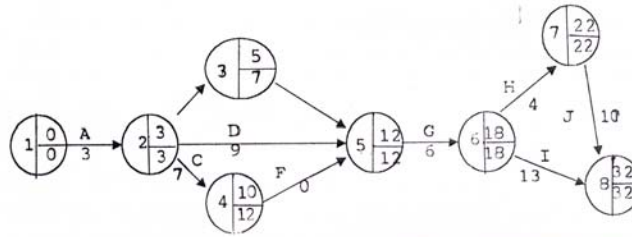
Table 3:

			80	100	0	0	0
Program	Profit/unit	Qty.	X	Y	S ₁	S ₂	S ₃
Y	100	300	0	1	5/6	-1/6	0
X	80	120	1	0	-2/3	1/3	0
S3	0	240	0	0	7/6	-5/6	1
Net evaluation row			0	0	-500/6	+100/6	
					+160/3	-80/3	0
					$= \frac{180}{6}$	$= -\frac{60}{6}$	

All the values of the net evaluation row of Table 3 are either zero or negative, the optimal program has been obtained.

Here $X = 120$, $y = 300$ and the maximum profit
 $= 80 \times 120 + 100 \times 300 = 9600 + 30,000$
 $= \text{Rs. } 39,600.$

(c)



Critical path A D G H J

1-----2-----5-----6-----7-----8

(ii) A D G H J is the critical path having normal project duration

$3 + 9 + 6 + 4 + 10 = 32$ days

Normal project cost:- Direct cost = Rs. 704

Indirect cost (32×9) = 288

992

(iii) Calculation of total float

Activity	Nt(days)	E_F	L_F	Float ($L_F - E_F$)
1-2	3	3	3	0
2-3	3	6	7	1
2-4	7	10	12	2
2-5	9	12	12	0
3-5	5	11	12	1
4-5	0	10	12	2
5-6	6	18	18	0
6-7	4	22	22	0
6-8	13	31	32	1
7-8	10	32	32	0

FINAL COURSE – GROUP-II
SUGGESTED ANSWER OF MAY 20005

PAPER – 6 : MANAGEMENT INFORMATION AND CONTROL SYSTEMS

*Question No. 1 is compulsory. Answer any **four** questions from the remaining six questions.
All questions carry equal marks.*

Question 1

(a) *Your client has recently switched over from manual accounting to computerised accounting. When you receive computerized accounts for the first quarter, you find the following types of error:*

- (i) *Incomplete or unauthorized data input*
- (ii) *Errors in the files or database during updating*
- (iii) *Improper distribution or disclosure of output.*

You, as an information system auditor, suggest the suitable test of controls for audit of computer processing so that the above-mentioned errors can be prevented. (10 marks)

(b) *State the objectives and scope of IT Act, 2000. (5 marks)*

(c) *Why is Computer fraud a serious threat to any business organisation ? (5 marks)*

Answer

(a) **Test of controls for Audit of Computer Processing:** During computer processing, the system might fail to detect erroneous input, improperly correct input errors, process erroneous input into files or databases during updating. Auditors must periodically re-evaluate processing controls to ensure their reliability. The following test of controls may be used:

- Evaluate adequacy of processing control standards and procedures.
- Evaluate adequacy and completeness of data editing controls.
- Verify adherence to processing control procedures by observing computer operations and the data control function.
- Verify that selected application system output is properly distributed.
- Reconcile a sample of batch totals and follow up on discrepancies.
- Trace disposition of a sample of errors flagged by data edit routines to ensure proper handling.
- Verify processing accuracy for a sample of sensitive transactions.
- Verify processing accuracy for a selected computer generated transactions.
- Search for erroneous or unauthorized code via analysis of program logic.
- Check accuracy and completeness of processing controls using test data.
- Monitor online processing using concurrent audit techniques.
- Recreate selected reports to test for accuracy and completeness.

The auditor must periodically re-evaluate processing controls to ensure their continued reliability. If processing controls are unsatisfactory, user and source data controls may be strong enough to compensate.

- (b) The IT Act 2000, passed by both the houses of Indian Parliament in May 2000 and subsequently received the assent of the President in August 2000, contains the Cyber Laws. It provides the legal infrastructure for e-commerce and it is important to understand the various perspectives of the Act.

The objectives of the Act are:

- To grant legal recognition to transactions carried out through electronic data interchange and other means of electronic communication commonly referred to as "electronic commerce" replacing the paper-based communication;
- To give legal recognition to Digital Signature for authentication of any information or matter which requires authentication under any law;
- To facilitate electronic filing of documents with Government Departments;
- To facilitate electronic data storage;
- To facilitate and give legal sanction to electronic funds transfers between banks and financial institutions;
- To give legal recognition for keeping of books of account by Bankers in electronic form;
- To amend the Indian Penal Code, the Indian Evidence Act, 1872; the Banker's Book Evidence Act, 1891 and the Reserve Bank of India Act, 1934.

Scope of the Act: This Act is applicable to whole of India, unless otherwise provided in the Act. It also applies to any offence or contravention there under committed outside India by any person.

Different provisions of this Act came into force on the different dates as notified by the Central Government.

The Act shall not be applicable to the following :

- a negotiable instrument as defined in Section 13 of the Negotiable Instruments Act, 1881;
- a Power of Attorney as defined in Section 1A of the Powers-of-Attorney Act, 1882;
- a trust as defined in Section 3 of the Indian Trusts Act, 1882;
- a will as defined in Section (h) of Section 2 of the Indian Succession Act, 1925 including any other testamentary disposition by whatever name called;
- any contract for the sale or conveyance of immovable property or any interest in such property;
- Any such class of documents or transactions as may be notified by the Central Government in the Official Gazette.

- (c) In the modern business scenario, most of the businesses are dependent on networked or stand-alone computers. Even so, the individual businesses are also linked through computer networks or by electronic payments over the Internet. Hence, with the growth of electronic commerce and electronic cash, there are major threats of hacking, risk of interception and thefts, as well as destruction of electronic payments during transmissions.

It is very evident that the computer fraud is very different from the conventional frauds as:

- It is easily hidden and hard to detect. There may not be any easily recognizable audit trail and the fraud is likely to be hidden in enormous volumes of data.
- Evidence of computer crime, besides being hard to be found out, is difficult to present to a court in a manner, which is legally admissible and effective. It is not only extremely difficult to prosecute or defend the computer crimes; it is very hard to ensure that the evidence complies with the relevant statutes. It is also difficult to explain to the judge or jury having insufficient exposure to computers especially in India.
- There are various ways, which may not be obvious, to commit the computer frauds e.g.:
 - A few keystrokes are needed to manipulate the invisible data.
 - Employees as well as outsiders can access any computer remotely.
 - Huge volume of data can be transported on a floppy or CD which can be written in a very short time.

Lack of knowledge about the functioning of computers and protection of systems enables the fraudster to take advantage and commit the computer frauds/crimes. The extent of damage caused by the unauthorized interference with computer system may be totally disproportionate with the effort involved to cause the damage e.g. the insertion of virus takes few seconds whereas the loss/damage of data may be enormous as it may have been collected and created in the organisation since the inception of the computer.

“Using a computer to cause prejudice, in the sense of financial and / or reputational damage, to a business” may be called a Computer Fraud. This statement describes precisely the damages caused by any computer fraud. Hence, the computer fraud, committed in any manner, is a serious threat to the business and appropriate measures must be taken to prevent the computer frauds.

Question 2

- (a) *What is “Information Security”? State the core principles of Information Security.*
(10 marks)
- (b) *“A decision support system supports the human decision-making process rather than providing a means to replace it”. Justify the above statement by stating the characteristics of decision support system.*
(5 marks)

- (c) *Describe the main pre-requisites of a Management Information System, which makes it an effective tool.* (5 marks)

Answer

- (a) **“Information Security”** relates to protection of valuable asset (data or information) in any form recorded, processed, stored, shared, transmitted or retrieved. The data or information is protected against all threats leading to its loss, damage, inaccessibility, integrity or unauthorized disclosure. The protection of these valuable assets is achieved by deploying layered series of technical as well as non-technical safeguards such as physical security, user-ids, passwords, smart cards, biometrics, anti-virus, firewalls etc.

In other words, it can be stated that the objective of Information Security is to safeguard the interests of those relying on Information and the Information Systems as well as communications delivering the information, against any harm resulting from failure of confidentiality, integrity and availability (CIA).

There are eight core principles supporting the Information Security as stated below:

- (i) **Accountability:** The roles, responsibility and accountability of data owners, process owners, technology providers and users have to be defined very explicitly, formalized and communicated to all concerned. In accomplishment of this, the following areas have to be addressed:
- Specification of ownership of data and Information;
 - Users identification and their authorization for accessibility of information;
 - Log-book of activities for management audit trails;
 - Assignment of responsibilities for maintenance of data and information;
 - Institution of investigative and remedial procedures on occurrence of breach or attempt to breach of security
- (ii) **Awareness:** In order to foster confidence in information, the data owners, process owners, technology providers, users and other concerned parties with legitimate interest must be enlightened and trained to gain the knowledge about the existence and extent of general risks, which the organisation and its systems are facing, the security initiatives and requirements of the organisation.

The following issues need to be considered:

- Level of detail disclosed must not compromise security;
- Appropriate knowledge is available to all parties, not just users, who have a legitimate right to be informed.
- Awareness is part of the induction program for new recruits to an organisation so as to build security awareness as part of the corporate culture.
- Recognition that maintaining awareness is an on-going process.

- (iii) **Multidisciplinary:** While addressing the information security, both technical as well

as non-technical issues have to be addressed. Security is not only technology, it covers much wider areas such as administrative, organisational, operational and legal issues. Hence, Information Security policies and procedures have to be developed and reinforced through technical standards, codes of practice, audit, legislative, legal and regulatory requirements, and also through awareness, education and training.

Issues to consider are:

- Business value or sensitivity of the information asset;
- Impact of the organizational and technological changes on the administration of security;
- Technologies that are available to meet the security objectives;
- Requirements of legislation and industry norms; and
- Requirements to carefully manage advanced security techniques.

- (iv) **Cost Effectiveness:** Different levels of security may be required to address the risks to information. Security levels and associated costs must be compatible with the value of the information.

Issues to consider include:

- Value to and dependence of the organisation on particular information assets;
- Value of the data or information itself, based on a pre-defined level of confidentiality or sensitivity;
- Threats to the information, including the severity and probability of such threats;
- Safeguards that will minimize or eliminate the threats, including the costs of implementing the safeguards;
- Costs and benefits of incremental increases to the level of security;
- Safeguards that will provide an optimum balance between the harm arising from a security breach and the costs associated with the safeguards; and
- Where available and appropriate, the benefit of adopting established minimum security safeguards as a cost-effective alternative to balancing costs and risks.

- (v) **Integration:** The information security policies, procedures and practices must be coordinated and integrated with other policies and procedures of the organisation as well as third parties associated with the business processes of the organisation so that a coherent and effective security system is evolved. This requires that all levels of the information cycle-gathering, recording, processing, storing, sharing, transmitting, retrieving, and deleting-are covered.

Issues to be considered are:

- Security policy and management included as an integral part of the overall management of the organization;
- Concurrent development of security systems with information systems or, at least, harmonization of all security processes to provide a consistent security framework;
- Review of inter-related systems to ensure that the level of security is compatible; and
- Risks relating to third parties on whom the organization's business processes depend.

(vi) **Reassessment / Audit:** The information Security is not just a one-time effort, it is an unending journey. Hence, it should be reassessed / audited periodically as the information system and its security requirements keep on varying over time.

Issues to be considered are:

- Increase in dependence on the information systems requiring an upgrade to the business continuity plans and arrangements;
- Changes to the information systems and their infrastructure;
- New threats to the information systems requiring better safeguards;
- Emerging security technologies providing more cost effective safeguards than were possible earlier; and
- Different business focus, or organizational structure, or legislation necessitating a change in the existing level of security.

(vii) **Timeliness:** The information security procedures, so evolved and implemented must ensure the timely response to the real or attempted breach. Automated tools must be deployed to support real-time and after-the-fact monitoring.

(viii) **Ethical Factors:** Information and its security must be provided and used in a manner respecting the rights and interests of others. In other words, the level of security must be consistent with the use and flow of information, a hallmark of a democratic society. The following must be promoted amongst the users:

- Ethical use and / or disclosure of data and information.
- Fair presentation of data and information to users.
- Secure destruction of data or information, sensitive but not required any longer.

(b) A decision support system (DSS) is defined as a system that provides tools to managers to assist them in solving semistructured and unstructured problems in their own way. A DSS is not intended to make decisions for managers, but rather to provide managers with a set of capabilities that enables them to generate the information required by them in making decisions. The DSS are characterised by following three properties:

- (i) **Semi-structured / Unstructured decisions** – Structured decisions are those that are easily made from a given set of inputs. Unstructured decisions and semi-structured decisions are decisions for which information obtained from a computer system is only a portion of the total knowledge needed to make the decision. The DSS is particularly well adapted to help with semi-structured / unstructured decisions. In DSS, the problem is first defined and formulated. It is then modelled with DSS software. The model is run on the computer to provide results. The modeller, in reviewing these results, might decide to completely reformulate the problem, refine the model, or use the model to obtain other results.
 - (ii) **Ability to adapt to changing need** – Semi-structured / unstructured decisions often do not conform to a predefined set of decisions-making rules. Because of this, their decision support system must provide for enough flexibility to enable users to model their own information needs. The DSS designer understands that managers usually do not know in advance what information they need and, even if they do, those information needs keep changing constantly. Thus, rather than locking the system into rigid information producing requirements, capabilities and tools are provided by DSS to enable users to meet their own output needs.
 - (iii) **Ease of Learning and Use** - Since decision support systems are often built and operated by users rather than by computer professionals, the tools that company possesses should be relatively easy to learn and use. Such software tools employ user-oriented interfaces such as grid, graphics, non-procedural 4GL and easily read documentation. These interfaces make it easier for user to conceptualise and perform the decision making process.
- (c) **Pre-requisites of an MIS** – The following are pre-requisites of an effective MIS:
- (i) **Database** – It is a superfile which consolidates data records formerly stored in many data files. The data in database is organised in such a way that access to the data is improved and redundancy is reduced. Normally, the database is subdivided into major information sub-sets needed to run. The database should be user-oriented, capable of being used as a common data source, available to authorized persons only and should be controlled by a separate authority such as DBMS. Such a database is capable of meeting information requirements of its executives, which is necessary for planning, organising and controlling the operations of the business.
 - (ii) **Qualified System and Management Staff** - MIS should be manned by qualified officers. These officers who are experts in the field should understand clearly the views of their fellow officers. The organizational management base should comprise of two categories of officers (i) System and Computer experts and (ii) Management experts. Management experts should clearly understand the concepts and operations of a computer. Their whole hearted support and cooperation will help in making MIS an effective one.
 - (iii) **Support of Top Management** - An MIS becomes effective only if it receives the full support of top management. To gain the support of top management, the officer should place before them all the supporting facts and state clearly the benefits

which will accrue from it to the concern. This step will certainly enlighten the management and will change their attitude towards MIS.

- (iv) **Control and Maintenance of MIS** – Control of the MIS means the operation of the system as it was designed to operate. Sometimes users develop their own procedures or shortcut methods to use the system, which reduces its effectiveness. To check such habits of users, the management at each level in the organisation should device checks for the information system control.

Maintenance is closely related to control. There are times when the need for improvements to the system will be discovered. Formal methods for changing and documenting changes must be provided.

- (v) **Evaluation of MIS** – An effective MIS should be capable of meeting the information requirements of its executives in future as well. The capability can be maintained by evaluating the MIS and taking appropriate timely action. The evaluation of MIS should take into account the following points:

- Examining the flexibility to cope with future requirements ;
- Ascertaining the view of the users and designers about the capabilities and deficiencies of the system ;
- Guiding the appropriate authority about the steps to be taken to maintain effectiveness of MIS.

Question 3

- (a) *What are the factors considered to design the ideal layout of a printed output?*

(10 marks)

- (b) *What is Vendor evaluation? Define the process for the same.*

(10 marks)

Answer

- (a) A printed output format is nothing but the arrangement of data items. While designing the printed output, the systems analyst builds the mock of actual report or document as planned to appear during actual operation. It should display the location, position of all information such as item details as well as summaries, control breaks with headings, names, addresses, instructions notes and comments etc. To start the designing, one has to determine the data items to be included in the output. The systems analyst can use layout screens, with a CASE Tools to design the report besides the manual process.

There are few guidelines to design the output, which should be followed while preparing the layout form. It will make the job much easier for the analyst, and also ensure that users will receive an understandable report. Some of these guidelines are as stated below:

1. Reports and documents should be so designed that it is to be read from left to right and top to bottom.

2. It should be easiest to find the most important items/highlights of the report.
 3. Each page of the report should include the title and heading of the report along with the page no., date of report generation and column headings. The title should be descriptive but yet concise. Each page should be numbered. Date of generation helps the users in determining the utility of the report at the time of reference and makes the complete review process a very effective one. Column headings serve to orient the user to the report contents.
 4. Each data item should have a heading, a very short and descriptive. Similar items should be grouped together on the report with the description printed only once at the change or in case it spills over to the next page.
 5. Control breaks should be used in the report for better readability. They should be clearly separated from rest of data with additional lines. In order to draw the attention of the user, either the boxes or bold letters or both should be used at control breaks. One can use special characters also to highlight the control breaks. This makes it easier to find critical information.
 6. There should be sufficient margin at left and right as well as at top and bottom for better concentration of the user. It also helps in getting the report bound for permanent records storage without any information being hidden in binding.
 7. The detail line for variable data should be defined by indicating whether each space is to be used for an alphabetic, special or numeric character.
 8. Finally the mock reports should be thoroughly reviewed by the users and programmers for feasibility, readability, usefulness, understandability as well as aesthetic appeal. This not only helps in generating the quality reports but also saves significant development efforts, which go into re-development of modified reports later.
- (b) Once the proposals are received from various vendors for the system, it is the responsibility of the IT Incharge or the committee to select the best product relevant to the requirements/needs of the organization. It is a very tedious and time consuming process and needs a very professional approach in order to safeguard the interests of the organization. The vendors would be offering various types of variations, configurations and options. In order to facilitate the process, following are the factors contributing to evaluation and validation process of vendors' proposals:
- (i) **Performance Rating of the proposed system in relation to its cost:** It is imperative that besides fulfilling the information needs of the organization, the system should also have the capability to process the data within the stipulated time frame as determined by the users. There are quite a few measures of performance such as speed of processing, response time, number of users supported, system configuration etc. One can use the benchmark tests to study the operating efficiency of the system. In this approach, the vendors are provided with the sample data and the task is performed by each vendor. Subsequently representatives of

the organization examine the outputs for accuracy, consistency as well as processing efficiency.

- (ii) **Cost Benefits of the Proposed system:** In this process, the cost benefit analysis is performed in relation to the performance benefits against the Total Cost of Operations (TCO). The accountant should also examine the various options of financing (Purchase or Leasing etc.) in detail. Based on this realistic Cost Benefit Analysis, the decision is taken.
- (iii) **Maintainability of the Proposed system:** It refers to the flexibility and customization scope inbuilt in the proposed system for effective use in the organization. For example, whether the changes occurring due to the federal tax laws and statutory legal requirements can be incorporated in the package easily or not. The maintenance cost of large systems like **ERP** packages is very high, some times manifolds of the initial purchase cost. Considerable emphasis should be given on this dimension and must be incorporated in validation process.
- (iv) **Compatibility with Existing Systems:** The proposed system has to be operated in integration with other existing systems in the organization so that it forms a part of the Integrated Enterprise System. Moreover, it also has to be compatible with the existing hardware and other computing environment like operating system, application software, procedural concerns etc.
- (v) **Vendor Support:** Another important aspect in validation is the vendor support. In order to implement any application, training, help in implementation and testing, assistance in maintenance and back-up systems are very significant in measuring the vendor support. The availability of "business-hours-only" support versus "round-the-clock" support is yet another important consideration.

Other factors worth considering are:

1. Vendor's past performance in terms of commitment;
2. Availability, quality and cost of:
 - Systems Analysts and Programmers for development and customization;
 - Maintenance;
 - Support in terms of development, programming and hardware installation during conversion period;
 - Training to familiarise the employees with the operating characteristics of the new system.
 - Computer facility for emergency back-up purpose;
 - Support offices proximity for call response time;
 - Availability of wide selection of hardware; and
 - Choice of systems software.

Question 4

- (a) A Company is planning to introduce a new range of products. The top management is advised to get developed a marketing information system which can enhance the decisional capacities in various marketing activities. You being in-charge of this project suggest what information sub-systems are required to be developed. (10 marks)
- (b) Describe any five functional areas of a system which needs to be analysed by system analyst for detailed investigation of the present system. (5 marks)
- (c) Describe various access control methods used for safety of the database. (5 marks)

Answer

(a) **Marketing Information System** - It is aimed at supporting the decision making, reporting and transaction processing requirements of marketing and sales management. It consists of following inter-related information sub-systems to enhance the decision-making capacities in various marketing activities:

1. **Sales** - The objective of the sales manager is to coordinate the sales effort so that the long-term profitability of the company is maximized. Decisions are required in the area of adequate stocks, effective distribution channels, effective motivation of sales personnel, promotion of more profitable products or product lines and good customer relations. Information required for analysis and support of sales is as stated below:

(a) **Sales Support** – Sales support information system provides information to sales personnel about the following:

- (i) Product descriptions and performance specifications
- (ii) Product prices;
- (iii) Quantity discounts,
- (iv) Sales incentives for salespersons
- (v) Sales promotions;
- (vi) Strengths and weaknesses of competitor's product;
- (vii) Products' inventory levels.
- (viii) The histories of customers' relations with the company.
- (ix) Sales policies and procedures established by the company
- (x) Buying habits of customers

(b) **Sales analysis** – The sales analysis is a major activity in most companies involved in sales. Its purpose is to provide information for analysis of

- (i) Product sales trends;
- (ii) Product profitability on the product-by-product basis;
- (iii) The performance of each sales region and sales branch;

- (iv) The performance of respective sales persons.

Information for sales analysis is derived primarily from the sales order entry system; the majority of information from actual sales transactions and is contained on sales invoice. It includes information on product type, product quality, price, customer identity and type, sales region and salesperson etc.

- 2. Market Research and Intelligence** –The objective of marketing research is to investigate problems confronting the other managers in the marketing function. These problems may involve sales, product development, advertising and promotion, customer service, or general marketing management needs. To satisfy these decision-making and reporting requirements, the market research department must either periodically or upon demand gather information from a wide variety of sources. The investigations undertaken by market research helps in satisfaction of following informational needs of managers:

- (i) Information about the economy and economic trends and the probable impact of these trends on demand for the product.
- (ii) Information about the past sales; and sales trends for the entire industry;
- (iii) Information about potential new markets for product;
- (iv) Information about competitors, its product, strength, weaknesses, new product plans, strategies and so on.

The decision-maker can use the information provided by marketing research in a number of ways for decision making process.

- 3. Advertising and Promotions** - The promotion and advertising development devotes its attention to planning and executing advertising campaign and to carry out various product promotions. This includes:

- (i) Promotion through limited budget;
- (ii) Allocating resources in most effective manner
- (iii) Analysing an array of information, sales people, locations, products, styles, sizes etc.;
- (iv) Storing information that can be combined with past experiences of managers ;
- (v) Establishing a body of knowledge on the response of market for each of the several types of promotional activities such as coupons, contests, trade show;
- (vi) Continuously refreshing and modifying the information base in accordance with rapid changing environment.

- 4. Product Development and Planning** – Product development involves analysing a possible opportunity for a new product and evaluating preferred specifications and probable market success. Often the market research activity initially perceives the opportunity and passes along information about it to the new product development group. Alternatively,

- Sales persons may be aware of their need for a new product;
- Customer call reports may help elicit information about new product needed which may encourage sales persons to think about new product possibilities.
- Sales analysis system indicates the most desirable characteristics for the new product;
- Market researchers gather information about the size and structure of the market place for the product.

The product development department uses all these information to develop specifications for a new product. Product planning system provides marketing management with packaging, promotion, pricing and style recommendations throughout the life of product.

5. **Product Pricing System** – Product pricing is a complex managerial activity that is affected by product cost, customer demand, market psychology, competitors, prices and various actions taken by competitors. Prices may be determined on a full cost or marginal cost basis which is usually seen as the starting point in setting prices. Pricing information system almost always utilizes information about product cost. Past sales profitability information is useful to help in determining how much prices should be adjusted for changes in cost to ensure that margins are maintained.
 6. **Customer Service** – The objective of marketing department is to satisfy customers with product and customer service. To achieve these objectives, management provides customers with technical assistance and product maintenance. Decisions are required in the area of training of service personnel, capabilities of equipment and location facilities to serve customers and assist in the dissemination of technical information to the customers. These decisions must be congruent with the marketing management strategy regarding customer satisfaction and service.
- (b) **Analysis of the Present System** - Detailed investigation of the present system involves collecting, organizing and evaluating facts about the system and the environment in which it operates. Survey of existing methods, procedures, data flow, outputs, files, input and internal controls should be intensive in order to fully understand the present system and its related problems. There are several functional areas, which should be studied in depth. We have discussed below five major functional areas:
- (i) **Analyse Inputs** – Source documents are used to capture the originating data for any type of the system. The system analyst should be aware of the various sources from where the data are initially captured. He must keep in view the fact that outputs for one area may serve as an input for another area. He must understand the nature of each form, what is contained in it, who prepared it, from where the form is initiated, where it is completed, the distribution of the form and other similar considerations to determine how these inputs fit into the framework of the present system.

- (ii) **Review data files** – The analyst should investigate the data files maintained by each department noting their number and size, where they are located, who uses them and the number of times per given time interval these are used. This information may be contained in the system and procedures manuals. He should also review all online and off-line files which are maintained in the organisation as it will reveal information about data that are not contained in any output. The related cost of retrieving and processing the data is another important feature to be considered by the system analyst.
 - (iii) **Review methods, procedures and data communication** – Methods and procedures transforms input data into useful output. A procedure review is an intensive survey of the methods by which each job is accomplished, the equipment utilized and the actual location of the operations. Its basic objective is to eliminate unnecessary tasks or to perceive improvement opportunities in the present information system. The analyst must review the types of data communication equipments including data interface, data link, modems, dial-up and leased lines and multiplexers. He must understand how the data communication network is used in the present system so as to identify the need to revamp the network when the new system is installed.
 - (iv) **Analyse Outputs** - The outputs or reports should be scrutinized carefully by the system analyst in order to determine how well they will meet the organisation's need. The analyst must understand what information is needed and why, who needs it and when and where it is needed. Additional questions concerning the sequence of the data, how often the form reporting it is used, how long it is kept on file etc. must be investigated. Often many reports are a carry-over from earlier days and have little relevance to current operations. Attempts should be made to eliminate all such reports in the new systems.
 - (v) **Review internal controls** - A detailed investigation of the present information system is not complete until internal controls are reviewed. Locating the control points helps the analyst to visualize the essential parts and framework of a system. An examination of internal controls may indicate weaknesses that should be removed in the new system. The adoption of advanced methods, procedures and equipments might allow much greater control over the data.
- (c) **Access Control Methods:** In data base environment, access control risks include corruption, theft, misuse and destruction of data. These originate from both unauthorised intruders and authorised users who exceed their access privileges. Several data base access control features are discussed below:
- (i) **User View** – The user view or sub-scheme is a subset of the total database that defines the user's data domain and provides access to the database. Though the DBA has primary responsibility for user view design, he works closely with users and system designer in this task. Access privileges to the data, as defined in their view, should commensurate with the user's legitimate needs. User view can restrict user access to a limited set of data, they do not define task privileges such a read,

delete or write. Often several users may share a single user view but have different authority levels.

- (ii) **Database Authorization Table** - The database authorisation table contains rules that limit the actions a user can take. Each user is granted certain privileges that are coded in the authority table, which is used to verify the user's action requests.
- (iii) **User-defined Procedures** - A user defined procedure allows the user to create a personal security program or routine to provide more positive user identification than a single password can. For example, the security procedure asks a series of personal questions, which only the legitimate user is likely to know.
- (iv) **Data Encryption** - Many database systems use encryption procedures to protect highly sensitive data, such as product formula, personnel pay rates, password files and certain financial data. Data encryption uses an algorithm to scramble selected data, thus making it unreadable to an intruder browsing the database. In addition to protecting stored data, encryption is used for protecting data that are transmitted across networks.
- (v) **Biometric Devices** - Biometric devices measure various personal characteristics such as fingerprints, voiceprints, retina prints or signature characteristics. These user characteristics are digitised and stored permanently in a database security file or on an identification card that the user carries. When an individual attempts to access the database, a special scanning device captures his or her biometric characteristics, which are compared with the profile data stored internally or on the ID Card. If the data do not match, access is denied.

Question 5

- (a) *What do you understand by disaster recovery plan ? Discuss its various components.*
(10 marks)
- (b) *Explain different activities involved in conversion from manual system to computerized system.*
(5 marks)
- (c) *Discuss the desired characteristics of a good coding system.*
(5 marks)

Answer

- (a) **Disaster Recovery Plan** - The term disaster recovery describes the contingency measures that organisations have adopted at key computing sites to recover from or to prevent any monumentally bad event or disaster. A disaster may result from natural causes such as fire, flood or earthquake etc. or from other sources such as a violent takeover, wilful or accidental destruction of equipment or any other act of such catastrophic proportion that the organisation could be ruined. The primary objective of a disaster recovery plan is to assure the management that normalcy would be restored in a set time after any disaster occurs, thereby minimising losses to the organisation.

Although each organisation would have its own tailored disaster recovery plan, the general components of the plan are as follows:

- (1) **Emergency Plan** - It outlines the actions to be undertaken immediately after a disaster occurs. It identifies the personnel to be notified immediately. It provides guidelines on shutting down equipment, termination of power supply, removal of storage files, and removable discs. It sets out evacuation procedures. It also provides return procedures as soon as the primary facility is ready for operation like backing up data files at off-site, deleting data from disk drives at third party site, relocation of proper versions of backup files etc.
- (2) **Recovery Plan** – This part of disaster recovery plan sets out how the full capabilities will be restored. The following steps may be carried out under this plan:
 - (i) Inventory of hardware, application systems, system software, documentation etc. must be taken.
 - (ii) Criticality of application systems to the organisation and the importance of their loss must be evaluated. An indication must be given of the efforts and cost involved in restoring the various application systems.
 - (iii) An application systems hierarchy must be spelt out. This would be used when the management decides to accept a degraded mode of operation.
 - (iv) Selection of a disaster recovery site must be made. A reciprocal agreement with another organisation having compatible hardware and software could be made.
 - (v) Formal backup arrangement should be made. This should cover the periodical exchange of information between the two sites regarding changes to hardware / software, the time and duration of system availability.
- (3) **Backup Plan** - Organisation no matter how physically secure, their systems are always vulnerable to the disaster. Therefore, an effective safeguard is to have a backup of anything that could be destroyed, be it hardware or software. As far as software is concerned, it is necessary to make copies of important programs, data files, operating system and test programs etc. in order to get back into operation before the company can suffer an intolerable loss. Often, the originals are stored at a site that is physically distant from the actual site and where duplicate copies are used for processing. The backup copies must be kept in a place, which is not susceptible to the same hazards as the originals.
- (4) **Test Plan** – Test Plan looks after the testing of DRP and analysis of the result. It identifies deficiencies in the emergency, backup or recovery plan. It contains procedures for conducting DRP testing like:
 - (i) *Paper Walkthrough* - It involves critical personnel in the plan's execution, reasoning out what might happen in the event of different disasters.
 - (ii) *Localised Tests* - It simulates system crash. This test is performed on different aspects of DRP.
 - (iii) *Full operational test* - It is nearer to disaster conditions. Paper walkthrough and localised test should have been conducted before completely shutting

down the operation to simulate disasters.

(b) **Activities involved in conversion:** Conversion includes all those activities, which must be completed to successfully convert from the previous system to the new information system. Fundamentally these activities can be classified as follows:

(i) **Procedure Conversion** - Operating procedures, for both computer operations and functional area operations, should be completely documented for the new system. Operating procedures must be clearly spelt out for personnel in the functional areas undergoing changes. Information on input, data files, methods, procedures, outputs and internal controls must be presented in clear, concise and understandable terms for the average reader. Qualified system personnel should provide training in the conversion areas to communicate and coordinate new development.

(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. Present manual files are likely to be inaccurate and incomplete where deviations from the accepted formats are common. 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. Data from floppy discs, magnetic tapes and comparable media will have to be placed on magnetic disc to construct an on-line common database.

File conversion programs must be thoroughly tested. Adequate controls should be implemented for output of conversion program.

(iii) **System Conversion** - After online 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. Consideration should be given to operating the old system for some more time to permit checking and balancing the total results of both systems. All differences must be reconciled. If necessary, appropriate changes are made to the new system and its programs. The old system can be dropped as soon as the data processing group is satisfied with the new system's performance.

(iv) **Scheduling personnel and equipments** – Scheduling data processing operations of a new information system and the new equipment is very necessary. Schedule 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. Daily schedule should be prepared in accordance with the master schedule and should include time necessary for reruns, program testing, special non-recurring reports and other necessary runs. Just as the equipment must be scheduled for its maximum utilisation, so must be personnel who operate the equipment.

(v) **Alternative Plans in case of equipment failure** – Alternative processing plans

must be implemented in case of equipment failure. Priorities must be given to those jobs which are critical to an organisation such as billing, payroll and inventory. Critical jobs can be performed manually until the equipment is set right. Documentation of alternative plans stating explicitly what the jobs are, how they are to be handled in case of equipment failure, where compatible equipment is located, who will be responsible for each area during downtime and what dead-lines must be met during the emergency.

(c) Characteristics of a Good Coding Scheme

- (i) **Individuality** – The code must identify each object in a set uniquely and with absolute precision. To use one code number for several objects in a set would obviously cause a great deal of confusion. The code should be universally used over the entire organisation.
- (ii) **Space** - As far as possible code number must be much briefer than description.
- (iii) **Convenience** - The format of code number should facilitate their use by people. This implies that code number should be short and simple and consist of digits and or upper case alphabets. It is better to avoid use of special symbols.
- (iv) **Expandability** – As far as possible, growth in the number of objects in a set should be provided for. Therefore, whilst introducing the scheme, longer number of digits/number than necessary at present may be adopted as the code length. Related items must use similar number.
- (v) **Suggestiveness** - The logic of the coding scheme should be readily understandable. Also, the letter or number should be suggestive of the item characteristics. But this should not be carried too far in lengthening the code since it would defeat the purpose of brevity.
- (vi) **Permanence** – Changing circumstances should not invalidate the scheme or invalidation in future should be kept to minimal.

Question 6

- (a) *What are the characteristics and features of an ERP ?* (5 marks)
- (b) *List any five ERP Vendors and briefly describe the ERP packages offered by them.* (5 marks)
- (c) *What are called Work benches ? Describe the various tools used in programming work bench.* (10 marks)

Answer

- (a) An ERP (Enterprise Resource Planning) system is not only the integration of various functional systems / processes in the organization, but has few more **characteristics** as stated below to qualify as a full-fledged ERP solution:
 - (i) **Flexibility:** An ERP system is flexible enough to respond fast to the changing needs of the organization. The Client Server technology enables ERP to run across

various databases at the back-end using Open Data Base Connectivity.

- (ii) **Modular and Open:** ERP system has the open architecture i.e. any modules can be interfaced or detached without affecting the use of rest of the modules. It should support multiple hardware platforms as well as third party add-on solutions.
- (iii) **Comprehensive:** It supports various organizational functions and is suitable for wide range of business organizations.
- (iv) **Beyond the company:** It is not confined to the organizational boundaries rather it is extended to the external business entities connected to the organization with online connectivity.
- (v) **Best Business Practice:** It has inbuilt best business practices applicable worldwide and imposes its own strategies and logics over existing culture and processes of the organization.

Some of the major features of an ERP are:

- It provides multi-platform, multi-facility, multi-mode of manufacturing, multi-currency and multi-lingual facilities.
 - It supports strategic and business planning activities, operational planning and execution activities, material and resource planning.
 - It has end-to-end Supply Chain Management to optimize the overall demand and supply.
 - It facilitates integrated Information Systems covering all functional areas like manufacturing, procurement, sales and distribution, payables, receivables, human resources, inventory and finance etc.
 - It enhances customer services through increased efficiency in core activities thus augmenting the corporate image.
 - It bridges the information gap across organization.
 - ERP is the solution for better project management.
 - It allows introduction of latest technologies like Electronic Funds Transfer, Electronic Data Interchange, Internet, Intranet, E-commerce etc.
 - It eliminates business problems like material shortages, productivity, customer service, cash management, quality and prompt delivery; and
 - It provides intelligent business tools like Decision Support System, Executive Information System, Data Mining etc.
- (b) There are quite a few ERP packages available in the market these days. Some of these are developed indigenously also. However, these indigenous packages may not be able to compete with the global ERP packages in terms of functionality and coverage of business segments and scale. Some of the global packages along with the vendors are listed below:

Baan (The Baan Company): Initially developed for an aircraft company ,it was

subsequently launched as a generalized package in 1994. It offers sound technology and coverage of broad functional scope.

Business Planning and Control System (BPCS): It targets only manufacturing companies. It offers strong functionality for discrete and Kanban manufacturing. However, it lags in process oriented implementation tools and workflow.

Mapics XA (Marcam Corporation): It is viewed by many as a legacy application.

MFG/Pro (QAD): Strong in repetitive manufacturing, originally designed to meet MRPII standards, it offers reliable manufacturing functionality and straight forward implementation.

Oracle Applications (Oracle): It gives Internet-enabled, network-centric computing. It also offers database, tools, implementation, applications and UNIX operating systems under one stop-shop umbrella. It is currently running on wide choice of hardware.

R/3 (SAP): It is a market leader with excellent philosophy of matching business processes with its modules. It covers almost all business segments.

Systems 21 (JBA) : Its software license revenues are small compared to other major ERP vendors. It offers a rugged, reliable manufacturing solution.

- (c) **CASE Work Benches** - CASE work benches are used to support process phases such as specification, design etc. They consist of sets of tools with variable degree of integration. There are many types of work benches to support most software process activities, for example, software development work benches, cross development work benches, configuration management, documentation and project management work benches.

The **programming work bench** is made up of a set of tools to support the process of program development. Some of these tools, which are part of a programming workbench, are:

- (i) **Language Compiler** – It translates host programs to object code. As part of a translation process, an abstract syntax tree and a symbol table is created.
- (ii) **Structured editor** – It incorporates embedded programming language knowledge and edits the syntax representation of the program in the AST rather than its source code text.
- (iii) **Linker** – It is used to link the object code programme with components, which have already been compiled.
- (iv) **Loader** – It loads the executable program into the computer memory prior to execution.
- (v) **Cross-referencer** – It produces a cross-reference listing showing where all program names are declared and used.
- (vi) **Pretty Printer** – It scans the AST and prints the source program according to embedded formatting rules.

Answer

(a) **Transaction Logs** – Every transaction successfully processed by the system should be recorded on transaction log, which serves as a journal. There are two reasons for creating a transaction log. First, the transaction log is a permanent record of transactions. The validated transaction file produced at the data input phase is usually a temporary file. Once processed, the records on this file are erased to make room for the next batch of transactions. Second, not all the records in the validated transaction file may be successfully processed. Some of these records may fail tests in the subsequent processing stages. A transaction log should contain only successful transactions i.e. those that have changed account balances. Unsuccessful transactions should be placed in an error file. The transaction log and error files combined should account for all the transactions in the batch file. The validated transaction file may then be scratched with no loss of data.

(b) **Data Dictionary** – A data dictionary is a computer file that contains descriptive information about the data items in the files of an information system. Thus, it is a computer file about data. Each computer record of a data dictionary contains information about a single data item used in the system. This information may include:

- (i) Codes describing the data item's length, data type and range.
- (ii) Identification of the source documents used to create the data item.
- (iii) Names of the computer files that store the data item.
- (iv) Names of the computer programs that modify the data item.
- (v) The identity of the computer programs or individuals permitted to access the data item for the purpose of file maintenance, upkeep or inquiry.
- (vi) The identity of the computer programs or individuals not permitted to access the data item.

A data dictionary has a variety of uses as stated below:

- Programmers and system analysts can use it as a documentation aid.
- It can help accountants and auditors to establish an audit trail.
- It can be used to plan the flow of transaction data through the system.
- It can serve as an important aid to document internal control procedures.

(c) **Client-Server Model** - It refers to computing technologies in which the hardware and software components are distributed across a network. Client-server (c/s) technology intelligently divides the processing work between the server and the workstation. The server handles all the global tasks while the workstation handles all the local tasks. The server only sends those records to the workstation that are needed to satisfy the information request. Network traffic is significantly reduced. The result of this system is that it is fast, secure, reliable, efficient, inexpensive and easy-to-use.

Client-server technology model has following characteristics:

- (i) The client and server portion can operate on separate platform.
 - (ii) Client/server platform can be upgraded independently.
 - (iii) The server is able to serve multiple clients concurrently.
 - (iv) A significant portion of the application logic resides at the client end.
 - (v) Action is usually initiated at the client end, not the server end.
 - (vi) A user-friendly GUI resides at the client end. A structured query language capability is offered by majority of client/server systems.
 - (vii) The database server provides data protection and security.
- (d) **Disc Imaging and Analysis Technique** – It enables the fraud investigator to discover evidence of transactions that the fraudster thought were inaccessible or had been destroyed. It works in the following stages:
- (i) Using specialist hardware/software without the suspect necessarily being alerted. An exact copy of the computer hard disc is taken leaving the original completely intact and leaving no trace of the copying process. This preserves the integrity of the hard disc and confidentiality of the investigation. The image is written directly to an optical disc, which can be copied onto a CD ROM for investigative purpose.
 - (ii) The image copy of disc is processed and areas of storage containing partially overwritten files and files which have been marked as deleted but not overwritten are recorded. At the time the image is taken, it is probable that there will be a number of deleted files or file fragments that have not been overwritten and are therefore available to investigator.
 - (iii) The final stage is the analysis of the processed image. This is done by search software, which can be programmed to find references to suspect transactions. The search is across all the contents of disc. Information can be recovered from investigation of free space, lost chains, slack space, deleted files, temporary Internet files etc.

SUGGESTED ANSWERS – FINAL – MAY 2005

The Suggested Answers for Paper 7: - Direct Taxes are based on the provisions applicable for A.Y. 2005-06, which is the assessment year relevant for May, 2005 exams.

PAPER – 7 : DIRECT TAXES

Answer all questions

Question 1

SK Private Limited is engaged in the business of civil construction. The Profit and Loss account of the company for the year ended 31st March, 2005 is as under:

	Rs.		Rs.
Opening stock of building materials	40,000	Receipts from the business of Civil construction contracts	37,60,000
Salary to workers and employees	4,10,000	Rent of godown	80,000
Purchase of building materials	24,00,000	Surplus from insurance compensation received for loss of plant and machinery by fire	2,00,000
Interest on loan	3,20,000	Interest on company deposits	25,000
Office administration expenses	2,60,000	Dividend from companies	50,000
Travelling expenses	1,40,000	Closing stock of building materials	25,000
Municipal taxes on godown	12,000		
Insurance premium for godown	8,000		
Directors' remuneration	2,53,000		
Depreciation on plant and machinery	65,000		
Provision for tax:			
Current tax	1,00,000		
Deferred tax	<u>43,000</u>		
Net profit	89,000		
	<u>41,40,000</u>		<u>41,40,000</u>

The following additional information is also available :

- Municipal tax of godown includes Rs.3,000 not paid by the company.
- The book value of the plant and machinery, which was insured against fire, was Rs.4,20,000. The written down value of plant and machinery block under section 43(6) as on 31st March, 2004 was Rs.1,85,000.

- (iii) The entire building materials were purchased from a firm in which the managing director of this company is a partner. The fair market value of the materials purchased is Rs.20,00,000.
- (iv) Interest on loan includes Rs.15,000 being interest on loan taken for investment in shares of various companies.
- (v) Office administration expenses include Rs.90,000 paid as a donation to a charitable organization recognized under Section 80G.
- (vi) The prescribed rate of depreciation under the Income Tax rules for plant and machinery is 25%.
- (vii) The company has decided to follow the presumptive tax provision in respect of its business income.

Compute the total income of SK Private Ltd. for the assessment year 2005-06. Your answer should include explanations of your treatment of various items. Ignore the provision of minimum alternate tax under Section 115JB. (16 marks)

Answer

Computation of total income of S.K. Private Limited for the A.Y. 2005-06

Particulars	Rs.	Rs.
A. Profits & gains of business		
Presumptive profit from the business of civil construction as per section 44AD (8% of Rs.37,60,000)		3,00,800
B. Capital Gains		
As per section 45(1A), where any money is received under an insurance from an insurer on account of damage to or destruction of any capital asset due to fire, any profit arising on receipt of such money is to be taxed as capital gains. For the purpose of section 48, the value of money received shall deemed to be full value of consideration received or accruing as a result of transfer of such capital asset.		
Amount received from insurance company (4,20,000 + 2,00,000)	6,20,000	
It is assumed that the surplus of Rs.2 lakhs credited to profit and loss account represents the surplus over the book value of plant and machinery.		
Less: WDV of the block as at 1.4.04	1,85,000	
Short term capital gains		4,35,000
(Capital gains from transfer of a depreciable capital asset is		

deemed to be a short-term capital gain u/s 50)

C. Income from house property

Gross Annual Value	80,000	
(Rent from godown is taken to be the gross annual value in the absence of other information relating to municipal value, fair rent etc..)		
Less: Municipal tax actually paid (12,000-3,000)	9,000	
Net annual value	71,000	
Less: Deduction under section 24		
30% of net annual value u/s 24 (1)	21,300	
		49,700

D. Income from other sources

Interest on company deposits	25,000	
Dividend from companies [Exempt under section 10(34), assuming that dividend is from domestic companies]	-	
		25,000

Gross Total Income **8,10,500**

Less: Deduction under Chapter VI-A

Section 80G

Donation to recognised charitable organisation

Amount donated	90,000	
Qualifying Amount (restricted to 10% of Gross Total Income)	81,050	
Deduction under this section (50% of qualifying amount)	40,525	

Total Income **7,69,975**

Notes:

- As per section 44AD, in the case of an assessee engaged in the business of civil construction or supply of labour for civil construction, an amount equal to 8% of gross receipts paid or payable to the assessee shall be deemed to be profits and gains from such business at the option of the assessee. The option is available if the gross receipts does not exceed Rs.40 lakhs in the relevant previous year. In this case, the company's gross receipts in the previous year on account of such business does not exceed Rs.40 lakhs. Thus, the company is entitled to exercise the option of paying tax under presumptive tax system.

2. Where the assessee opts for paying income tax under presumptive tax provisions of section 44AD, the deductions allowable under sections 30 to 38, including depreciation, shall be deemed to have been allowed. Therefore, separate deductions are not allowable for salary, purchase of materials, interest on loan, office administration expenses, travel expenses and directors' remuneration, since they are deemed to have been already allowed.
3. As deductions under sections 30 to 38 are deemed to have been allowed, the question of disallowance under section 40A(2) or any other provision does not arise. Therefore, even if the assessee company makes payment for purchase of materials to a firm, where the managing director is a partner, disallowance u/s 40A(2) is not attracted.
4. Similarly, WDV of assets used for such business shall be deemed to have been computed as if depreciation has been actually allowed.
5. Since dividend income is fully exempt under section 10(34), no deduction can be claimed in respect of any expenditure incurred to earn such income as per the provisions of section 14A. Therefore, interest on loan taken for investment in shares, dividend from which is exempt under section 10(34), is not allowable as deduction.

Question 2

- (a) *Mr. X bought 10,000 equity shares of TT Ltd., listed in stock exchanges in India and abroad and a constituent of BSE 500 on 15th March, 2003 @Rs.2,250 per share. He sold the shares at Rs.5,000 per share on 31st December, 2004. The brokerage and securities transactions tax deducted were at 0.5% and 0.075% respectively. Examine the liability of Mr. X to income tax for the assessment year 2005-06. Will your answer be different, if instead of selling the shares in the market Mr. X privately transferred the shares to his son at the same price? (Cost Inflation Factors : 2002-03-447; 2004-05-480) (6 marks)*
- (b) *Gangaram Public Charitable Trust runs a hospital, which derived income of Rs.250 lakhs, from its operational activities. Expenses incurred to earn such income are Rs.55 lakhs. Depreciation on various assets used in the hospital is Rs.15 lakhs. Out of income of Rs.250 lakhs, the amount accrued but not received as on 31-03-2005 is Rs.20 lakhs. The institution earmarked and set apart Rs.30 lakhs in March, 2005 to give as advance for a building intended to be taken on lease for expansion of the hospital, but the amount was paid on 7th April, 2005, as the lease agreement could not be signed by 31st March, 2005. The trust has got an ERP package developed and installed by an IT company during the year. The total cost to the trust on account of the ERP package was Rs.85 lakhs. Advice the trust on its total income, if the trust has incurred Rs.12 lakhs for purchase of a number of desktop and laptop computers for use in the hospital. (8 marks)*

Answer

- (a) As per section 10(38) introduced by the Finance (No.2) Act, 2004, any income arising from the transfer of a long-term capital asset, being equity shares of a company is exempted from income tax on fulfillment of the following conditions:

- (i) The sale of equity shares is effected on or after 1st October, 2004, being the date on which Chapter VII of the Finance (No.2) Act, 2004 (i.e. Securities Transactions Tax) came into force and
- (ii) Such transaction is chargeable to securities transactions tax.

For a listed equity share, being a constituent of BSE-500, sold on or after 1st October, 2004 the provisions of section 10(38) shall apply. As the shares of TT Ltd. are held by Mr.X for more than 12 months before transfer, they are long-term capital assets. Since the sale took place after 1-10-2004 and the transaction was subject to securities transactions tax, the long term capital gain arising from transfer of such shares shall be exempted from income tax u/s 10(38).

In the second case, Mr. X privately transferred the shares to his son at Rs.5000 per share. Since the sale was not entered in any stock exchange, securities transactions tax was not payable on such sale. Hence, the provisions of section 10(38) will not apply. The provisions of section 112 relating to calculation of tax on long term capital gains would apply.

The tax liability on capital gains will be governed by the proviso to section 112(1) under which long term capital gains on listed securities will be taxed at 20% of capital gains computed taking indexation benefit or at 10% of the capital gains computed without indexation benefit, whichever is lower.

Particulars	Rs.
Computation of capital gains taking into consideration indexation benefit	
Gross sale consideration	5,00,00,000
Less: Brokerage @ 0.5%	2,50,000
Net sale consideration	4,97,50,000
Less: Indexed cost of acquisition (2,25,00,000 x 480/447)	2,41,61,074
Long-term capital gain	2,55,88,926
Tax on above @20% [after exhausting basic exemption limit of Rs.50,000]	51,07,786
Surcharge @10%	5,10,779
	56,18,565
Education cess @2%	1,12,371
Total tax payable	57,30,936
Computation of capital gains without taking into consideration indexation benefit	
Gross sale consideration	5,00,00,000
Less: Brokerage @ 0.5%	2,50,000
Net sale consideration	4,97,50,000
Cost of acquisition	2,25,00,000

Long-term capital gain	2,72,50,000
Tax @ 10%	27,25,000
Surcharge @ 10%	2,72,500
	29,97,500
Education cess @ 2%	59,950
Total tax payable	30,57,450

So, the tax payable will be Rs.30,57,450 (being lower of the two)

Note:

1. In arriving at the net consideration, only brokerage can be deducted. The securities transaction tax paid is not deductible as per the last proviso to section 48.
2. According to the proviso to section 112(1)(a), if the assessee does not have any income other than long-term capital gains, the basic exemption limit should be exhausted against long-term capital gains. Therefore, tax on long-term capital gains has been calculated @ 20% after exhausting basic exemption limit, assuming that Mr. X is a resident. However, the same is not relevant for computing tax on long-term capital gains @10% without considering indexation benefit.

(b) The total income of the trust for the A.Y. 2005-06 is computed hereunder:

Particulars	Rs. in lakhs
Income derived from property held under trust	250
Less: Expenses incurred thereto	55
Depreciation on assets	15
	70
	180
Less: 15% to be set apart (15% of Rs.180 lakhs)	27
	153
Less: Income not received during the year, which can be spent in the year of receipt or in the immediately following year	20
	133
Less: Non-application of income due to delay in signing lease agreement [The amount was applied on 7.4.2005 i.e. in the immediately following year – Option to be exercised in writing before the expiry of the time allowed under section 139(1) for furnishing the return of income]	30
Amount to be applied for the objects of the trust by 31.3.2005	103
Less: Amount applied for the objects of the trust	
(i) For development and installation of ERP package for	85

the purpose of the trust

(ii) For purchase of desktop and laptop computers for the purposes of the trust

	12	97
Taxable Income		6

Note -

- (i) Depreciation should be allowed while computing income of a trust under section 11(1)(a). A trust can claim depreciation on assets even if the cost of assets has been fully allowed as application of income under section 11 in the past years. Even when the whole of capital expenditure has been treated as an application of income for charitable purpose u/s 11, the trust can still claim depreciation on assets used for its purposes on the basis of normal commercial principles.
- (ii) If the income applied to charitable purposes in India falls short of 85% of the income derived during the year from property held under trust for the reason that the whole or any part of its income has not been received during that year, then such income, at the option of the person in receipt of income, can be applied during the previous year in which the income is received or in the immediately following previous year. The option is to be exercised in writing before expiry of the time allowed u/s 139(1) for filing return of income.
- (iii) The word "applied" used in section 11 means that the income is actually applied for the charitable purposes of the trust. The word "applied" does not necessarily imply "spent". Even if a certain amount is irretrievably earmarked and allocated for charitable purposes, the said amount can be deemed to have been applied for charitable purposes. [*CIT vs. Trustees of H.E.H. Nizams Charitable Trust, (1981) 131 ITR 497 (AP).*]
- (iv) The cost of getting an ERP package developed and installed is a capital expenditure. A charitable trust can apply its income either for revenue expenditure or for capital expenditure provided the expenditure is incurred for promoting the objects of the trust. Purchase of a fixed asset to be utilised for the purpose of the trust amounts to application of income for charitable purposes as held by the Supreme Court in *S.R.M.C.T.M. Tiruppani Trust vs. CIT (1998) 230 ITR 636*.

Question 3

- (a) *Mr. Gavaskar sought voluntary retirement from a Government of India Undertaking and received compensation of Rs.40 lakhs on 31st January, 2005. He is planning to use the money as capital for a business dealership in electronic goods. The manufacturer of the product requires a security deposit of Rs.15 lakh, which would carry interest at 8% p.a. Gavaskar's wife is a graduate and has worked as marketing manager in a multinational company for 15 years. She now looks for a change in employment. She is willing to join her husband in running the business. She expects an annual income of Rs.3 lakhs. Mr. Gavaskar would like to draw a monthly remuneration of Rs.40,000 and also interest @10%*

p.a. on his capital in the business. Mr. Gavaskar has approached you for a tax efficient structure of the business.

Discuss the various issues, which are required to be considered for formulating your advice. Computation of income or tax liability is not required. (8 marks)

- (b) *GK Ltd. filed its return of income for the assessment year 2002-03 on 1.4.2003. The assessing officer levied a penalty of Rs. 5,000 under Section 271F. The assessee makes a submission to the CIT (Appeals) that he has furnished the return of Income within the due date specified in Section 139(4) and hence no penalty should be levied under 271F. Discuss. (3 marks)*
- (c) *An assessee's case is pending in appeal before the Income Tax Appellate Tribunal for assessment year 2000-01. Since the appeal is pending, the assessee wishes to file an application to the Settlement Commission for disclosing additional income, the income tax on which is Rs.15 lakhs. Is it possible to make such application? Will your answer be different if the Tribunal sets aside the case and restores the matter to Commissioner (Appeals)? (3 marks)*

Answer

- (a) The selection of the form of organisation to carry on any business activity is essential in view of the differential tax rates prescribed under the Income-tax Act, 1961 and specific concessions and deductions available under the Act in respect of different entities. For the purpose of formulating advice as to the tax efficient structure of the business, it is necessary for the tax consultant to consider the following issues:
1. In the case of sole proprietary concern, interest on capital and remuneration paid to the proprietor is not allowable as deduction under section 37(1) as the expenditure is of personal nature. On the other hand, in the case of partnership firm, both interest on capital and remuneration payable to partners are allowable under section 37(1) subject to the conditions and limits laid down in section 40(b). Remuneration and interest should be authorised by the instrument of partnership and paid in accordance with such instrument. Interest to partners can be allowed up to 12% on simple interest basis, while the limit for allowability for partners' remuneration is based on book profit under section 40(b).
 2. Partner's share in the profits of firm is not taxed in the hands of the partners by virtue of section 10(2A).
 3. If a proprietary concern is formed, the salary of Mrs. Gavaskar shall be allowed as deduction under section 37(1).
 4. The possibility of invoking section 40A(2) cannot be ruled out as salary is payable to a relative, who is an interested person within the meaning of section 40A(2). However, it can be argued successfully that salary of Rs.3 lakh is justified in view of her long experience as marketing manager of a multinational company and the fair market value of services to be rendered by her to the concern.

5. An issue arises as to whether remuneration of Mrs. Gavaskar would be includible in the total income of Mr. Gavaskar. Under section 64(1)(ii), remuneration of the spouse of an individual working in a concern in which the individual is having a substantial interest shall be included in the total income of the individual. However, the clubbing provision does not apply if the spouse possesses technical or professional qualifications and the income is solely attributable to the application of his or her technical or professional knowledge and experience. Further, technical or professional qualifications do not necessarily mean the qualifications obtained by degree or diploma of any recognized body [*Batta Kalyani vs. CIT (1985) 154 ITR 0059 (AP)*] The experience of Mrs. Gavaskar as a marketing manager in a multinational company for 15 years may reasonably be considered as a professional qualification for this purpose.
 6. If Mrs. Gavaskar joins the proprietary concern of her husband as employee, remuneration of Rs.3 lakhs shall be taxed in her hands under the head "salary" and she will get standard deduction under section 16.
 7. If she joins as partner in the business, remuneration shall be taxed in her hand as business income under section 28 to the extent such remuneration is allowed in the hands of the firm under section 40(b).
 8. The tax rate applicable to an individual depends on the level of his/her income. The rate of tax in the highest tax slab (i.e. above Rs.1,50,000) is 30%; the tax rate for a partnership firm is 35%. For an individual, surcharge at 10% is attracted if his total income exceeds Rs.8,50,000. For firms, the applicable surcharge is 2.5% for A.Y.2005-06. Education cess@2% is attracted in both cases.
- (b) Penalty of Rs.5,000 under section 271F is imposable on a person who is required to furnish return of income under section 139(1) for failure to furnish such return before the end of the relevant assessment year. It is true that the assessee can file a belated return under section 139(4) within one year from the end of the relevant assessment year or before completion of assessment, whichever is earlier. However, right to file a belated return after the end of the assessment year does not mean that the liability to pay penalty ceases. The Supreme Court's decision in *Pradip Lamps Works vs. CIT (2001) 249 ITR 0797* supports this view. Hence, the assessee is liable for penalty under section 271F for late filing of the return.
- (c) As per section 245A(b) for the purpose of application to the Settlement Commission for settlement of cases, the word 'case' means any proceeding under the Income-tax Act for the assessment or reassessment of any person in respect of any year or years, or by way of appeal or revision in connection with such assessment or reassessment, which may be pending before an income-tax authority on the date of making the application under section 245C(1). If an appeal is pending before the Income-tax Appellate Tribunal (ITAT), it cannot be treated as a proceeding pending within the meaning of section 245A because ITAT is not an income tax authority. Hence, it will not be possible for the assessee to make an application to the Settlement Commission.

If the Tribunal sets aside the case and restores the matter to Commissioner (Appeals), it can be treated as a proceeding pending before an income-tax authority since Commissioner (Appeals) is an income-tax authority under clause (c) of section 116. In that case, the assessee can make an application before the Settlement Commission.

Question 4

- (a) What is the legislative objective of bringing into existence the provisions relating to transfer pricing ? (3 marks)
- (b) Your client, Ashavari Ltd. has two industrial undertakings-one engaged in production of audio music CDs and cassettes and the other engaged in production of video CDs. As a restructuring drive, the company has decided to sell its undertaking producing video CDs as a going concern by way of slump sale for Rs. 450 lakhs to a new company called Tori Ltd., in which it holds 75% equity shares. The balance sheet of Ashavari Ltd. as on 31st March, 2005 reads as follows :

	Rs. in lakhs	
	Audio Unit	Video Unit
Fixed Assets	150	225
Debtors	150	112.5
Inventories	75	37.5
Liabilities	42	75
Paid up share capital	Rs. 378 lakhs	
General Reserve	Rs. 222 lakhs	
Share premium	Rs. 33 lakhs	
Revaluation Reserve	Rs. 140 lakhs	

The company set up the video unit on 1st April, 2001. The written down value of the block of assets for tax purpose as on 31st March, 2005 is Rs.200 lakhs of which Rs.85 lakhs are attributable to video unit.

- (i) Determine the tax liability which would arise to Ashavari Ltd. from slump sale; (5 marks)
- (ii) Suggest modification of the restructuring plan of Ashavari Ltd. without changing the amount of consideration so as to make it more tax efficient. (3 marks)

Answer

- (a) The presence of multinational enterprises in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions prompted the

Government to set up an Expert Group to examine the issues relating to transfer pricing. There is a possibility that two or more entities belonging to the same multinational group can fix up their prices for goods and services and allocate profits among the enterprises within the group in such a way that there may be either no profit or negligible profit in the jurisdiction which taxes such profits and substantial profit in the jurisdiction which is tax haven or where the tax liability is minimum. This may adversely affect a country's share of due revenue. The increasing participation of multinational groups in economic activities in India has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, which may lead to erosion of tax revenue. Therefore, transfer pricing provisions have been brought in by the Finance Act, 2001 with a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises.

- (b) (i) As per section 50B, any profits or gains arising from the slump sale effected in the previous year is chargeable to income tax as capital gains arising from the transfer of capital assets and shall be deemed to be the income of the previous year in which the transfer took place.

If the assessee owned and held the undertaking transferred under slump sale for more than 36 months before slump sale, the capital gain shall be deemed to be long-term capital gain.

Particulars	Rs.
Calculation of capital gains	
Slump sale consideration	4,50,00,000
Less: Cost of acquisition (net worth) [See Working Note below]	1,60,00,000
Long-term capital gain	2,90,00,000
Calculation of tax liability	
Income tax @ 20%	58,00,000
Surcharge @ 2.5%	1,45,000
	59,45,000
Education cess @ 2%	1,18,900
Total tax liability	60,63,900

Working Note:

Net worth of Video unit	Rs
WDV of block of assets	85,00,000
Debtors	1,12,50,000
Inventories	37,50,000
	<u>2,35,00,000</u>
Less: Liabilities	75,00,000
Net worth	<u>1,60,00,000</u>

Note - Indexation benefit is not available in case of slump sale as per section 50B(2)

- (ii) Transfer of any capital asset from a holding company to its 100% Indian subsidiary company is exempted from tax under section 47(iv). Therefore, if it is possible for Ashavari Ltd to acquire the entire shareholding of Tori Ltd and then make slump sale, then the resultant capital gain shall not attract capital gains tax liability.

However, Ashavari Ltd should not transfer any shares in Tori Ltd for 8 years from the date of slump sale.

Question 5

- (a) Alap Ltd. has made payments on various dates in financial year 2004-05 to Vilambit Ltd. towards work done under different contracts as follows :

Contract Number	Date of payment	Amount (Rs.)
1.	5.5.2004	13,000
2.	6.6.2004	15,000
3.	8.8.2004	20,000
4.	10.9.2004	20,000
5.	10.10.2004	10,000

Alap Ltd. claims that it is not liable to deduction of tax at source under section 194C. Examine the correctness of the claim made by the company. What would be the position if the value of the contract no. 5 is Rs. 1,000 only and there is no other contract during the year. (4 marks)

- (b) The profit and loss account of East West Bank Ltd. operating in India for the financial year 2004-05 contains, interalia, the following particulars :

	(Rupees in crores)
Profit before taxation	100
Depreciation as per books	25
Depreciation admissible as per income tax rules	40
Corporation tax disputed by the bank and not paid	10
Bad debts written off	45
Provision for non-performing assets as per prudential norms of Reserve Bank of India	250
Provision for standard assets at 2% of such advance as per the above norms	5
Net depreciation on investments under "held-for-trading" and "available-for-sale" categories calculated on lower of cost price or market price basis as per guidelines of Reserve Bank of India.	30

Other Information:

- In assessment year 2003-04 provision for doubtful debts allowed in assessment amounted to Rs.35 crores only
- The assessment for assessment year 2004-05 resulted in a loss and unabsorbed depreciation amounting to Rs.30 crores and Rs.40 crores respectively and the bank was not allowed deduction on account of provision for doubtful debts
- Unrealised interest income not recognized in the accounts in financial year 2004-05 in respect of non-performing assets as per asset classification norms of RBI amounts to Rs. 65 crores.
- The aggregate average rural advances calculated as per section 36(1)(viii) read with rule 6 ABA amounts to Rs.30 crores.

From the above information compute total income of the bank for the A.Y. 2005-06.

(10 marks)

Answer

- Prior to 1st October, 2004, section 194C(3) provided that tax is not required to be deducted at source from any sum credited or paid in pursuance of a contract, the consideration for which does not exceed Rs.20,000. To prevent the practice of composite contracts being split up into contracts valued at less than Rs.20,000 to avoid tax deduction, the Finance (No.2) Act, 2004 has amended section 194C(3) with effect from 1st October, 2004 to provide that tax has to be deducted at source where the amount credited or paid or likely to be credited or paid to a contractor or sub-contractor exceeds Rs.20,000 in a single payment or Rs.50,000 in the aggregate during a financial year. While determining the

aggregate limit of Rs.50,000, the amount paid/credited prior to 1.10.2004 to the contractor has also to be considered for ascertaining TDS obligation.

Therefore, in the given case, even though the value of each individual contract does not exceed Rs.20,000, the aggregate amount of the sums paid exceeds Rs.50,000. Therefore, Alap Ltd's contention is not correct and tax of Rs.1,631 [i.e. 1,560 + 39 + 32 (i.e. 2% of Rs.78,000 as increased by surcharge and education cess)] is required to be deducted at source from Rs.10,000, being the amount of the last contract.

If the value of the last contract is Rs.1,000, the tax required to be deducted at source is Rs.1,443 [i.e. 1,380 + 35 + 28 (i.e. 2% of Rs.69,000 as increased by surcharge and education cess)]. Thus, the tax required to be deducted at source exceeds the value of the last contract during the year which happens to be the first contract after 1.10.04, when the new provision came into effect. It is possible to take a view that due to practical difficulties arising out of the amendment made by the Finance (No.2) Act, 2004 to section 194C w.e.f. 1.10.2004, if the assessee has deducted tax of Rs.1,000 under section 194C, he will not be liable for penalty under section 271C for non-deduction of Rs.443.

(b) Computation of total income of East West Bank Limited for the A.Y. 2005-06

Particulars	Rs. in crores	
Profits & gains of business		
Net profit as per profit & loss account		100
Add: Depreciation as per books	25	
Disputed corporation tax disallowed as it is not paid - section 43B	10	
Bad debts [See Note 3 below]	45	
Provision for doubtful debts considered separately	255	335
		435
Less: Depreciation as per Income-tax Rules		40
		395
Less: Provision for doubtful debts u/s 36(1)(viiia)		
7.5% of total income before allowing deduction under Chapter VI-A (7.5% of Rs.395 crores)	29.63	
10% of aggregate average advances by rural branches (10% of Rs.30 crores)	3.00	32.63
		362.37
Business income for the year		362.37
Less: Carried forward business loss of A.Y. 2004-05	30	
Unabsorbed depreciation of A.Y. 2004-05	40	70.00
		292.37
Gross total income		292.37
Deduction under Chapter VI-A		Nil
Total Income		292.37

Note:

1. Investments held under "held-for-trading" and "available-for-sale" categories are to be considered as stock in trade of bank even though they are shown under the head "investments" in the balance sheet under the Banking Regulations Act [Refer *United Commercial Bank Ltd. vs CIT (1999) 106 Taxman 601 (SC)*]. Hence, loss due to diminution in value of investments is allowed as deduction. As the effect has already been given in the accounts, no further adjustment is required.
2. Interest on bad or doubtful categories of debts as per Reserve Bank's guidelines is to be taxed in the previous year in which it is credited by the bank to its profit & loss account or the year in which it is actually received by the bank, whichever is earlier, as per the provisions of section 43D. Therefore, unrealised interest on non-performing assets amounting to Rs.65 crores is not taxable in the assessment year 2005-06.
3. Section 36(1)(vii) provides that where the actual amount of bad debts exceeds the credit balance in the provision for bad and doubtful debts, such excess bad debts written off can be claimed as deduction.

The credit balance in the provision for doubtful debts includes both the opening balance and the credit during the year adding up to Rs.67.63 crores (i.e. 35 crores + 32.63 crores), whereas the bad debts written off during the year is only Rs.45 crores. Therefore, the bad debts written off during the year is not in excess of the credit balance in the provision for doubtful debts account. Hence, no deduction is allowable under section 36(1)(vii) in respect of bad debts written off during the year (**See Provision for doubtful debts account below given for better understanding of the students**).

It is assumed that the provision for doubtful debts of Rs.35 crores for A.Y.2003-04 is the closing balance of that year due to absence of information on opening balance and bad debts for that year. Therefore, Rs.35 crores would be the opening balance for the A.Y.2005-06, since the bank was not allowed deduction on account of provision for doubtful debts for A.Y.2004-05.

Provision for doubtful debts A/c (For A.Y.2005-06)

	Rs. in crores		Rs. in crores
To Debtors	45.00	By balance b/f	35.00
(bad debts written off)		(Opening balance)	
To balance c/f	22.63	By Profit and Loss A/c	32.63
(Closing balance)		(Provision made during the year)	
	67.63		67.63

Question 6

- (a) *Arif, a resident both in India and Malaysia in previous year 2004-05, owns immovable properties (including residential house) at Malaysia and India. He has earned income of Rs. 50 lakhs from rubber estates in Malaysia during the financial year 2004-05. He also sold some property in Malaysia resulting in short-term capital gain of Rs. 10 lakhs during the year. Arif has no permanent establishment of business in India. However, he has derived rental income of Rs. 6 lakhs from property let out in India and he has a house in Lucknow where he stays during his visit to India. The Article 4 of the double taxation avoidance agreement between India and Malaysia provides that where an individual is a resident of both the Contracting States, then he shall be deemed to be resident of the Contracting State in which he has permanent home available to him. If he has permanent home in both the Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closer (centre of vital interests).*

You are required to state with reasons whether the business income of Arif arising in Malaysia and the capital gains in respect of sale of the property situated in Malaysia can be taxed in India.
(6 marks)

- (b) *EIH Private Ltd's assessment for assessment year 1996-97 was completed under Section 143(3) on 31st December, 1998. The company went in appeal to the Commissioner (Appeals) and the appeal was decided on 16th August, 2003 and the appeal effect was duly given by the Assessing Officer on 25th August, 2003. Thereafter, on 1st September, 2004 the Assessing Officer noticed a mistake in calculation of depreciation on a particular block of assets, which reduced the income by Rs.1.10 lakh. The assessing officer issued notice under section 154 for the purpose of rectifying the mistake. Is such rectification permissible?*
(3 marks)
- (c) *Can a person resident in India seek advance ruling from the Authority for Advance Ruling?*
(3 marks)

Answer

- (a) Section 90(1) of the Income-tax Act empowers the Central Government to enter into an agreement with the Government of any country outside India for avoidance of double taxation of income under the Indian law and the corresponding law of that country. Section 90(2) provides that where the Central Government has entered into an agreement with the Government of any other country for granting relief of tax or for avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of the Income-tax Act, 1961 shall apply to the extent they are more beneficial to that assessee.

Arif has a residential house both in Malaysia and India. Thus, he has a permanent home in both the countries. However, he has no permanent establishment of business in India. The Double Taxation Avoidance Agreement (DTAA) with Malaysia provides that where an individual is a resident of both the countries, he shall be deemed to be resident of that country in which he has a permanent home and if he has a permanent home in both the countries, he is deemed to be resident of that country, which is the centre of his vital interests i.e. the country with which he has closer personal and economic relations. Arif

owns rubber estates in Malaysia from which he derives business income. However, Arif has no permanent establishment of his business in India. Therefore his personal and economic relations with Malaysia are closer, since Malaysia is the place where –

- (a) the property is located and
- (b) the permanent establishment (PE) has been set-up

Therefore, he shall be deemed to be resident of Malaysia for A.Y. 2005-06.

The fact of the case and issues arising therefrom are similar to that of *CIT vs. P.V.A.L. Kulandagan Chettiar* (2004) 137 Taxman 460, where the Supreme Court held that –

- (1) If an assessee is deemed to be a resident of a contracting State where his personal and economic relations are closer, then in such a case, the fact that he is a resident in India to be taxed in terms of sections 4 and 5 would become irrelevant, since the DTAA prevails over sections 4 and 5.
- (2) The treaty has application as well to capital gains derived from immovable property situated at Malaysia vide Article 6 of the tax treaty.

Therefore, in this case, Arif is not liable to income tax in India for assessment year 2005-06 in respect of business income and capital gains arising in Malaysia.

- (b) Any rectification order under section 154 has to be passed within 4 years from the end of financial year in which the order sought to be amended was passed. Order sought to be amended does not necessarily mean the original order. It could be any order including the amended or rectified order. Thus, for subsequent rectification, the time limit of 4 years shall be from the end of the financial year in which the earlier rectification order was passed. [*Hind Wire Industries Ltd vs. CIT* (1995) 212 ITR 639 (SC)]. In the given case, the time limit of 4 years has to be reckoned from the end of the financial year in which the order giving effect to the CIT(Appeal)'s decision was passed i.e. the time limit has to be reckoned from the end of previous year 2003-04. Therefore, the rectification order can be passed by the Assessing Officer at any time before expiry of 4 years from the end of the financial year 2003-04 i.e. on or before 31st March, 2008. In this case, the mistake was noticed by the Assessing Officer on 1st September, 2004, for which he issued notice under section 154 for rectifying the mistake. Such rectification is permissible in view of the fact that the time limit expires only on 31st March, 2008.

- (c) Section 245N enables a resident falling within any such class or category of persons as may be notified by the Central Government to make an application for Advance Ruling. Such notified resident applicants can seek ruling in respect of issues relating to computation of total income which is pending before any income-tax authority or the Appellate Tribunal. Such a resident applicant can make an application to seek decision on a question of law or a question of fact. Public sector companies as defined in section 2(36A) of the Income-tax Act, 1961 have been notified as applicant for this purpose.

Further, a resident can make an application seeking advance ruling in relation to the tax liability of a non-resident arising out of a transaction undertaken or proposed to be undertaken by him with such non-resident.

Question 7

- (a) A company submitted the return of income for assessment year 2002-03 on 10th October, 2002. The Assessing Officer served a notice u/s 143(2) on the company on 14th August, 2003 in order to make assessment under section 143(3). Thereafter, on 1st September, 2003, the Assessing Officer issued an intimation under section 143(1). Such intimation shows a demand for Rs.10,500 towards tax and interest. The company argues that the issue of intimation under section 143(1) is bad in law. Discuss. (3 marks)
- (b) The assessment of Ashok for assessment year 2001-02 was completed under section 143(3) on 15th January, 2004. The Commissioner acting under section 263 directed the Assessing Officer to add certain amount appearing in the balance sheet in total income of Ashok. Ashok did not challenge the order of the Commissioner under section 263 by filing appeal to the Tribunal. The Assessing Officer passed a fresh assessment order on 1st October, 2004 including the said amount in total income of Ashok pursuant to the order of the Commissioner. Ashok disputed the fresh assessment order in appeal to Commissioner (Appeals) under Section 246A. The Commissioner (Appeals) dismissed the appeal on the ground that the Assessing Officer only complied with direction of the Commissioner under section 263, which was not disputed by Ashok in appeal to Tribunal. Examine the correctness of the stand taken by the Commissioner (Appeals). (3 marks)
- (c) MKG Agency is a partnership firm consisting of father and three major sons. The partnership deed provided that after the death of father, the business shall be continued by the sons, subject to the condition that the firm shall pay 20% of the profits to the mother. Father died in March, 2003. In the previous year 2003-04 the reconstituted firm paid Rs.1 lakh (equivalent to 20% of the profits) to the mother and claimed the amount as deduction from its income. Examine the correctness of the claim of the firm. (3 marks)

Answer

- (a) This issue came up before the Apex Court, in *CIT v. Gujarat Electricity Board* (2003) 260 ITR 0084. The Supreme Court held that once regular assessment proceedings have commenced under section 143(2) of the Income-tax Act, 1961, it is a limitation on the jurisdiction of the Assessing Officer to commence proceedings under section 143(1)(a) of the Act. Section 143(1)(a) of the Act enacts a summary procedure for quick collection of tax and quick refunds. Under the scheme, if there is a serious objection to any of the orders made by the Assessing Officer determining the income, it is open to the assessee to ask for rectification under section 154. It is not open to the Revenue to issue intimation under section 143(1)(a) of the Income-tax Act, 1961, after notice for regular assessment is issued under section 143(2). The Legislature intended that where the summary procedure under section 143(1) has been adopted, there should be scope available for the Revenue, either *suo moto* or at the instance of the assessee, to make a regular assessment under section 143(2). However, the converse is not available. A regular assessment proceeding having been commenced under section 143(2), there is no need for a summary proceeding under section 143(1)(a).

- (b) An assessee can file an appeal to the Tribunal against the order passed by the Commissioner u/s 263. However, in this case, the assessee did not file any appeal to the Tribunal against the order of the Commissioner u/s 263. He waited for the fresh assessment order to be passed by the Assessing Officer in pursuance of the direction of the Commissioner. The order of any fresh assessment made under section 150 pursuant to direction contained in an order of revision under section 263 is itself appealable under section 246A(1)(b). Therefore, the mere fact that the assessee did not dispute the order of the Commissioner by filing an appeal to the Tribunal does not take away the right of the assessee to dispute the fresh assessment order by filing appeal to Commissioner (Appeals) u/s 246A. Therefore, the stand taken by the Commissioner (Appeals) is not correct in law.
- (c) The issue raised in the problem is based on the concept of diversion of income by overriding title, which is well recognised in the income tax law. In the instant case, the amount of Rs.1 lakh, being 20% of profits of the firm, paid to the mother gets diverted at source by the charge created in her favour as per the terms of the partnership deed. Such income does not reach the assessee. Rather, such income stands diverted to the other person as such other person has a better title over the title of the assessee. The firm might have received the said amount but it so received for and on behalf of the mother, who possesses the overriding title. Therefore, the amount paid to the mother should be excluded from income of the firm. The view has been confirmed in *CIT vs. Nariman B. Bharucha & Sons (1981) 130 ITR 863 (Bom)*.

Question 8

Steel, Oil and Coal are partners in a firm engaged in the business of running a manufacturing unit in the municipal town of Siliguri having a population of more than 10,000 located in the State of West Bengal. Given below is the Balance Sheet of the firm as on 31st March, 2005:

	Rs. in lakhs		Rs. in lakhs
Partner's Capital		Urban Land	300
Steel	300	Urban Land (Construction not allowed)	700
Oil	400	Factory Land	200
Coal	<u>200</u>	900 Residential House	300
Cash credit from bank	200	Plant (WDV)	120
(Secured by hypothecation of stock and debtors)			
Term loan taken from bank	1,200	Factory shed	400
(Secured by charge on gold and silver)			
Creditors	1,000	Lorry (WDV)	100

Other liabilities	600	Stocks	300
		Gold and Silver	800
		Sundry Debtors	180
		Advance Tax	200
		Cash at Banks	300
Total	3,900		3,900

Two urban lands are valued by independent valuer at Rs.550 and Rs.50 lakhs respectively. The market value of gold and silver on the balance sheet date is Rs.1,100 lakhs. The value of residential house as per Rule 3 of schedule III is Rs.350 lakhs.

Term loan was taken for purchase of : (a) plant and machinery Rs.300 lakhs;(b) Lands, the plots are of which are of equal size Rs.700 lakhs.

The residential house is occupied by partner Steel, who looks after the production activity of the firm.

Partner Oil is a non-resident for Income-tax purposes.

The partners share the profits in the ratio of 2 : 2 : 1.

Details of personal assets of the partners as on 31st March, 2005 are as follows :

Particulars	(Rs. in lakhs)*		
	Steel	Oil	Coal
Shares of Companies	40	Nil	Nil
Cash in hand (in India)	Nil	0.75	Nil
Fixed deposit and other deposits with banks	35	32	40
Loan taken for making investment in the firm	30	Nil	Nil
Residential House in Nairobi, Kenya	Nil	400	Nil

You are required to determine the assessable wealth of each partner as at 31st March, 2005 stating clearly the reason for inclusion or exclusion of each item. (10 marks)

* In the question paper, "rupees in lakhs" had been given as "rupees in thousands". This problem has been solved below taking the figures as "rupees in lakhs".

Answer

A partnership firm is not liable to wealth tax u/s 3 of the Wealth Tax Act. However, in respect of assets belonging to the firm, the individual partners are deemed to be the owners of those assets as per section 4(1)(b). Therefore, the value of partner's interest in assets of the firm determined in the manner laid down in Schedule III is to be included in the net wealth of the partner.

The value of the interest of each partner in the assets of the firm has to be determined as per Rules 15 and 16 of Schedule III to the Wealth Tax Act.

Net wealth of the firm on the valuation date shall be first determined without considering the exemption u/s 5.

The net wealth as calculated to the extent of partners' capital is to be allocated among the partners in proportion to their capital contribution. The balance of the net wealth shall be allocated as per the agreement for distribution of assets in the event of dissolution and where there is no such agreement, in their profit sharing ratio. The sum total of amounts so allocated to a partner shall be treated as the value of interest of that partner in the firm.

The assets eligible for exemption u/s 5 are also to be included in the value of interest of each partner. The exemption u/s 5 shall be available to the individual partners while computing their net wealth.

Computation of net wealth of firm for the A.Y. 2005-06

Particulars	Rs. in lakhs
1. Urban land [See Note 1]	550
2. Residential house [See Note 2]	300
3. Gold & silver [See Note 3]	1100
	1950
Less: Deductible debts u/s 2(m) in respect of urban land (Rs.700 lakhs $\times$ $\frac{1}{2}$) [See Note 6]	350
Net Wealth	1600

Note –

- Since the value as per Rule 20 of Schedule III i.e. Rs.550 lakhs exceeds book value of Rs.300 lakhs by more than 20%, value as per Schedule III has to be taken to be the value of urban land.
- Written down value of the residential house of the firm is required for the purpose of comparison with Schedule III value. Only if the value as per Schedule III exceeds the written down value by more than 20%, should Schedule III value be taken for computing net wealth of the firm. However, since the written down value is not given in the question, it has been assumed that the Balance Sheet value represents the written down value for the purpose of solving the problem. In such a case, for calculation of net wealth of firm, assuming the balance sheet value to be the written down value, the value of residential house should be Rs.300 lakhs, since this value does not exceed Schedule III value of Rs.350 lakhs by more than 20%.
- Since the value of gold and silver as per Rule 18 of Schedule III i.e. the market value of Rs.1100 lakhs exceeds the book value of Rs.800 lakhs by more than 20%, the market value of Rs.1100 lakhs has been taken as the value of gold and silver.

4. As per sub-rule 2(d) of Rule 14, the value of the following assets which are disclosed in the Balance Sheet should not be taken into account namely -
 - (i) Advance tax under the Income-tax Act
 - (ii) The value of assets in respect of which wealth tax is not payable under this Act [In this case, the following are the assets in respect of which wealth tax is not payable – urban land on which construction is not allowed, factory land, factory shed, plant, stocks, sundry debtors and cash at bank].
5. As per the Madras High Court decision in *Southern Roadways Ltd. v. CWT (2001) 251 ITR 0213*, “motor car” covers all motor vehicles other than heavy vehicles, such as lorries and buses. Therefore, Lorry, being a heavy vehicle is not covered under “motor car” and hence is not an asset under section 2(ea).
6. It has been assumed that term loan of Rs.700 lakhs was taken for purchase of urban lands only. Since the plots are of equal size, Rs.350 lakhs is allowable as deduction, since it represents a debt in respect of a taxable asset, namely, urban land. The balance Rs.350 lakhs represents a debt in respect of urban land on which construction is not allowed which is not an asset under section 2(ea), and hence deduction is not allowable.

Allocation of firm's net wealth to partners

Particulars	Steel	Oil	Coal
Net wealth to the extent of aggregate capital of partners in 3:4:2	300	400	200
Balance of net wealth in profit sharing ratio of 2:2:1	280	280	140
	580	680	340

Computation of partners' net wealth

Particulars	Steel	Oil	Coal
Interest in assets of the firm	580	680	340
Cash in hand in excess of Rs.50,000 is an asset u/s 2(ea)	-	0.25	-
	580	680.25	340
Less: exemption u/s 5 in respect of house property *	108.75	127.50	63.75
Deductible debts u/s 2(m) for loan taken in making investment in firm	30	-	-
Net wealth	441.25	552.75	276.25

*Interest in residential property of the firm = Value of house x value of partner's interest/net wealth of firm

Steel's share = $300 \times 580/1600$ = Rs.108.75 lakh

Oil's share = $300 \times 680/1600$ = Rs.127.50 lakh

Coal's share = $300 \times 340/1600 = \text{Rs.}63.75 \text{ lakh}$

Residential house property at Kenya is to-be excluded as Oil is a non-resident and the asset owned by a non-resident outside India is not taxable as per section 6(i).

The suggested answers for Indirect Taxes (Paper 8) are based on the provisions as amended by Finance (No.2) Act, 2004 and Notifications/Circulars issued up to 31.10.2004 which are relevant for May 2005 examinations.

PAPER – 8 : INDIRECT TAXES

Question Nos. 1, 6 and 9 are compulsory.

*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 Cenvat Credit Rules, 2002 :*

(i) *Exempted goods*

(ii) *Final products*

(iii) *First stage dealer.* (2 x 2 = 4 marks)

(b) *What are the situations where transaction value under Section 4 of the Central Excise Act does not apply?* (4 marks)

(c) *A trader supplies fabrics to independent processor. Cost of fabrics is Rs.1,150. The processor charges Rs.450 which includes Rs.350 as processing charges and Rs.100 as his profit. After processing, goods are sent back to the trader who sells them at Rs.1,800. Transport charges for receiving goods at the premises of the processor is Rs.50 and the transport charges for sending goods after processing is Rs.60.*

Please determine the assessable value of the goods under Section 4 of the Central Excise Act. (6 marks)

(d) *Before 1.3.2003, light diesel oil was one of the input as per the definition of input given in Cenvat Credit Rules. M/s. Rim purchased duty paid light diesel oil in January, 2003 and availed of Cenvat Credit on 4.1.2003. When input definition was amended to exclude LDO, department asked the company Rim to reverse the amount of Cenvat Credit in respect of the stock of LDO with them as on 1.3.2003.*

Advise M/s. Rim as to whether they have to reverse the credit? (6 marks)

Answer

(a) *As per Cenvat Credit Rules, 2002*

(i) *As per Rule 2(d) of the Cenvat Credit Rules, 2002, “exempted goods” means goods which are exempt from the whole of the duty of excise leviable thereon, and includes goods which are chargeable to “Nil” rate of duty.*

- (ii) As per Rule 2(e) of the Cenvat Credit Rules, 2002, "final products" means excisable goods manufactured or produced from "inputs".
- (iii) As per Rule 2(f) of the Cenvat Credit Rules, 2002, "first stage dealer" means a dealer who purchases the goods directly from, -
 - (i) the manufacturer under the cover of an invoice issued in terms of the provisions of Central Excise Rules, 2002 or from the depot of the said manufacturer, or from premises of the consignment agent of the said manufacturer or from any other premises from where the goods are sold by or on behalf of the said manufacturer, under cover of an invoice; or
 - (ii) an importer or from the depot of an importer or from the premises of the consignment agent of the importer, under cover of an invoice;

As per Cenvat Credit Rules, 2004:

- (i) As per Rule 2(d) of the Cenvat Credit Rules, 2004, "exempted goods" means goods which are exempt from the whole of the duty of excise leviable thereon, and includes goods which are chargeable to "Nil" rate of duty.
- (ii) Rule 2(h) of Cenvat Credit Rules, 2004 defines "final products" as excisable goods manufactured or produced from input, or using input service.
- (iii) As per Rule 2(ij) of Cenvat Credit Rules, 2004, a "first stage dealer" means a dealer who purchases the goods directly from-
 - (a) the manufacturer under the cover of an invoice issued in terms of the provisions of Central Excise Rules, 2002 or from the depot of the said manufacturer, or from premises of the consignment agent of the said manufacturer or from any other premises from where the goods are sold by or on behalf of the said manufacturer, under cover of an invoice; or
 - (b) an importer or from the depot of an importer or from the premises of the consignment agent of the importer, under cover of an invoice.
- (b) As per section 4 of the Central Excise Act, assessable value shall be the transaction value if the following conditions are fulfilled –
 - (i) there is a sale of goods,
 - (ii) the sale of goods is for delivery at the time and place of the removal,
 - (iii) the assessee and the buyer are not related persons, and
 - (iv) the price is the sole consideration for the sale.

If any one of the above conditions is not satisfied, the transaction value will not be taken as the assessable value. The value in such a case shall be determined on the basis of

the Central Excise (Determination of Price of Excisable Goods) Rules, 2000 notified under section 4(1)(b) of the Central Excise Act.

- (c) In case of *Ujagar Prints v. Union of India* 1989 (39) E.L.T. 493 (S.C), the Supreme Court has held that in respect of valuation of goods produced on job work basis, the assessable value shall include cost of material, processing charges and profit of processor. However, the trader's profit (customers' profit who got the goods processed) being post-manufacturing profit shall not be included in the assessable value. The Apex Court has clarified that the processor's factory gate shall be treated as deemed factory gate as if the processed fabrics were sold at processor's factory gate.

Therefore, applying the ratio of the abovementioned decision of the Supreme Court, the assessable value in this case shall be the aggregate of cost of fabrics, processing charges, processor's profit and cost of transportation for receiving goods at the premises of the processor. Thus, the assessable value shall be Rs.1650 [1150+350+100+50] and not Rs.1800 at which the trader sells the goods. Cost of transportation of Rs.60 from the processor's place to the trader's premises shall not be included in the assessable value as the place of the processor is deemed to be the place of removal of goods.

- (d) Rule 2(g) of the Cenvat Credit Rules, 2002 was amended w.e.f. 01.03.2003 to exclude light diesel oil (LDO) from the definition of inputs vide *Notification No. 13/2003-C.E. (N.T.)*, dated 1-3-2003. The Karnataka High Court in *Grasim Industries Ltd v. C.B.E.C.* 2004 (163) E.L.T. 10 (Kar) has held that credit on LDO, lying in stock on 28-2-2003, should not be reversed, as it would amount to taking away of vested right which have already accrued to the assessee in terms of the excise laws. The Supreme Court also conformed to the view taken by the Karnataka High Court and dismissed the appeal filed by the Government – 2004 (170) E.L.T. A 306 (S.C.)

In view of the above judgement, M/s Rim need not reverse the Cenvat credit in respect of the opening stock of LDO with them as on 1.3.2003 as L.D.O. was one of the specified inputs in January 2003 when Cenvat credit of the duty paid on it was availed.

Note: The principle enunciated by the abovementioned case law holds equally good for Cenvat Credit Rules, 2004 as well.

Question 2

- (a) Explain briefly with reference to the provisions of the Central Excise Act the term "Deemed Manufacture". (3 marks)
- (b) Discuss the provisions of the Central Excise Act relating to collection of amount by a person from his buyer in excess of the duty assessed or determined and paid on any excisable goods. (4 marks)
- (c) When shall a person be deemed to be a related person for the purpose of valuation under the Central Excise Act? (4 marks)

(d) Describe power to summon persons under the Central Excise Act. (4 marks)

Answer

(a) As per section 2(f) of the Central Excise Act, 1944 "manufacture" includes any process-

- (i) incidental or ancillary to the completion of a manufactured product; and
- (ii) which is specified in relation to any goods in the Section or Chapter Notes of the First Schedule to the Central Excise Tariff Act, 1985 as amounting to manufacture, or
- (iii) which, in relation to the goods specified in the Third Schedule, involves packing or repacking of such goods in a unit container or labelling or re-labelling of containers including the declaration or alteration of retail sale price on it or adoption of any other treatment on the goods to render the product marketable to the consumer,

and the word "manufacturer" shall be construed accordingly and shall include not only a person who employs hired labour in the production or manufacture of excisable goods, but also any person who engages in their production or manufacture on his own account.

The processes that qualify to be manufacture as per clause (ii) and (iii) of section 2(f) are termed as deemed manufacture.

Thus, if any process which is specified in the Section or Chapter Notes of the First Schedule to the Central Excise Tariff Act, 1985 as amounting to manufacture is carried out, goods will be deemed as manufactured, even if as per Court decisions, the process may not amount to manufacture. For instance, Note 2 of Chapter 9 provides that in case of tea, or tea waste, blending, sorting, packing or re-packing into smaller containers shall amount to manufacture. Similarly, if any of specified processes (like re-packing, re-labelling, alteration of retail sale price etc.) is being carried out on goods covered in Third Schedule to the Central Excise Act, 1944, the process will be deemed to be as that of manufacture.

(b) Section 11D of the Central Excise Act governs the provisions relating to collection of amount by a person from a buyer in excess of the duty assessed or determined and paid on any excisable goods in the following manner:

- (1) Every person who is liable to pay duty and has collected any amount in excess of the duty assessed or determined and paid on any excisable goods from the buyer of such goods in any manner as representing duty of excise, shall forthwith pay the amount so collected to the credit of the Central Government. This provision is notwithstanding anything to the contrary contained in any order or direction of the Appellate Tribunal or any Court or in any other provision of this Act or the regulations made there under.
- (2) The Central Excise officer may serve on the person who is liable to pay the amount

under sub-section (1) a notice if such amount has not been paid to the credit of the Central Government. The notice requires such person to show cause why he should not pay the amount, as specified in the notice to the credit of the Central Government.

- (3) The Central Excise officer shall, after considering the representation, if any, made by the person on whom the notice is served, determine the amount due from such person (not being in excess of the amount specified in the notice). Thereupon such person shall pay the amount so determined.
 - (4) The amount paid to the credit of the Central Government under sub-section (1) or sub-section (3) shall be adjusted against the duty payable by the person on finalisation of assessment or any other proceeding for determination of the duty of excise relating to the excisable goods referred to in sub-section (1).
 - (5) Where any surplus is left after the adjustment made under sub-section (4), the amount of such surplus shall either be credited to the Fund or, as the case may be refunded to the person who has borne the incidence of such amount, in accordance with the provisions of section 11B. Such person may make an application under section 11B in such cases within six months from the date of the public notice to be issued by the Assistant Commissioner of Central Excise for the refund of such surplus amount.
- (c) Section 4(3)(b) of Central Excise Act, 1944 states that persons shall be deemed to be related if:
- (i) they are inter-connected undertakings;
 - (ii) they are relatives;
 - (iii) amongst them the buyer is a relative and a distributor of the assessee, or a sub-distributor of such distributor; or
 - (iv) they are so associated that they have interest, directly or indirectly, in the business of each other.
- “Inter-connected undertakings” shall have the meaning assigned to it in clause (g) of section 2 of the Monopolies and Restrictive Trade Practices Act, 1969 and “relative” shall have the meaning assigned to it in clause (41) of section 2 of the Companies Act, 1956.
- (d) Section 14 of the Central Excise Act deals with the power to summon persons. As per this section any Central Excise Officer empowered by the Central Government in this behalf, shall have power to summon any person whose attendance he considers necessary for:
- (i) giving evidence, or
 - (ii) producing a document or any other thing

in any enquiry which he is making for any of the purposes of this Act.

All persons so summoned shall be bound to attend, either in person or by an authorised agent, as such officer may direct. Further, these persons shall be bound to state the truth upon any subject in respect of which they are examined and produce documents and other things as may be required. Exemptions under sections 132 and 133 of the Code of Civil Procedure shall be applicable to requisitions for attendance under this section. Every inquiry under this section shall be deemed to be a "judicial proceeding" within the meaning of section 193 and section 228 of the Indian Penal Code.

Question 3

- (a) *Is there any exception to the rule that central excise duty is payable by a producer or manufacturer of goods on removal thereof from the factory and duty is payable by someone else?* (2 marks)
- (b) *What are the dates for determination of rate of central excise duty under Central Excise Rules, 2002?* (3 marks)
- (c) *Please discuss the manner of payment of duty under Central Excise Rules, 2002. [Rule 8 only]* (4 marks)
- (d) *M/s. SYL purchases film from the manufacturer thereof on payment of appropriate central excise duty. They undertake the processes of lamination/metallisation of the said film. The department directs them to pay central excise duty as the processes undertaken by them amount to manufacture.*

Please offer your comments with the help of decided case law. (6 marks)

Answer

- (a) As per rule 4(1) of the Central Excise Rules, 2002, excise duty is payable by a person who produces or manufactures excisable goods, or who stores such goods in a warehouse. However sub-rule (2) of Rule 4 lays down that in respect of molasses produced in a khandsari sugar factory, *the person who procures such molasses*, whether directly from such factory or otherwise, pays duty leviable on such molasses in the same manner as if such molasses have been produced by him.
- (b) The dates for determination of rate of duty have been prescribed in Rule 5 of Central Excise Rules, 2002 as under:
 - (i) in case of excisable goods other than khandsari molasses, the relevant date for determination of rate of duty shall be the date when goods are removed from the factory.
 - (ii) in case of khandsari molasses, the relevant date for determination of rate of duty shall be the date of receipt of molasses in the factory of the procurer.

- (iii) in case of excisable goods being used within the factory, the relevant date for determination of rate of duty shall be the date on which goods are issued for such use.
- (c) Rule 8 of the Central Excise Rules, 2002 prescribes the manner of payment of duty as under:
 - (i) The duty on the goods shall be paid by the 5th day of the month following the month of removal except for the month of March.
 - (ii) In case of removal of goods during the month of March, the duty shall be paid by the 31st day of March.
 - (iii) If an assessee is availing the exemption under a notification based on the value of clearances in a financial year, the duty shall be paid by the 15th day of the following month except in case of removal of goods in March for which the duty shall be paid by the 31st day of March.
 - (iv) The duty liability shall be deemed to have been discharged only if the amount payable is credited to the account of the Central Government by the specified date.
 - (v) If the assessee deposits the duty by cheque, the date of presentation of the cheque in the bank designated by the Central Board of Excise & Customs for this purpose shall be deemed to be the date on which the duty has been paid subject to the realisation of that cheque.
- (d) As per section 3 of the Central Excise Act, 1944 a duty of excise is levied on goods produced or manufacture in India. For understanding the concept of manufacture, the Indian Courts have been relying on the famous paragraph from an American judgment which defines manufacture. The paragraph *inter alia* provides that as a result of manufacture, a new and different article must emerge having a distinctive name and character or use.

The issue in the problem has been considered by the Supreme Court in the case of *Meltex (I) Pvt. Ltd. v. C.C.E. 2004 (165) E.L.T. 129 (S.C)* wherein it has held that laminating/metallising of duty paid films does not amount to manufacture as:

- (i) no new and distinct product comes in to existence, and
- (ii) the product which is a film at the onset remains a film, even after lamination or metallisation.

Therefore, applying the ratio of the abovementioned decision to the present problem, it can be inferred that the stand taken by the department is not tenable in law.

Question 4

- (a) Does the maxim "*Latter the Better*" apply in classifying the excisable goods? (3 marks)

- (b) *Mention briefly the provisions regarding export under bond to Nepal where payment of duty is in freely convertible currency.* (6 marks)
- (c) *Deputy Commissioner of Central Excise passes an adjudication order classifying the goods manufactured by MTZ under heading 85.42 and charges duty @ 16% ad valorem. MTZ pays the duty without challenging the adjudication order. After 4 months they realise that partial exemption under a notification was available to goods manufactured by them. They file a claim for refund of duty paid in excess on the ground that benefit of exemption can be claimed at any time.*

Are MTZ entitled to the refund of duty claimed in time?

(Note : Presume that principle of unjust enrichment does not apply). (6 marks)

Answer

- (a) The Central Excise Tariff Act, 1985 incorporates five Rules of Interpretation. Rule 3(c) of the Rules for the Interpretation provides that when goods cannot be classified by reference to rule 3(a) or rule 3(b), they shall be classified under the heading which occurs last in the numerical order among those which equally merit consideration.

Thus the maxim "Latter the Better" applies in determining the classification of the excisable goods.

- (b) Export to Nepal under bond where payment is in freely convertible currency is governed by *Notification No. 45/2001-C.E. (N.T.) dated 26.6.2001* as amended. The provisions are as under:

- (1) The importer in Nepal before the export of goods takes place shall:
 - (i) make full payment to the exporter by furnishing Foreign Inward Remittance Certificate from any bank authorized to deal in foreign exchange by Reserve Bank of India, or
 - (ii) open an irrevocable letter of credit in favour of the exporter in India.
- (2) This condition does not apply if the excisable goods other than consumer goods but excluding motor vehicles, are exported without payment of duty as:
 - (a) supplies to projects financed by any United Nations Agency, the International Bank for Reconstruction and Development, International Development Association, the Asian Development Bank or any other multilateral agency of like nature;
 - (b) to all diplomatic missions in Nepal provided the Indian Embassy or the Ministry of External Affairs certifies that the import is for the personnel of the diplomatic community.
- (3) The exporter shall furnish a bond before the Assistant/Deputy Commissioner of

Central Excise having jurisdiction over the factory, warehouse, or the approved premises or such other officer as authorised by the Board on this behalf from where the goods are removed, for export to Nepal.

- (4) Where the export is against an irrevocable letter of credit, the exporter shall furnish a certificate from the Reserve Bank of India or any other bank authorized to deal in foreign exchange by the Reserve Bank of India showing that full payment has been received in freely convertible currency.
 - (5) On receipt of such a certificate and on the satisfaction that the goods have been exported in terms of bond, the bond accepting authority shall discharge the exporter of his liabilities under the bond.
- (c) It has been held by the Supreme Court in the case of *CCE v. Flock India Ltd. 2000 (120) E.L.T. 285 (S.C)* that where an adjudicating authority has passed an order which is appealable under the statute and the party aggrieved did not choose to exercise the statutory right of filing an appeal it is not open to the party to question the correctness of the order of the adjudicating authority subsequently by filing a claim for refund. If this position is accepted then the provisions for adjudication and appeal in the Act and the Rules will lose their relevance and the entire exercise will be rendered redundant.

In the given question, the classification dispute has been decided by the Deputy Commissioner after passing an adjudication order and no appeal has been filed thereafter. Therefore, the order has attained finality. Thus, applying the ratio of the above decision, MTZ cannot claim refund by filing a claim for the same.

Question 5

- (a) *In what circumstances additional evidence can be produced by an appellant before the Commissioner (Appeals) of Central Excise?* (5 marks)
- (b) *M/s. RKR manufactures footwear bearing the brand name "Lotus" which is owned by M/s. Lotus Industries Ltd. for manufacture of detergent powder. When the department disallowed the benefit of small scale exemption under Notification No. 9/2003-C.E. on the ground that their goods are bearing brand name of another person, M/s. R.K.R. contended that M/s. Lotus Industries Ltd. owns brand name 'Lotus' only for detergent power and not for footwear.*
Decide the case with reasons and mention case law, if any. (5 marks)
- (c) *"Mere selling of a commodity does not mean it is marketable". Elucidate.* (5 marks)

Answer

- (a) Rule 5 of the Central Excise (Appeals) Rules, 2001 provides that the appellant shall not be entitled to produce before the Commissioner (Appeals) any evidence, whether oral or documentary, in addition to evidence produced by him during the course of the

proceedings before the adjudicating authority. However, additional evidence can be produced in the following circumstances –

- (1) where the adjudicating authority has refused to admit evidence which ought to have been admitted, or
- (2) where the appellant was prevented by sufficient cause from producing the evidence which he was called upon to produce by adjudicating authority, or
- (3) where the appellant was prevented by sufficient cause from producing, before the adjudicating authority any evidence which is relevant to any ground of appeal, or
- (4) where the adjudicating authority has made the order appealed against without giving sufficient opportunity to the appellant to adduce evidence relevant to any ground of appeal.

The Commissioner (Appeals) has to record the reasons for admitting the additional evidence in writing. Further, the adjudicating authority or an officer authorized by the said authority has to be allowed a reasonable opportunity:

- (1) to examine the evidence or document or to cross examine any witness produced by the appellant; or
- (2) to produce any evidence or any witness in rebuttal of the additional evidence.

The power of the Commissioner(Appeals) to direct the production of any document, or the examination of any witness, to enable him to dispose of the appeal is independent of the above provisions relating to additional evidence and his powers will not be affected by the said provisions.

- (b) Paragraph 4 of the *Notification No. 9/2003-CE dated 01.03.2003* provides that the benefit of Small Scale Industry (SSI) exemption shall not apply to the goods bearing a brand name or trade name, whether registered or not, of another person. As per Explanation (A) to the notification, brand name or trade name means:

- ◆ a brand name or trade name, whether registered or not, that is to say a name or a mark, such as symbol, monogram, label, signature or invented word or writing
- ◆ which is used in relation to such specified goods for the purpose of indicating, or so as to indicate a connection in the course of trade
- ◆ between such specified goods and some person using such name or mark with or without any indication of the identity of that person.

Supreme Court has held in the case of *CCEx, v. Bhalla Enterprises 2004 (173) E.L.T. 225 (S.C)* that:

- (i) clause 4 of the Notification read with Explanation (A) clearly debars those persons from the benefit of the SSI exemption who use someone else's name in connection

with their goods, either with the intention of indicating, or in a manner so as to indicate a connection between their goods and such other person;

- (ii) there is no requirement for the owner of the trade mark using the name or mark with reference to any particular goods;
- (iii) The object of the Notification is clearly to grant benefits only to those industries which otherwise do not have the advantage of a brand name.

In other words, if brand name of another person is used even in respect of goods of other class or kind (different from the nature of the goods of the owner of brand name), benefit of SSI exemption shall not be available.

In view of the aforementioned provisions, M/s RKR will not be entitled to the SSI exemption as their goods bear the brand name “LOTUS” owned by M/s. Lotus Industries Ltd. The fact that M/s. RKR uses the brand name on footwear while the same is being used by M/s. Lotus Industries Ltd. on detergent powder will have no relevance.

- (c) Unless the goods are capable of being marketed, they cannot be charged to duty. Marketability is the capability of a product of being put into the market for sale. Supreme Court in *Union of India v. Delhi Cloth and General Mills Case – 1977 (1) ELT (J199)* has held that in order to become goods, it is necessary that an article must be something which can ordinarily come to the market to be bought and sold.

However, the Apex Court in *UOI v Indian Aluminium Co. Ltd. 1995 (77) ELT 268* has held that dross and skimmings are not marketable commodity even if they can be sold to recover some metal as everything which is sold is not necessarily a marketable commodity as known to the commerce and which, it may be worthwhile to trade in. The dross and skimmings arising during the manufacture of aluminium are nothing but waste or rubbish which is thrown up in the course of manufacture. They are not metal in the same class as waste or scrap. It may be possible to recover some metal from them and therefore they can be sold.

This view has been reiterated by the Supreme Court in *CCE v. Tata Iron and Steel Co. Ltd. 2004 (165) E.L.T. 386 (S.C.)* wherein the Apex Court has held that the dross and skimming are merely the refuse, scum or rubbish produced during the process of manufacture. The Supreme Court has held that merely because the dross and skimming are sold to customers, it cannot be inferred that they are marketable commodity as even rubbish can be sold. However, that does not make rubbish a marketable commodity. Mere selling of a commodity does not mean that it is marketable since a commodity can also be sold as rubbish. Marketability means selling of a commodity which is known to the commerce and which may be worthwhile to trade in.

In view of these decisions it can be inferred that in order to be marketable an item should be capable of being bought and sold. However, the item should be something which is

worthwhile to trade in and not just refuse, scum or rubbish.

PART - B

Question 6

- (a) *Briefly explain with reference to the provisions of the Customs Act any two of the following:*
- (i) *Entry*
 - (ii) *Prohibited goods*
 - (iii) *Warehouses.* (2 x 2 = 4 marks)
- (b) *A material was imported by air at CIF price of 5,000 US\$. Freight paid was 1,500 US\$ and insurance cost was 500 US\$. The banker realized the payment from importer at the exchange rate of Rs.45 per dollar. Central Board of Excise and Customs notified the exchange rate as Rs.44.50 per US\$.*
- Find the value of the material for the purpose of levying duty.* (4 marks)
- (c) *Discuss the provisions regarding 'Transit of Goods' and 'Transshipment of goods' without payment of duty under the Customs Act.* (4 marks)
- (d) *State the circumstances under which a revision petition can be filed before the Central Government under the Customs Act.* (4 marks)
- (e) *Write a note on project import and mention eligible projects.* (4 marks)

Answer

- (a) (i) As per section 2(16) of the Customs Act, 1962 entry in relation to goods means an entry made in a bill of entry, shipping bill or bill of export and includes in the case of goods imported or to be exported by post, the entry referred to in section 82 or the entry made under the regulations made under section 84.
- (ii) As per section 2(33) of the Customs Act, 1962 prohibited goods means any goods the import or export of which is subject to any prohibition under the Customs Act or any other law for the time being in force but does not include any such goods in respect of which the conditions subject to which the goods are permitted to be imported or exported have been complied with.
- (iii) As per section 2(43) of the Customs Act, 1962, warehouse means a public warehouse appointed under section 57 or a private warehouse licensed under section 58. A warehouse is a place where goods after landing are permitted to be removed without payment of duty. Duty is collected at the time of clearance from the warehouse. A public warehouse is owned and managed by a Government body like Central Warehousing Corporation. A private warehouse is licensed in a place

where there is no public bonded warehouse.

(b) CIF value	5000 US \$
Less: Freight	1500 US \$
Less: Insurance	<u>500 US \$</u>
Therefore, FOB value	<u>3000 US \$</u>
Assessable value for Customs purpose:	
FOB value	3000 US \$
Add: Freight (20% of FOB value)	600 US \$
Add: Insurance (actual)	<u>500 US \$</u>
CIF for Customs purpose	4100 US \$
Add: 1% for landing charges	<u>41 US \$</u>
Value for Customs purpose	4141 US \$
Exchange rate as per CBEC	Rs. 44.50 per US \$
Assessable value	= Rs. 44.50 x 4141 US \$
	= Rs. 184274.50

Notes:

- (1) As the material has been imported by air, the freight has been restricted to 20% of FOB value i.e. 600 US \$. [Second proviso to Rule 9(2) of Customs Valuation (Determination of Price of Imported Goods) Rules, 1988]
- (2) Landing charges have been considered as per Rule 9(2)(b) of the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988.
- (3) Rate of exchange as notified by CBEC has been considered as per section 14(3)(a) of the Customs Act, 1962.

- (c) Transit of goods:** Section 53 provides that any goods imported in a conveyance and mentioned in the import manifest or the import report, as the case may be, as for transit in the same conveyance to any place outside India or any customs station, may be allowed to be so transited without payment of duty. However, the goods should not have been prohibited under section 11 of the Customs Act.

Transshipment of goods: This refers to transfer of goods from one conveyance to another. It may be from one port to any other major port or airport in India.

Section 54 provides that:

- (1) where any goods imported into a customs station are intended for transshipment, the person-in-charge of conveyance will have to present a bill of transshipment to the proper officer in the prescribed form;
 - (2) where any goods imported in to a customs station are mentioned in the import manifest or import report, as for transshipment to any place outside India, such goods will be allowed to be so transhipped without payment of duty. However, the goods should not have been prohibited under section 11 of the Customs Act.
 - (3) where any goods imported into a customs station are mentioned in the import manifest or import report for transshipment to any major port (as defined in the Indian Ports Act, 1908) or to customs airport or customs port (as notified by the Board) or to any other customs station and the proper officer is satisfied about the bona-fide intention for transshipment of the goods to such customs station, the proper officer may allow the goods to be transhipped, without payment of duty.
- (d) The first proviso to section 129A of the Customs Act, 1962 provides that the Appellate Tribunal shall not have jurisdiction to decide any appeal in respect of any order passed by Commissioner (Appeals) if such order relates to, -
- (a) any goods imported or exported as baggage;
 - (b) any goods loaded in a conveyance for importation into India, but which are not unloaded at their place of destination in India, or which are short landed at that destination;
 - (c) payment of drawback as provided in Chapter X, and the rules made thereunder.

In such cases, redressal lies with the Central Government. Section 129DD(1) enables the appellant to get the orders of Appellate Commissioner (on these three aspects) annulled or modified by the Central Government.

Sub-section 1A of section 129DD enables the Commissioner of Customs to direct the proper officer to make an application on his behalf to the Central Government for revision of an order. However, such application can be made only if the Commissioner is of the opinion that the order passed by the Commissioner (Appeals) under section 128A is not legal or proper.

- (e) Project Imports are the imports of machinery, instruments, and apparatus etc., falling under different classifications, required for initial set up of a unit or for substantial expansion of an existing unit. In a project several different items are required, each of which is importable at different rates of customs duties. Hence, it becomes very complicated to make assessment for such project imports. Therefore, one consolidated rate of customs duty has been made applicable for all items imported under a project irrespective of the nature of the goods and their customs classification.

The items eligible for project import are specified in Heading 98.01 of the Customs Tariff Act, 1975. These include all items of machinery, spare parts within prescribed limits, components or raw materials etc. for initial setting up of a unit or for substantial expansion of the same. The eligible projects or the projects for which the scheme has been made applicable are Industrial Plants, Irrigation Projects, Power Projects, Mining Projects, Projects for Oil or Mineral Exploration and other projects as may be notified by the Central Government.

Question 7

- (a) *Explain with reference to the Customs Act:*
- (i) *Conditions for filing application to Settlement Commission.* (3 marks)
 - (ii) *Service of order etc. under Section 153 of the Customs Act.* (2 marks)
- (b) *Mention the orders against which appeal lies to the Supreme Court under Section 130E of the Customs Act.* (5 marks)
- (c) *Briefly explain the time limit for issuing show cause notice for demanding customs duty short paid.* (5 marks)

Answer

- (a) (i) According to section 127B of the Customs Act 1962, the following conditions are to be fulfilled for filing an application for settlement of cases.
- (i) the applicant has filed the bill of entry or the shipping bill in respect of import or export of goods, as the case may be.
 - (ii) a show cause notice in respect of such bill of entry or shipping bill has been issued to the applicant by the proper officer.
 - (iii) the additional duty accepted is more than Rs 2 lakhs.
 - (iv) the case is not pending with CESTAT or any Court.
 - (v) the application does not relate to goods to which section 123 applies or to goods in relation to which any offence under the Narcotic Drugs and Psychotropic Substances Act, 1985 has been committed.
 - (vi) the application is not for the interpretation of the classification of the goods under the Customs Tariff Act, 1975.
- (ii) According to section 153 of the Customs Act 1962, order or decision passed or any summons or notice issued under the Customs Act, shall be served by tendering the order, decision, summons or notice or sending it by registered post to the person for whom it is intended or to his agent. In case if this is not possible, the order, decision, summons or notice shall be affixed on the notice board of the customs house.

- (b) As per section 130E of the Customs Act, an appeal shall lie to the Supreme Court from-
- (a) any judgment of High Court delivered
 - (i) in an appeal made under section 130, or
 - (ii) on a reference made under section 130 by the Appellate Tribunal before 01.07.2003, or
 - (iii) on a reference made u/s 130 A,if the High Court certifies the case to be fit for appeal to the Supreme Court. Such certification can be done by the High Court on its own motion or on an oral application made by or on behalf of the aggrieved party, immediately after passing of the judgement.
 - (b) any order of the Appellate Tribunal having relation to the determination of rate of customs duty or value of goods, among other things.
- (c) Section 28 of the Customs Act, 1962 provides that where the customs duty has been short paid, a show cause notice shall be issued-
- (i) within one year from the relevant date in the case of any import made by any individual for his personal use or by Government or by any educational, research or charitable institution or hospital;
 - (ii) within six months from the relevant date in any other case.
- However, if the customs duty has been short paid by reason of collusion or any willful mis-statement or suppression of facts by the importer or the exporter or their agent or employee, the show cause notice can be issued within five years from the relevant date.
- Relevant date means –
- (i) in a case where duty is not levied, the date on which the proper officer makes an order for the clearance of goods;
 - (ii) in the case of provisional assessment, the date of adjustment of duty after the final assessment;
 - (iii) in any other case, the date of payment of duty.

Question 8

- (a) *When the ship on its arrival from Dubai was searched by the Customs Officers, they found 2,000 biscuits of gold kept concealed in the ceiling of one of the unoccupied cabin. The Chief Cook of the ship admitted the concealing of the gold. The Captain of the ship deposed in his statement that he alongwith Chief Engineer and Chief Officer had inspected the vessel for contraband goods and inspection did not reveal anything. No evidence was also found that captain was involved in the smuggling of gold.*

Discuss whether the ship is liable to confiscation under the Customs Act. (5 marks)

- (b) *M/s. XYZ, a 100% export oriented undertaking (100% E.O.U. in short) imported DG sets and furnace oil duty free for setting up captive power plant for its power requirements for export production. They used the power so generated for export production but sold surplus power in domestic tariff area. Is customs department justified in demanding duty on DG sets and furnace oil as surplus power has been sold in domestic tariff area?*

(5 marks)

- (c) *Mention the circumstances under which goods are considered to have been removed improperly from a warehouse under the Customs Act. (5 marks)*

Answer

- (a) Section 115(2) of the Customs Act, 1962 *inter alia* provides that any conveyance used as a means of transport in the smuggling of any goods or in the carriage of any smuggled goods shall be liable to confiscation. However, if the owner of the conveyance proves that the conveyance was so used without the knowledge and connivance of the owner himself, his agent, and the person in charge of the conveyance, the conveyance shall not be liable to confiscation. As per section 2(31)(a) of the Customs Act, in case of a vessel, the master of the vessel is the person-in-charge.

Since, in the problem there is no evidence that the captain of the ship i.e., the master of the vessel had any knowledge about the smuggling of the gold or he had connived in the smuggling of gold, the ship shall not be liable to be confiscated.

In a similar situation, the Supreme Court has set aside the order of confiscation of a truck carrying forest produce in contravention of the provisions of the Forest Act as the authorities failed to establish that the owner of the truck had any knowledge about the truck being so used. [*Forest Conservator v. Sharad Ramachandar Kale* 2000 (121) E.L.T. 14 (S.C.)]

- (b) D.G. Sets, spare parts of D.G. Sets and consumables, such as furnace oil/lubricating oil/HSD are exempt from duty if used in connection with the production of goods meant for export by a 100% EOU vide *Notification Nos. 13/81-Cus., 53/91-Cus. and 1/95-Cus.* In *Commissioner v. Hanil Era Textile Ltd. - 2005 (180) E.L.T. A044 (S.C.)* the Supreme Court agreed to the view taken by the Tribunal that in the absence of a restrictive clause in the notifications that imported goods are to be solely or exclusively used for manufacture of goods for export, there is no violation of any condition of notification if surplus power generated due to unforeseen exigencies is sold in domestic tariff area.

Therefore, no duty can be demanded from M/s XYZ for selling the surplus power in domestic tariff area for the following reasons:

- (i) They have used the DG sets and furnace oil imported duty free for generation of

power, and

- (ii) such power generated has been used for manufacturing goods for export, and
 - (iii) only the surplus power has been sold, as power cannot be stored.
- (c) Section 72 of the Customs Act provides that in any of the following circumstances the goods shall be considered to have been removed improperly from a warehouse –
- (a) where any warehoused goods are removed from a warehouse in contravention of section 71 of the Customs Act;
 - (b) where any warehoused goods have not been removed from a warehouse at the expiration of the period during which such goods are permitted under section 61 to remain in a warehouse;
 - (c) where any warehoused good have been taken under section 64 as samples without payment of duty;
 - (d) where any goods in respect of which a bond has been executed under section 59 and which have not been cleared for home consumption or exportation are not duly accounted for to the satisfaction of the proper officer.

PART - C

Question 9

- (a) *Whether service tax under the provisions of Finance Act, 1994 is chargeable on the following services:*
- (i) *Use of the precincts of a religious place as a mandap*
 - (ii) *Payment of service is received in India in convertible foreign exchange*
 - (iii) *An interior decorator provides service of beautification of spaces in Srinagar*
 - (iv) *Services provided by a sub-broker to an investor.* (2 x 4 = 8 marks)
- (b) (i) *Mention the issues on which an advance ruling can be sought in service tax matters.* (5 marks)
- (ii) *When does an advance ruling on service tax become void ab initio?* (2 marks)

Answer

- (a) (i) No, as *Notification No. 14/2003 – ST, dated 20.6.2003* exempts services provided to any person by a mandap keeper for the use of the precincts of a religious place as a mandap from service tax.
- (ii) No, as *Notification No. 21/2003 - ST, dated 20.11.2003* exempts services provided to any person in respect of which payment is received in India in convertible foreign exchange from service tax.

- (iii) As per section 64(1) of the Finance Act, 1994 the provisions of Finance Act, 1994 relating to service tax are not applicable in the state of Jammu and Kashmir. Therefore, no service tax is chargeable in this case.
- (iv) Yes, service tax is chargeable on service provided by a sub-broker to an investor as Finance (No.2) Act, 2004 has amended the definition of stock broker as provided in section 65(101) of Finance Act, 1994 to include sub-broker also. Section 65(105)(a) *inter alia* states that services provided by a stock broker are taxable services.
- (b) (i) As per section 96C of Finance Act, 1994 an advance ruling can be sought in the following matters:
 - (a) classification of any service as a taxable service under Chapter V of Finance Act, 1994;
 - (b) the valuation of taxable services for charging service tax;
 - (c) the principles to be adopted for the purposes of determination of value of the taxable service under the provisions of Chapter V;
 - (d) applicability of notifications issued under Chapter V;
 - (e) admissibility of credit of service tax.
- (ii) Section 96F of Finance Act, 1994 provides that if the Authority of Advance Ruling finds, on a representation made to it by the Commissioner of Central Excise or otherwise, that an advance ruling has been obtained by the applicant by fraud or misrepresentation of facts, it may, by order, declare such ruling to be void ab initio.