

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.

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

Question 1

The following are the summarised Balance Sheets of PD Co. Ltd. and SD Co. Ltd. as on 31.3.2004.

Liabilities	PD Co. Ltd. Rs.	SD Co. Ltd. Rs.
Share Capital:		
Authorised	<u>70,00,000</u>	<u>30,00,000</u>
Issued and Subscribed Capital		
Equity shares of Rs. 10 each fully paid	50,00,000	20,00,000
Capital Reserve	5,00,000	3,10,000
Revenue Reserve	8,50,000	75,000
Profit and Loss Account	4,00,000	2,80,000
Sundry Creditors	2,50,000	2,25,000
Bills Payable	<u>1,00,000</u>	<u>10,000</u>
	<u>71,00,000</u>	<u>29,00,000</u>
Assets	PD Co. Ltd. Rs.	SD Co. Ltd. Rs.
Land and Buildings	20,00,000	15,20,000
Plant and Machinery	20,00,000	8,00,000
Furniture	5,00,000	1,60,000
Investments	16,10,000	—
Stock	3,40,000	1,00,000
Sundry Debtors	3,60,000	2,00,000
Bills Receivable	50,000	40,000
Bank	<u>2,40,000</u>	<u>80,000</u>
	<u>71,00,000</u>	<u>29,00,000</u>

PD Ltd. acquired 80% shares of SD Ltd. on 30.09.2003 at a cost of Rs. 18,10,000. On 1.10.2003 SD Ltd. declared and paid dividend on Equity Shares. PD Ltd. appropriately adjusted its share of dividend in Investment Account.

On 1.4.2003, the Capital Reserve and Profit and Loss Account stood in the books of SD Ltd. at Rs. 50,000 and Rs. 2,75,000 respectively.

Land and Buildings standing in the books of SD Ltd. at Rs. 16,00,000 on 1.4.2003, revalued at Rs.20,00,000 on 1.10.1993. Furniture, which stood in the books at Rs. 2,00,000 on 1.4.2003 revalued at Rs.1,50,000 on 1.10.2003. In both the cases the effects have not yet been given in the books.

SD Ltd. bought an item of machinery from PD Ltd. on hire-purchase basis. The following are the balances in respect of this machinery in the books on 31.03.2004:

	Rs.
Instalment due	20,000
Instalment not due	8,000
Hire-purchase stock reserve	1,600

The above items stood included under appropriate heads in Balance Sheet.

Prepare a Consolidated Balance Sheet of PD Ltd. and its subsidiary SD Ltd. as at 31.03.2004, complying with the requirements of AS-21. (16 marks)

Answer

Consolidated Balance Sheet of PD Co. Ltd. with its subsidiary SD Co. Ltd. as on 31st March, 2004

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
<i>Share Capital:</i>			<i>Fixed Assets:</i>		
Authorised	<u>70,00,000</u>		Land and buildings		
Issued and subscribed			PD Ltd.	20,00,000	
Equity shares of Rs. 10			SD Ltd. (W.N. 2)	<u>19,50,000</u>	39,50,000
each, fully paid up	50,00,000		Plant and machinery		
Minority interest (W.N. 5)	6,14,000		PD Ltd.	20,00,000	
<i>Reserves and surplus:</i>			SD Ltd.	<u>8,00,000</u>	
Capital reserve (W.N. 8)	12,18,000			28,00,000	
Revenue reserve (W.N. 9)	8,80,000		Less: Unrealised profit		
Profit and loss account	4,92,400		on hire purchase		
(W.N. 10)			transaction	<u>5,600</u>	27,94,400
<i>Current liabilities and</i>			Furniture		
<i>provisions:</i>			PD Ltd.	5,00,000	
<i>Current liabilities</i>			SD Ltd. (W.N. 2)	<u>1,35,000</u>	6,35,000

Sundry creditors			<i>Current assets, loans and advances:</i>		
PD Ltd.	2,50,000		<i>Current assets</i>		
SD Ltd.	<u>2,25,000</u>		Stock		
	4,75,000		PD Ltd.	3,40,000	
Less: Mutual hire			SD Ltd.	<u>1,00,000</u>	
purchase indebtedness	<u>28,000</u>	4,47,000		4,40,000	
Bills payable			Less: Hire purchase		
PD Ltd.	1,00,000		instalment not due	<u>8,000</u>	4,32,000
SD Ltd.	<u>10,000</u>	1,10,000	Sundry debtors		
			PD Ltd.	3,60,000	
			SD Ltd.	<u>2,00,000</u>	
				5,60,000	
			Less: Hire purchase		
			Instalment due	<u>20,000</u>	5,40,000
			<i>Loans and advances:</i>		
			Bills receivable		
			PD Ltd.	50,000	
			SD Ltd.	<u>40,000</u>	90,000
			<i>Cash and Bank Balances:</i>		
			Bank		
			PD Ltd.	2,40,000	
			SD Ltd.	<u>80,000</u>	<u>3,20,000</u>
		<u>87,61,400</u>			<u>87,61,400</u>

Working Notes:**1. Analysis of reserves and profits of SD Co. Ltd. as on 31.03.2004.**

		<i>Pre-acquisition profit upto 30.09.2003 (Capital profits)</i>	<i>Post-acquisition profits (1.10.2003 – 31.3.2004)</i>		
			<i>Capital reserve</i>	<i>Revenue reserve</i>	<i>Profit and loss account</i>
Capital reserve as on 31.3.2004	3,10,000				
Less: Balance as on 1.4.2003	<u>50,000</u>	50,000			
Created during the year	<u>2,60,000</u>	1,30,000	1,30,000		
Revenue reserve as on 31.3.2004	75,000				

Less: balance as on 1.4.2003	<u>—</u>			
Created during the year	<u>75,000</u>	37,500		37,500
Profit and loss account as on 31.3.2004	2,80,000			
Add: Dividend paid on 1.10.2003 (out of pre-acquisition profits)	<u>2,50,000</u>			
	5,30,000			
Less: balance as on 1.4.2003	<u>2,75,000</u>			
Earned during the year	<u>2,55,000</u>	1,27,500		1,27,500
Profit as on 1.4.2003	2,75,000			
Less: Dividend paid [(Rs.18,10,000 – Rs.16,10,000) × 5/4]	2,50,000			
Balance of pre-acquisition profit as on 31.3.2004	<u>25,000</u>	25,000		
Revaluation reserves as on 1.10.2003:				
Profit on land and buildings (W.N. 2)		4,40,000		
Loss on furniture (W.N. 2)		(30,000)		
Difference in depreciation (for 6 months) due to revaluation:				
Short depreciation on land and building (W.N. 3)				(10,000)
Excess depreciation on furniture (W.N. 3)				<u>5,000</u>
Total		<u>7,80,000</u>	<u>1,30,000</u>	<u>37,500</u> <u>1,22,500</u>
Minority Interest (20%)		1,56,000	26,000	7,500 24,500
Share of PD Co. Ltd. (80%)		<u>6,24,000</u>	<u>1,04,000</u>	<u>30,000</u> <u>98,000</u>

2. Profit or loss on revaluation of assets in the books of SD Ltd. and their book values as on 31.3.2004

Rs.

Land and buildings

Book value as on 1.4.2003	16,00,000
Depreciation at 5% p.a. $[(80,000 \times 100)/16,00,000]$ for 6 months	<u>40,000</u>
	15,60,000

Revalued on 1.10.2003	<u>20,00,000</u>
Profit on revaluation	<u>4,40,000</u>
Value as per balance sheet on 31.3.2004	15,20,000
Add: Profit on revaluation	<u>4,40,000</u>
	19,60,000
Less: Short Depreciation (W.N. 3)	<u>10,000</u>
Value as on 31.3.2004	<u>19,50,000</u>
Furniture:	
Book value as on 1.4.2003	2,00,000
Less: Depreciation @ 20% p.a. $[(40,000 \times 100)/2,00,000]$ for 6 months	<u>20,000</u>
	1,80,000
Revalued on 1.10.2003	<u>1,50,000</u>
Loss on revaluation	<u>30,000</u>
Value as per balance sheet on 31.3.2004	1,60,000
Less: Loss on revaluation	<u>30,000</u>
	1,30,000
Add: Excess depreciation written back (W.N. 3)	<u>5,000</u>
Value as on 31.3.2004	<u>1,35,000</u>

3. Calculation of short/excess depreciation

	<i>Building</i>	<i>Furniture</i>
Revalued figure as on 1.10.2003	20,00,000	1,50,000
Rate of depreciation	5% p.a.	20% p.a.
Depreciation for 6 months on revalued figure (1.10.2003 to 31.3.2004)	50,000	15,000
Depreciation already provided	<u>40,000</u>	<u>20,000</u>
Difference [(short)/excess]	<u>(10,000)</u>	<u>5,000</u>

4. Calculation of cost of control

	Rs.
Share capital in SD Ltd.	16,00,000
Add: Capital profit	<u>6,24,000</u>
	22,24,000
Less: Cost of Investments	<u>16,10,000</u>
Capital Reserve	<u>6,14,000</u>

5. Calculation of minority interest

	<i>Rs.</i>	<i>Rs.</i>
Share capital		4,00,000
Capital (pre-acquisition) profits		1,56,000
Revenue (post-acquisition) profits:		
Capital Reserve	26,000	
Revenue reserve	7,500	
Profit and loss	<u>24,500</u>	<u>58,000</u>
		<u>6,14,000</u>

6. Stock reserve (plant and machinery)

Percentage of profit on hire purchase transaction

$$\frac{1,600 \times 100}{8,000} = 20\%$$

20% on Rs. 20,000 = Rs. 4,000

Total unrealised profit = Rs. 4,000 + Rs. 1,600 = Rs. 5,600

7. Elimination of mutual indebtedness

Elimination of mutual indebtedness in respect of sale of machinery on hire purchase basis will be made as under in the Consolidated Balance Sheet.

	<i>Creditors</i>	<i>Debtors</i>	<i>Stock</i>	<i>Plant and machinery</i>
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
Total (PD Ltd. and SD Ltd.)	4,75,000	5,60,000	4,40,000	28,00,000
Less: Instalment due	20,000	20,000	—	—
Less: Instalment not due	8,000	—	8,000	—
Less: Profit on plant purchased by SD Ltd. from PD Ltd. on hire purchase	—	—	—	5,600
	<u>4, 47,000</u>	<u>5,40,000</u>	<u>4,32,000</u>	<u>27,94,400</u>

For consolidated balance sheet purpose, the unrealised profits will be eliminated by deducting Rs. 5,600 from Plant & Machinery and from profit and loss account.

8. Consolidated capital reserve as on 31.3.2004

	<i>Rs.</i>
Capital reserve of PD Ltd. as on 31.3.2004	5,00,000
Add: Share in post acquisition capital reserve of SD Ltd. (W.N. 1)	1,04,000
Add: Cost of control (W.N. 4)	<u>6,14,000</u>
	<u>12,18,000</u>

9. Consolidated revenue reserve as on 31.3.2004

	<i>Rs.</i>
Revenue reserve of PD Ltd. as on 31.3.2004	8,50,000
Add: Share in post acquisition revenue reserve of SD Ltd. (W.N. 1)	<u>30,000</u>
	<u>8,80,000</u>

10. Consolidated profit and loss account as on 31.3.2004

	<i>Rs.</i>
Profit and loss account balance of PD Ltd. as on 31.3.2004	4,00,000
Add: Share in post acquisition profit and loss account of SD Ltd. (W.N. 1)	98,000
Less: Unrealised profit on hire purchase	<u>(5,600)</u>
	<u>4,92,400</u>

Note: In the question, the balance of capital reserve and profit and loss account of SD Ltd., as on 1.4.2003 only has been given and not of revenue reserve. Hence, it has been assumed in the above solution that the revenue reserve is created during the year from current year's profits.

Question 2

The following is the Profit and Loss Account of Galaxy Ltd. for the year ended 31.03.2004. Prepare a Gross Value Added Statement of Galaxy Ltd. and show also the reconciliation between Gross Value Added and Profit before taxation.

Profit and Loss Account for the year ended 31.03.2004

	<i>Notes</i>	<i>Amount</i>
		<i>(Rs. in lakhs)</i>
<i>Income:</i>		
<i>Sales</i>	—	890
<i>Other Income</i>	—	<u>55</u>
		945
<i>Expenditure:</i>		
<i>Production and operational expenses</i>	(a)	641
		—

Administration expenses (Factory)	(b)	33	—
Interest	(c)	29	—
Depreciation		<u>17</u>	<u>720</u>
Profit before taxes		—	225
Provision for taxes	(d)	—	<u>30</u>
Profit after tax		—	195
Balance as per last Balance Sheet		—	<u>10</u>
			<u>205</u>
Transferred to General Reserve		45	—
Dividend paid		<u>95</u>	—
		140	—
Surplus carried to Balance Sheet		<u>65</u>	—
		<u>205</u>	—

Notes:

- (a) Production and Operational expenses Rs. in lakhs
- | | |
|--|------------|
| Consumption of raw materials | 293 |
| Consumption of stores | 59 |
| Salaries, Wages, Gratuities etc. (Admn.) | 82 |
| Cess and Local taxes | 98 |
| Other manufacturing expenses | <u>109</u> |
| | <u>641</u> |
- (b) Administration expenses include salaries, commission to Directors Rs.9.00 lakhs
Provision for doubtful debts Rs. 6.30 lakhs.
- Rs. in lakhs
- (c) Interest on loan from ICICI Bank for working capital 9
- Interest on loan from ICICI Bank for fixed loan 10
- Interest on loan from IFCI for fixed loan 8
- Interest on Debentures 2
- 29
- (d) The charges for taxation include a transfer of Rs. 3.00 lakhs to the credit of Deferred Tax Account.
- (e) Cess and Local taxes include Excise Duty, which is equal to 10% of cost of bought-in material. (16 marks)

Answer**Galaxy Ltd.****Gross Value Added Statement for the year ended 31st March, 2004**

	<i>Rs. in lakhs</i>	<i>Rs. in lakhs</i>
Sales		890
<i>Less: Cost of bought in materials and services:</i>		
Production and operational expenses (293 + 59 + 109)	461	
Administration expenses (33 – 9)	24	
Interest on working capital loan	9	
Excise duty (Refer working note)	<u>55</u>	<u>549</u>
Value added by manufacturing and trading activities		341
<i>Add: Other income</i>		<u>55</u>
Total value added		<u>396</u>

Application of Value Added

			<i>%</i>
To Employees			
Salaries, wages, gratuities etc.	82		20.71%
To Directors			
Salaries and commission	9		2.27%
To Government			
Cess and local taxes (98 – 55)	43		
Income tax	<u>27</u>	70	17.68%
To Providers of capital			
Interest on debentures	2		
Interest on fixed loan	18		
Dividends	<u>95</u>	115	29.04%
To Provide for maintenance and expansion of the company			
Depreciation	17		
General reserve	45		
Deferred tax	3		
Retained profits (65 – 10)	<u>55</u>	<u>120</u>	<u>30.30%</u>
		<u>396</u>	<u>100%</u>

Statement showing reconciliation of Gross Value Added with Profits before taxation

		<i>Rs. in lakhs</i>
Profits before taxes		225
<i>Add:</i>		
Depreciation	17	
Directors' remuneration	9	
Salaries, wages & gratuities etc.	82	
Cess and local taxes	43	
Interest on debentures	2	
Interest on fixed loan	<u>18</u>	<u>171</u>
Total value added		<u>396</u>

Working Note:**Calculation of Excise Duty**

Say cost of bought in materials and services is 'x'

Excise Duty is 10% of x = x/10

$$x = 461 + 24 + 9 + x/10$$

$$x = 494 + x/10 = 549 \text{ (approx.)}^*$$

$$\text{Excise Duty} = 549 - 494 = \text{Rs. } 55$$

* The above calculated excise duty is not exactly 10% of cost of bought in material amounting Rs. 549. The difference is due to approximation.

Question 3

The Capital Structure of M/s XYZ Ltd., on 31st March, 2003 was as follows:

		<i>Rs.</i>
<i>Equity Capital</i>	<i>18,000 Shares of Rs. 100 each</i>	<i>18,00,000</i>
<i>12% Preference Capital</i>	<i>5,000 Shares of Rs. 100 each</i>	<i>5,00,000</i>
<i>12% Secured Debentures</i>		<i>5,00,000</i>
<i>Reserves</i>		<i>5,00,000</i>
<i>Profit earned before Interest and Taxes during the year</i>		<i>7,20,000</i>
<i>Tax Rate</i>		<i>40%</i>
<i>Generally the return on equity shares of this type of Industry is 15%.</i>		

Subject to:

- (a) *The profit after tax covers Fixed Interest and Fixed Dividends at least 4 times.*

- (b) The Debt Equity ratio is at least 2;
 (c) Yield on shares is calculated at 60% of distributed profits and 10% of undistributed profits;

The Company has been paying regularly an Equity dividend of 15%.

The risk premium for Dividends is generally assumed at 1%.

Find out the value of Equity shares of the Company.

(16 marks)

Answer

Calculation of profit after tax (PAT)		Rs.
Profit before interest & tax (PBIT)		7,20,000
Less: Debenture interest (Rs. 5,00,000 × 12/100)		<u>60,000</u>
Profit before tax (PBT)		6,60,000
Less: Tax @ 40%		<u>2,64,000</u>
Profit after tax (PAT)		3,96,000
Less: Preference dividend $\left(\text{Rs. } 5,00,000 \times \frac{12}{100} \right)$	60,000	
Equity dividend $\left(\text{Rs. } 18,00,000 \times \frac{15}{100} \right)$	<u>2,70,000</u>	<u>3,30,000</u>
Retained earnings (undistributed profit)		<u>66,000</u>

Calculation of Interest and Fixed Dividend Coverage

$$\begin{aligned}
 &= \frac{\text{PAT} + \text{Debenture interest}}{\text{Debenture interest} + \text{Preference dividend}} \\
 &= \frac{\text{Rs. } 3,96,000 + 60,000}{\text{Rs. } 60,000 + 60,000} \\
 &= \frac{\text{Rs. } 4,56,000}{\text{Rs. } 1,20,000} = 3.8 \text{ times}
 \end{aligned}$$

Calculation of Debt Equity Ratio

$$\begin{aligned}
 \text{Debt Equity Ratio} &= \frac{\text{Debt (long term loans)}}{\text{Equity (shareholders' funds)}} \\
 &= \frac{\text{Debentures}}{\text{Preference share capital} + \text{Equity share capital} + \text{Reserves}}
 \end{aligned}$$

$$= \frac{\text{Rs. 5,00,000}}{\text{Rs. 5,00,000} + 18,00,000 + 5,00,000}$$

$$\text{Debt Equity Ratio} = \frac{\text{Rs. 5,00,000}}{\text{Rs. 28,00,000}} = .179$$

The ratio is less than the prescribed ratio.

Calculation of Yield on Equity Shares

Yield on equity shares is calculated at 60% of distributed profits and 10% of undistributed profits:

60% of distributed profits (60% of Rs. 2,70,000)	1,62,000
10% of undistributed profits (10% of Rs. 66,000)	<u>6,600</u>
	<u>1,68,600</u>

$$\begin{aligned} \text{Yields on equity shares} &= \frac{\text{Yield on shares}}{\text{Equity share capital}} \times 100 \\ &= \frac{\text{Rs. 1,68,600}}{\text{Rs. 18,00,000}} \times 100 \\ &= 9.37\% \end{aligned}$$

Calculation of Expected Yield on Equity Shares

Normal return expected	15%
Add: Risk premium for low interest and fixed dividend coverage (3.8 < 4)	1%*
Risk for debt equity ratio not required	<u>Nil**</u>
	<u>16%</u>

Value of an Equity Share

$$\begin{aligned} &= \frac{\text{Actual yield}}{\text{Expected yield}} \times \text{Paid up value of a share} \\ &= \frac{9.37}{16} \times 100 = \text{Rs. 58.56} \end{aligned}$$

* When interest and fixed dividend coverage is lower than the prescribed norm, the riskiness of equity investors is high. They should claim additional risk premium over and above the normal rate of return. Hence, the additional risk premium of 1% has been added.

** The debt equity ratio is lower than the prescribed ratio, that means outside funds (Debts) are lower as compared to shareholders' funds. Therefore, the risk is less for equity shareholders. Therefore, no risk premium is required to be added in this case.

Question 4

- (a) X Co. Ltd. supplied the following information. You are required to compute the basic earning per share:

(Accounting year 1.1.2002 – 31.12.2002)

Net Profit	:	Year 2002 : Rs. 20,00,000
	:	Year 2003 : Rs. 30,00,000
No. of shares outstanding prior to Right Issue	:	10,00,000 shares
Right Issue	:	One new share for each four outstanding i.e., 2,50,000 shares. Right Issue price – Rs. 20 Last date of exercise rights – 31.3.2003.

Fair rate of one Equity share immediately prior to
exercise of rights on 31.3.2003 : Rs. 25

- (b) A Ltd. Leased a machinery to B Ltd. on the following terms:

	(Rs. in Lakhs)
Fair value of the machinery	20.00
Lease term	5 years
Lease Rental per annum	5.00
Guaranteed Residual value	1.00
Expected Residual value	2.00
Internal Rate of Return	15%

Depreciation is provided on straight line method @ 10% per annum. Ascertain unearned financial income and necessary entries may be passed in the books of the Lessee in the First year.

- (c) The following particulars are stated in the Balance Sheet of M/s Exe Ltd. as on 31.03.2003:

	(Rs. in Lakhs)
Deferred Tax Liability (Cr.)	20.00
Deferred Tax Assets (Dr.)	10.00

The following transactions were reported during the year 2003-04:

(i) Tax Rate	50%
(ii) Depreciation – As per Books	50.00

	<i>Depreciation – for Tax purposes</i>	30.00
	<i>There were no addition to Fixed Assets during the year.</i>	
(iii)	<i>Items disallowed in 2002-03 and allowed for Tax purposes in 2003-04</i>	10.00
(iv)	<i>Interest to Financial Institutions accounted in the Books on accrual basis, but actual payment was made on 30.09.2004</i>	20.00
(v)	<i>Donations to Private Trusts made in 2003-04</i>	10.00
(vi)	<i>Share issue expenses allowed under 35(D) of the I.T. Act, 1961 for the year 2003-04 (1/10th of Rs. 50.00 lakhs incurred in 1999-2000)</i>	5.00
(vii)	<i>Repairs to Plant and Machinery Rs. 100.00 lakhs was spread over the period 2003-04 and 2004-05 equally in the books. However, the entire expenditure was allowed for Income-tax purposes.</i>	

*Indicate clearly the impact of above items in terms of Deferred Tax liability/Deferred Tax Assets and the balances of Deferred Tax Liability/Deferred Tax Asset as on 31.03.2004.
(8 + 8 + 4 = 20 marks)*

Answer

(a) Computation of Basic Earnings Per Share
(as per paragraphs 10 and 26 of AS 20 on Earnings Per Share)

	Year 2002 Rs.	Year 2003 Rs.
<i>EPS for the year 2002 as originally reported</i>		
= $\frac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$		
= (Rs. 20,00,000 / 10,00,000 shares)	2.00	
<i>EPS for the year 2002 restated for rights issue</i>		
= [Rs. 20,00,000 / (10,00,000 shares × 1.04*)]	1.92 (approx.)	
<i>EPS for the year 2003 including effects of rights issue</i>		
$\frac{\text{Rs. 30,00,000}}{(10,00,000 \text{ shares} \times 1.04 \times 3/12) + (12,50,000 \text{ shares} \times 9/12)}$		
$\frac{\text{Rs. 30,00,000}}{11,97,500 \text{ shares}}$	2.51 (approx.)	

* Refer working note 2.

Working Notes:

1. Computation of theoretical ex-rights fair value per share

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise} + \text{Number of shares issued in the exercise}}$$

$$= \frac{(\text{Rs. } 25 \times 10,00,000 \text{ shares}) + (\text{Rs. } 20 \times 2,50,000 \text{ shares})}{10,00,000 \text{ shares} + 2,50,000 \text{ shares}}$$

$$= \frac{\text{Rs. } 3,00,00,000}{12,50,000 \text{ shares}} = \text{Rs. } 24$$

2. Computation of adjustment factor

$$= \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex - rights value per share}}$$

$$= \frac{\text{Rs. } 25}{\text{Rs. } 24 \text{ (Refer Working Note 1)}} = 1.04 \text{ (approx.)}$$

(b) Computation of Unearned Finance Income

As per AS 19 on Leases, **unearned finance income** is the difference between (a) the **gross investment** in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

where :

- (a) **Gross investment** in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.

$$\begin{aligned} \text{Gross investment} &= \text{Minimum lease payments} + \text{Unguaranteed residual value} \\ &= (\text{Total lease rent} + \text{Guaranteed residual value}) + \text{Unguaranteed residual value} \\ &= [(\text{Rs. } 5,00,000 \times 5 \text{ years}) + \text{Rs. } 1,00,000] + \text{Rs. } 1,00,000 \\ &= \text{Rs. } 27,00,000 \end{aligned}$$

- (b) Table showing present value of (i) Minimum lease payments (MLP) and (ii) Unguaranteed residual value (URV).

Year	MLP inclusive of URV	Internal rate of return (Discount factor 15%)	Present Value
	Rs.		Rs.
1	5,00,000	.8696	4,34,800
2	5,00,000	.7561	3,78,050

3	5,00,000	.6575	3,28,750	
4	5,00,000	.5718	2,85,900	
5	5,00,000	.4972	2,48,600	
	1,00,000	.4972	49,720	
	(guaranteed residual value)			
			<u>17,25,820</u>	(i)
	1,00,000	.4972	49,720	(ii)
	(unguaranteed residual value)			
		(i) + (ii)	<u>17,75,540</u>	(b)

Unearned Finance Income = (a) – (b)
 = Rs. 27,00,000 – Rs. 17,75,540
 = Rs. 9,24,460

Journal Entries in the books of B Ltd.

		Rs.	Rs.
<i>At the inception of lease</i>			
Machinery account	Dr.	17,25,820*	
To A Ltd.'s account			17,25,820*
(Being lease of machinery recorded at present value of MLP)			
<i>At the end of the first year of lease</i>			
Finance charges account (Refer Working Note)	Dr.	2,58,873	
To A Ltd.'s account			2,58,873
(Being the finance charges for first year due)			

* As per para 11 of AS 19, the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payments from the standpoint of lessee, the amount recorded should be the present value of these minimum lease payments. Therefore, in this case, as the fair value of Rs. 20,00,000 is more than the present value amounting Rs. 17,25,820, the machinery has been recorded at Rs. 17,25,820 in the books of B Ltd. (the lessee) at the inception of the lease. According to para 13 of the standard, at the inception of the lease, the asset and liability for the future lease payments are recognised in the balance sheet at the same amounts.

A Ltd.'s account	Dr.	5,00,000	
To Bank account			5,00,000
(Being the lease rent paid to the lessor which includes outstanding liability of Rs. 2,41,127 and finance charge of Rs. 2,58,873)			
Depreciation account	Dr.	1,72,582	
To Machinery account			1,72,582
(Being the depreciation provided @ 10% p.a. on straight line method)			
Profit and loss account	Dr.	4,31,455	
To Depreciation account			1,72,582
To Finance charges account			2,58,873
(Being the depreciation and finance charges transferred to profit and loss account)			

Working Note:

Table showing apportionment of lease payments by B Ltd. between the finance charges and the reduction of outstanding liability.

Year	Outstanding liability (opening balance)	Lease rent	Finance charge	Reduction in outstanding liability	Outstanding liability (closing balance)
	Rs.	Rs.	Rs.	Rs.	Rs.
1	17,25,820	5,00,000	2,58,873	2,41,127	14,84,693
2	14,84,693	5,00,000	2,22,704	2,77,296	12,07,397
3	12,07,397	5,00,000	1,81,110	3,18,890	8,88,507
4	8,88,507	5,00,000	1,33,276	3,66,724	5,21,783
5	5,21,783	5,00,000	<u>78,267</u>	<u>5,21,783</u>	1,00,050*
			<u>8,74,230</u>	<u>17,25,820</u>	

* The difference between this figure and guaranteed residual value (Rs. 1,00,000) is due to approximation in computing the interest rate implicit in the lease.

(c) Impact of various items in terms of deferred tax liability/deferred tax asset.

Transactions	Analysis	Nature of difference	Effect	Amount
Difference in depreciation	Generally, written down value method of depreciation is adopted under IT Act which leads to higher depreciation in earlier years of useful life of the asset in comparison to later years.	Responding timing difference	Reversal of DTL	Rs. 20 lakhs × 50% = Rs. 10 lakhs
Disallowances, as per IT Act, of earlier years	Tax payable for the earlier year was higher on this account.	Responding timing difference	Reversal of DTA	Rs. 10 lakhs × 50% = Rs. 5 lakhs
Interest to financial institutions	It is allowed as deduction under section 43B of the IT Act, if the payment is made before the due date of filing the return of income (i.e. 31st October, 2004).	No timing difference	Not applicable	Not applicable
Donation to private trusts	Not an allowable expenditure under IT Act.	Permanent difference	Not applicable	Not applicable
Share issue expenses	Due to disallowance of full expenditure under IT Act, tax payable in the earlier years was higher.	Responding timing difference	Reversal of DTA	Rs. 5 lakhs × 50% = Rs. 2.5 lakhs
Repairs to plant and machinery	Due to allowance of full expenditure under IT Act, tax payable of the current year will be less.	Originating timing difference	Increase in DTL	Rs. 50 lakhs × 50% = Rs. 25 lakhs

Deferred Tax Liability Account

Dr.				Cr.			
Rs. in lakhs				Rs. in lakhs			
31.3.2004	To	Profit and Loss account (Depreciation)	10.00	1.4.2003	By	Balance b/d	20.00
					By	Profit and Loss Account	25.00
	To	Balance c/d	<u>35.00</u>			(Repairs to plant)	_____
			<u>45.00</u>				<u>45.00</u>
				1.4.2004	By	Balance b/d	35.00

Deferred Tax Asset Account

Dr.				Cr.			
Rs. in lakhs				Rs. in lakhs			
1.4.2003	To	Balance b/d	10.00	31.3.2004	By	Profit and Loss Account:	
						Items disallowed in 2002-03 and allowed as per I.T. Act in 2003-04	5.00
						Share issue expenses	2.50
			_____		By	Balance c/d	<u>2.50</u>
			<u>10.00</u>				<u>10.00</u>
1.4.2004	To	Balance b/d	2.50				

Question 5

- (a) From the following details of Loan Fund of Kanpur Institute of Technology for the year 2003-2004, you are required to prepare a statement showing changes in the Loan Fund Balance :

	Rs.
Fund balance as on 1.4.2003	25,00,000
Grants from the Government and Society	12,00,000
Grants from Revenue Fund	50,000
Other transfer from Unrestricted Fund	70,000
Investment income	60,000

<i>Interest on Loan</i>	40,000
<i>Refund to Granters</i>	25,000
<i>Bad Debts written off</i>	15,000
<i>Administration and collection costs</i>	25,000

- (b) Mr. Investor buys a stock option of ABC Co. Ltd. in July, 2003 with a strike price on 30.07.2003 of Rs. 250 to be expired on 30.08.2004. The premium is Rs. 20 per unit and the market lot is 100. The margin to be paid is Rs. 120 per unit.

Show the accounting treatment in the books of Buyer when:

- (i) the option is settled by delivery of the asset, and
(ii) the option is settled in cash and the index price is Rs. 260 per unit.

(4 + 12 = 16 marks)

Answer

- (a) **Kanpur Institute of Technology**
Statement of changes – Loan funds

		<i>Rs.</i>
Balance as on 1st April, 2003		25,00,000
<i>Additions during the year 2003-2004:</i>		
Grants from government and society	12,00,000	
Investment income	60,000	
Interest on loan	40,000	
Grants from revenue fund	50,000	
Other transfer from unrestricted funds	<u>70,000</u>	14,20,000
<i>Deductions during the year 2003-04:</i>		
Refund to granters	25,000	
Bad debts written off	15,000	
Administration and collection costs	<u>25,000</u>	<u>(65,000)</u>
Balance as on 31st March, 2004		<u>38,55,000</u>

- (b) Accounting entries in the books of buyer

2003	<i>At the time of inception</i>		<i>Rs.</i>	<i>Rs.</i>
July	Stock option premium account	Dr.	2,000	
	To Bank account			2,000
	<u>(Being premium paid to buy a stock option)</u>			

	Deposit for margin money account	Dr.	12,000	
	To Bank account			12,000
	(Being margin money paid on stock option)			
	<i>At the time of settlement</i>			
	(i) <i>Option is settled by delivery of the asset</i>			
August	Shares of ABC Ltd. account	Dr.	25,000	
	To Deposit for margin money account			12,000
	To Bank account			13,000
	(Being option exercised and shares acquired, Rs. 12,000 margin money adjusted and the balance amount was paid)			
	Profit and loss account	Dr.	2,000	
	To Stock option premium account			2,000
	(Being the premium transferred to profit and loss account on exercise of option)			
	(ii) <i>Option is settled in cash</i>			
	Profit and loss account	Dr.	2,000	
	To Stock option premium account			2,000
	(Being the premium transferred to profit and loss account)			
	Bank account (Rs. 100 × 10)	Dr.	1,000	
	To Profit and loss account			1,000
	(Being profit on exercise of option)			
	Bank account	Dr.	12,000	
	To Deposit for margin money account			12,000
	(Being margin on equity stock option received back on exercise of option)			

Question 6

Write short notes on the following:

- (a) "Non-Performing Assets" as per NBFC Prudential Norms (RBI) directions.
- (b) Some key differences between IAS, US GAAP and Indian AS with respect to
 - (i) Fixed Assets
 - (ii) Changes in Accounting Policy and Prior period items.

- (c) *Environmental Accounting.*
- (d) *Advantages and disadvantages of setting of Accounting Standards. (4 × 4 = 16 marks)*

Answer

(a) “Non–Performing Asset” as per NBFC Prudential Norms (RBI) directions means:

- (i) An asset, in respect of which, interest has remained past due for six months;
- (ii) A term loan inclusive of unpaid interest, when the instalment is overdue for more than six months of which interest amount remained past due for six months;
- (iii) A bill which remained overdue for six months;
- (iv) The interest in respect of a debt or the income on receivables under the head ‘other current assets’ in the nature of short term loans/advances that remained overdue for a period of six months;
- (v) Any dues on account of sales of assets or services rendered or reimbursement expenses made, which remained overdue for a period of six months;
- (vi) The lease rental and hire purchase instalment, which has become overdue for a period of more than twelve months;
- (vii) In respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities made available to borrower /beneficiary when anyone of the credit facilities becomes NPA.

However, an NBFC may classify each such account on the basis of record of recovery as regards hire purchase and lease transactions.

(b)

	IAS	US GAAPs	Indian AS
(i) Fixed Assets	Fixed assets are carried at historical cost. Revaluation of fixed assets is allowed but the capitalisation of exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets is not permitted.	Fixed assets are carried at historical cost. Only downward revaluation is permitted for impairment. Exchange fluctuations on loans taken for purchase of fixed assets are expensed when incurred.	Fixed assets are usually carried at historical cost, revaluations of Fixed Assets are permitted in AS 10. AS 28 permits impairment of assets if specified conditions are satisfied. AS 11 (Revised 2003) requires that exchange differences arising on repayment of liabilities incurred for acquiring fixed assets should be recognized in the statement of profit and loss.

(ii) Changes in Accounting Policy and Prior period items.	Prior period items are accounted by restating to prior years and making adjustments to retained profits. The effect of change in accounting policies is disclosed separately in the profit and loss statement.	Prior period items are accounted by restating to prior years and adjustments to retained profits. Changes in accounting policies are not accounted by restating prior years but the effect of such changes is separately disclosed in the Profit and Loss statement in the same manner as in IAS.	As per AS 5, changes in accounting policies and prior period items are reported on prospective basis, if material, beginning with the year of change. Unlike in US GAAPs and IAS, AS 5 requires the restatement of comparatives to account for accounting errors, the adjustment is required to be made in the current year with disclosures of the prior period amounts.
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- (c) The term 'environment' includes everything in all its manifest forms, on the earth, beneath the earth and above the earth. A business enterprise takes support of social and ecological system in order to maximize wealth. Economic activity, social welfare and a diverse environment, all are linked and ultimately depend on each other. The functioning of an enterprise may have some favourable and some adverse effects on the environment. Hence, it is felt that there is a need for maintaining accounts of the effects of activities of business entity on the environment. Environmental accounting can be defined as a system (methodology) for measuring environmental performance and communicating the results of these measurements to users. It helps in presenting the utilization of natural resources by an enterprise, the costs incurred to use them and the income earned therefrom in a transparent manner. Environmental accounting, entirely a new concept, is a faithful attempt to identify the resources exhausted and the costs rendered reciprocally to the enterprise by a business corporation. Thus environmental accounting stands for recording and documenting environmental performance to facilitate effectiveness of environmental management system with reference to compliance, safety and quality control. It provides a data base for taking corrective steps and future action for developing organisation's environmental strategy and for identifying environmentally based opportunities for gaining an edge over one's competitors. If proper environmental accounting system is established, the enterprise will be able to anticipate environmental damage and therefore can prevent it from happening.

Of course environmental accounting is still in an early stage of evolution and it is being groomed under the voluntary leadership of a variety of enterprises around the world. Recognising the importance of protecting and preserving the environment, a number of laws have been enacted throughout the world.

- (d) The Accounting Standards seek to describe the accounting principles, the valuation

techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in companies' economic performance. The setting of accounting standards has the following advantages:

- (i) Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.
- (ii) There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.
- (iii) The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards practised in different countries.

However, there are some disadvantages of setting of accounting standards:

- (i) Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.
- (ii) There may be a trend towards rigidity and away from flexibility in applying the accounting standards.
- (iii) Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

MAFA-SN-2004.docPAPER – 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 question. Working notes should form part of the answer.*

Question 1

You own an unused Gold mine that will cost Rs. 10,00,000 to reopen. If you open the mine, you expect to be able to extract 1,000 ounces of Gold a year for each of three years. After that the deposit will be exhausted. The Gold price is currently Rs. 5,000 an ounce, and each year the price is equally likely to rise or fall by Rs. 500 from its level at the start of year. The extraction cost is Rs.4,600 an ounce and the discount rate is 10 per cent.

Required:

- (a) *Should you open the mine now or delay one year in the hope of a rise in the Gold price?*
- (b) *What difference would it make to your decision if you could costlessly (but irreversibly) shut down the mine at any stage? Show the value of abandonment option. (20 marks)*

Answer

- (a) (i) Assume we open the mine now at $t = 0$. Taking into account the distribution of possible future price of gold over the next three years, we have

$$\begin{aligned}
 NPV &= - \text{Rs.} 10,00,000 + \frac{1,000 \times [0.5 \times 5,500 + 0.5 \times 4,500] - 4,600}{1.10} \\
 &\quad + \frac{1,000 \times [(0.5)^2 (6,000 + 5,000 + 5,000 + 4,000) - 4,600]}{(1.10)^2} \\
 &\quad + \frac{1,000 \times [(0.5)^3 (6,500 + 5,500 + 5,500 + 4,500 + 4,500 + 5,500 + 4,500 + 3,500) - 4,600]}{(1.10)^3} \\
 &= - \text{Rs.} 5,260
 \end{aligned}$$

Because the NPV is negative, we should not open the mine at $t = 0$. It does not make sense to open the mine at any price less than or equal to Rs. 5,000 per ounce.

- (ii) Assume that we delay one year until $t = 1$, and open the mine if the price is Rs. 5,500.

At that point :

$$NPV = - \text{Rs.} 10,00,000 + \sum_{t=1}^3 \frac{(1,000) \times (5,500 - 4,600)}{(1.10)^t} = \text{Rs.} 12,38,167$$

If the price at t_1 reaches Rs. 5,500, then expected price for all future periods is Rs. 5,500.

NPV at $t_0 = \text{Rs. } 12,38,167/1.10 = \text{Rs. } 11,25,606$

If the price rises to Rs. 5,500 at $t = 1$, we should open the mine at that time.

The expected NPV of this strategy is:

$$(0.50 \times \text{Rs. } 11,25,606) + (0.50 \times 0) = \text{Rs. } 5,62,803$$

As already stated mine should not be opened if the price is less than or equal to Rs. 5,000 per ounce.

If the price at t_1 reaches Rs. 4,500, then expected price for all future periods is Rs. 4,500. In that situation we should not open the mine.

- (b) Suppose we open the mine at $t = 0$, when the price is Rs. 5,000. At $t = 2$, there is a 0.25 probability that the price will be Rs. 4,000. Then since the price at $t = 3$ cannot rise above the extraction cost, the mine should be closed. If we open the mine at $t = 0$, when the price was Rs.5,000 with the closing option the NPV will be:

$$\begin{aligned} \text{NPV} &= - \text{Rs. } 10,00,000 + \sum_{t=1}^2 \frac{(5,000 - 4,600) \times 1,000}{(1.10)^t} \\ &\quad + \frac{.125 \times [1,900 + 900 + 900 + 900 - 100 - 100] \times 1,000}{(1.10)^3} \\ &= \text{Rs. } 1,07,438 \end{aligned}$$

Therefore, the NPV with the abandonment option is Rs. 1,07,438.

The value of the abandonment option is:

$$0.25 \times 1,000 \times (600) / (1.10)^3 = \text{Rs. } 1,12,697$$

The NPV of strategy (2), that to open the mine at $t = 1$, when price rises to Rs. 5,500 per ounce, even without abandonment option, is higher than option 1. Therefore, the strategy (2) is preferable.

Under strategy 2, the mine should be closed if the price reaches Rs. 4,500 at $t = 3$, because the expected profit is $(\text{Rs. } 4,500 - 4,600) \times 1,000 = - \text{Rs. } 1,00,000$.

The value of the abandonment option is:

$$0.125 \times (1,00,000) / (1.10)^4 = \text{Rs. } 8,538$$

Note: Students may also assume that the price of the gold remains at Rs. 5,000 to solve the question.

Question 2

- (a) Calculate economic value added (EVA) with the help of the following information of Hypothetical Limited:

Financial leverage : 1.4 times

Capital structure : *Equity Capital Rs. 170 lakhs*
Reserves and surplus Rs. 130 lakhs
10% Debentures Rs. 400 lakhs
Cost of Equity : *17.5%*
Income Tax Rate : *30%.*

(b) A has invested in three Mutual Fund Schemes as per detailed below:

	MF A	MF B	MF C
<i>Date of investment</i>	01.12.2003	01.01.2004	01.03.2004
<i>Amount of investment</i>	Rs. 50,000	Rs. 1,00,000	Rs. 50,000
<i>Net Asset Value (NAV) at entry date</i>	Rs. 10.50	Rs. 10	Rs. 10
<i>Dividend received upto 31.03.2004</i>	Rs. 950	Rs. 1,500	Nil
<i>NAV as at 31.03.2004</i>	Rs. 10.40	Rs. 10.10	Rs. 9.80

Required:

What is the effective yield on per annum basis in respect of each of the three schemes to Mr. A upto 31.03.2004?

(c) *Explain the term 'Exposure Netting', with an example.*

(d) *Distinguish between Money market and Capital Market.* (6 + 6 + 5 + 3 = 20 marks)

Answer

(a) Financial Leverage = PBIT/PBT

$$1.4 = \text{PBIT} / (\text{PBIT} - \text{Interest})$$

$$1.4 = \text{PBIT} / (\text{PBIT} - 40)$$

$$1.4 (\text{PBIT} - 40) = \text{PBIT}$$

$$1.4 \text{ PBIT} - 56 = \text{PBIT}$$

$$1.4 \text{ PBIT} - \text{PBIT} = 56$$

$$0.4 \text{ PBIT} = 56$$

$$\text{or } \text{PBIT} = \frac{56}{0.4} = \text{Rs. 140 lakhs}$$

$$\text{NOPAT} = \text{PBIT} - \text{Tax} = \text{Rs. 140 lakhs} (1 - 0.30) = \text{Rs. 98 lakhs.}$$

$$\text{Weighted average cost of capital (WACC)} = 17.5\% \times (300 / 700) + (1 - 0.30) \times (10\%) \times (400 / 700)$$

$$= 11.5\%$$

$$\text{EVA} = \text{NOPAT} - (\text{WACC} \times \text{Total Capital})$$

$$= \text{Rs. 98 lakhs} - 0.115 \times \text{Rs. 700 lakhs}$$

$$= \text{Rs. 17.5 lakhs}$$

(b)	Scheme	Investment	Unit Nos.	Unit NAV 31.3.2004	Total NAV 31.3.2004
		Rs.		Rs.	Rs.
	MFA	50,000	4761.905	10.40	49,523.812
	MFB	1,00,000	10,000	10.10	1,01,000
	MFC	50,000	5,000	9.80	49,000

Scheme	NAV (+) / (-)	Dividend Received	Total Yield	Number of days	Effective Yield (% P.A.)
	Rs.	Rs.	Rs.		
MFA	(-)476.188	950	473.812	122	2.835%
MFB	(+)1,000	1,500	2,500	91	10.027%
MFC	(-)1,000	Nil	(-)1,000	31	(-)24%

- (c) Exposure Netting refers to offsetting exposures in one currency with Exposures in the same or another currency, where exchange rates are expected to move in such a way that losses or gains on the first exposed position should be offset by gains or losses on the second currency exposure.

The objective of the exercise is to offset the likely loss in one exposure by likely gain in another. This is a manner of hedging forex exposures though different from forward and option contracts. This method is similar to portfolio approach in handling systematic risk.

For example, let us assume that a company has an export receivables of US\$ 10,000 due 3 months hence, if not covered by forward contract, here is a currency exposure to US\$.

Further, the same company imports US\$ 10,000 worth of goods/commodities and therefore also builds up a reverse exposure. The company may strategically decide to leave both exposures open and not covered by forward, it would be doing an exercise in exposure netting.

Despite the difficulties in managing currency risk, corporates can now take some concrete steps towards implementing risk mitigating measures, which will reduce both actual and future exposures. For years now, banking transactions have been based on the principle of netting. Where only the difference of the summed transactions between the parties is actually transferred. This is called settlement netting. Strictly speaking in banking terms this is known as settlement risk. Exposure netting occurs where

outstanding positions are netted against one another in the event of counter party default.

- (d) The capital market deals in financial assets. Financial assets comprises of shares, debentures, mutual funds etc. The capital market is also known as stock market.

Stock market and money market are two basic components of Indian financial system. Capital market deals with long and medium term instruments of financing while money market deals with short term instruments.

Some of the points of distinction between capital market and money market are as follows:

	Money Market	Capital Market
(i)	There is no classification between primary market and secondary market	There is a classification between primary market and secondary market.
(ii)	It deals for funds of short-term requirement.	It deals with funds of long-term requirement.
(iii)	Money market instruments include interbank call money, notice money upto 14 days, short-term deposits upto three months, commercial paper, 91 days treasury bills.	Capital Market instruments are shares and debt instruments.
(iv)	Money market participants are banks, financial institution, RBI and Government	Capital Market participants include retail investors, institutional investors like Mutual Funds, Financial Institutions, corporate and banks.

Question 3

- (a) ABC Limited's shares are currently selling at Rs. 13 per share. There are 10,00,000 shares outstanding. The firm is planning to raise Rs. 20 lakhs to Finance a new project.

Required:

What is the ex-right price of shares and the value of a right, if

- The firm offers one right share for every two shares held.
 - The firm offers one right share for every four shares held.
 - How does the shareholders' wealth change from (i) to (ii)? How does right issue increases shareholders' wealth?
- (b) Fair finance, a leasing company, has been approached by a prospective customer

intending to acquire a machine whose Cash Down price is Rs. 3 crores. The customer, in order to leverage his tax position, has requested a quote for a three year lease with rentals payable at the end of each year but in a diminishing manner such that they are in the ratio of 3 : 2 : 1.

Depreciation can be assumed to be on straight line basis and Fair Finance's marginal tax rate is 35%. The target rate of return for Fair Finance on the transaction is 10%.

Required:

Calculate the lease rents to be quoted for the lease for three years.

- (c) Explain briefly about net asset value (NAV) of a Mutual Fund Scheme.

(6 + 8 + 6 = 20 marks)

Answer

- (a) (i) Number of shares to be issued : 5,00,000

$$\text{Per - right} = \frac{\text{Rs. } 1,30,00,000 + 20,00,000}{15,00,000} = \text{Rs. } 10$$

Subscription price Rs. 20,00,000 / 5,00,000 = Rs. 4

$$\text{Value of right} = \frac{\text{Rs. } 10 - 4}{2} = 3$$

- (ii) $\text{Per - right} = \frac{\text{Rs. } 1,30,00,000 + 20,00,000}{12,50,000} = \text{Rs. } 12$

Subscription price Rs. 20,00,000 / 2,50,000 = Rs. 8

$$\text{Value of right} = \frac{\text{Rs. } 12 - 8}{4} = \text{Rs. } 1$$

- (iii) Since right issue is constructed in such a way so that shareholders' proportionate share will remain unchanged, shareholders' wealth does not change from (i) to (ii).

Right issue increases shareholders' wealth because the cost of issuing right shares is much lower than the cost of a public issue.

- (b) Capital sum to be placed under Lease

Rs. in lakhs

Cash Down price of machine 300.00

Less: Present value of depreciation

Tax Shield

$$\begin{array}{rcl}
 100 \times .35 \times \frac{1}{(1.10)} & 31.82 & \\
 100 \times .35 \times \frac{1}{(1.10)^2} & 28.93 & \\
 100 \times .35 \times \frac{1}{(1.10)^3} & \underline{26.30} & 87.05 \\
 & & \underline{212.95}
 \end{array}$$

If the normal annual lease rent per annum is x , then cash flow will be:

Year	Post-tax cash flow	P.V. of post-tax cash flow
1	$3x \times (1 - .35) = 1.95x$	$1.95x \times (1/1.10) = 1.7727x$
2	$2x \times (1 - .35) = 1.3x$	$1.30x \times [(1/(1.10)^2)] = 1.0743x$
3	$x \times (1 - .35) = 0.65x$	$0.65x \times [1/(1.10)^3] = \underline{0.4884x}$
		$\underline{= 3.3354x}$

Therefore $3.3354x = 212.95$ OR $x = \text{Rs. } 63.8454 \text{ lakhs}$

Year-wise lease rentals:	Rs. in lakhs
Year 1	$3 \times 63.8454 \text{ lakhs} = 191.54$
2	$2 \times 63.8454 \text{ lakhs} = 127.69$
3	$1 \times 63.8454 \text{ lakhs} = 63.85$

- (c) Net Asset Value (NAV) is the total asset value (net of expenses) per unit of the fund calculated by the Asset Management Company (AMC) at the end of every business day. Net Asset Value on a particular date reflects the realizable value that the investor will get for each unit that he is holding if the scheme is liquidated on that date.

The performance of a particular scheme of a mutual fund is denoted by Net Asset Value (NAV). Net Asset Value may also be defined as the value at which new investors may apply to a mutual fund for joining a particular scheme.

It is the value of net assets of the fund. The investors' subscription is treated as the capital in the balance sheet of the fund, and the investments on their behalf are treated as assets. The NAV is calculated for every scheme of the MF individually.

$$\text{The Net Asset Value (NAV)} = \frac{\text{Net Assets of the scheme}}{\text{Number of units outstanding}}$$

Net Assets of the scheme will normally be:

Market value of investments + Receivables + Accrued Income + Other Assets – Accrued

Expenses – Payables – Other Liabilities

Since investments by a Mutual Fund are marked to market, the value of the investments for computing NAV will be at market value.

NAV of MF schemes are published on a daily basis in Newspapers and play an important part in investors' decisions to enter or to exit. Analyst use the NAV to determine the yield on the schemes.

Question 4

(a) Which position on the index future gives a speculator, a complete hedge against the following transactions:

- (i) The share of Right Limited is going to rise. He has a long position on the cash market of Rs. 50 lakhs on the Right Limited. The beta of the Right Limited is 1.25.
- (ii) The share of Wrong Limited is going to depreciate. He has a short position on the cash market of Rs. 25 lakhs on the Wrong Limited. The beta of the Wrong Limited is 0.90.
- (iii) The share of Fair Limited is going to stagnant. He has a short position on the cash market of Rs. 20 lakhs of the Fair Limited. The beta of the Fair Limited is 0.75.

(b) Mr. A is contemplating purchase of 1,000 equity shares of a Company. His expectation of return is 10% before tax by way of dividend with an annual growth of 5%. The Company's last dividend was Rs. 2 per share. Even as he is contemplating, Mr. A suddenly finds, due to a budget announcement dividends have been exempted from tax in the hands of the recipients. But the imposition of dividend Distribution tax on the Company is likely to lead to a fall in dividend of 20 paise per share. A's marginal tax rate is 30%.

Required:

Calculate what should be Mr. A's estimates of the price per share before and after the Budget announcement?

(c) Excel Exporters are holding an Export bill in United States Dollar (USD) 1,00,000 due 60 days hence. They are worried about the falling USD value which is currently at Rs. 45.60 per USD. The concerned Export Consignment has been priced on an Exchange rate of Rs. 45.50 per USD. The Firm's Bankers have quoted a 60-day forward rate of Rs. 45.20.

Calculate:

- (i) Rate of discount quoted by the Bank
- (ii) The probable loss of operating profit if the forward sale is agreed to.

(d) Distinguish between Forfeiting and Factoring. (6 + 6 + 4 + 4 = 20 marks)

Answer

(a)	Sl. No.	Company Name	Trend	Amount (Rs.)	Beta	Index (Rs.)	Value	Position
	(i)	Right Ltd.	Rise	50 lakh	1.25	62,50,000		Short
	(ii)	Wrong Ltd.	Depreciate	25 lakh	0.90	22,50,000		Long
	(iii)	Fair Ltd.	Stagnant	20 lakh	0.75	<u>15,00,000</u>		Long
						<u>25,00,000</u>		Short

(b) The formula for determining value of a share based on expected dividend is:

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

Where

P_0 = Price (or value) per share

D_0 = Dividend per share

g = Growth rate expected in dividend

k = Expected rate of return

Hence,

Price estimate before budget announcement:

$$P_0 = \frac{2 \times (1 + 0.05)}{(0.10 - 0.05)} = \text{Rs. } 42.00$$

Price estimate after budget announcement:

$$P_0 = \frac{1.80 \times (1.05)}{(.07 - .05)} = \text{Rs. } 94.50$$

(c) (i) Rate of discount quoted by the bank

$$= \frac{(45.20 - 45.60) \times 365 \times 100}{45.20 \times 60} = 5.38\%$$

(ii) Probable loss of operating profit:

$$(45.20 - 45.50) \times 1,00,000 = \text{Rs. } 30,000$$

(d) Forfeiting was developed to finance medium to long term contracts for financing capital goods. It is now being more widely used in the short-term also especially where the contracts involve large values. There are specialized finance houses that deal in this business and many are linked to some of main banks.

This is a form of fixed rate finance which involves the purchase by the forfeiture of trade

receivables normally in the form of trade bills of exchange or promissory notes, accepted by the buyer with the endorsement or guarantee of a bank in the buyer's country.

The benefits are that the exporter can obtain full value of his export contract on or near shipment without recourse. The importer on the other hand has extended payment terms at fixed rate finance.

The forfeiture takes over the buyer and country risks. Forfeiting provides a real alternative to the government backed export finance schemes.

Factoring can however, broadly be defined as an agreement in which receivables arising out of sale of goods/services are sold by a "firm" (client) to the "factor" (a financial intermediary) as a result of which the title to the goods/services represented by the said receivables passes on to the factor. Henceforth, the factor becomes responsible for all credit control, sales accounting and debt collection from the buyer(s). In a full service factoring concept (without recourse facility) if any of the debtors fails to pay the dues as a result of his financial instability/insolvency/bankruptcy, the factor has to absorb the losses.

Some of the points of distinction between forfeiting and factoring have been outlined in the following table.

Factoring	Forfeiting
This may be with recourse or without recourse to the supplier.	This is without recourse to the exporter. The risks are borne by the forfeiter.
It usually involves trade receivables of short maturities.	It usually deals in trade receivables of medium and long term maturities.
It does not involve dealing in negotiable instruments.	It involves dealing in negotiable instrument like bill of exchange and promissory note.
The seller (client) bears the cost of factoring.	The overseas buyer bears the cost of forfeiting.
Usually it involves purchase of all book debts or all classes of book debts.	Forfeiting is generally transaction or project based. Its structuring and costing is case to case basis.
Factoring tends to be a 'case of' sell of debt obligation to the factor, with no secondary market.	There exists a secondary market in forfeiting. This adds depth and liquidity to forfeiting.

Question 5

- (a) Given below is information of market rates of Returns and Data from two Companies A and B:

	Year 2002	Year 2003	Year 2004
Market (%)	12.0	11.0	9.0
Company A (%)	13.0	11.5	9.8
Company B (%)	11.0	10.5	9.5

Required:

- (i) Determine the beta coefficients of the Shares of Company A and Company B.
(ii) Distinguish between 'Systematic risk' and 'Unsystematic risk'.
(b) The following information is provided related to the acquiring Firm Mark Limited and the target Firm Mask Limited:

	Firm Mark Limited	Firm Mask Limited
Earning after tax (Rs.)	2,000 lakhs	400 lakhs
Number of shares outstanding	200 lakhs	100 lakhs
P/E ratio (times)	10	5

Required:

- (i) What is the Swap Ratio based on current market prices?
(ii) What is the EPS of Mark Limited after acquisition?
(iii) What is the expected market price per share of Mark Limited after acquisition, assuming P/E ratio of Mark Limited remains unchanged?
(iv) Determine the market value of the merged firm.
(v) Calculate gain/loss for shareholders of the two independent companies after acquisition.
(c) Explain the terms 'Intrinsic value of an option' and the 'Time value of an option'.

(8 + 8 + 4 = 20 marks)

Answer

- (a) (i) **Company A:**

Year	Return % (Ra)	Market return % (Rm)	Deviation R(a)	Deviation Rm	D Ra × DRm	Rm ²
1	13.0	12.0	1.57	1.33	2.09	1.77
2	11.5	11.0	0.07	0.33	0.02	0.11
3	<u>9.8</u>	<u>9.0</u>	-1.63	-1.67	<u>2.72</u>	<u>2.79</u>
	<u>34.3</u>	<u>32.0</u>			<u>4.83</u>	<u>4.67</u>

$$\text{Average } R_a = 11.43$$

$$\text{Average } R_m = 10.67$$

$$\text{Covariance} = \frac{4.83}{2} = 2.42$$

$$\hat{\alpha} = \frac{2.42}{2.34} = 1.03$$

Company B:

Year	Return % (R_a)	Market return % (R_m)	Deviation $R(a)$	Deviation R_m	$D R_a \times D R_m$	R_m^2
1	11.0	12.0	0.67	1.33	0.89	1.77
2	10.5	11.0	0.17	0.33	0.06	0.11
3	<u>9.5</u>	<u>9.0</u>	-0.83	-1.67	<u>1.39</u>	<u>2.79</u>
	<u>31.0</u>	<u>32.0</u>			<u>2.34</u>	<u>4.67</u>

$$\text{Average } R_a = 10.33$$

$$\text{Average } R_m = 10.67$$

$$\text{Covariance} = \frac{2.34}{2} = 1.17$$

$$\hat{\alpha} = \frac{1.17}{2.34} = 0.50$$

- (ii) Systematic risk refers to the variability of return on stocks or portfolio associated with changes in return on the market as a whole. It arises due to risk factors that affect the overall market such as changes in the nations' economy, tax reform by the Government or a change in the world energy situation. These are risks that affect securities overall and, consequently, cannot be diversified away. This is the risk which is common to an entire class of assets or liabilities. The value of investments may decline over a given time period simply because of economic changes or other events that impact large portions of the market. Asset allocation and diversification can protect against systematic risk because different portions of the market tend to under perform at different times. This is also called market risk.
- Unsystematic risk however, refers to risk unique to a particular company or industry. It is avoidable through diversification. This is the risk of price change due to the unique circumstances of a specific security as opposed to the over all market. This risk can be virtually eliminated from a portfolio through diversification.

(b) Particulars	Mark Ltd.	Mask Ltd.
EPS	Rs. 2,000 Lakhs/ 200 lakhs = Rs. 10	Rs. 400 lakhs / 100 lakhs Rs. 4
Market Price	Rs. 10 × 10 = Rs. 100	Rs. 4 × 5 = Rs. 20

- (i) The Swap ratio based on current market price is
 $\text{Rs. 20} / \text{Rs. 100} = 0.2$ or 1 share of Mark Ltd. for 5 shares of Mask Ltd.
 No. of shares to be issued = $\text{Rs. 100 lakh} \times 0.2 = \text{Rs. 20 lakhs}$.

- (ii) EPS after merger

$$= \frac{\text{Rs. 2,000 lakhs} + \text{Rs. 400 lakhs}}{200 \text{ lakhs} + 20 \text{ lakhs}}$$

$$= \text{Rs. 10.91}$$

- (iii) Expected market price after merger assuming P / E 10 times.

$$= \text{Rs. 10.91} \times 10 = \text{Rs. 109.10}$$

- (iv) Market value of merged firm

$$= \text{Rs. 109.10 market price} \times 220 \text{ lakhs shares} = 240.02 \text{ crores}$$

- (v) Gain from the merger

Post merger market value of the merged firm Rs. 240.02 crores

Less: Pre-merger market value

$$\text{Mark Ltd. } 200 \text{ Lakhs} \times \text{Rs. 100} = 200 \text{ crores}$$

$$\text{Mask Ltd. } 100 \text{ Lakhs} \times \text{Rs. 20} = 20 \text{ crores} \quad \text{Rs. 220.00 crores}$$

Gain from merger Rs. 20.02 crores

Appropriation of gains from the merger among shareholders:

	Mark Ltd.	Mask Ltd.
Post merger value	218.20 crores	21.82 crores
Less: Pre-merger market value	200.00 crores	20.00 crores
Gain to Shareholders	18.20 crores	1.82 crores

(c) Intrinsic value of an Option:

Intrinsic value of an option and the time value of an option are primary determinants of an option's price. By being familiar with these terms and knowing how to use them, any one will find himself in a much better position to choose the option contract that best suits his particular investment requirements.

Intrinsic Value is the value that any given option would have if it were exercised today. It

is defined as the difference between the option's strike price (X) and the stock's actual current price (CP). In the case of a call option, you can calculate this intrinsic value by taking $CP - X$. If the result is greater than zero (in other words, if the stock's current price is greater than the option's strike price), then the amount left over after subtracting $CP - X$ is the option's intrinsic value. If the strike price is greater than the current stock price, then the intrinsic value of the option is zero – it would not be worth anything if it were to be exercised today (please note that an option's intrinsic value can never be below zero. To determine the intrinsic value of a put option, simply reverse the calculation to $X - CP$).

To illustrate, let us assume Wipro stock is priced at Rs. 105. In this case, a Wipro 100 *call* option would have an intrinsic value of (Rs. 105 – Rs. 100 = Rs 5). However, a Wipro 100 *put* option would have an intrinsic value of zero (Rs. 100 – Rs. 105 = Rs. – 5). Since this figure is less than zero, the intrinsic value is zero. Again, intrinsic value can never be negative). On the other hand, if we were to look at a Wipro *put* option with a strike price of 120, then this particular option would have an intrinsic value of Rs. 15 (Rs. 120 – Rs. 105 = Rs. 15).

Time Value: This is the second component of an option's price. It is defined as any value of an option other than its intrinsic value. Looking at the example above, if Wipro is trading at Rs. 105 and the Wipro 100 *call* option is trading at Rs. 7, then we would say that this option has Rs. 2 of time value (Rs. 7 option price – Rs. 5 intrinsic value = Rs. 2 time value). Options that have zero intrinsic value are comprised entirely of time value. Time value is basically the risk premium that the seller requires to provide the option buyer with the right to buy/sell the stock up to the expiration date. This component may be regarded as the “insurance premium” of the option. This is also known as extrinsic value. Time value decays over time. In other words, the time value of an option is directly related to how much time an option has until expiration. The more time an option has until expiration, the greater the chances of option ending up in the money.

Question 6

- (a) Briefly explain 'Buy Back of Securities' and give the management objectives of buying Back Securities.
- (b) Explain the term 'Insider Trading' and why Insider Trading is punishable.
- (c) Write a brief note on the tax issues relating to Foreign Collaboration Agreements.
- (d) A customer with whom the Bank had entered into 3 months forward purchase contract for Swiss Franks 1,00,000 at the rate of Rs. 36.25 comes to the bank after two months and requests cancellation of the contract. On this date, the rates are:

Spot	CHF 1 = Rs. 36.30	36.35
One month forward	36.45	36.52

Determine the amount of Profit or Loss to the customer due to cancellation of the contract.
(5 + 5 + 6 + 4 = 20 marks)

Answer

(a) Buy Back of securities:

Companies are allowed to buy back equity shares or any other security specified by the Union Government. In India Companies are required to extinguish shares bought back within seven days. In USA Companies are allowed to hold bought back shares as treasury stock, which may be reissued. A company buying back shares makes an offer to purchase shares at a specified price. Shareholders accept the offer and surrender their shares.

The following are the management objectives of buying back securities:

- (i) To return excess cash to shareholders, in absence of appropriate investment opportunities.
- (ii) To give a signal to the market that shares are undervalued.
- (iii) To increase promoters holding, as a percentage of total outstanding shares, without additional investment. Thus, buy back is often used as a defence mechanism against potential takeover.
- (iv) To change the capital structure.

(b) Insider Trading:

Insider Trading is a buying or selling or dealing in securities of a listed company, by a director, member of management, an employee or any other person such as internal or statutory auditor, agent, advisor, analyst consultant etc. who have knowledge of material, 'inside' information not available to general public. The dealing in securities by an insider is illegal when it is predicated upon utilization of inside information to profit at the expense of other investors who do not have access to such investment information. The word insider has wide connotation. An outsider may be held to be an insider by virtue of his engaging himself in this practice on the strength of inside information.

Insider trading which is an unethical practice resorted by those in power in corporates has manifested not only in India but elsewhere in the world causing huge losses to common investors thus driving them away from capital market. Therefore, it is punishable.

(c) Tax issues relating to foreign collaborations:

Foreign collaborations can be either technical or financial or sometimes both.

In the case of technical collaborations, the important tax-related considerations that would arise are:

- (i) Treatment of technical fees – when to be capitalized and subjected to depreciation

and when to be charged to Profit and Loss Account.

While the tax treatment has to be determined in every individual case as applicable, generally:

- ◆ Fees relating to advice on procurement of machinery/assets, can be capitalized to the value of such asset
- ◆ Fees relating to process are revenue in nature and are to be amortised over a period.
- ◆ Fees relating to use of brand name are to be treated as revenue expenditure.

The issue of tax deduction at source from such fees as payable is also to be studied carefully and compliance taken care of.

(ii) Treatment of Dividend/distribution of profit

Normally there could be a withholding tax in the case of dividend to non-resident shareholders. As of now, in India in view of corporate dividend tax, there is no tax on dividend in the hands of recipients.

(iii) Since in a foreign collaboration agreement at least two countries are involved, the applicability of respective Double Taxation Relief Agreement is also to be studied and the relevant provisions taken into account.

(d) Original contract for Swiss Francs 1,00,000 @ 36.25 – amount receivable by the customer.

To cancel the purchase contract 1 month before the due date – The contract will be cancelled at 1 month forward sale rate i.e. Swiss Francs 1 = 36.52 payable by the customer.

Hence, Swap profit / loss to the customer:

Rs. 36.52	payable by the customer
Rs. 36.25	receivable by the customer
Rs. 0.27	Net payable by the customer i.e. loss

Therefore, total loss to the customer is

$$\text{Swiss Francs } 1,00,000 \times \text{Rs. } 0.27 = \text{Rs. } 27,000$$

PAPER – 3 : ADVANCED AUDITING

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

Question 1

What are your views on the following?

- (a) A Ltd. was under audit for the year ended 31.03.2004. An appeal filed by A Ltd. against the demand of Excise Duty of Rs. 26 crores was pending before the Supreme Court for which neither provision was made nor was disclosed in the notes to the financial statements. On 12th July, 2004, the auditor came to know through paper reports that the point involved in the appeal of A Ltd. was adjudicated by the Supreme Court in the case of some other assessee, which is in favour of the department of Excise Duty. The auditor insisted that provisions be made of Rs. 26 crores in the financial statements. The Management was of the view that since its own case is still pending, no provision is called for. It was also of the view that the event does not have any effect on the financial position of the company on the date of the Balance Sheet. Is the view of the Management tenable? (5 marks)
- (b) Kevin Industries Ltd. has a paid up capital of Rs. 20 crores divided into equity shares of Rs. 10 each as on 31.03.2003. During the financial year 2003-04 it has issued bonus shares in the ratio 1 : 1. The net profit after tax for the years 31-03.2003 and 31.3.2004 is Rs. 10 crores and Rs. 15 crores respectively. The Earnings Per Share (EPS) disclosed in the financial statements for the above two years is Rs. 5.00 and Rs. 3.75 respectively. Is the disclosure correct? (5 marks)
- (c) An auditor of Sagar Ltd. was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Is he right in his approach? (5 marks)
- (d) A firm of a father and a son is receiving Rs. 2 lakhs towards job work done for XYZ Ltd. during the year ended on 31.03.04. The total job work charges paid by XYZ Ltd. during the are over Rs. 50 lakhs. The father is a Managing Director of XYZ Ltd. having substantial holding. The Managing Director told the auditor that since he is not involved in the activities of the firm and since the amount paid to it is insignificant; there is no need to disclose the transaction. He further contended that such a payment made in the last year was not disclosed. Is Managing Director right in his approach? (5 marks)

Answer

- (a) **Subsequent Events:** Accounting Standard 4 on "Contingencies and Events Occurring After the Balance Sheet Date" deals with all those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors of the company. As per AS 4, those events can be identified as adjustable events which provide further evidence of

conditions that existed at the balance sheet date; and non-adjustable events are those which are indicative of conditions that arise subsequent to the Balance Sheet Date. AAS 19 on "Subsequent Events" lays down that the "auditor should consider the effect of subsequent events on the financial statements and on the auditor's report". In the instant case, A Ltd. had a pending demand of Rs. 26 crores made by the Excise Department for which appeal was made in the Supreme Court. Since the issue involved in the appeal of A Ltd. was similar to the point in case of some other company and since the appeal of that company was decided against that company and in favour of the Excise Department, it is necessary for A Ltd. to make a provision of Rs. 26 crores. The case settled by the Supreme Court on similar point reflects significant developments affecting the assessment about the potential risk faced by the company. The view of the management that its own appeal is undecided or that it has no effect on the financial position as on 31.03.2004 is not at all tenable. Since the financial position is materially affected, the auditor should express a qualified opinion or an adverse opinion as may be appropriate.

- (b) **Disclosure of Earnings Per Share:** AS 20 on Earning Per Share (EPS) prescribes principles for the determination and presentation of EPS. As per AS 20, the earnings per share have to be disclosed as basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. In the instant case, Kevin Industries Ltd., both the basic as well as the diluted earnings per share would be the same since there are no dilutive instruments that have been issued by the company. As per AS 20, in the case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration and thus would lead to increase in number of equity shares without any adjustment to outstanding capital amount. Therefore, the number of equity shares outstanding is increased without an increase in resources. The standard further requires that the number of equity shares outstanding before the event of a bonus issue to be adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. Hence the EPS calculated as on 31-03-2003 would be Adjusted EPS and the same would be disclosed. In view of the above, the EPS will be calculated as under:

As on 31.03.2003	Profits	=	Adjusted EPS
	Adjusted No. of Shares		
	10,00,00,000		
As on 31.03.2004	4,00,00,000	=	Rs. 2.5
	Profits		
	No. of shares		
	15,00,00,000	=	EPS
	4,00,00,000		
			Rs. 3.75

Since the above figures of EPS have not been disclosed, Kevin Industries Ltd. has not complied with the provisions of AS 20. Therefore, the auditor would have to qualify his report in terms of section 227(3)(d) of the Companies Act, 1956.

- (c) **Validity of Management Representation:** The physical verification of fixed assets is the primary responsibility of the management. The auditor, however, is required to examine the verification programme adopted by the management. He must satisfy himself about the existence, ownership and valuation of fixed assets. In the case of Sagar Ltd., the auditor has not been able to verify the existence and value of some machinery despite the verification procedure followed in routine audit. He accepted the certificate given to him by the management without making any further enquiry. As per AAS 11, when representation relate to matters which are material to the financial information, then the auditor should seek corroborative audit evidence for other sources inside or outside the entity. He should evaluate whether such representations are reasonable and consistent with other evidences and should consider whether individuals making such representations can be expected to be well informed on the matter. "Representation by Management" cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter. Therefore, the approach adopted by the auditor is not right.
- (d) **Related Party Transactions:** Accounting Standard 18, "Related Party Disclosures" applies to the facts of the case. AS 18 requires disclosure of party relationship and transactions between a reporting enterprise and its related parties. The parties are considered to be related if at any time during the reporting period, one party has the ability to control the other party or exercise significant influence over the other party in making decisions. As per the explanation given in AS 18, significant influence is said to exist in case the investing party has 20% or more voting power in the enterprise. In the instant case, the managing director of XYZ Ltd. is a partner in the firm with his son which has been paid Rs. 2 lakhs as job work charges. The managing director is having a substantial holding in the firm. The case is squarely covered by AS 18. The approach of the managing director is not tenable under the law and accordingly all disclosure requirements have to be complied. Accordingly, the approach followed by the Managing Director is not right. Under the circumstances, the auditor shall have to modify his report. Also it has to be seen whether section 299 regarding disclosure of interest by interested directors has been complied with. If it is not complied with, the auditor needs to modify the report appropriately.

Question 2

Do you approve of the following? If not, why?

- (a) *A firm of Chartered Accountants was appointed by a company to evaluate the costs of the various products manufactured by it for its information system. One of the partners of the firm was a Non-Executive Director of the company.* (4 marks)

- (b) *Mr. Qureshi, Chartered Accountant, in practice died in a road accident. His widow proposes to sell the practice of her husband to Mr. Pardeshi, Chartered Accountant, for Rs. 5 lakhs. The price also includes right to use the firm name-Qureshi and Associates. Can widow of Qureshi sell the practice and can Mr. Pardeshi continue to practice in that name as a proprietor?* (4 marks)
- (c) *Trimurthy Pan Masala (P) Ltd. was incurring heavy losses in the last several years since it could not withstand the competition in the market. The State in which the company had its registered office and also its major sales had moved a bill in the State Assembly to ban manufacture and sale of all kinds of Pan Masalas in the State. While finalizing the accounts for the year ended 31-03-2004, the CFO of the company created a Deferred Tax Asset for the tax benefits that would arise in future years from the earlier years losses that had remained unabsorbed in Income Tax.* (4 marks)
- (d) *Big Ltd. has borrowed Rs. 30 lakhs from State Bank of India during the financial year 2003-04. The borrowings are used to invest in shares of Small Ltd., a subsidiary company of Big Ltd., which is implementing a new project estimated to cost Rs. 50 lakhs. As on 31st March, 2004, since the said project was not complete, the directors of Big Ltd. resolved to capitalize the interest accruing on borrowings amounting to Rs. 4 lakhs and add it to the cost of investments.* (4 marks)

Answer

- (a) **Evaluation of Cost of Products:** Clause 4 of Part I of the Second Schedule to Chartered Accountants Act, 1949 states that expressing an opinion on financial statements of any business or any enterprise in which the auditor, his firm or a partner in his firm has a substantial interest would constitute misconduct, unless he discloses the interest also in his report. Also, the Council of the Institute of Chartered Accountants of India has stated that in cases where a member of the Institute is a director of a company, or the firm in which the said member is a partner, should not express any opinion on its financial statements. As per facts of the case, the firm has been retained to evaluate the cost of products manufactured by it for its information system. It is a part of management consultancy service of the firm and moreover its partner was on the Board. Hence, the firm can perform this assignment and it will not constitute misconduct. However, the firm while accepting the position as auditor in future would have to consider whether it would be possible to act in independent manner and express opinion on financial statements.
- (b) **Sale of Goodwill:** With reference to Clause (2) of Part I to the First Schedule to Chartered Accountants' Act, 1949 the Council of the Institute of Chartered Accountants of India had an occasion to consider whether the goodwill of a proprietary concern of chartered accountant can be sold to another member who is otherwise eligible, after the death of the proprietor. It laid down that the sale is permitted subject to certain conditions. It further resolved that the legal heir of the deceased member has to obtain the permission of the Council within a year of the death of the proprietor concerned. Thus in a given case and on the facts, the widow of Mr. Qureshi who has sold the

practice for Rs. 5 lakhs is nothing but sale of goodwill. Thus the act of Mrs. Qureshi is permissible.

- (c) **Creation of Deferred Tax Asset:** Accounting Standard 22 on “Accounting for Taxes” requires that Deferred Tax Asset (DTA) should be recognised for all timing differences, subject to the considerations of prudence. The Standard further states that unabsorbed losses of the business can be considered for creation of DTA provided there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such DTA can be realised. In view of this, the DTA created by the CFO of Trimurthy Pan Masala (P) Ltd. is not in order. Since the company which is in the business of manufacturing of *panmasala* has been incurring heavy losses and in addition to this the State in which the company is having its major sales is proposing the ban on sale and manufacture of pan masala, the statutory auditor would, therefore, have to qualify his report and mention the extent of amounts of loss and reserves which are under and overstated respectively.
- (d) **Capitalisation of Interest:** As per AS 13 on “Accounting for Investments”, the cost of investment includes acquisition charges such as brokerage, fees and duties. In the instant case, Big Ltd. has used borrowed funds for purchasing shares of its subsidiary company Small Ltd. Rs. 4 lakhs interest payable by Big Ltd. to State Bank of India can not be called as cost of investment. The Accounting Standard 16 on “Borrowing Costs” also does not consider investment in shares as qualifying asset that can enable a company to add the borrowing costs to investments. In the instant case, the statutory auditor would qualify his report by stating that the borrowing costs have been wrongly added to the cost of investments rather than charging them to profit and loss account. The effect of the same on the profits for the year would also have to be mentioned.

Question 3

- (a) *What are ‘Initial Audit Engagements’?* (2 marks)
- (b) *In an initial audit engagement the auditor will have to satisfy about the sufficiency and appropriateness of ‘Opening Balances’ to ensure that they are free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow in cases (i) when the financial statements are audited for the preceding period by another auditor; and (ii) when financial statements are audited for the first time.* (7 marks)
- (c) *If, after performing the procedure, you are not satisfied about the correctness of ‘Opening Balances’; what approach you will adopt in drafting your audit report in two situations mentioned in (b) above?* (7 marks)

Answer

- (a) **Initial Engagement – Opening Balances:** As per AAS 22 ‘Initial Engagements - Opening Balances’ initial audit engagements mean:
- (i) When the auditor is engaged to carry out the audit of financial statements of an entity for the first time; or.

- (ii) When the financial statements of the entity for the preceding period were audited by another auditor;

The situation mentioned in (ii) above arises whenever there is a change of auditor. The situation mentioned in (i) above is obviously when the auditor is appointed to take up the audit for the first time or no audit was carried out of the financial statements of the entity for the immediately preceding period.

(b) (i) Financial Statements Audited by Another Auditor – Audit Procedure:

- (a) Ordinarily the current auditor can place reliance on the closing balances contained in the audited financial statements of the preceding period. Sufficient audit evidence will be obtained for verifying opening balances, which are closing balances of the earlier period by perusing the copies of the audited financial statements.
- (b) If during the performance of audit for the current period the possibility of misstatements in opening balances is indicated, some indirect audit evidence can be obtained as part of the audit procedures performed during the current period. For example, the collections and payments of opening balances in the accounts of debtors and creditors respectively during the current period will provide evidence as to their existence, correctness and valuation at the beginning of the period.

- (ii) **Audit of Financial Statements for the First Time – Audit Procedure:** When the audit of financial statements is being conducted for the first time, the auditor has to perform auditing procedures to obtain sufficient appropriate audit evidence. Since opening balances represent effect of transaction and events of the preceding period and accounting policies applied in the preceding period, the auditor need to obtain evidence having regard to nature of opening balances, materiality of the opening balances and accounting policies. Since it will not be possible for auditor to perform certain procedures, e.g., observing physical verification of inventories, etc. the auditor may obtain confirmation, etc. and perform suitable procedures in respect of fixed assets, investments, etc. The auditor can also obtain management representation with regards to the opening balances.

- (c) **Drafting Audit Report:** If after performing the laid down procedure in AAS 22, “Initial Engagements - Opening Balances”, the auditor is not satisfied in either of the above situations, he should, as appropriate express a qualified opinion or disclaimer of opinion. At times, it is also likely that the auditor opines that the profit and loss account is qualified but balance sheet is found to be unqualified. If the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

Question 4

- (a) *Enumerate the ‘Basic Elements of Audit Report’ as enshrined in AAS-28. (8 marks)*

(b) Bring out the significance of the following two illustrative paragraphs found in the statutory auditor's report in recent days.

(i) Opening Paragraph:

"We have audited the attached Balance Sheet of as at 31st March, 2xxx and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements". (4 marks)

(ii) Scope Paragraph:

"We conducted our audit in accordance with the auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material statement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial presentation. We believe that our audit provides a reasonable basis for our opinion." (4 marks)

Answer

(a) **Basic Elements of Auditor's Report:** As per AAS 28, "The Auditor's Report on Financial Statements", the auditor's report includes the following basic elements:

1. **Title:** It is appropriate to use the term "Auditor's Report" in the title so as to distinguish the same from other reports, e.g., Board of Directors' Report, etc.
2. **Addressee:** Ordinarily, the auditor's report is addressed to the authority appointing the auditor.
3. **Opening or Introductory Paragraph:** The auditor's report should identify the financial statements of the enterprise that has been audited including the date of and period covered by the financial statements. This introductory paragraph must state that the preparation of financial statements is the responsibility of the management and that the auditor's responsibility is to express an opinion based on audit.
4. **Scope Paragraph:** The auditor's report should describe the scope of the audit stating that the audit was conducted in accordance with auditing standards generally accepted in India. It must also lay down briefly the work performed by the auditor and the constraints involved in discharge of his attest function.
5. **Opinion Paragraph:** This paragraph is mainly devoted for expression of opinion as to whether the financial statements give a true and fair view and whether they comply with the statutory requirements.
6. **Date of Report:** The date of an auditor's report on the financial statements is the date on which the auditor signs the report expressing an opinion on the financial statements. The date of report informs the reader that the auditor has considered the effect on the financial statements and on the report of the events and

transactions of which the auditor became aware and that occurred up to that date. Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.

7. *Place of Signature*: The report should name specific location, which is ordinarily the city where the audit report is signed.
 8. *Auditor's Signature*: The report should be signed by the auditor in his personal name. Where the firm is appointed as the auditor, the firm name should also be mentioned. The proprietor or partner signing the report should also mention his membership number.
- (b) (i) **Opening Paragraph**: The opening or introductory paragraph identifies the financial statements of the entity that have been audited, including the date of and period covered by the financial statements. Further, the significance of 'opening paragraph' is to bring to the notice of the users of financial statements that preparation of the accounts is the responsibility of the management of the enterprise, whereas the responsibility of the auditor is to express an opinion on the said accounts based on audit carried out by him. The preparation of such statements requires management to make significant accounting estimates and judgements, as well as to determine the appropriate accounting principles and methods used in preparation of the said statements.
- (ii) **Scope Paragraph**: The significance of 'scope paragraph' is to inform the users about the practices and procedures followed in conduct of audit by the auditor. The auditor states in this paragraph that the audit was planned and performed in accordance with generally auditing standards generally accepted in India. The auditor also states that the audit provides a reasonable basis for his opinion. The significance of this paragraph lies in the fact that auditor wishes to convey to readers about the scope of audit by highlighting the nature and process of audit. The test check approach of audit adopted by the auditor in performing his work as also the significant aspect of evaluation of accounting principles and accounting estimates is also clarified. The basic objective of auditing that the auditor provides only "reasonable assurance" is emphasised in this paragraph. In a way, such a statement signifies inherent limitations of audit.

Question 5

- (a) *State the specific problems, which may arise in the implementation of internal control in an EDP system.* (8 marks)
- (b) *What are the characteristics of 'On-line Computer System'?* (4 marks)
- (c) *Explain : Tagging and Tracing* (4 marks)

Answer

- (a) **Specific problems of EDP relating to Internal Control:** In an EDP system, the following specific problems arise in the implementation of internal control:
- (i) **Separation of duties:** In a manual system, separate individuals are responsible for initiating transactions, recording transactions, and custody of assets. As a basic control, separation of duties prevents or detects errors and irregularities. In a computer system, however, the traditional notion of separation of duties does not always apply. For example, a program may reconcile a vendor invoice against a receiving document and print a cheque for the amount owed to a creditor. Thus, the program is performing functions that in a manual systems would be considered incompatible. In minicomputer and PC environments, separation of incompatible functions may be even more difficult to achieve. Some minicomputers and PCs allow users to change programs and data easily; furthermore, they provide no record of these changes. If the minicomputer or PC does not have an inbuilt capability to provide a secure record of changes, it may be difficult to determine whether incompatible functions have been performed by systems users.
 - (ii) **Delegation of authority and responsibility:** A clear line of authority and responsibility is an essential control in both manual and computer systems. In a computer system, however, delegating authority and responsibility in an unambiguous way may be difficult because some resources are shared among multiple users. For example, one of the objectives of using a database management system is to provide multiple users with access to the same data, thereby reducing the control problems that arise with maintaining redundant data. When multiple users have access to the same data and integrity of the data is somehow violated, it is not always easy to trace who is responsible for corrupting the data and who is responsible for identifying and correcting the error. Some organizations have attempted to overcome these problems by designating a single user as the owner of data. This user assumes ultimate responsibility for the integrity of the data.
 - (iii) **Competent and trustworthy personnel:** The technology of data processing is now exceedingly complex-much more complex than in the days of manual systems. Highly skilled personnel are needed to develop, modify, maintain, and operate today's computer systems. Thus, the existence of competent and trustworthy personnel becomes even more important when computer systems are used to process an organization's data, since a relatively small number of individuals assume major responsibility for the integrity of the data.
 - (iv) **System of authorizations:** Management issues two types of authorizations to execute transactions. General authorizations establish policies for the organization to follow: for example, a fixed price list is issued for personnel to use when products are sold. Specific authorisations apply to individual transactions: for example, acquisitions of major capital assets may have to be approved by the board of directors. In a manual system, auditors evaluate the adequacy of procedures for

authorisation by examining the work of employees. In a computer system authorisation procedures often are embedded within a computer program. For example, the order entry module in a sales system may determine the price to be charged to a customer. Thus, when evaluating the adequacy of authorisation procedures, auditors have to examine not only the work of employees but also the veracity of program processing.

- (v) **Adequate documents and records:** In a manual system, adequate documents and records are necessary to provide an audit trail of activities within the system. In computer systems, documents may not be used to support the initiation, execution and recording of some transactions. For example, in an on line order entry system customers orders received by telephone may be entered directly into the system. Similarly, some transactions may be activated automatically by a computer system: For example, an inventory replenishment program may initiate purchase orders when stock levels fall below a set amount. Thus, no visible audit or management trail may be available to trace the transaction. The absence of a visible audit trail is not a problem for the auditor provided that systems have been designed to maintain a record of all events and there is a means of accessing these records. In well-designed computer systems, audit trails are often more extensive than those maintained in manual systems.
- (vi) **Physical control over assets and records:** Physical control over access to assets and records is critical in both manual systems and computer systems. Computer systems differ from manual systems, however, in the way they concentrate the data processing assets and records of an organization. For example, in a manual system, a person wishing to perpetrate a fraud may be maintained at a single site-the data processing installation. Thus, the perpetrator does not have to go to physically distance locations to execute the fraud.
- (vii) **Adequate management supervision:** In a manual system management supervision of employee activities is relatively straight forward because managers and employees are often at the same physical location. In computer systems, however, data communications may be used to enable employees to be closer to the customers they service. Thus, supervision of employees may have to be carried out remotely. Supervisory controls must be built into the computer system to compensate for the controls that usually can be exercised through observation and inquiry.
- (viii) **Comparing recorded accountability with assets:** Periodically, data and the assets that the data purports to represent should be compared to determine whether incompleteness or inaccuracies in the data exist or shortages in the assets have occurred. In a manual system, independent staff prepares the basic data used for comparison purposes. In a computer system, however, programs are used to prepare this data. For example, programs may sort an inventory file by warehouse location and prepare counts by inventory item at different warehouses. If

unauthorized modifications occur to the programs or data files that the programs use, an irregularity may not be discovered.

(b) Characteristics of 'On-line Computer System'

- (i). *Validation Checks*: When data are entered on-line, they are usually subject to immediate validation checks. Data failing this validation would not be accepted and a message may be displayed on the terminal screen, providing the user with the ability to correct the data and re-enter the valid data immediately. For example, if the user enters an invalid inventory part number, an error message will be displayed enabling the user to re-enter a valid part number.
 - (ii) *On-Line Access*: Users may have on-line access to the system that enables them to perform various functions, e.g., to enter transactions and to read, change or delete programs and data files through the terminal devices. Unlimited access to all of these functions in a particular application is undesirable because it provides the user with the potential ability to make unauthorised changes to the data and programs. The extent of this access will depend upon such things as the design of the particular application and the implementation of software designed to control access to the system.
 - (iii) *Transaction Trail*: An on-line computer system may be designed in a way that does not provide supporting documents for all transactions entered into the system. However, the system may provide details of the transactions on request or through the use of transaction logs or other means. Illustrations of these types of systems include orders received by a telephone operator who enters them on-line without written purchase orders, and cash withdrawals through the use of automated teller machines.
 - (iv) *Programmer Access*: Programmers may have on-line access to the system that enables them to develop new programs and modify existing programs. Unrestricted access provides the programmer with the potential to make unauthorised changes to programs and obtain unauthorised access to other parts of the system. The extent of this access depends on the requirements of the system. For example, in some systems, programmers may have access only to programs maintained in a separate program development and maintenance library; whereas, in emergency situations which require changes to programs that are maintained on-line, programmers may be authorised to change the operational programs. In such cases, formal control procedures would be followed subsequent to the emergency situation to ensure appropriate authorisation and documentation of the changes.
- (c) Tagging and Tracing**: It is a technique better than Integrated Test Data Facility. It involves tagging the client's input data in such a way that relevant information is displayed at key points. It uses the actual data, and so the question of elimination of 'special entries' test data designed under Integrated Test Data Facility does not arise. The hard copy, so produced is available only to the auditor and may describe such inputs as hours worked in a pay period in excess of 50; or sales orders processed in excess of Rs.1,00,000. This enables the auditor to examine transactions at the intermediate steps

in processing. The advantage of the tagging and tracing approach lies in the use of actual data and elimination of the need for reversing journal entries. The disadvantage is that the erroneous data will not necessarily be tagged. An effective combination approach may be to use the ITF approach (integrated test facility) for a few hypothetical transactions and the tagging and tracing approach to follow line data through a complex system.

Question 6

- (a) *You have been appointed Management Auditor of a large manufacturing company suffering from working capital crunch. Enlist and discuss the related areas which you would probe into to overcome the company's problem. (8 marks)*
- (b) *Miranda Spinning Mills Ltd. is a sick company and has accumulated losses of Rs. 10 crores. The company has Rs. 12 crores in its share Premium Account. The Management desires to adjust the accumulated losses against the share premium balance. Advise the company giving your reasons. (8 marks)*

Answer

- (a) Adequate working capital is required for liquidity and smooth operations of the company. To ensure an adequate flow of working capital to the manufacturing company, the following action plan may be considered.
- (i) *Working Capital Estimation:* The company should start by preparing a statement of the projected working capital requirements. This should be based on the functional budgets in sales, production, expenses, capital expenditure and the Master Budget consisting of projected profit and loss and the Balance Sheet.
 - (ii) *Cash Flow Statement / Cash Budget:* Month-wise cash budgets showing inflows and outflows of cash heading-wise should be prepared to analyse the major inflows and outflows affecting the entity. At this stage any wasteful outflow can be traced and eliminated. Bank reconciliation should be undertaken periodically so that outstandings can be traced and acted upon. This is also necessary to reduce the float time.
 - (iii) *Inventory / Stock Management:* Raw materials and inventories should be classified properly to determine the level of stock of materials. The method of costing also needs to be looked at minutely. There is a need to establish linkage with the production pattern and work backwards accounting for time factor in receipt of material. This needs to be worked out carefully since at no cost, production schedule should be hampered. The caution also need to be exercised that there is not unused/obsolete inventory. The system of inventory management needs to be looked at so as to check the avoidable wastes/scrap generated during storage and handling. Just in time philosophy will enable the company to reduce processing time, stocks and related costs. The adoption of such a mechanism would bring down the cost to a considerable extent.

- (iv) *Credit Management*: The company should lay down a proper policy for evaluating customers, determining the credit period and offering discounts for early payment. An age-wise analysis of debtors should also be prepared so as to avoid credit to defaulters. The sale department need to be geared up so that realisation can be made in time. A careful analysis should be done of various customers according to pattern of sales so as to exercise control on their respective debit balances. The company should through its purchase department endeavour to avail the maximum credit period from its creditors. This would enhance the working capital of the company.
 - (v) *Funds Flow Analysis*: The company should prepare a funds flow analysis, distinguishing between long-term and short-term sources and applications.
 - (vi) *Investment Management*: The idle funds of the company, if any, should be invested in short-term securities to augment the income.
 - (vii) *WIP Analysis*: Minimum WIP should be monitored and for the purpose it is necessary to ensure that no bottlenecks develop at any stage during the production process.
- (b) **Application of Share Premium Account**: Section 78 of the Companies Act, 1956 deals with the application of premium received on issue of shares. Sub-section (1) of the said section provides that where a company issues shares at a premium, whether for cash or otherwise, the amount received as premium on such shares shall be transferred to an account called "Share Premium Account" and the provisions of the Companies Act, 1956 relating to reduction of share capital of a company except as provided in the section shall apply as if the share premium account was paid up share capital of the company. Sub-section (2) of the said section provides that notwithstanding anything contained in sub-section(1), share premium account may be applied by the company for issue of bonus shares, writing off of preliminary expenses of the commission paid or discount allowed on any issue of shares or debentures of the company or for paying the premium on redemption of preference shares or debentures of the company. In view of these provisions of the Companies Act, 1956, it is not permitted to adjust its accumulated losses against the share premium account.

Question 7

- (a) *Section 274 of the Companies Act, 1956 is applicable to appointment of Directors. Briefly explain your duty as a statutory auditor in this connection.* (8 marks)
- (b) *A company has paid interim dividend at 10% based on its half-yearly performance while at the end of the year suffered a net loss. How you will deal with the matter in your audit report as a statutory auditor?* (4 marks)
- (c) *State the procedure for verification of Agents' Balances in the course of audit of a General Insurance Company.* (4 marks)

Answer

- (a) **Appointment of Directors – Auditor's Duty:** As per section 274(1)(g) of the Companies Act, 1956, a person is disqualified to be appointed as a director in case such person is a director of a public company which has not filed the annual accounts for any continuous period of three years; or such company has failed to repay its deposits or interest thereon on due date or pay dividend and such failure continues for one year or more.

Section 227(3)(f) of the Companies Act, 1956 requires the statutory auditor to state whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274. Further, the Department (now Ministry of Company Affairs) has also issued the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003. Rule 4 requires that the statutory auditors of both the appointing as well as the disqualifying company to:

- (i) report under section 227(3)(f) of the Act to the members of the respective companies as to whether any director is disqualified from being appointed as a director under clause (g) of section 274(1) of the Companies Act, 1956; and
- (ii) furnish a certificate every year as to whether on the basis of his examination of the books and records of the company, any director of the company is disqualified as a director or not.

The auditor is required to obtain written representation as to names of directors, particulars of appointment, default by the company, etc. As a part of audit procedures, the auditor is required to obtain the necessary information before giving his report. The auditor is required to obtain evidence in the form of written representation from a director in respect of each such company has not defaulted in terms of the section 274(1)(g). The written representation should also be noted and taken on record by the Board. The auditor should also verify the information provided by the management and direction from the information contained in the register mentioned u/s 303(1) of the Act. Accordingly, the auditor is required to report appropriately.

- (b) **Declaration of Interim Dividend:** Section 205 of the Companies Act, 1956 permits declaration of interim dividend. Ordinarily based on the performance of the company and taking a conservative view, the Board of Directors of the company declare the interim dividends. Quite often the advice of the auditor is sought before declaring an interim dividend. When this is done, he should suggest that an interim accounts should be prepared to ascertain the amount of profits that has been made. Assuming that interim accounts have been prepared and they disclose profits sufficient for the declaration of dividend after making appropriate provisions for depreciation, compulsory transfers to reserves, bad debts and other contingencies, only then the proportion of profits which have to be distributed as interim dividend may be decided.

Since the company has suffered a net loss at the end of the year, obviously the directors have miscalculated the performance of the company about the second half of the year. If the company had a sufficient balance in the profit and loss account as at the beginning of the year, the dividend declared could be paid out of the same. The balance had also to

be sufficient to transfer the relevant amounts to reserves. In such a case the auditor need not report anything. Moreover, if such balance was not available, the dividend could also be paid out of reserves. In the situation of dividends to be declared out of reserves, a maximum of only 10% dividend is allowed. If, however, there is no balance in the profit and loss account nor any reserves were available, the dividend would be clearly paid out of capital. The auditor would have to qualify his report mentioning the fact of the dividend having been paid out of capital.

(c) General Insurance Company – Verification of Agents' Balances: The following are the audit procedures for verification of outstanding agents' balances:

- (i) Scrutiny and review of control accounts debit balances and their nature should be enquired into.
- (ii) Examination of inoperative balances and treatment given for old balances be looked into.
- (iii) Enquiring into the reasons for retaining the old balance.
- (iv) Verification of old debit balances which may require provision or adjustment. Explanation be obtained from the management in this regard.

Question 8

Write short notes on any **four** of the following:

- (a) *Certificate for Special Purpose vs. Audit Report*
- (b) *Audit vs. Investigation*
- (c) *Sauda Book*
- (d) *Other Misconduct*
- (e) *Advantages of Cost Audit to Government*
- (f) *Principal Enactments Governing Bank Audit*
- (g) *Corporate Governance*
- (h) *Responsibility of Joint Auditors*

(4 × 4 = 16 marks)

Answer

- (a) Certificate for Special Purpose vs. Audit Report:** A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. Government authorities may, under various statutes or notifications, require reports or certificates from auditors in support of statements or other information prepared by an enterprise. Reports or certificates on specific matters may also be required from auditors by an enterprise, for its own special purposes. These reports or certificates to specific requirements of the individual users is unlike a 'general purposes report' e.g. an auditor's report on financial statements which is intended for general use. A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of

specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein, e.g., certification of export turnover, etc. On the other hand, when the reporting auditor gives the report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.

- (b) **Audit vs. Investigation:** Etymologically, auditing and investigation are largely overlapping concepts because auditing is nothing but an investigation used in a broad sense. Both auditing and investigation are fact finding techniques but their basic nature and objectives differ as regards scope, frequency, basis, thrust, depth and conclusiveness. Audit and investigation differ in objectives and in their nature. Auditing is general while investigation is specific. The object of auditing is to ensure that the financial statements are free and fair and not misleading or unreliable. The merit of auditing lies in its ability to pronounce in general terms whether the accounts are basically reliable or not and in accordance with the legal requirements and regulations applicable to the particular audit. Audit is not based on suspicion unless circumstances exist to arouse suspicion of the auditor.

Investigation implies systematic, critical and special examination of the records of a business for a specific purpose. The examination conducted under investigation is intensive as well as exhaustive so far as the activities or areas of accounting is concerned. Investigation requires a concentrated focus on the subject matter of inquiry and related matters. Often, investigations may spread over a period longer than one year and its scope may extend to inquiry beyond the books of accounts if the circumstances so require.

- (c) **Sauda Book:** All members of a stock exchange are required to maintain a 'Sauda Book', which contains details of all deals transacted by them on a day to day basis. This is a basic record, which each member is required to maintain regularly on day-to-day basis. It contains the details regarding the name of the code of the client on whose behalf the deals have been done, rate and quantity of bought or sold. These details are maintained datewise. This register contains all the transactions, which may be of any of the kind mentioned below :

- ◆ member's own business on the Exchange,
- ◆ member's business on the Exchange on behalf of clients,
- ◆ member's business with the clients on principal-to-principal basis,
- ◆ member's business with the members of other Stock Exchanges,
- ◆ member's business on behalf of his clients with the members of other Stock Exchanges, and
- ◆ spot transactions, etc.

- (d) **Other Misconduct:** A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, 1949 if he is found guilty of any professional or "Other Misconduct". "Other Misconduct" has not been defined in the Act. This provision empowers

the Council to enquire into any misconduct of a member even if it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work, would expose him to disciplinary action. For example, a member who is found to have forged the will of a relative, would be liable to disciplinary action even though the forgery may not have been done in the course of his professional duty. Other misconduct would also relate to conviction by a competent court for an offence involving moral turpitude punishable with cause transportation or imprisonment to an offence not of a technical nature committed by the member in his professional capacity.

In the absence of a statutory definition of “other misconduct”, the question whether a particular act or omission constitutes “other misconduct” has to be decided on the facts and circumstances of each case. In this context, the judgement of the Supreme Court in “*Council of the Institute of Chartered Accountants of India and another vs B. Mukherjee*” acquires special significance. After examining the nature, scope and extent of the disciplinary jurisdiction, which can be exercised under the provisions of the Act, the Supreme Court observed as under:

“We therefore, take the view that, if a member of the Institute is found, *prima facie*, guilty of conduct, which, in the opinion of the Council renders him unfit to be a member of the Institute, even though such conduct may not attract any of the provision of the Schedules, it would still be open to the Council to hold an inquiry against the member in respect of such conduct and a finding, against him, in such an inquiry, would justify appropriate action being, taken by the High Court”.

Some illustrative examples, where a member may be found guilty of “Other Misconduct”, under the aforesaid provisions rendering, himself unfit to be member are:

- (i) Where a chartered accountant retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.
 - (ii) Where a chartered accountant makes a material misrepresentation.
 - (iii) Where a chartered accountant uses the services of his articled or audit clerk for purposes other than professional practice.
 - (iv) Conviction by a competent court of law for any offence under Section 8 (v) of the Chartered Accountants Act 1949.
 - (v) Misappropriation by office-bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.
 - (vi) Non-replying within a reasonable time and without a good cause to the letter of the public authorities.
- (e) **Advantages of Cost Audit to Government:** Cost auditor's approach is to ensure that the cost accounting plan is in consonance with the objectives set by the organisation and the system of accounting is geared towards the attainment of the objectives. A cost accounting system designed to exercise control over cost may be different from the one if the objective is to fix price. Accordingly, over a period of time particularly in view of administered pricing

system the cost accounting becomes quite important. Some of the specific advantages which can be reaped by the Government are:

- (i) It helps in the fixation of selling prices of essential commodities and thereby avoiding undue profiteering.
- (ii) In the case of cost plus contracts of Government, it helps to fix the price at reasonable level.
- (iii) It enables the Government to focus the attention on inefficient units.
- (iv) It enables the Government to lay down policies in favour of protecting certain industries.
- (v) It facilitates the settlement of disputes brought to the Government.
- (vi) It creates healthy competition in the industry.

(f) Principal Enactments Governing Bank Audit: There is an elaborate framework governing the functioning of banks in India. The whole of banking sector can be categorise into several sectors such as commercial banks, cooperative banks, foreign banks, etc. The principal enactments which govern the functioning of various types of bank are as under:

- (a) Banking Regulation Act, 1949;
- (b) Banking Companies (Acquisition of Transfer of Undertakings) Act, 1970;
- (c) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980;
- (d) State Bank of India Act, 1955;
- (e) State Bank of India (Subsidiary Banks) Act, 1959
- (f) Regional Rural Banks Act, 1976;
- (g) Companies Act, 1956; and
- (h) Cooperative Societies Act, 1912 or the relevant State Cooperative Societies Acts.

Besides, the above enactments, the provisions of Reserve Bank of India Act, 1934, also affect the functioning of banks. The Act gives wide powers to Reserve Bank of India to give directions to Banks; such directions also have considerable effect on the functioning of banks.

(g) Corporate Governance: Corporate governance is the system by which companies are directed and controlled by the management in the best interest of the shareholders and others ensuring greater transparency and better and timely financial reporting. The Board of Directors are responsible for governance of their companies. A number of reports and codes of corporate governance have been published internationally. The Securities and Exchange Board of India (SEBI) had set up a Committee under the Chairmanship of Shri Kumar Manglam Birla to formulate the code of corporate governance. Based on this report, SEBI has by circular in February 2000 directed stock exchanges to amend the Listing Agreement between them and the entities whose

securities are listed on such stock exchanges and include a new Clause 49 in such Listing Agreement. Various clauses deal with composition of board, setting-up of audit committee including scope thereof, remuneration of directors, meetings of Board, contents of management discussions and analysis report, etc. Clause 49 also prescribes that there shall be a separate section on Corporate Governance in the annual reports of company, with a detailed compliance report on Corporate Governance. Non compliance of any mandatory requirement i.e. which is part of the listing agreement with reasons there of and the extent to which the non-mandatory requirements have been adopted, should be specifically highlighted. Further, the entity is required to obtain a certificate from the statutory auditor of the entity as regards compliance of conditions of corporate governance as stipulated in that clause.

Note: SEBI has revised Clause 49 vide its Circular dated October 29, 2004.

- (h) **Responsibility of Joint Auditors:** AAS-12 on, “Responsibility of Joint Auditors” deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act, 1956. Main features of the said AAS are discussed below:

- ◆ *Division of Work:* Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.
- ◆ *Coordination:* Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

- (a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;
- (b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.
- (c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
- (d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and
- (e) for ensuring that the audit report complies with the requirements of the relevant

statute.

- (f) It is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.
- (g) The responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.
- (h) Each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE

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

Question 1

Answer any **two** of the following:

- (a) ABC Ltd. has 12 directors on its board and has the following clause in its Articles of Association:

“The questions arising at any meeting of the Board of Directors or any Committee thereof shall be decided by a majority of votes, except in cases where the Companies Act, 1956 expressly provides otherwise.”

In a meeting of the Board of Directors of ABC Ltd. 8 directors were present. After competition of discussion on a matter voting was done. 3 directors voted in favour of the motion, 2 directors voted against the motion while 3 directors abstained from voting.

You are required to state with reference to the provisions of the Companies Act, 1956 whether the motion was carried or not. (5 marks)

- (b) Mr. Patel has transferred his shares of a listed company registered in his name to Mr. Mehta. Mr. Mehta has failed to get the shares registered in his name before the company declared and paid the dividend on the shares.

Examine with reference to the provisions of Securities Contracts (Regulation) Act, 1956, whether Mr. Patel is entitled to retain the dividend even though he has transferred the shares before declaration of dividend. (5 marks)

- (c) The Rural Electrification Corporation, New Delhi issued 6 years bonds to public directly and not through any Stock Exchange. Whether the Rural Electrification Corporation can do so? Is it not a violation of Securities Contracts (Regulation) Act, 1956? (5 marks)

Answer

- (a) Regulation 74(1) of Table A of Schedule I to the Companies Act, 1956 provides that save as otherwise expressly provided in the Companies Act, 1956, questions arising at any meeting of the Board shall be decided by a majority of votes.

In the problem given in the question, the similar articles exist in the Articles of Association of ABC Ltd. In the given case, only 8 directors out of a total strength of 12 directors are present and out of those 8 directors present only 5 directors have exercised their votes. In such a case, only those directors who are present and vote on a motion are considered for determining whether the motion is carried or not. That means, only 5 directors who voted on the motion are to be considered. Accordingly, since number of directors who voted in favour of the motion being 3 is higher than the number of directors who voted against the motion being 2, the motion is carried or is considered to be passed by majority, unless it is a matter requiring unanimous voting as in the case of a resolution under Section 372A(2).

- (b) Section 27(1) of Securities Contracts (Regulation) Act, 1956 provides that a holder of security whose name appears on the books of the company, can legally receive and retain any dividend declared by the company even if he has transferred the security for a valuable consideration. However, he (holder) cannot receive or retain the dividend if the transfer deed with all other documents required for transfer is lodged with the company within 15 days of the date on which the dividend became due.

The period of 15 days shall be extended as follows:-

- (1) In case of death of the transferee, by the actual period taken by his legal representative to establish his claim to the dividend.
- (2) In case of loss of the transfer deed by theft or any other cause beyond the control of the transferee, by the actual period taken for the replacement thereof and
- (3) In case of delay in the lodging of any security and other documents relating to the transfer due to causes connected with the post, by the actual period of delay. [Explanation to Section 27(1)].

Further according to Section 27(2)(a), a company can pay any dividend, which has become due to any person whose name is for the time being registered in the books of the company as the holder of the security.

In view of the above Mr. Patel is entitled to retain the dividend received by him if the transferee Mr. Mehta has not lodged the transfer deed with the company within 15 days of the date on which the dividend became due or the extended period as per Explanation of Section 27(1).

However, Section 27(1) will not affect the right of the transferee to enforce his rights if any against the transferor or any other person if the company refuses to register, the transfer of security in the name of transferee. [Section 27(2)(b)].

- (c) In order to prevent undesirable transactions in securities and to promote healthy stock market, the Securities Contract (Regulation) Act, 1956 was enacted. Stock Exchanges are recognized under the Act. Section 73 of the Companies Act, 1956 lays down that offer of shares or debentures to public for subscription shall be only after the permission of the Stock Exchange. Section 28 of the Securities Contract (Regulation) Act, 1956 says that the provisions of the Act shall not apply to the Government, the Reserve Bank of India, any local authority or any corporation set-up by a special law or any person who has effected any transaction with or through the agency of any such authority as stated above. The Rural Electrification Corporation is a corporation established under a special statute enacted by the Parliament. Therefore, the Corporation need not require permission of any Stock Exchange. It is exempted. There is no violation of the provisions of the Securities Contract (Regulation) Act of 1956 because according to section 28 provisions are not applicable to this corporation.

Question 2

Answer any two of the following:

- (a) (i) *Tomco Ltd., a vehicles manufacturing company in India has received an order from a transport company in Italy for supply of 100 Trucks on lease. You are required to state, how the said Tomco Ltd. can accept such an order.* (3 marks)
- (ii) *Forex Dealers Ltd. is an Authorised Person within the meaning of Foreign Exchange Management Act, 1999. Reserve Bank of India issued certain directions to the said Authorised Person to file certain returns, which it failed to file. You are required to state the penal provisions to which the said Authorised Person has exposed itself.* (4 marks)
- (b) (i) *Mr. Sekhar resided for a period of 150 days in India during the Financial year 2003-2004 and thereafter went abroad. He came back to India on 1st April, 2004 as an employee of a business organization. What would be his residential status during the financial year 2004-2005?* (3 marks)
- (ii) *Mr. Atul, an Indian National desires to obtain Foreign Exchange for the following purposes:*
- (a) *Remittance of US Dollar 10,000 for payment for goods purchased from a party situated in Nepal.*
- (b) *US Dollar 10,000 for remitting as commission to his agent in U.S.A. for sale of commercial plot situated near Bangalore, consideration in respect of which was received by Mr. Atul by way of foreign currency inward remittance amounting to US Dollar 1,00,000.*

Advise him, if he can get the Foreign Exchange and under what conditions. (4 marks)

- (c) *Poly Ltd., (hereinafter referred to as "Seller"), manufacturer of footwears entered into an agreement with City Traders (hereinafter referred to as "purchaser"), for sale of its products. The agreement includes, among others, the following clauses:*
- (i) *That the Purchaser shall not deal with goods, products, articles, by whatever name called, manufactured by any person other than the Seller.*
- (ii) *That the Purchaser shall not sale the goods manufactured by the Seller outside the municipal limits of the city of Secunderabad.*
- (iii) *That the Purchaser shall sale the goods manufactured by the Seller at the price as embossed on the price label of the footwear. However, the purchaser is allowed to sale the footwear at prices lower than those embossed on the price label.*

You are required to examine with relevant provisions of the Competition Act 2002, the validity of the above clauses. (7 marks)

Answer

- (a) (i) "Export," means the taking out of India to a place outside India any goods (Section

2(1) of Foreign Exchange Management Act, 1999). Hence sending 100 trucks on lease to Italy is an 'export' within the meaning of Section 2(1).

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

Based on the above provisions, it can be concluded that if the company, namely, Tomco Ltd. wants to accept the order for despatching 100 trucks to Italy on lease, it has to take prior permission of the Reserve Bank of India.

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

Since as per the facts given in the question, the Authorised person, namely, Forex Dealers Ltd., has failed to file the returns as directed by the Reserve Bank of India. According to the above provisions, it has exposed itself to a penalty which may extend to ten thousand rupees and in the case of continuing contraventions in the nature of failure to file the returns, with an additional penalty which may extend to two thousand rupees for every day during which such contravention continues.

- (b) (i) According to the provisions of section 2(v) of the Foreign Exchange Management Act, 1999, a person in order to qualify for the purpose of being treated as a "Person Resident in India" in any financial year, must reside in India for a period of more than 182 days during the preceding financial year. In the given case, Mr. Sekhar has resided in India for a period of only 150 days, i.e., less than 182 days, during the financial year 2003-2004. Hence he cannot be considered as a "Person Resident in India" during the financial year 2004-2005 irrespective of the purpose or duration of his stay.
- (ii) 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, drawal of Foreign Exchange for some of the Current Account transactions is prohibited. As regards some other Current Account transactions, Foreign Exchange can be drawn with prior permission of the Central Government while in case of some Current Account transactions prior permission of Reserve Bank of India is required.

- (a) In respect of item (a), i.e. remittance to Nepal, such remittance is prohibited and the same is included in First Schedule to the Foreign Exchange Management (Current Account Transactions) Rules, 2000. Hence Mr. Atul cannot withdraw Foreign Exchange for this purpose unless specifically exempted by RBI by general or special order.
- (b) The type of payment as envisaged in item (b) is covered under Third Schedule to the Foreign Exchange Management (Current Account Transactions) Rules, 2000 and for withdrawing foreign Exchange exceeding 5% (five percent) of the inward remittance as commission to agent abroad for sale of commercial plot in India, Mr. Atul will require the prior permission of the Reserve Bank of India.

Current Account Transactions have been liberalized by RBI, Foreign Exchange Department with effect from 24.02.2004 vide A.P. (DIR Series) Circular No.76 dated 24.02.2004. Now authorized persons (authorized dealers) are authorized to allow freely such remittances ((i.e.) commission to agents abroad for sale of commercial plots) up to USD 25000 or 5 per cent of inward remittance per transaction, whichever is higher. As the amount to be remitted is only USD 10,000, authorized person (authorized dealer) may be approached for permission.

- (c) Provisions of section 3(1) of the Competition Act, 2002 prohibits any agreement for goods and/or services that may have an appreciable adverse effect on competition in India.

Provisions of section 3(2) of the said Act states that any agreement entered into in contravention of provision of section 3(1) of the said Act shall be void.

Sections 3(3) and 3(4) of the said Act enumerates the types of the agreements which are to be treated as contravening the provisions of the said section 3(1). According to section 3(4) of the said Act, any agreement among enterprises or persons at different stages of the production chain in different markets, in respect of production, supply, distribution, storage, sale or price of, or trade in goods or provision of services including the following shall be treated as agreements in contravention of the said section 3(1):

- (a) tie-in-arrangement ;
- (b) exclusive supply agreement ;
- (c) exclusive distribution agreement ;
- (d) refusal to deal
- (e) re-sale price maintenance

The clauses of the agreement given in the question are covered by above mentioned provisions Clause at Sr. No.(i) comes under exclusive supply agreement; Clause at Sr. No.(ii) comes under exclusive distribution agreement and Clause at Sr. No.(iii) is covered by re-sale price maintenance.

Explanations to said section 3(4) explains the above terms.

According to Explanation (b), exclusive supply agreement includes any agreement restricting in any manner, the purchaser in the course of his trade from acquiring or otherwise dealing in any goods other than those of the seller or any other person.

According to Explanation (c), exclusive distribution agreement includes any agreement to limit, restrict or withhold the output or supply of any goods or allocate any area or market for the disposal or sale of the goods.

According to Explanation (e), "resale price maintenance" includes any agreement to sell goods on condition that the prices to be charged on the resale by the purchaser shall be the price stipulated by the seller unless it is clearly stated that prices lower than those prices may be charged.

In view of the above provisions of the Competition Act, 2002, validity of the clauses of the agreement as given in the question can be determined as follows:

- (i) Clause (i) restricts the purchaser to deal in the goods of manufacturers other than the seller. Hence this is in contravention of the provisions of section 3(1) of the said Act.
- (ii) Clause (ii) restricts the purchaser to sell the goods within a specified area. Hence this is in contravention of the provisions of section 3(1) of the said Act
- (iii) Clause (iii) stipulates the resale price, but it allows the purchaser to sell the goods at lower prices than the stipulated prices. Hence this is a valid clause.

But, the law states that any such agreement containing any of the prohibited clause shall be void. Therefore, even if the agreement contains some valid clauses, it shall still be termed as void if it contains even one prohibited clause.

Question 3.

Answer any **two** of the following:

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

	As at 31.03.2002 Rs.	As at 31.03.2003 Rs.	As at 31.03.2004 Rs.
<i>Paid up Capital</i>	50,00,000	50,00,000	75,00,000
<i>General Reserve</i>	45,00,000	50,00,000	60,00,000
<i>Debenture Redemption Reserve</i>			
<i>Reserve</i>	15,00,000	20,00,000	25,00,000
<i>Reserve Secured Loans</i>	10,00,000	15,00,000	30,00,000
<i>Net Profit for the year</i> (as calculated in accordance with the provisions of Section 349 and 350 of the Companies Act, 1956)	12,50,000	19,00,000	34,50,000

In the ensuing Board Meeting scheduled to be held on 5th November 2004, among other items of agenda, following item is also appearing:

“To decide about borrowing from financial institutions on long-term basis.”

Based on above information, you are required to find out as per the provisions of the Companies Act, 1956, the amount upto which the Board can borrow from financial institutions without seeking the approval in general meeting. (8 marks)

- (b) *The Annual Accounts of CALM Ltd., a listed company from for the year ended 31st March, 2003 were finalized on 31st May, 2004. The Company had a paid up capital of Rs.50.00 Lacs and free reserves of Rs.100.00 Lacs. The Company did not have any accumulated losses. The Board of Directors of the Company wishes to make a public issue of Equity Shares amounting to Rs. 10.00 Crores comprising of offer to public through offer document, firm allotment and promoters contribution. State, how this can be done under SEBI Guidelines.*

What would be your answer in the following cases:

- (a) *If CALM Ltd. was a Private Sector Bank known as CALM Bank Ltd.*
- (b) *If the issue of above mentioned Rs.10.00 Crores was a right issue. (8 marks)*
- (c) *Explain briefly the distinction between “Mandatory” and “Directory” provisions in a statute. How the Court deals with them differently? (8 marks)*

Answer

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

Since the decision to borrow is to be taken in a meeting to be held on 5th November, 2004, the figures relevant for this purpose are the figures as per the Balance Sheet as at 31.03.2004. According to the above provisions, the Board of Directors of RBS Ltd. can borrow, without obtaining approval of the shareholders in a general meeting, upto an amount calculated as follows:

Paid up capital	Rs. 75,00,000/-
General Reserve (being free reserve)	Rs. 60,00,000/-
Debenture Redemption Reserve (This reserve is not to be considered since it is kept apart for specific purpose of debenture redemption)	_____
Aggregate of paid up capital and free reserve	<u>Rs. 1,35,00,000/-</u>

Total borrowing power of the Board of Directors of the company. i.e., 100% of the aggregate of paid up capital and free reserves	Rs. 1,35,00,000/-
Less amount already borrowed as secured loans	<u>Rs. 30,00,000/-</u>
Amount upto which the Board of Directors can further borrow without the approval of shareholders in a general meeting.	<u>Rs 1,05,00, 000/-</u>

It is presumed that the amount already borrowed as secured loans are not "temporary loans" obtained from the company's bankers in the ordinary course of business within the meaning of Explanation II to Section 293.

- (b) As per DIP Guidelines issued by SEBI (Para 2.3.1) a listed company shall be eligible to make a public issue of equity shares or any security convertible at later date into equity share provided that the aggregate of proposed issues and all previous issues made in the same financial year in terms of size (i.e) offer through offer document + firm allotment + promoters' contribution through the offer documents), issue size does not exceed five (5) times its pre-issue net worth as per audited balance sheet of the last financial year (Clause 2.3.1.)

The said Guidelines further provide that a listed company which does not fulfil the condition given above, shall be eligible to make a public issue subject to complying with the conditions specified in clause 2.2.2 (Clause 2.3.2)

The Board of Directors of CALM Ltd. proposed to make a public issue during the financial year 2004 – 2005. The eligibility is to be determined with reference to the balance sheet of the last financial year (i.e) balance sheet as at 31st March 2004. But the latest available audited balance sheet is balance sheet as at 31st March 2003. The proposed issue (Rs. 10 crores) exceeds 5 times the net worth on 31st March 2003 (net worth Rs.1.5 crores). The company must take efforts to get accounts for the financial year 2003 – 2004 audited. If the proposed issue exceeds 5 times the net worth on 31st March 2004 also, the company has to comply with the conditions specified in Clause 2.2.2. The company can choose any one of the 2 alternative methods specified in Clause 2.2.2. They are

- (i) The issue is made through book building process with at least 50% of the issue being allotted to the qualified institutional buyers.
- (ii) Get the 'project' appraised and see that there is at least 15% participation by financial institutions/scheduled commercial banks, of which at least 10% comes from the appraisers. In addition to this, at least 10% of the issue size shall be allotted to qualified institutional buyers. (Clause 2.2.2)

As the proposed public issue is equity shares amounting to Rs.10 crores, the post-issue face value of capital of the company is more than Rs.10 crores. If it is less than Rs.10

crores, the company must make arrangement for compulsory market making for at least 2 years from the date of listing of shares in the manner specified in Clause 2.2.2 (b)(ii).

The restriction imposed under SEBI Guidelines on public issue by a listed company is not applicable to a private sector bank set up under sub-section (c) of section 5 of the Banking Regulation Act, 1949 and which has received licence from the Reserve Bank of India. Similarly the restriction is not applicable to a right issue by a listed company. Hence in both cases Calm Ltd., would have been free to make issue of Rs.10.00 crores (Para 2.4.1)

- (c) The distinction between a provision which is mandatory and one which is ' directory' is that when it ' mandatory' , it must be strictly complied with, when it is ' directory' , it would be sufficient that it substantially complied with. Non-observance of mandatory provisions involves the consequences invalidating. But non-observance of directory provision does not entail the consequence of invalidating, whatever other consequences may occur.

No general rule can be laid down for deciding whether any particular provision on a statute is mandatory or directory. In each case the court has to consider not only the actual word used, but has to decide the legislatures intent. For ascertaining the real intention of the legislature, the court may consider, amongst other things, the following

1. The nature and design of the statute.
2. The consequence, which would flow from construing one-way or the other.
3. The impact of other provisions by resorting to which the necessity of complying with the provision in question can be avoided.
4. Whether or not the statute provides any penalty if the provision in question is not complied with
5. If the provision in question is not complied with, whether the consequences would be trivial or serious.
6. Most important of all, whether the object of the legislation will be defeated or furthered.

Where a specific penalty is provided in a statute itself for non-compliance with the particular provision of the Act no discretion is left to the court to determine whether such provision is directory or mandatory - it has to be taken as mandatory.

Question 4

- (a) *Mr. Doubtful was appointed as Managing Director of Carefree Industries Ltd. for a period of five years with effect from 1.4.2000 on a salary of Rs.12 lakhs per annum with other perquisites. The Board of Directors of the company on coming to know of certain questionable transactions, terminated the services of the Managing Director from 1.3.2003. Mr. Doubtful termed his removal as illegal and claimed compensation from the company. Meanwhile the company paid a sum of Rs.5 lakhs on ad hoc basis to Mr. Doubtful pending settlement of his dues. Discuss whether:*
- (i) *The company is bound to pay compensation to Mr. Doubtful and, if so, how much.*

- (ii) *The company can recover the amount of Rs. 5 lakhs paid on the ground that Mr. Doubtful is not entitled to any compensation, because he is guiding of corrupt practices.* (8 marks)
- (b) *Excellent Technical Consultants Ltd. has approached you seeking your opinion on the following appointments relating to directors and their relatives*
- (i) *Appointment of Mr. Sonata (relative of one of the directors) as the Managing Director of the Company on a monthly remuneration of Rs.40,000 and other perquisites as are currently being allowed to other executives of the Company.*
- (ii) *Appointment of Mr. Romesh (relative of one of the directors) as the General Manager – Marketing of the Company on a consolidated monthly remuneration of Rs.30,000.*
- (iii) *Appointment of Mr. Kamal (relative of one of the directors) as an Accounts Manager of the Company on a consolidated monthly remuneration of Rs.18,000.*
- Express your opinion explaining the relevant provisions of the Companies Act, 1956.* (7 marks)

Answer

- (a) According to Section 318 of the Companies Act, 1956, compensation can be paid only to a Managing or Whole-time Director. Amount of compensation cannot exceed the remuneration which he would have earned if he would have been in the office for the unexpired term of his office or for 3 years whichever is shorter. No compensation shall be paid, if the director has been found guilty of fraud or breach of trust or gross negligence in the conduct of the affairs of the company.

In light of the above provisions of law, the company is not liable to pay any compensation to Mr. Doubtful, if he has been found guilty of fraud or breach of trust or gross negligence in the conduct of affairs of the company. But, it is not proper on the part of the company to withhold the payment of compensation on the basis of mere allegations. The compensation payable by the company to Mr. Doubtful would be Rs.25 Lacs calculated at the rate of Rs.12 Lacs per annum for unexpired term of 25 months.

Regarding adhoc payment of Rs.5 Lacs, it will not be possible for the company to recover the amount from Mr. Doubtful in view of the decision in case of *Bell vs. Lever Bros. (1932) AC 161* where it was observed that a director was not legally bound to disclose any breach of his fiduciary obligations so as to give the company an opportunity to dismiss him. In that case the Managing Director was initially removed by paying him compensation and later on it was discovered that he had been guilty of breaches of duty and corrupt practices and that he could have been removed without compensation.

- (b) As per provisions of section 314(1) of the Companies Act, 1956, except with the consent of the company accorded by way of a special resolution, no director or relative of a director shall hold any office or place of profit, which carried a monthly remuneration of Rs.10000/- or more, except that of Managing Director or Manager of the Company.

Further, as per the provisions of Section 314(1B) of the Companies Act, 1956, no relative of a director can be appointed to any office or place of profit under the company which carries a monthly remuneration of not less than Rs.50,000/- (as per Notification vide 5th February, 2003) except with the prior consent of the company by way of a special resolution and the approval of the Central Government.

In the light of above legal provisions the opinion on the appointments of various persons as stated in the question can be expressed as follows:

- (i) Mr. Sonata is being appointed as the Managing Director of the Company, the provisions of section 314(1) are not attracted even though he is a relative of a director. This is because the appointment of Managing Director or Manager is outside the provisions of section 314 of the Companies Act, 1956. If Mr. Sonata is not already a director of the company, steps must be taken to appoint him first as an additional director/director. Thereafter he may be appointed as Managing Director by complying with the requirements under section 269 read with Schedule XIII to the Companies Act. The appointment can be made by the Board subject to the approval of the company in general meeting as the proposed remuneration is within the limits laid down in Schedule XIII.
- (ii) Since the remuneration proposed to be paid to Mr. Romesh does exceed Rs.50,000/- per month, provisions of section 314(1B) are not attracted and approval of the Central Government is not required. However, as the proposed remuneration exceeds Rs.10,000/- his appointment shall require the passing of special resolution by the company. The special resolution is required to be passed at a general meeting of the company held for the first time after such appointment.
- (iii) In case of Mr. Kamal, since the remuneration proposed to be paid to him exceeds Rs.10,000/- but does not exceed Rs.50,000/- per month, his appointment shall require the passing of special resolution by the company only and the no approval of the Central Government is required. The special resolution according to the consent may be passed at a general meeting of the members of the company held for the first time after such appointment.

Question 5

- (a) *Mr. Weldon was appointed as a Director of Esquire Engineering Ltd., with effect from 1st October, 2002. Since the Company, namely, Esquire Engineering Ltd. wanted to take full advantage of the wisdom and expertise of Mr. Weldon, it offered him remuneration payable on monthly basis and made an application to the Central Government for approval for payment of such remuneration. Anticipating the approval of the Central Government, Esquire Engineering Ltd. started paying such remuneration from the date of appointment and continued to do so till 31st March, 2003. The Central Government did not fully approve the remuneration proposed by the company and restricted the same to a lower amount. On scrutiny of the accounts, it was established that the company, till 31st March, 2003, has paid to Mr. Weldon a total sum of Rs.1.20 Lacs in excess of the remuneration sanctioned by the Central Government.*

You are required to:

- (i) State with reference to the provisions of the Companies Act, 1956 in respect of recovery and waiver of recovery of the excess remuneration so paid, whether Mr. Weldon can keep the excess remuneration so received and under what conditions.
 - (ii) Draft a resolution for waiver of recovery of the excess remuneration so paid by the Company. (8 marks)
- (b) (i) The Articles of Association of MKP Limited incorporated with an Authorised Share Capital of Rs.50 crores divided into 5 crore Equity Share of Rs.10 each contained the following clause:
- "The qualification of a director shall be the holding of at least 1,000 Equity Shares in the Company and such a director, if not already so qualified shall have to obtain his qualification within a period of 30 days from the date of his appointment as a director."*
- Examine the validity of the above clause in the light of the provisions of the Companies Act, 1956.*
- (ii) Redraft the above clause which would conform to the provisions of the Companies Act, 1956. (7 marks)

Answer

- (a) (i) Mr. Weldon was appointed as a non-executive director. The services to be rendered by him are not stated to be of a professional nature. Hence, the provisions of Section 309 (4) are attracted in this case. According to Section 309(4) of the Companies Act, 1956 a non-executive director may be paid remuneration by way of monthly, quarterly or annual payment basis with the approval of the Central Government.

Section 309(5A) of the Companies Act, 1956 states that if any director draws or receives, directly or indirectly, by way of remuneration any sum in excess of the limits prescribed by section 309 of the Companies Act, 1956 or without the prior approval of the Central Government, wherever required, then such director shall refund such excess remuneration to the company and until such refund is made, he shall hold such sum in trust for the company.

Section 309(5B) of the Companies Act, 1956 states that the company shall not waive the recover of any sum refundable under section 309(5A) of the Companies Act, 1956 unless permitted by the Central Government.

In light of the above mentioned provisions of the Companies Act, 1956, Mr. Weldon is under obligation to refund the excess remuneration of Rs.1.20 Lakhs received by him from the company and till the same is refunded, he shall hold the said sum in trust for the company. Similarly, the company is also not eligible to waive the recovery of such excess sum. However, the company can waive the recovery and Mr. Weldon can keep such excess sum, if the permission from the Central

Government as envisaged in section 309(5B) of the Companies Act, 1956 is obtained.

- (ii) Board Resolution for waiver of recovery of excess remuneration paid to a director:

"RESOLVED that subject to the approval of the Central Government, the Board does hereby decides to waive the recovery of a sum of Rs.1.20 Lacs paid to Mr. Weldon, a director of the company during the period from 1st October, 2002 to 31st March, 2003 in excess of the remuneration sanctioned by the Central Government in terms of section 309 of the Companies Act 1956."

"RESOLVED FURTHER that an appropriate application under section 309(5B) of the Companies Act, 1956 be made to the Central Government and that Mr, the Secretary of the company be and is hereby authorized to take necessary action in this regard."

- (b) (i) The subject matter of the question is covered by the provisions of section 270 of the Companies Act, 1956. The Companies Act, 1956 does not provide for any qualification for becoming a director of any company. According to the said section, any person appointed as a director is required to obtain the qualification if it is so provided by the Articles of Association of the company.

The said section states that in case the Articles of Association of a company provides for the qualification of a director, then such a director is required to obtain the requisite qualification within a period of two months from the date of his appointment as a director. The section further states that any clause in the Articles of Association requiring the director to obtain the qualification shares within a shorter time than two months shall be void.

The said section also puts a maximum limit on the qualification that can be prescribed by the Articles of Association. Such maximum limit being shares with nominal value not exceeding Rs.5,000 or in a case where the nominal value of one shares exceeds Rs. 5,000 then the qualification share shall be maximum one share.

Based on the provisions of section 270 of the Companies Act, 1956 as explained above, the clause in the Articles of Association as given in the question is void since it stipulates the obtaining of the qualification shares within a period of 30 days which is shorter than two months. Moreover the clause also violates the maximum limit of share qualification by prescribing the same to be 1,000 shares of Rs.10 each totaling Rs.10,000 which is more than the limit of Rs.5,000 as prescribed in the said section.

- (ii) The clause to be included in the Articles of Association regarding qualification of directors conforming to the provisions of the Companies Act, 1956 may be as follows:

"The qualification of a director shall be the holding of at least 500 equity shares in the company and such a director if not already so qualified shall have to obtain his

qualification within a period of two months from the date of his appointment as a director.”

Question 6

- (a) (i) *An Interstate Cooperative Society has been incorporated on 1st May, 2004 as a Producer Company under the provisions of the Companies Act, 1956. Give your comments on its proposal to have 18 directors on its Board after incorporation as a Producer Company.*
- (ii) *A Producer Company wants to issue bonus shares. You are required to state the relevant provisions of the Companies Act, 1956 in this regard.*
- (iii) *What are the modes of investment, from and out of its general reserves, available to a Producer Company formed and registered under Section 581C of the Companies Act, 1956. (8 marks)*
- (b) *Mr. Raj, a director of POL Ltd., submitted his resignation from the post of director to the Board of Directors on 30th June, 2004 and obtained a receipt therefore on the same day. The Board of Directors of POL Ltd. neither accepted the resignation nor did it file Form No.32 with the Registrar of Companies. You are required to state whether Mr. Raj ceases to be the Director of POL Ltd. and if yes, since when? (7 marks)*

Answer

- (a) (i) As per provisions of section 581O of the Companies Act, 1956, any Producer Company can not have more than fifteen directors. However, by way of a proviso, the said section further provides that in the case of an inter-State co-operative society which is incorporated as a Producer Company, may have more than fifteen directors for a period of one year from the date of its incorporation as a Producer Company.
- In view of the above provisions of the Companies Act, 1956 the proposal to have 18 directors by the Producer Company after its incorporation as such, is a valid proposition, but since it is incorporated on 1st May, 2004, it can have more than 15 directors for one year only from the date of its incorporation
- (ii) As per provisions of section 581ZJ of the Companies act 1956, any Producer Company may, upon recommendation of the Board and passing of resolution in the general meeting, issue bonus shares by capitalisation of amounts from general reserves referred to in section 581ZI in proportion to the shares held by the Members on the date of the issue of such shares.
- (iii) As per Producer Companies (General Reserves) Rules. 2003 issued by the Department of Company Affairs, Ministry of Finance, Government of India on 7th August, 2003 a producer company formed and registered under section 581C of the Companies Act, 1956, shall make investments from and out of its general reserves in the following manner, namely:-

- (a) in approved securities, fixed deposits, units and bonds issued by the Central or State Governments or cooperative societies or scheduled bank; or
 - (b) in a co-operative bank, state co-operative bank, co-operative land development bank or central co-operative bank; or
 - (c) with any other scheduled bank; or
 - (d) in any of the securities specified in section 20 of the Indian Trusts Act, 1882; or
 - (e) in the shares or securities of any other multi-state co-operative society or any co-operative society; or
 - (f) in the shares, securities or assets of a public financial institutions specified under section 4A of the Companies Act, 1956.
- (b) There is no provision in the Companies Act, 1956 relating to resignation from his office by a director. If there is any provision in the articles giving the right to a director to resign at any time, the resignation will take effect without any need for its acceptance by the Board of Directors or the company in general meeting. In absence of a specific provision in the articles of association, a director can resign without being required to give reasonable notice. In *T. Murari Vs. State* [(1976) 46 Comp. Cas. 613] the Madras High Court held that even in the absence of a provision in respect of resignation under the Companies Act, 1956 or under the articles of association of the company, the resignation tendered by a director or a managing director unequivocally in writing will take effect from the time when such resignation is tendered.

The said judgement was followed by the same court in the case of *S.S. Lakshman Pillai Vs. ROC* (1997) 47 Comp. Cas. 652.

In a recent judgement in the case of *Mother Care (India) Ltd Vs. Prof. Ramaswamy P. Aiyar* [(2004) 51 SCL 243] the Karnataka High Court observed that as the appointment of a director is not a bilateral character, the question of acceptance of the request to relinquish the office would arise and filing of Form No.32 in terms of section 303(2) of the Companies Act, 1956 is only a consequential act to be performed by the company in obedience of the statutory provision, but it is not an act to be complied with in order to make a resignation valid.

Where the resignation letter states that it is to take effect on acceptance, or where the articles so require, acceptance is necessary to end the tenure of office of a director.

In view of the above legal position, Mr. Raj has ceased to be a director of POL Ltd. with effect from 30th June, 2004, provided his resignation letter does not state that the resignation is to take effect on acceptance or the articles of POL Ltd. does not so require.

Question 7

- (a) (i) As per provisions of the Companies Act, 1956, what is the status of XYZ Ltd., a Company incorporated in London, U.K., which has a Share Transfer Office at Mumbai?

- (ii) *ABC Ltd., a foreign company having its Indian principal place of business at Kolkata, West Bengal is required to deliver various documents to Registrar of Companies under the provisions of the Companies Act, 1956. You are required to state, where the said company should deliver such documents.*
- (iii) *In case, a foreign company does not deliver its documents to the Registrar of Companies as required under Section 597 of the Companies Act, 1956, state the penalty prescribed under the said Act, which can be levied. (8 marks)*
- (b) *M/s BEF Ltd., a public limited company is having a paid up share capital of Rs.2.50 crores. Whether it is obligatory for the company to have a whole-time secretary? Will it make any difference, if the capital of the said BEF Ltd. was Rs.1.50 crores? If yes, what other formality would have to be complied by it under the provisions of the Companies Act, 1956. (7 marks)*

Answer

- (a) (i) According to section 591 of the Companies Act, 1956, a company incorporated outside India and having a place of business in India is treated as a "Foreign Company". As per clause (c) of section 602 of the said Act, the expression ' place of business' includes a Share Transfer office. Thus, according to the provisions of the Companies Act, 1956, the status of XYZ Ltd. incorporated in London, U.K., which has a Share Transfer office in Mumbai, shall be that of a ' Foreign Company' .
- (ii) According to section 597 of the Companies Act, 1956, any document which a foreign company is required to deliver to the Registrar of Companies shall be delivered to the Registrar having jurisdiction over New Delhi and also to the Registrar of the State in which the principal place of business of the foreign company is situate.
- In light of the above provisions of the Companies Act, 1956, ABC Ltd. is required to deliver the requisite documents to the Registrar of Companies having jurisdiction over New Delhi and also to the Registrar of Companies, West Bengal.
- (iii) Section 598 of the Companies Act, 1956 prescribes the penalty for non-compliance of the provisions of section 597 of the said Act. According to the provisions of the said section 598, the foreign company and its every officer or agent, who is in default, shall be punishable with a fine upto Rs.10,000/- and in case of continuing offence, additional fine upto Rs.1,000/- per day for the period during which the default continues.
- (b) Section 383A of the Companies Act, 1956 provides that every company having a paid up capital not less than the prescribed limit (presently the limit being Rs.2.00 crores) shall have a whole time secretary. The Secretary must be a member of the Institute of Company Secretaries of India.

In view of the provision of the said section 383A, the Company, namely, BEF Ltd is under statutory obligation to have whole time Secretary since its paid up capital exceeds

Rs.2.00 crores. In case, the paid up capital of BEF Ltd is less than Rs.2.00 crores, it is not necessary for it to have whole-time secretary.

Since, its capital, as per second part of question, is Rs.1.50 crores, it is not required to have whole-time secretary.

However, the proviso to section 383A(i) of the Companies Act, 1956 requires that in case of a company having paid up share capital of Rs.10.00 Lacs or more, it has to file with Registrar of Companies, a certificate obtained from a Secretary in whole time practice. This certificate is called Compliance Certificate. This is to be attached to the Report of Board of Directors under Section 217 of the Companies Act, 1956. The certificate is to be filed with Registrar of Companies within 30 days from the date of holding of the Annual General Meeting each year.

Question 8

- (a) *Mr. Kailash, an employee of M/s Sweetwill Ltd. met with an accident and died. The accident occurred when Mr. Kailash was on company's duty. He held one hundred shares partly paid. Normally the company has a first and permanent lien on the shares. The Board of Directors however, relaxed the said provision with regard to these shares as a goodwill gesture on the part of the company. Is the action of the Company valid? State the reasons. Whether company's lien can be extended to dividends payable on such shares?* (8 marks)
- (b) *State the procedure for the following, explaining the relevant provisions of the Companies Act, 1956:*
- (i) *Appointment of First Auditor, when the Board of Directors did not appoint the First Auditor within one month from the date of registration of the company.*
 - (ii) *Removal of Statutory Auditor (appointed in last Annual General Meeting) before the expiry of his term.*
- What difference it would make, if the Auditor was First Auditor appointed by the Board of Directors?* (7 marks)

Answer

- (a) A company cannot have lien on shares unless provided in the Articles of Association. Therefore provision to this effect should be in the Articles. As per Regulation 9 of Table A, the Company has first and paramount lien on every share (which has not been fully paid up) for all monies (whether presently payable or not) called or payable at a fixed time in respect of that share and on all shares which are not fully paid up standing registered in the name of a single person, for all moneys presently payable by him or his estate to the company.

The Board of Directors may, however, at any time declare any share to be wholly or in part exempted from the said provision. Hence, exempted Mr. Kailash's estate from the provision of the said clause is in order and valid. [Regulation 9 of Table A].

Further the company's lien is extended to all dividends payable on such shares as per Regulation 9(2) of Table A.

- (b) (i) Section 224(5) of the Companies Act, 1956 lays down that the first auditor of a company shall be appointed by the Board of Directors within one month of the date of registration of the company.

If the Board of Directors fails to exercise its power, the company in general meeting may appoint the first Auditor or Auditors.

Subsequently Auditor or Auditors of a company are appointed every year by the shareholders in annual general meeting by passing an ordinary resolution.

- (ii) Auditor appointed in an Annual General Meeting may be removed from office before the expiry of his term only by the company in general meeting, after obtaining the previous approval from the Central Government in that behalf [Section 224 (7)].

Further the company has to follow the following procedure prescribed in Section 225 (2) and (3) as explained below:

1. No special notice under section 225 (1) is required for a resolution in the general meeting to remove the auditor. But decision must be taken at a Board meeting to remove the auditor, hold the general meeting etc.
2. The auditor shall be informed of the Board's decision immediately. [Section 22(2)].
3. The auditor can make a representation. The copy of the representation should be sent to all the members to whom notice of meeting is sent. If the copy of the representation is not sent as it was received late or because of the company's fault, the auditor may insist that the representation may be read at the meeting. [Section 225(3)].
4. If company does not wish to send the representation to the members or read at the general meeting, the company has to apply to Central Government/Company Law Board. If Central Government/Company Law Board is satisfied that the right of representation is being misused by auditor to secure needless publicity for defamatory matter, the Central Government/Company Law Board may order that the representation need not be sent and the representation need not be read at the meeting. (Provisio to Section 225(3)).
5. An ordinary resolution is to be passed at the general meeting for the removal of the auditor.

The first auditors appointed by Board can be removed by the company at a general meeting. (Proviso (a) to Section 224 (5)). The provisions in respect of removal as contained in Section 225 (2) & (3) are applicable for removal of first auditors also. (Section 225 (4)). However, in case of removal of first auditor appointed by the

Board of Directors, only an ordinary resolution is sufficient to remove the auditor and Central Government's approval is not required.

Question 9

- (a) Following information is available from the audited Balance Sheet as at 31st March, 2004 of ASK Ltd.:

<i>Share Capital:</i>	<i>Rs.</i>
<i>Equity Share Capital (5,00,000 shares of Rs. 10 each fully Paid up in cash)</i>	<i>50,00,000</i>
<i>Less: Calls in arrear</i>	<i><u>50,000</u></i>
	<i>49,50,000</i>
<i>Preference Share Capital</i>	<i>15,00,000</i>
<i>Share Application Money</i>	<i>10,00,000</i>
 <i>Reserves and Surplus:</i>	
<i>Securities Premium</i>	<i>15,00,000</i>
<i>Capital Redemption Reserve</i>	<i>12,00,000</i>
<i>Fixed Assets Revaluation Reserve</i>	<i>10,50,000</i>
<i>Sinking Fund Reserve</i>	<i>11,00,000</i>
<i>General Reserve</i>	<i>40,00,000</i>
<i>Profit and Loss Account</i>	<i>22,00,000</i>
<i>Dividend Equalisation Reserve</i>	<i>6,00,000</i>
<i>Secured Loans:</i>	
<i>Cash Credit facility from Bank</i>	<i>1,00,00,000</i>

You are required to find out, explaining the relevant provisions of the Companies Act, 1956, the amount upto which the Board of Directors can invest in securities of other bodies corporate and/or give loans. (8 marks)

- (b) Some small shareholders of TRG Ltd., a company listed with Mumbai Stock Exchange, want to appoint Mr. Raj, who is holding 1,000 Equity Shares of Rs.10 each in the Company as a Director as their representative on the Board of Directors of the said Company. You are required to state the relevant provisions of the Companies Act, 1956 in respect of such proposal to appoint Mr. Raj as a Small Shareholders' Director. (7 marks)

Answer

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

- (b) give any guarantee, or provide security, in connection with a loan made by any person to, or other person, by any body corporate; and
- (c) acquire, by way of subscription, purchase or otherwise the securities of any other body corporate exceeding 60% of its Paid up Share Capital and free reserves or 100% of its free reserves, whichever is more without prior authorization by way of a special resolution passed in a general meeting. (Section 372 A (1)).

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

Paid up Share Capital:

Equity Share Capital (500,000 shares of Rs.10/- each fully paid up in cash)	Rs. 50,00,000/-
Less: Calls in arrear	<u>Rs. 50,000/-</u>
	Rs.49,50,000/-
Add: Preference Share Capital	<u>Rs.15,00,000/-</u>
Total of Paid up Share Capital	<u>Rs.64,50,000/-</u>

Free-Reserves:

Securities Premium	Rs. 15,00,000/-
General Reserve	Rs. 40,00,000/-
Profit & Loss Account	Rs. 22,00,000/-
Dividend Equalisation Reserve	<u>Rs. 6,00,000/-</u>
Total Free Reserves	<u>Rs. 83,00,000/-</u>
Total of Paid up Share Capital and Free Reserves	<u>Rs. 1,47,50,000/-</u>

As per explanation to the said section, "Free Reserves" means those reserves, which, as per audited balance sheet of the company, are free for distribution as dividend and shall include balance to the credit of the securities premium account but shall not include share application money. (explanation (b) to section 372A).

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

Ceiling limit for investments:

60% of Paid up Share Capital and free reserves	
(i.e. 60% of Rs.14,750,000/-)	Rs. 88,50,000/-
100% of Free Reserves (i.e.100% of Rs.83,00,000/-)	Rs. 83,00,000/-

Since 60% of Paid up Share Capital and free reserves is Rs.88,50,000/- which is higher than 100% of Free Reserves, the directors of ASK Ltd. can advance loans and make investments in other bodies corporate upto a total limit of Rs. 88,50,000/- without obtaining prior approval from the shareholders. It may be noted that the amount of secured loan given in question has no relevance in determining the limit up to which investments/loans can be made.

(b) The provisions of section 252 of the Companies Act, 1956, and the Companies (Appointment of Small Shareholders' Director) Rules, 2001 in respect of appointment of Small Shareholders' Director are as follows:

- (1) The provisions of appointment of Small Shareholders' Director are applicable to public companies having paid-up share capital of Rs.5.00 Crores or more and having 1000 or more small shareholders. In case, TRG Ltd. is fulfilling both these conditions, then only its shareholders shall be eligible to proceed in the direction of appointing Mr. Raj as a Small Shareholders' Director. {Proviso to section 252 (1)}
- (2) Small Shareholder for this purpose means a shareholder holding shares of nominal value of Rs. 20,000/- or less.[Explanation to section 252(1)].
- (3) Small Shareholders who intend to propose Mr. Raj as a Small Shareholders' Director have to leave a notice of their intention with TRG Ltd. at least 14 days before the meeting and such notice has to be signed by at least 100 small shareholders.
- (4) According to the rules, the person whose name is to be proposed for the post of Small Shareholders' Director should himself be a small shareholder. Since Mr. Raj is holding shares of nominal value of Rs.10,000/- only, which is less than Rs.20,000, he is eligible to be nominated as such.
- (5) The said notice shall contain the name, address, number of shares held, of Mr. Raj whose name is to be proposed as a Small Shareholders Director and also that of other shareholders proposing Mr Raj.
- (6) Before the meeting, Mr. Raj has to sign and file with TRG Ltd., his consent in writing to act as a director.
- (7) Since TRG Ltd. is a company, which is listed with Mumbai Stock Exchange, it shall elect small shareholders' nominee through the postal ballot.
- (8) On scrutinizing the postal ballot, if Mr. Raj secures the requisite number of votes, he will be elected as a director for a term of 3 years and on expiry of the term shall be eligible to be re-appointed if small shareholders so wish at that time. However, he need not have to retire by rotation.
- (9) Mr. Raj shall be treated as director for all other purposes except for appointment as whole time director or managing director.

SUMMARY OF EXAMINERS' COMMENTS ON THE PERFORMANCE OF CANDIDATES

PAPER – 1 : ADVANCED ACCOUNTING

General Comments

The overall performance of the candidates, as commented by the examiners, was not satisfactory. The quality of most of the answers reflected candidates' lack of analytical ability and indepth knowledge of the subject. Questions requiring application of Accounting Standards and Guidance Notes in real life situations have not been answered well. The candidates are advised to improve their skills and knowledge level to match with the standards expected from them at Final Level. It is also observed that the candidates neglect the theoretical aspects of the subject, they are advised to go through the study material carefully. The candidates should present the answers in organized manner and solutions to practical problems must be given in prescribed formats along with suitable working notes.

Specific Comments

Question 1. Holding Company Accounts: Poor performance was observed by the examiners in this question. The answers of the candidates revealed inadequate knowledge of AS 21 on Consolidated Financial Statements. The adjustments of revaluation of assets and payment of dividend by SD Co. Ltd. were not correctly treated by some candidates. Many among them could not work out the unrealized profit included in the sale of machinery on hire purchase basis and thereby, could not proceed to draw the required consolidated balance sheet.

Question 2. Gross Value Added Statement: This was a practical question requiring candidates to prepare a gross value added statement. Candidates were also required to reconcile the gross value added with profit before taxation. Many candidates were unable to calculate correct amount of excise duty and some of them could not show the treatment of deferred tax. Only a few candidates could give the correct computation of cost of bought in material and services. Overall unsatisfactory performance was observed in this question.

Question 3. Valuation of Shares: By and large, examiners reported poor performance of the candidates in this question. Very few candidates could understand the requirements of the question and were able to find the value of equity shares. The candidates were confused in taking numerator and denominator while working out interest and dividend coverage ratio. Some of them could not work out expected yield on equity shares and consequently failed to proceed in the desired direction.

Question 4. Problems based on Accounting Standards:

(a) AS 20 – Earnings per Share: Except for the candidates, who were not aware of the relevant provisions of AS 20, this part of the question was fairly attempted. However, some candidates erred in calculation of adjustment factor and thereby, failed to compute the basic earnings per share correctly.

(b) AS 19 – Leases: The answers of the candidates showed lack of conceptual understanding of the standard. Most of the candidates were not able to give correct journal entries. Very few examinees ascertained the correct amount of unearned finance income.

(c) AS 22 – Accounting for Taxes on Income: The examiners observed that the candidates lack the understanding of the Accounting Standard and hence, could not indicate the impact of the given items (creation or reversal) in terms of deferred tax asset/ deferred tax liability. Consequently, the candidates could not show the correct balance of deferred tax asset/deferred tax liability.

Question 5.(a) Accounting for Not for Profit Organisations: Satisfactory performance of the candidates was reported in this part of the question. Almost all the candidates had attempted the question, though some of them wrongly deducted 'interest on loan' in statement of changes in loan fund balance.

(b) Accounting for stock option: This question was well attempted by most of the candidates. However, some of the candidates did not seem to have knowledge of the Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options and were not able to show the required accounting treatment in the books of buyer.

Question 6. Short Notes (Theory Question): The performance of the candidates was average in this theory question. Many candidates could not distinguish the treatment of (i) fixed assets and (ii) changes in accounting policies under IAS, US GAAPs and Indian AS. Also few among them were not able to state the disadvantages of setting of Accounting Standards. Other parts of the question were attempted properly by large proportion of the candidates. In general, answers lacked proper presentation, good expression, clarity and precision.

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

General Comments

- (i) The general performance was well below par. The conceptual knowledge was poor. The approach to solving the problem was still academic in nature. The candidates approach need to be more practical oriented.
- (ii) It seems that students do not generally read current financial affairs/Business magazines and news papers etc.
- (iii) The standard pf English language used by the candidates was poor.
- (iv) Working notes were not given properly and presentation was poor.
- (v) Attempt to the theoretical questions was generally unsystematic and conclusions/opinions relating to practical questions were not properly explained.

Specific comments

Question 1. The performance of majority of the candidates was found to be extremely poor. It appeared that most of the candidates were unable to understand the problem properly. A very small percentage of candidates were able to compute the NPV when $t=0$ on correct lines.

Question 2.(a) A large number of candidates could not calculate even the weighted average cost of capital and profit before interest and tax from leverage ratio. Very few candidates could work out economic value added correctly.

(b) Majority of the candidates were unable to compute effective yields of mutual fund schemes on per annum basis accurately.

(c) It appears that many candidates were not familiar with topic.

(d) Answers were generally satisfactory.

Question 3.(a) Few candidates were able to calculate value of rights properly and were not clear whether there will be any increase in shareholder's wealth.

(b) Candidates were not able to calculate lease rentals properly.

(c) Candidates were not able to explain NAV of mutual fund properly even though this a very common term.

Question 4.(a) Candidates lacked the idea needed to answer this question on Index futures correctly

(b) Majority of the candidates were able to solve the problem correctly in part. In most of the answers it was seen that candidates did not consider the individual tax rate correctly to determine the share price.

(c) This question on foreign exchange was well answered.

(d) Many candidates did not have correct idea about the term 'forfeiting'.

Question5.(a) (i) Candidates were found to be much more comfortable while answering the problem on beta coefficients.

(ii) The theory part of this question was also well answered

(b) Performance of candidates on this problem was also good barring the part relating to calculation of gain/loss for shareholders after acquisition.

(c) Most of the candidates were found to have insufficient knowledge to explain the terms 'intrinsic value' and 'time value' of an option correctly.

Question 6.(a) This question was more or less well answered.

(b) Performance of candidates was found to be really good on this question.

(c) Most of the candidates were found to have little ideas on tax issues relating to foreign collaboration agreement

(d) This part of the question was correctly answered by most of the candidates.

PAPER – 3 : ADVANCED AUDITING

General Comments

1. Lack of adequate knowledge on the part of candidate as far as the Institute's publications, statements and standards are concerned.
2. Candidates wrote answers without first analysing the exact requirement of each question.
3. Lack of command over language.

Specific Comments

Question 1.(a) The difference between contingent liability and provision for a liability which is not contingent any more was not properly understood by many candidates.

(b) Lack of knowledge of applicability of AS 18 by many candidates about the disclosure requirements.

(c) Many candidates could not give proper arguments with reference to AAS 11 as to the significance of management representation.

(d) Many candidates thought that the matter relates to father and son in a Chartered Accountant's firm and went on answering the question in view of code of ethics. Others have dealt at length about Sections 297, 301 and 314 of the Companies Act, 1956 instead of AS 18.

Question 2.(b) Many candidates wrongly stated that Mr. Pardeshi can pay Goodwill to Mrs. Qureshi but can continue the practice in the name of M/s Qureshi and Associates only for one year.

(c) Some candidates were not clear about provisions of AS 22 as to reasons for creating Deferred Tax Asset.

(d) Many candidates were not clear about provisions of AS 16 relating to capitalization of interest.

Question 3. Many candidates explained the concept of initial engagement and duties of auditor properly. However, answer on reporting requirements on audit procedure and approach in drafting audit report was not properly explained.

Question 5. Specific problem relating to implementation of internal control in EDP system was explained properly by majority of candidates but most of them failed to discuss characteristics of "on-line computer system" as well as Tagging and Training properly.

Question 7.(b) Many candidates failed to discuss statutory auditor's responsibilities in respect of disqualification of directors under section 274(1)(g) of the Companies Act, 1956.

PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE**General Comments**

From the assessment of the general performance of the candidates, it appears that they have followed a casual approach and without sufficient preparation. Depth of knowledge, clarity in presentation, analytical writing skills were lacking. Relevant sections, case laws and updates in the various Acts wherever necessary were not mentioned in the answers. Since, the level of knowledge required for the subject is expert knowledge, candidates are advised to refer the bare acts, law journals, institutes study material and one or two reference books.

Specific Comments

Question 1. Except on sub-question (c), the performance of the candidates was reasonably good. In question 1 (c), candidates wrote general answer without referring to the provisions of the Section 28 of the Securities (Contracts) Regulation Act, 1956 and Section 73 of the Companies Act, 1956 which stipulates that offer to public for subscription of shares or debentures shall be only after obtaining permission from the stock exchange.

Question 2. The overall performance was not satisfactory. Candidates were not conversant with the provisions of the Foreign Exchange Management Act, 1999. Candidates have also not studied the Competition Act, 2002.

Question 3. Question 3(a) was based on Section 293(1)(d) of the Companies Act, 1956. However, many candidates wrote answer to the question by mixing up the provisions of Section 372A and Section 293(1)(d) of the Companies Act, 1956. Answer to question on SEBI (DIP) Guidelines was unsatisfactory.

Question 4. Candidates wrote reasonably good answers to both sub-parts of the question.

Question 5. Though the quality of the answers were fair, many of the candidates did not state that the permission of Central Government is required for waiver of amount recoverable as per provisions of Section 309(5B) of the Companies Act, 1956. The drafting of the resolution was not upto the mark.

Question 6. The quality of answers to questions on Producer Company were average. In the sub-part (b) of the question candidates failed to mention that there is no provision in the Companies Act, 1956 dealing with resignation of office by a director and also did not mention that resignation by a director is governed by the Articles of Association of the Company.

Question 7. General performance to both the parts of the question was satisfactory.

Question 8. In sub-part (a) of the question, most of the candidates did not state the provisions of Regulation 9 Table A. In answering sub-part (b) of the question dealing, appointment of first auditor and removal of statutory auditor, candidates are required to explain the provisions of section 224(5) in respect of appointment of first auditor. As regards the removal of auditor the procedure laid down in Sections 224(7) and 225(2) & (3) and proviso (a) section 224(5) are to be explained briefly.

Question 9. Only few candidates could solve the problem based on Section 372A of the Companies Act, 1956. Candidates are required to explain only the relevant portion of Section 372A for the purpose of computation of limits up to which the Board of Directors can invest in securities etc. (Section 372A(1) and Explanation (b)).

In second part of the question dealing with the appointment of Small Shareholder's Director, candidates are required to explain in detail the Proviso and Explanation to Section 252(1) of the Companies Act, 1956 and also state that the small shareholders' director shall be elected in accordance with the Companies (Appointment of Small Shareholder's Director) Rules, 2001.

PAPER – 5 : COST MANAGEMENT

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

Question 1

- (a) What do you mean by 'Back flushing' in JIT system ? Explain briefly the problems with back flushing that must be corrected before it will work properly. (4 marks)
- (b) Explain Skimming pricing strategy. (4 marks)
- (c) Panchwati Cement Ltd. produces '43 grade' cement for which the company has an assured market. The output for 2004 has been budgeted at 1,80,000 units at 90% capacity utilisation. The cost sheet based on output (per unit) is as follows:

	Rs.
Selling price	130
Direct material	30
Component 'EH'	9.40
Direct wages @ Rs. 7 per hour	28
Factory overhead (50% fixed)	24
Selling and distribution overheads (75% variable)	16
Administrative overhead (fixed)	5

The factory overheads are applied on the basis of direct labour hours.

To utilise the idle capacity and to improve the profitability of the company, the following proposals were put up before the Board of Directors for consideration:

- (i) An order has been received from abroad for 500 units of product '53 grade' cement per month at Rs. 175 per unit. The cost data are:
Direct material Rs. 56 per unit, direct labour 10 hours per unit, selling and distribution overhead applicable to this product order is Rs. 14 per unit and variable factory overhead are chargeable on the basis of direct labour hours.
- (ii) The company at present manufactures component 'EH', one unit of which is required for each unit of product '43 grade'. The cost details for 15,000 units of component 'EH' are as follows:

	Rs.
Direct materials	30,000
Direct labour	52,500
Variable overheads	25,500
Fixed overheads	33,000
Total	1,41,000

The component 'EH' however is available for purchase at the market at Rs. 7.90 per unit.

- (iii) In the event of company deciding to purchase the component 'EH' from market, the company has two alternatives for the use of the capacity so released, which are as under:

- (a) Rent out the released capacity at Re. 1 per hour.
- (b) Manufacture component 'GYP' which can be sold at Rs. 8 per unit. The cost data of this component for 15,000 units are:

	Rs.
Direct materials	42,000
Direct labour	31,500
Factory variable overheads	13,500
Other variable overheads	25,500
Total	1,12,500

Required:

- (i) Prepare a statement showing profitability of the company envisaged in the budget.
- (ii) Evaluate the export order and state whether it is acceptable or not.
- (iii) Make an appraisal of proposal to manufacture component 'EH' and state whether the component 'EH' should be manufactured in the factory or purchased from the market. Assume that no alternative use of spare capacity is available.
- (iv) Evaluate the alternative use of the spare capacity and state whether to manufacture or buy the component 'EH' and if your decision is to buy the component 'EH', which of the two alternatives for the use of spare capacity will you prefer ? (16 marks)

Answer

(a) Back flushing in a JIT system

Traditional accounting systems record the flow of inventory through elaborate accounting procedures. Such systems are required in those manufacturing environment where inventory/WIP values are large. However, since JIT systems operate in modern manufacturing environment characterized by low inventory and WIP values, usually also

associated with low cost variances, the requirements of such elaborate accounting procedures does not exist.

Back flushing requires no data entry of any kind until a finished product is completed. At that time the total amount finished is entered into the computer system which is multiplied by all components as per the Bill of materials (BOM) for each item produced. This yields a lengthy list of components that should have been used in the production process and this is subtracted from the opening stock to arrive at the closing stock to arrive at the closing stock/inventory.

The problems with back flushing that must be corrected before it works properly are:

- (i) The total production quantity entered into the system must be absolutely correct, if not, then wrong components and quantities will be subtracted from the stock.
- (ii) All abnormal scrap must be diligently tracked and recorded. Otherwise materials will fall outside the back flushing system and will not be charged to inventory.
- (iii) Lot tracing is impossible under the back flushing system. This is required when a manufacturer needs to keep records of which production lots were used to create a product in case all the items in a lot need be recalled.
- (iv) The inventory balance may be too high at all times because the back flushing transaction that relieves inventory usually does so only once a day, during which time other inventory is sent to the production process. This makes it difficult to maintain an accurate set of inventory records in the warehouse.

(b) Skimming pricing

It is a policy where the prices are kept high during the early period of a product's existence. This can be synchronised with high promotional expenditure and in the latter years the prices can be gradually reduced. The reasons for following such a policy are as follows:

- (i) The demand is likely to be inelastic in the earlier stages till the product is established in the market.
- (ii) The gradual reduction in price in the latter years will tend to increase the sales.
- (iii) This method is preferred in the beginning because in the initial periods when the demand for the product is not known the price covers the initial cost of production.
- (iv) High initial capital outlays needed for manufacture, results in high cost of production. In addition to this, the producer has to incur huge promotional activities resulting in increased costs. High initial prices will be able to finance the cost of production particularly when uncertainties block the usual sources of capital.

(c) (i) Profitability as per original Budget

		<i>Rs ('000s)</i>	<i>Rs('000s)</i>
Sales(1,80,000 units × Rs 130)	(A)		23,400
Direct Material (1,80,000 units × Rs 30)		5,400	

Component 'EH' (variable cost = Rs 7.20 per unit)		1,296
Direct wages (1,80,000 units × Rs 28)		5,040
Variable factory overheads (1,80,000 units × Rs 24 × 50%)		2,160
Variable selling & distribution (1,80,000 units × Rs 16 × 75%)		2,160
Total variable cost	(B)	16,056
Contribution	(A – B)	7,344
Fixed factory overheads		2,160
Fixed selling & distribution overheads		720
Component 'EH' @2.20(Fixed cost per unit)		396
Fixed administrative overhead		900
Profit		3,168

(ii)

Export order

	<i>Rs per Unit</i>	<i>Rs per Unit</i>
Direct material	56	
Direct labour (10 hours × Rs 7 per hour)	70	
Variable factory overhead (Rs 3 × 10 labour hours)	30	
Selling and distribution overheads	14	
Total variable cost		170
Selling price (export)		175
Contribution		5

Since the product earns contribution of Rs.5 per unit, it should be accepted.

Total units 500(per month) = 6000 units(per annum)

Therefore additional contribution (6000 units × Rs 5) = Rs.30,000

Total hours on product '43 grade' (1,80,000 units × 4) = 7,20,000 Hrs

Total hours on component 'EH' (1,80,000 units × 0.5*) = 90,000 Hrs

$$* \frac{\text{Direct Labour cost}}{\text{No of units produced} \times \text{Labour rate per hour}} = \frac{\text{Rs } 52,500}{15,000 \text{ units} \times \text{Rs } 7 \text{ per hour}} = 0.5 \text{ Hrs}$$

Total hours utilised at 90% capacity = 7,20,000 hours + 90,000 hours = 8,10,000 hours

$$100\% \text{ capacity hours} = \frac{8,10,000 \text{ hours} \times 100}{90} = 9,00,000 \text{ Hrs}$$

Balance hours available = 90,000 hours p.a

Hours required for export order 60,000 hours.

Both contribution per unit of export order and availability of capacity confirm its acceptance.

(iii) Component 'EH' make or buy

(Per 15,000 units)	Make (Rs.)	Buy (Rs.)
Direct material	30,000	
Direct labour	52,500	
Variable factory overhead	25,500	
Total	1,08,000	1,18,500
Per unit	7.20	7.90

If the company makes the component the out of pocket cost is Rs.7.20 per unit whereas if the component is bought , the out of pocket cost is Rs.7.90.

Decision : If the capacity remains idle it is profitable to make.

(iv) Alternative use of the spare capacity

Units required = 1,80,000 units and hours required = $1,80,000 \times 0.5 = 90,000$ Hrs

Cost of buying component 'EH' = $(1,80,000 \text{ units} \times \text{Rs } 7.90) = \text{Rs } 14,22,000$

Cost of making component 'EH' = $(1,80,000 \text{ units} \times \text{Rs } 7.20) = \text{Rs } 12,96,000$

Hence , excess cost of buying = Rs.1,26,000

Rent income $(90,000 \text{ hours} \times \text{Rs } 1) = \text{Rs } 90,000$

Contribution per unit from making component 'GYP' = $\text{Rs } 8 - \frac{\text{Rs } 1,12,500}{15,000 \text{ Units}} = \text{Rs } 0.5$ per unit.

Direct labour cost per unit of 'GYP' = $\frac{\text{Rs } 31,500}{15,000 \text{ Units}} = \text{Rs } 2.10$ per unit.

No. of labour hours required for one unit of 'GYP' = $\frac{\text{Rs } 2.10}{\text{Rs } 7} = 0.3$ Hrs

No. of units of 'GYP' in 90,000 hours = $\frac{90,000 \text{ hours}}{0.3 \text{ hours}} = 3,00,000$

Contribution from component 'GYP' = $3,00,000 \times \text{Rs } 0.50 = \text{Rs } 1,50,000$

Since the contribution from 'GYP' is greater than the extra variable cost of buying component 'EH' , component 'GYP' should be manufactured and component 'EH' should be purchased.

Question 2

- (a) What are the advantages and limitations of Zero base Budgeting ? (4 marks)
- (b) What are benchmarking code of conduct? (3 marks)
- (c) Explain briefly the main features of ERP. (4 marks)
- (d) A Company manufactures two Products A and B by making use of two types of materials, viz., X and Y. Product A requires 10 units of X and 3 units of Y. Product B requires 5 units of X and 2 units of Y. The price of X is Rs. 2 per unit and that of Y is Rs. 3 per unit. Standard hours allowed per product are 4 and 3, respectively. Budgeted wages rate is Rs. 8 per hour. Overtime premium is 50% and is payable, if a worker works for more than 40 hours a week. There are 150 workers.

The Sales Manager has estimated the sales of Product A to be 5,000 units and Product B 10,000 units. The target productivity ratio (or efficiency ratio) for the productive hours worked by the direct worker in actually manufacturing the product is 80%, in addition, the non-productive downtime is budgeted at 20% of the productive hours worked. There are twelve 5-day weeks in the budget period and it is anticipated that sales and production will occur evenly throughout the whole period.

It is anticipated that stock at the beginning of the period will be:

Product A 800 units; Product B 1,680 units. The targeted closing stock expressed in terms of anticipated activity during the budget period are Product A 12 days sales; Product B 18 days sales. The opening and closing stock of raw material of X and Y will be maintained according to requirement of stock position for Product A and B.

You are required to prepare the following for the next period:

- (i) Material usage and Material purchase budget in terms of quantities and values.
- (ii) Production budget.
- (iii) Wages budget for the direct workers. (8 marks)

Answer**(a) Advantages of ZBB**

- (i) It provides a systematic approach for evaluation of different activities and ranks them in order of preference for allocation of scarce resources.
- (ii) It ensures that the various functions undertaken by the organisation are critical for the achievement of its objectives and are being performed in the best way.
- (iii) It provides an opportunity to the management to allocate resources for various activities only after having a thorough cost-benefit analysis.
- (iv) The area of wasteful expenditure can be easily identified and eliminated.
- (v) Departmental budgets are closely linked with corporate objectives.

- (vi) The technique can also be used for the introduction and implementation of the system of 'management by objective'.

Limitations of ZBB

- (i) Various operational problems are likely to be faced in implementing the technique.
- (ii) The full support of top management is required.
- (iii) It is time consuming as well as costly.
- (iv) It requires proper trained managerial staff.

(b) Benchmarking code of conduct

Benchmarking is the process of identifying and learning from the best practices anywhere in the world. It is a powerful tool for continuous improvement. To contribute to efficient, effective and ethical benchmarking, individuals agree for themselves and their organisation to be abided by the following principles for the benchmarking with other organisations.

Suggested benchmarking code of conduct:

- (i) Principle of legality
- (ii) Principle of exchange
- (iii) Principle of confidentiality
- (iv) Principle of use
- (v) Principle of first party contact
- (vi) Principle of third party contact
- (vii) Principle of preparation

(c) Features of ERP

- It facilitates company wide integrated information systems covering all functional areas like manufacturing, purchase, payables, inventory etc.
- It performs core activities and increases customer services thereby projecting and enhancing the corporate image.
- It bridges the information gap across organisations.
- It offers a solution to better project management.
- It allows automatic introduction of the latest technologies like Electronic Fund Transfer, Internet, Video Conferencing etc.
- It eliminates business problems like shortage of material, inventory problems etc.
- It provides for improving and refining the business process.
- It provides complete integration of systems, not only across departments, but also across the companies under same management.

(d) (i)

Material usage budget

	<i>Product A (units)</i>	<i>Product B (units)</i>	<i>Total material usage units</i>	<i>Cost per unit (Rs)</i>	<i>Total cost of materials (Rs)</i>
Estimated sales	5,000	10,000			
Material X : 10 units per product A and 5 units per product B	50,000	50,000	1,00,000	2	2,00,000
Material Y : 3 units per product A and 2 units per product B	15,000	20,000	35,000	3	1,05,000
Total	65,000	70,000	1,35,000		3,05,000

Material Purchase Budget

	<i>X Units</i>	<i>Y Units</i>	<i>Total</i>
Required for sales	1,00,000	35,000	
Add: desired closing stock			
Product A:			
1,000 units (A) $\times$ 10 units (X) = 10,000 units of X			
3,000 units (B) $\times$ 5 units (X) = 15,000 units of X.	25,000		
Product B:			
1,000 units (A) $\times$ 3 units (Y) = 3000 units of Y			
3,000 units (B) $\times$ 2 units (Y) = 6,000 units of Y.		9,000	
	1,25,000	44,000	
Less: Opening stock			
Product A:			
800 units (A) $\times$ 10 units (X) = 8,000 units of X			
1,680 units (B) $\times$ 5 units (X) = 8,400 units of X	16,400		
Product B			
800 units (A) $\times$ 3 units (Y) = 2,400 units of Y			
1,680 units (B) $\times$ 2 units (Y) = 3,360 units of Y.		5,760	
Units to be purchased	1,08,600	38,240	1,46,840
Cost per unit	Rs.2	Rs.3	
Cost of purchase (Rs.)	2,17,200	1,14,720	3,31,920

(ii)

Production Budget

	<i>Product A</i>	<i>Product B</i>
	<i>Units</i>	<i>Units</i>
Sales	5,000	10,000
Add: Closing stock**	1,000	3,000
	6,000	13,000
Less: Opening stock	800	1,680
Production	5,200	11,320

**Calculation of closing stock:

Budgeted period is 12 weeks of 5 days each =60 days.

$$\text{Product A} = \frac{5,000 \times 12}{60} = 1,000 \text{ units}$$

$$\text{Product B} = \frac{10,000 \times 18}{60} = 3,000 \text{ units}$$

(iii)

Wages budget for direct workers

	<i>Product A</i> (hrs)	<i>Product B</i> (hrs)	<i>Total</i> (hrs.)
Standard hours (budgeted)			
5,200 units (A) × 4 hours per unit and 11,320 units (B) × 3 hours per unit.	20,800	33,960	54,760
Standard hours at 80% efficiency ratio			68,450
Add: non productive time (20% of 68,450)			13,690
			82,140
Labour hours required (150 workers × 8 hours per day × 60 days)			72,000
Overtime			10,140

Wages for normal hours (72,000 × 8) = Rs 5,76,000

Wages for overtime (10,140 × 8 × 1.5) = Rs 1,21,680

Total wages = Rs 6,97,680

Question 3

- (a) XYZ Ltd. manufactures four products, namely A, B, C and D using the same plant and process. The following information relates to a production period: (11 marks)

Product	A	B	C	D
Output in units	720	600	480	504
Cost per unit:	Rs.	Rs.	Rs.	Rs.
Direct Material	42	45	40	48
Direct labour	10	9	7	8
Machine hours per unit	4 hrs.	3 hrs.	2 hrs.	1 hr.

The four products are similar and are usually produced in production runs of 24 units and sold in batches of 12 units. Using machine hour rate currently absorbs the production overheads. The total overheads incurred by the company for the period is as follows:

	Rs.
Machine operation and Maintenance cost	63,000
Setup costs	20,000
Store receiving	15,000
Inspection	10,000
Material handling and dispatch	2,592

During the period the following cost drivers are to be used for the overhead cost:

Cost	Cost driver
Setup cost	No. of production runs
Store receiving	Requisition raised
Inspection	No. of production runs
Material handling and dispatch	Orders executed

It is also determined that:

- Machine operation and maintenance cost should be apportioned between setup cost, store receiving and inspection activity in 4:3:2.
- Number of requisition raised on store is 50 for each product and the no. of order executed is 192, each order being for a batch of 12 of a product.

Required:

- (i) Calculate the total cost of each product, if all overhead costs are absorbed on machine hour rate basis.
 - (ii) Calculate the total cost of each product using activity base costing.
 - (iii) Comment briefly on differences disclosed between overheads traced by present system and those traced by activity base costing. (11 marks)
- (b) A manufacturing company produces two types of product the SUPER and REGULAR. Resource requirements for production are given below in the table. There are 1,600 hours of assembly worker hours available per week. 700 hours of paint time and 300 hours of inspection time. Regular customers bill demand at least 150 units of the REGULAR type and 90 units of the SUPER type. (8 marks)

Table				
Product	Profit/contribution Rs.	Assembly time Hrs.	Paint time Hrs.	Inspection time Hrs.
REGULAR	50	1.2	0.8	0.2
SUPER	75	1.6	0.9	0.2

Formulate and solve the given Linear programming problem to determine product mix on a weekly basis.

Answer

- (a) (i) **Total cost of different products (overhead absorption on Machine hour basis)**

	A	B	C	D
	Rs.	Rs.	Rs.	Rs.
Direct material	42	45	40	48
Direct labour	10	09	07	08
Overhead	72	54	36	18
Cost of production per unit	124	108	83	74
Out put in unit	720	600	480	504
Total cost	89,280	64,800	39,840	37,296

Machine hours $(720 \times 4 + 600 \times 3 + 480 \times 2 + 504 \times 1) = 6,144$ hours.

Rate per hour = $\frac{\text{Rs } 1,10,592}{6,144 \text{ hours}} = \text{Rs } 18 \text{ per hour.}$

(ii) Activity based costing system

	<i>Set up</i>	<i>Store receiving</i>	<i>Inspection</i>
Machine operation and maintenance cost of Rs 63,000 to be distributed in the ratio of 4: 3: 2.	28,000	21,000	14,000

<i>Cost</i>	<i>Rs</i>	<i>Drivers</i>	<i>No</i>	<i>Cost per unit of driver (Rs)</i>
Set up	48,000	Production runs	96	500
Store receiving	36,000	Requisitions raised	200	180
Inspection	24,000	Production runs	96	250
Material handling and disp	2,592	Orders	192	13.50

Production Run for A (720/24) = 30 ; B (600/24) = 25 ; C (480/24) = 20 ; D (504/24) = 21.

	<i>A (Rs)</i>	<i>B (Rs)</i>	<i>C (Rs)</i>	<i>D (Rs)</i>
Direct material	30,240	27,000	19,200	24,192
Direct labour	7,200	5,400	3,360	4,032
Setup	15,000	12,500	10,000	10,500
Store receiving	9,000	9,000	9,000	9,000
Inspection	7,500	6,250	5,000	5,250
Material handling and dispatch	810	675	540	567
Total cost	69,750	60,825	47,100	53,541
Per unit cost	96.875	101.375	98.125	106.23

(iii)

	<i>A (Rs.)</i>	<i>B (Rs.)</i>	<i>C (Rs.)</i>	<i>D (Rs.)</i>
Cost per unit (a)	124	108	83	74
Cost per unit (b)	96.88	101.38	98.13	106.23
Difference	(27.12)	(6.62)	15.13	32.23

The total overheads which are spread over the four products have been apportioned on different bases, causing the product cost to differ substantially in respect of product A

and D. A change from traditional machine hour rate to an activity system may have effect on price and profits to the extent that pricing is based on cost plus approach.

- (b) Let x_1 and x_2 denote the number of units produced per week of the product 'REGULAR' and 'SUPER' respectively.

$$\text{Maximise } Z = 50x_1 + 75x_2$$

Subject to

$$1.2x_1 + 1.6x_2 \leq 1,600 \text{ or } 12x_1 + 16x_2 \leq 16,000 \quad \text{---(i)}$$

$$0.8x_1 + 0.9x_2 \leq 700 \text{ or } 8x_1 + 9x_2 \leq 7,000 \quad \text{---(ii)}$$

$$0.2x_1 + 0.2x_2 \leq 300 \text{ or } 2x_1 + 2x_2 \leq 3,000 \quad \text{---(iii)}$$

$$x_1 \leq 150 \quad \text{---(iv)}$$

$$x_2 \leq 90 \quad \text{---(v)}$$

Let

$$x_1 = y_1 + 150$$

$$x_2 = y_2 + 90 \text{ where } y_1, y_2 \geq 0$$

$$\text{Maximize } Z = 50(y_1 + 150) + 75(y_2 + 90) \text{ or } Z = 50y_1 + 75y_2 + 14,250$$

Subject to :

$$12(y_1 + 150) + 16(y_2 + 90) \leq 16,000$$

$$8(y_1 + 150) + 9(y_2 + 90) \leq 7,000$$

$$2(y_1 + 150) + 2(y_2 + 90) \leq 3,000$$

$$\text{and } y_1, y_2 \geq 0$$

Adding slack variables s_1, s_2, s_3 , we get

$$\text{Maximize } Z = 50y_1 + 75y_2 + 14,250 \text{ subject to}$$

$$12y_1 + 16y_2 + s_1 = 12,760$$

$$8y_1 + 9y_2 + s_2 = 4,990$$

$$2y_1 + 2y_2 + s_3 = 2,520$$

Table -1

C_j	50 75 0 0 0							
C_b			y_1	y_2	s_1	s_2	s_3	
0	s_1	12,760	12	16	1	0	0	12760/16
0	s_2	4,990	8	9	0	1	0	4990/9
0	s_3	2,520	2	2	0	0	1	2520/2
$\uparrow$			-50	-75	0	0	0	

Table II

C_j	50 75 0 0 0							
C_b			y_1	y_2	s_1	s_2	s_3	
0	s_1	3889	-20/9	0	1	-16/9	0	
75	y_2	554.44	8/9	1	0	1/9	0	
0	s_3	1411	2/9	0	0	-2/9	1	
$\uparrow$			50/3	0	0	75/9	0	

Since all the elements in the index row are either positive or equal to zero , table II gives an optimum solution which is $y_1 = 0$ and $y_2 = 554.44$

Substituting these values we get

$$x_1 = 150$$

$$x_2 = 644.44 \text{ and the value of objective function is}$$

$$Z = 50 \times 150 + 75 \times 644.44$$

$$= \text{Rs. } 55,833$$

Question 4

- (a) "Relevant cost analysis helps in drawing attention of managers to those elements of costs, which are relevant for the decision." Comment . (5 marks)
- (b) A company manufactures two products X and Y. Product X requires 8 hours to produce while Y requires 12 hours. In April, 2004, of 22 effective working days of 8 hours a day, 1,200 units of X and 800 units of Y were produced. The company employs 100 workers in production department to produce X and Y. The budgeted hours are 1,86,000 for the year.

Calculate Capacity, Activity and Efficiency ratio and establish their relationship.

(6 marks)

- (c) *A manufacturing company runs its boiler on furnace oil obtained from X oil company and Y oil company whose depots are situated at a distance of 24 kms and 16 kms from the factory site.*

Transportation of furnace oil is made by company's own tank lorries (two) of 8 ton capacity each. Onward trips are made only with full load and the lorries return empty. The filling time takes an average of 40 minutes for X oil company and 30 minutes for Y oil company. The empty time in the factory is only 40 minutes for each. The average speed of lorries work out is 24 kms per hour. The varying operating charges average 80 paise per km covered and fixed charges gives an incidence of Rs. 7.50 per hour of operation.

Calculate the transportation cost per ton-km for each source of furnace oil. (8 marks)

Answer

- (a) Business decision involves planning for the future and requires consideration of several alternative choices. In making such decisions estimates of future costs and revenues are worked out. The costs that matter in business decisions are only future costs. Actual or current or historical costs may only be used for estimating future costs of the alternative choices but decision making would only require consideration of future costs which are pertinent to such decisions. Relevant costs are therefore such costs which will influence the decision and are directly related to the decision to be made. For example, in a machinery replacement decision, the original cost and the present depreciated book value of the old plants are not relevant. The expected sales value of the old plant is relevant because it will reduce the amount of investment in the new plant.

Some important points are –

- (i) Historical costs being sunk cost are not relevant to the decision.
- (ii) Even among future costs, those variable costs which do not differ under various alternatives are not relevant.
- (iii) If fixed expenses remain unchanged under different alternatives such expenses are not relevant to the decision.
- (iv) Book value of the equipment is not relevant because it is past cost.

Thus only such costs which are capable of making a difference in use decisions and enter into a choice between alternative courses of action are relevant.

(b) Standard hours produced

	<i>Product X</i>	<i>Product Y</i>	<i>Total</i>
Out put (units)	1,200	800	
Hours per unit	8	12	
Standard hours	9,600	9,600	19,200
<i>Actual hours worked</i>			
100 workers × 8 hours × 22 days =			17,600
<i>Budgeted hours per month</i>			
1,86,000/12 =			15,500

$$\text{Capacity Ratio} = \frac{\text{Actual hours}}{\text{Budgeted hours}} \times 100 = \frac{17,600}{15,500} \times 100 = 113.55\%$$

$$\text{Efficiency Ratio} = \frac{\text{Std. Hours produced}}{\text{Actual hours}} \times 100 = \frac{19,200}{17,600} \times 100 = 109.09\%$$

$$\text{Activity Ratio} = \frac{\text{Std. hour produced}}{\text{Budget . hours}} \times 100 = \frac{19,200}{15,500} \times 100 = 123.87\%$$

Relationship : Activity ratio = Efficiency ratio × Capacity ratio

$$\text{or } 123.87 = \frac{109.09 \times 113.55}{100}$$

(c) Calculation of variable cost

	<u>Distance</u> <i>X</i>	<u>Distance</u> <i>Y</i>
One side distance	24 km	16 km
Round trip	48 km	32 km
Variable cost @ .80 per km	Rs.38.40	Rs.25.60

Calculation of fixed cost

	<u>Distance</u> <i>X</i>	<u>Distance</u> <i>Y</i>
Actual running time for round trip distance at the speed of 24 km per hour	120 Min	80 Min
Filling time	40 Min	30 Min

Empty time	40 Min	40 Min
Total time	200 Min	150 Min
Fixed cost @ Rs 7.50 per hour	Rs.25	18.75
<i>Calculation of ton km</i>		
Capacity	8 tons	8 tons
Full load	24 km	16 km
Tons km	192	128

$$\text{Cost per ton km} = \frac{38.40 + 25}{192} = \text{Rs.0.33} \quad \frac{25.60 + 18.75}{128} = \text{Rs 0.347}$$

Question 5

- (a) Tycon Ltd. has two manufacturing departments organised into separate profit centres known as Textile unit and Process House. The Textile unit has a production capacity of 5 lacs metres cloth per month, but at present its sales is limited to 50% to outside market and 30% to process house.

The transfer price for the year 2004 was agreed at Rs.6 per metre. This price has been fixed in line with the external wholesale trade price on 1st January, 2004. However, the price of yarn declined, which was the raw material of textile unit, with effect, that wholesale trade price reduced to Rs. 5.60 per metre with effect from 1st June, 2004. This price was however not made applicable to the sales made to the processing house of the company. The textile unit turned down the processing house request for revision of price.

The Process house refines the cloth and packs the output known as brand Rayon in bundles of 100 metres each. The selling price of the Rayon is Rs. 825 per bundle. The process house has a potential of selling a further quantity of 1,000 bundles of Rayon provided the overall prices is reduced to Rs. 725 per bundle. In that event it can buy the additional 1,00,000 metres of cloth from textile unit, whose capacity can be fully utilised. The outside market has no further scope.

The cost data relevant to the operations are:

	Textile unit Rs.	Process house Rs.
Raw material (per metre)		
on 1 st June, 2004	3.00	Transfer price
Variable cost	1.20 (per metre)	80 (per bundle)
Fixed cost (per month)	4,12,000	1,00,000

You are required to:

- (i) *Prepare statement showing the estimated profitability for June, 2004 for Textile unit and Process house and company as a whole on the following basis:*
 - (a) *At 80% and 100% capacity utilisation of the Textile unit at the market price and the transfer price to the Processing house of Rs. 6 per metre.*
 - (b) *At 80% capacity utilisation of the Textile unit at the market price of Rs. 5.60 per metre and the transfer price to the Processing house of Rs. 6 per metre.*
 - (c) *At 100% capacity utilisation of the Textile unit at the market price of Rs. 5.60 per metre and the transfer price to the Processing house of Rs. 5.60 per metre.*
- (ii) *Comment on the effect of the company's transfer pricing policy on the profitability of Processing house.* (11 marks)
- (b) *Given the following project network, determine:* (8 marks)
 - (i) *Earliest expected completion time for each event*
 - (ii) *Latest allowable completion time for each event*
 - (iii) *Slack time for each event*
 - (iv) *The critical path*
 - (v) *The probability that the project will be completed on schedule, if the scheduled completion time is 38.*

Project Diagram

Answer**(a) (1) (a) At 80% level (in Rs)**

<i>-Textile unit</i>		<i>-Process house</i>	
Sales (4,00,000 × 6)	24,00,000	Sales (1,50,000/100) × 825	12,37,500
Less		Less	
Raw material (4,00,000 × 3)	12,00,000	Transfer Price (1,50,000 × 6)	9,00,000
Variable cost (4,00,000 × 1.2)	4,80,000	Variable cost (1,500 × 80)	1,20,000
Fixed cost	4,12,000	Fixed cost	1,00,000
Profit	3,08,000	Profit	1,17,500

Overall profit = 3,08,000 + 1,17,500 = Rs 4,25,500

At 100% level

Sales (5,00,000 × 6)	30,00,000	Sales (2,50,000/100) × 725	18,12,500
Less		Less	
Raw material (5,00,000 × 3)	15,00,000	Transfer Price (2,50,000 × 6)	15,00,000
Variable cost (5,00,000 × 1.2)	6,00,000	Variable cost	2,00,000
Fixed cost	4,12,000	Fixed cost	1,00,000
Profit	4,88,000	Profit	12,500

Overall profit = 4,88,000 + 12,500 = Rs 5,00,500

(b) At 80% level (market price 5.60 and transfer price 6/-) (in Rs)

<i>Textile unit</i>		<i>Process house</i>	
Sale (2,50,000 × 5.6)	1400000		
(1,50,000 × 6.0)	900000		
	23,00,000		
Less			
Raw material (4,00,000 × 3)	12,00,000		
Variable cost (4,00,000 × 1.2)	4,80,000		
Fixed cost	4,12,000		
Profit	2,08,000	Profit [As in (a) above.]	1,17,500

Overall profit = 2,08,000 + 1,17,500 = Rs 3,25,500

(c) At 100% level at market price and transfer price (5.60) (in Rs)

Sale (5,00,000 × 5.6)	28,00,000	Sales (2,50,000/100 × 725)	18,12,500
Less		Less	
Raw material (5,00,000 × 3)	15,00,000	Transfer Price (2,50,000 × 5.6)	14,00,000
Variable cost (5,00,000 × 1.20)	6,00,000	Variable cost (2,500 × 80)	2,00,000
Fixed cost	4,12,000	Fixed cost	1,00,000
Profit	2,88,000	Profit	1,12,500

Overall profit = 2,88,000 + 1,12,500 = 4,00,500

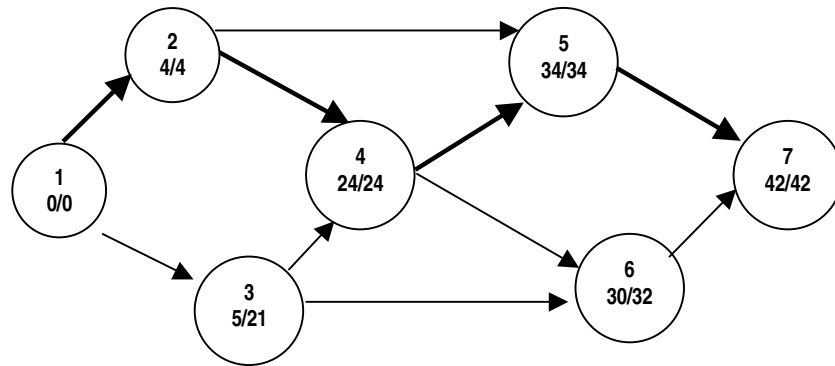
(ii) Comments on the profitability of processing house:-

	Transfer price (Rs)	Profit (Rs)
(a) 80% capacity	6.00	1,17,500
100% capacity	6.00	12,500
(b) 80% capacity	6.00	1,17,500
(c) 100% capacity	5.60	1,12,500

Processing house will not be interested to buy more than 1,50,000 meters from textile unit.

(b) The earliest expected completion time, latest allowable completion time and slack time for each event is:-

Event (i-j)	σ^2	t_e	Earliest start	Earliest finish	Latest start	Latest finish	Slack
1-2	2	4	0	04	0	4	0
1-3	3	5	0	5	16	21	16
2-4	01	20	4	24	4	24	0
2-5	10	20	4	24	14	34	10
3-4	2	3	5	08	21	24	16
3-6	4	8	5	13	24	32	19
4-5	4	10	24	34	24	34	0
4-6	2	6	24	30	26	32	2
5-7	1	8	34	42	34	42	0
6-7	8	10	30	40	32	42	2



The critical path is 1-2-4-5-7 = 42

Variance of project time $\sigma^2 = 2+1+4+1 = 8$

Therefore, $\sigma = \sqrt{8}$ and scheduled time $T_s = 38$

$$Z = \frac{38 - 42}{\sqrt{8}} = \frac{-4}{\sqrt{8}} = -1.41$$

From table on normal curve, the area of $Z = 1.41$ is given as 0.4207

Therefore the probability of completion of the project by the scheduled time = $(0.50 - 0.4207) = 7.93\%$

Question 6

- (a) What is Product Life-cycle Costing? Describe its characteristics and benefits. (5 marks)
- (b) A Marketing Manager has 4 subordinates and 4 tasks. The subordinates differ in efficiency. The tasks also differ in their intrinsic difficulty. His estimates of the time each subordinate would take to perform each task is given in the matrix below. How should the task be allocated one to one man so that the total man-hours are minimised?

(7 marks)

	I	II	III	IV
1	16	52	34	22
2	26	56	8	52
3	76	38	36	30
4	38	52	48	20

- (c) A company trading in motor vehicle spares wishes to determine the level of stock it should carry for the item in its range. Demand is not certain and replenishment of stock takes 3 days. For one item X, the following information is obtained: (7 marks)

Demand (unit per day)	Probability
1	.1
2	.2
3	.3
4	.3
5	.1

Each time an order is placed, the company incurs an ordering cost of Rs. 20 per order. The company also incurs carrying cost of Rs. 2.50 per unit per day. The inventory carrying cost is calculated on the basis of average stock.

The manager of the company wishes to compare two options for his inventory decision.

- A. Order 12 units when the inventory at the beginning of the day plus order outstanding is less than 12 units.
- B. Order 10 units when the inventory at the beginning of the day plus order outstanding is less than 10 units.

Currently (on first day) the company has a stock of 17 units. The sequence of random number to be used is 08, 91, 25, 18, 40, 27, 85, 75, 32, 52 using first number for day one.

You are required to carry out a simulation run over a period of 10 days, recommend which option the manager should choose.

Answer

(a) Product life cycle costing.

It is an approach used to provide a long-term picture of product line profitability, feedback on the effectiveness of the life cycle planning and cost data to clarify the economic impact on alternatives choices in the design, engineering phase etc. It is also considered as a way to enhance the control of manufacturing costs. It is important to track and measure costs during each stage of a product's life cycle.

Characteristics:-

- (i) Product life cycle costing involves tracing of costs and revenues of each product over the several calendar periods throughout their entire life cycle.
- (ii) Product life cycle costing traces research and design and development costs and total magnitude of these costs for each individual product and compared with product revenue.
- (iii) Report generation for costs and revenues.

Benefits: -

- (i) The product life cycle costing results in earlier actions to generate revenue or to lower cost than otherwise might be considered.
- (ii) Better decision should follow from a more accurate and realistic assessment of revenues and costs, at least within a particular life cycle stage.
- (iii) Product life cycle thinking can promote long-term rewarding in contrast to short-term profitability rewarding.
- (iv) It provides an overall framework for considering total incremental costs over the life span of a product.

(b)

	I	II	III	IV
1	16	52	34	22
2	26	56	8	52
3	76	38	36	30
4	38	52	48	20

Step 1:

Subtract the smallest element of each row from every element of the corresponding row

	I	II	III	IV
1	0	36	18	6
2	18	48	0	44
3	46	8	6	0
4	18	32	28	0

Step 2:

Subtract the smallest element of each column from every element in that column

	I	II	III	IV
1	0	28	18	6
2	18	40	0	44
3	46	0	6	0
4	18	24	28	0

Step 3:

Draw minimum number of horizontal and vertical lines to cover all the zeros

	I	II	III	IV
1	0	28	18	6
2	18	40	0	44
3	46	0	6	0
4	18	24	28	0

The optimal assignment is

1	•	I	=	16
2	•	III	=	8
3	•	II	=	38
4	•	IV	=	20

82 hours

Minimum time taken = 82 hours

(c) Allocation of random numbers

<i>Demand</i>	<i>Probability</i>	<i>Cumulative prob.</i>	<i>Random numbers</i>
1	.1	.1	00-09
2	.2	.3	10-29
3	.3	.6	30-59
4	.3	.9	60-89
5	.1	1.0	90-99

Option I

<i>Day</i>	<i>Random numbers</i>	<i>Opening Stock</i>	<i>Demand</i>	<i>Closing Stock</i>	<i>Order placed</i>	<i>Order in</i>	<i>Average stock</i>
1	08	17	1	16	-	-	16.5
2	91	16	5	11	12		13.5
3	25	11	2	09	-	-	10.0
4	18	09	2	07	-	-	8.00
5	40	07	3	04	-	12	5.50
6	27	16	2	14	-	-	15.0
7	85	14	4	10	12	-	12.00

8	75	10	4	06	-	-	8.00
9	32	6	3	3	-	-	4.50
10	52	3	3	-	-	12	1.50
							94.5

Carrying cost (94.5×2.50) = Rs.236.25

Ordering cost (2×20) = Rs. 40.00
Rs.276.25

Option 11

Day	Random no.	Opening Stock	Demand	Closing Stock	Order placed	Order in	Average stock
1	08	17	1	16	-	-	16.5
2	91	16	5	11	-	-	13.5
3	25	11	2	09	10	-	10.0
4	18	09	2	07	-	-	8.00
5	40	07	3	04	-	-	5.50
6	27	04	2	02	-	10	3.00
7	85	12	4	08	10	-	10.00
8	75	08	4	04	-	-	6.00
9	32	04	3	01	-	-	2.50
10	52	01	3	-	-	10	0.50
							75.5

Carrying cost (75.5×2.50) = Rs.118.75

Ordering cost (2×20) = Rs. 40.00
Rs.228.75

It can be noticed that there will be stock – out on the 10th day in option II. However, since there is no cost implication mentioned in the question for such stock –outs, option II appears to be better.

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) *"In On-line systems, conventional audit trail is difficult and almost impossible." Why? Explain the kind of audit techniques used in such system. (10 marks)*
- (b) *Define the following important terms in the light of the Section 2 of the I.T. Act, 2000 :*
- (i) *Affixing digital signature*
 - (ii) *Asymmetric crypto system*
 - (iii) *Computer network*
 - (iv) *Private and Public keys*
 - (v) *Secure system. (10 marks)*

Answer

- (a) Historically, auditors have placed substantial reliance in evidence-collection work on the paper trail that documents the sequence of events that have occurred within an information system. Paper based audit trails have been progressively disappearing as online computer-based systems have replaced manual systems and as source documents have given a way to screen based inputs and outputs. In a batch processing system, one can still expect to find a visible trail of "run-to-run " controls, which can be reconciled to the original input batch totals. In such systems, it is unusual to find any significant loss of audit trails regarding the control totals. In online systems, however, data are stored in device-oriented rather than human-oriented form. Moreover, data files belonging to more than one application may be updated simultaneously by each individual transaction. In such systems, traditional run-to-run controls do not exist and the potential for loss of audit trail is significant.

In a batch processing systems, the test data is prepared by an auditor for audit purposes and the results are obtained from the program under execution and copy of relevant files. The results are compared with the predetermined correct outputs. Any discrepancies indicating processing errors or control deficiencies etc. are thoroughly investigated. In on-line systems, such kind of audit trail is not desirable since millions of transactions can be processed in a short time. In such cases, evidence gathered after data processing is insufficient for audit purposes. In addition, since many on-line systems process transactions continuously, it is difficult or impossible to stop the system in order to perform audit tests. Hence, the auditor needs to identify problems that can occur in an information system on a more timely basis. For this reason, a set of audit techniques has been developed to collect evidence at the same time as an application system undertakes processing of its production data.

Following are some of the audit techniques, which are being used for on-line systems :

- (A) **Concurrent Audit Techniques:** These techniques can be used to continually monitor the system and collect audit evidence while live data are processed during regular operating hours. As the name suggests, this type of audit technique uses embedded audit modules, which are segments of program codes that perform audit functions. They also report test results to the auditors and store the evidence collected for the auditor's review. These techniques are often time consuming and difficult to use, but are less so, if incorporated when programs are developed.

There are five such techniques, which auditors commonly use. These are :

- (i) **Integrated Test Facility (ITF) :** In this technique, a small set of fictitious records is placed in the master file. Processing test transactions to update these dummy records will not affect the actual records. Actual and fictitious records are concurrently processed together, without the knowledge of employees. Auditor compares the output of dummy records with expected results and its controls to verify the correctness of the system.
- (ii) **Snapshot Technique :** This technique examines the way transactions are processed. Selected transactions are marked with special code that triggers the snapshot processes. Audit modules in the program record these transactions and their master file records before and after processing. Snapshot data are recorded in a special file and reviewed by the auditor to verify that all processing steps have been properly executed.
- (iii) **SCARF :** System Control Audit Review File uses embedded audit modules to continuously monitor transaction activities and collect data on transactions with special audit significance. The data is recorded in a SCARF file, which may have been exceptional transactions. Periodically the auditor receives a print out of the SCARF file, examines the information to identify any questionable transactions, and performs any necessary follow up investigation.
- (iv) **Audit Hooks :** These are audit routines that flag suspicious transactions. When audit hooks are employed, auditors can be informed of questionable transactions as soon as they occur. This approach, known as "real-time notification", displays a message on the auditor's terminal.
- (v) **CIS :** Continuous and intermittent simulation embeds an audit module in a DBMS. This module examines all transactions that update the DBMS using criterion similar to those of SCARF. If a transaction has special audit significance, the module independently processes the data, records the results and compares them with those obtained by the DBMS. Discrepancies are noted and details are investigated.

- (B) **Analysis of program logic:** If a serious natured unauthorized code is found, the auditor goes for detailed analysis of the program logic. This is a difficult task and

the auditor must be well versed with the programming language. These days following software packages serve as aids in this analysis.

- Automated flowcharting programs
- Automated decision table programs.
- Scanning Routine.
- Mapping Programs.
- Program tracing.

(b) The definition of important terms according to Section 2 of the Information Technology Act, 2000 is as under:

- (i) **“Affixing digital signature”** with its grammatical variation and cognate expressions means adoption of any methodology or procedure by a person for the purpose of authenticating an electronic record by means of digital signature.
- (ii) **“Asymmetric crypto system”** means a system of a secure key pair consisting of a private key for creating a digital signature and a public key to verify the digital signature.
- (iii) **“Computer network”** means the interconnection of one or more computers through –
 - (a) the use of satellite, microwave, terrestrial line or other communication media; and
 - (b) terminals or a complex consisting of two or more interconnected computers whether or not the interconnection is continuously maintained.
- (iv) **“Private and public keys”** refer to a key pair used in an asymmetric crypto system. Private key means the key used to create a digital signature whereas public key is used to verify the same and is listed in the Digital Signature Certificate.
- (v) **“Secure system”** means computer hardware, software and procedures that
 - are reasonably secure from unauthorized access and misuse;
 - provide a reasonable level of reliability and correct operation;
 - are reasonably suited to performing the intended functions; and
 - adhere to generally accepted security procedures.

Question 2

- (a) *What are the production information requirements of a GM (Production and Operations Management) with regard to production planning and control ?* (10 marks)
- (b) *What are the variables that the top management should consider during negotiations with the labour unions?* (5 marks)

- (c) *Successful executives take decisions relying more on intuition than on any quantitative analytical decision technique. Mention five characteristics of the types of information that are responsible for this phenomenon in executive decision-making. (5 marks)*

Answer

- (a) The production planning and control system involves two main procedures: the specification of materials and operations requirements and production scheduling. The information requirements of a GM for the materials and operations phase of any organisation are as stated below:

- (i) Firm's policy with regard to production of various products.
- (ii) Sales order, sales forecast, stock position, order backlog.
- (iii) Available labour force with their capabilities
- (iv) Standards of labour time, material, machine time and overhead cost etc.
- (v) Schedule of meeting the sales orders, region-wise, territory-wise etc.
- (vi) Quality norms for materials to be used and for the finished products.
- (vii) Break-up of the jobs and their resource requirements.

Planning the specific time at which product items should be manufactured is known as production scheduling. The information is required by the production-scheduling department so as to meet the following objectives:

- (i) to determine the stages of production in sequential and rational order;
- (ii) to minimise the idle time on the part of the operators and equipments;
- (iii) to assess the extent of need for subcontracting to outside parties;
- (iv) to ensure that completion dates and target dates of completing the production plans are met fully; and
- (v) to study alternative methods to performing the activities so that time taken to perform can be further reduced.

- (b) Many types of labour today are unionized. Unionized organisations usually have strict regulations regarding such items as pay scales, hiring and firing, promotions and working conditions. Management has the choice of trade – offs on the following variables during negotiations with the labour unions

- (i) Wage raise
- (ii) Paid holidays
- (iii) Contribution to employees, insurance and pension plan
- (iv) Overtime premiums.

Cost accountants/payroll accountants would be in the best position to make various estimates for the cost implication of trade off.

- (c) It is true that to a large extent, executives rely much more on their own intuition, gut feelings and past experience rather than on sophisticated analytical skills. The type of decisions that the executives must make is broad. Often, executives make these decisions based on a vision they have regarding what it will take to make their companies successful. The intuitive character of executive decision-making is reflected strongly in the types of information found most useful to executives.

Five characteristics of the types of information used in executive decision-making are discussed below:

- (i) **Lack of structure:** Many of the decisions made by executives are relatively unstructured. For instance, what general direction should the company take? Or what type of advertising campaign will best promote the new product line? These types of decisions are not so clear-cut as deciding how to debut a computer program or how to deal with an overdue account balance. Also, it is not always obvious which data are required or how to weigh available data when reaching at a decision.
- (ii) **High degree of uncertainty:** Executives work in a decision space that is often characterized by lack of precedent. For example, when the Arab oil embargo hit in the mid-1970s, no such previous event could be referenced for advice. Executives also work in a decision space where results are not scientifically predictable from actions. If prices are lowered, for instance, product demand will not automatically increase.
- (iii) **Future orientation:** Strategic-planning decisions are made in order to shape future events. As conditions change, organisations must also change. It is the executive's responsibility to make sure that the organisation keeps pointed toward the future. Some key questions about the future include: "How will future technologies affect what the company is currently doing? Where will the economy move next, and how might that affect consumer buying patterns? As one can see, the answers to all of these questions about the future external environment are vital.
- (iv) **Informal source:** Executives rely heavily on informal source for key information. For example, lunch with a colleague in another firm might reveal some important competitor strategies. Some other important information sources of information are meetings, tours around the company's facilities to chat with employees, brainstorming with a trusted colleague or two, and social events. Informal sources such as television might also feature news of momentous concerns to the executives.
- (v) **Low level of detail:** Most important executive decisions are made by observing broad trends. This requires the executive to be more aware of the large overviews than the tiny items. Even so, many executives insist that the answers to some questions can only be found by mucking through details.

Question 3

- (a) *Define a 2-tier and a 3-tier architecture.* (2 marks)
- (b) *What are the control techniques to be checked to ensure security for client/server technology?* (8 marks)
- (c) *Describe four categories of risks that are to be considered during the transition from the mainframe (or PC) to client/server.* (10 marks)

Answer

- (a) **2-tier and 3-tier architecture:** 2-tier refers to fat clients and 3-tier refers to fat servers in a client/server architecture. Fat client and fat-server serve as vivid descriptions of the type of client/server systems in place. In a fat-client system, more of the processing takes place on the client, like with a file server or database server. Fat-servers place more emphasis on the server and try to minimise the processing done by the clients. Examples of fat-servers are transaction, Groupware, and the web servers.
- (b) To increase the security for client / server technology, an IS auditor should ensure that the following control techniques are in place:
- ♣ Access to data and application is secured by disabling the floppy disk drive.
 - ♣ Diskless workstation prevents unauthorized access.
 - ♣ Unauthorized users may be prevented from overriding login scripts and access by securing automatic boot or startup batch files.
 - ♣ Network monitoring can be done to know about the client so that it will be helpful for later investigation, if it is monitored properly. Various network-monitoring devices are used for this purpose. Since this is a detective control technique, the network administrator must continuously monitor the activities and maintain the devices, otherwise these tools become useless.
 - ♣ Data encryption techniques are used to protect data from unauthorized access.
 - ♣ Authentication systems can be provided to a client, so that they can enter into system, only by entering login name and password.
 - ♣ Smart cards can be used. It uses intelligent hand-held devices and encryption techniques to decipher random codes provided by client-server based operating systems. A smart card displays a temporary password based on an algorithm and must be re-entered by the user during the login session for access onto the client-server system.
 - ♣ Application controls may be used and users will be limited to access only those functions in the system that are required to perform their duties.

(c) There are risks involved in the transition from mainframe (or PC) to client/server. These risks can be classified into four categories as discussed below:

- (i) **Technological Risk:** The technological risk is quite simple- Will the new system work? The short-term aspect of this question is -will it literally work? But more important aspect of the risk is that in the long run the system may grow obsolete. That it will become obsolete is probably inevitable thus the question becomes-how soon will it become obsolete. To resolve this issue, the firm and the IT consultant/division should understand system standards and market trends and use them in their decision making processes while deciding what system to incorporate into their organisation.
- (ii) **Operational Risks:** These risks parallel the technological risks in both the short and long run. Respectively, they are: will the organisation achieve the performance it needs from the new technology and will the software that it chooses be able to grow or adapt to the changing needs of the business. Once again sound planning and keeping an eye to the future are the only remedies for these risks.
- (iii) **Economic Risks:** In the short run, firms are susceptible to hidden costs associated with the initial implementation of the new client/server system. Cost will rise in the short term since one needs to maintain the old system (mainframe) and the new client server architecture development. In the long run, the concern centres around the support costs of the new system.
- (iv) **Political Risks:** Finally, political (people) risks involved in this transition are addressed. Here, the short-term question is-will end users and management be satisfied? The answer to this is definitely not if the system is difficult to use or is plagued with problems.

The long run question concerns costs, unless the mainframe is completely replaced, the total cost of transaction processing for the organisation as a whole goes up and this creates political problems.

Question 4

- (a) *List the various sources of acquiring the software.* (5 marks)
- (b) *Discuss four most compelling advantages of using a pre-written application package* . (5 marks)
- (c) *"The final step of the system implementation is its evaluation." What functions are being served by the system evaluation? Discuss development, operation and information evaluations.* (10 marks)

Answer

- (a) Once the computer hardware is decided, the question of software acquisition becomes important for the management. Some system software is supplied by the manufacturer, which may make a significant difference if it contains a package of special applicability to the job envisaged. Different sources for software acquisition are explained below:

- (i) At the time of selection of hardware, it should be identified which manufacturer supplies general/particular software.

It has been observed that all manufacturers supply general software packages for LP, PERT etc. and packages for such commercial applications as inventory control and production planning etc. A few manufacturers also offer packages specially designed for a particular industry such as airline reservation, banking and insurance.

- (ii) After deciding user outputs and input designs, the system developer may decide to create the software in-house i.e. a 'make decision'.
 - (iii) At this stage, the decision may be taken to acquire the software from the vendor. This decision is often called the 'buy decision'. In market, several pre-packaged application software in many business functions, including accounting, general ledger etc. are available. Therefore, they could be directly purchased, and personnels be trained to start the work immediately.
 - (iv) Computer manufacturers, large and small software houses and computer retail stores are some of the sources from where software packages can be purchased.
 - (v) There are user groups or association of users of a particular computer system, which are the sources of packaged software. These softwares are developed by one member organisation and made available to other members.
- (b) **Advantages of Pre-written Application Packages:** The four most compelling advantages of using pre-written application packages are summarized below:
- (i) **Rapid implementation:** Application packages are readily available to implement after they are purchased. In contrast, software developed in-house may take months or even years until it is ready for implementation.
 - (ii) **Low risk:** Since the application package is available in the finished form, the organisation knows what it is going to get for the price it has paid. With in-house developed software, the long development time breeds uncertainty with regard to both the quality of the final product and its final cost.
 - (iii) **Quality:** The firms engaged in application package developments are typically specialist in their products' niche area. Generally, they have a lot of experience in their specialized application field and hence can provide better software. In contrast, in-house programmers often have to work over a wide range of application areas; they may not be possessing expertise for undertaking proposed software development.
 - (iv) **Cost:** Software vendors can leverage the cost of developing a product by selling the product to several other firms, thereby realizing a lower cost from each application user. Thus, a pre-written application package generally costs less than an in-house developed package. In addition, many hidden costs are faced by organisations that want to develop applications in-house. Hence, application

packages, sometimes, turn out to be cheaper compared to in-house developed software.

(c) **Evaluation of the new system:** The final step of the system implementation is evaluation. Evaluation provides the feedback necessary to assess the value of information and the performance of personnel and technology included in the newly designed system. This feedback serves two functions:

1. It provides information as to what adjustments to the information system may be necessary.
2. It provides information as to what adjustments should be made in approaching future information system development projects.

There are two basic dimensions of information systems that should be evaluated. The first dimension is concerned with whether the newly developed system is operating properly. The other dimension is concerned with whether the user is satisfied with the information system with regard to the reports supplied by it.

Development evaluation: Evaluation of the development process is primarily concerned with whether the system was developed on schedule and within budget. This is a rather straightforward evaluation. It requires schedules and budgets to be established in advance and that record of actual performance and cost be maintained. It may be noted that very few information systems have been developed on schedule and within budget. In fact, many information systems are developed without clearly defined schedules or budgets. Due to the uncertainty and mystique associated with system development, they are not subjected to traditional management control procedures.

Operation evaluation: The evaluation of the information system's operation pertains to whether the hardware, software and personnel are capable to perform their duties and they do actually perform them so. Operation evaluation answers such questions:

1. Are all transactions processed on time?
2. Are all values computed accurately?
3. Is the system easy to work with and understand?
4. Is terminal response time within acceptable limits?
5. Are reports processed on time?
6. Is there adequate storage capacity for data?

Operation evaluation is relatively straightforward if evaluation criteria are established in advance. For example, if the systems analyst lays down the criterion that a system which is capable of supporting one hundred terminals should give response time of less than two seconds, evaluation of this aspect of system operation can be done easily after the system becomes operational.

Information evaluation: An information system should also be evaluated in terms of information it provides. This aspect of system evaluation is difficult and it cannot be

conducted in a quantitative manner, as is the case with development and operation evaluations. The objective of an information system is to provide information to support the organizational decision system. Therefore, the extent to which information provided by the system is supportive to decision making is the area of concern in evaluating the system. However, it is practically impossible to directly evaluate an information system's support for decision-making in an organisation. It must be measured indirectly. User satisfaction can be used as a measure to evaluate the information provided by an information system. Measurement of user satisfaction can be accomplished using the interview and questionnaire technique. If management is generally satisfied with an information system, it is assumed that the system is meeting the requirements of the organization. If management is not satisfied, modifications ranging from minor adjustments to complete redesign may be required.

Question 5

- (a) *Write a detailed note on the expectations, fears and the ground realities that a corporate management faces during the post-implementation phase of ERP.* (10 marks)
- (b) *What do you understand by ON-LINE, REAL-TIME SYSTEMS ?* (5 marks)
- (c) *For an On-line, Real-time sales order processing system, draw the systems flow chart.* (5 marks)

Answer

- (a) Most of the post-implementation problems of ERP can be traced to wrong expectations and fears. Sometimes it is also due to the ERP vendors and their pre-implementation sales hype. Popular expectations are :
 - An improvement in processes,
 - Increased productivity on all fronts,
 - Total automation and disbanding of all manual processes,
 - Improvement of all key performance indicators,
 - Elimination of all manual record keeping,
 - Real time information system available to concerned people on a need basis,
 - Total integration of all operations.

ERP software attempts to integrate all departments and functions across the enterprise onto a single computer system that serves the individual requirements of different departments. Instead of having discreet systems for finance and HR, it provides a common system for all. So if required, the materials department can view pending orders and instantly calculate the quantity of raw materials to be purchased. This keeps inventory levels within safe limits and hence controls costs. While all this may sound like a silver bullet to enterprises, ERP has gone sour for many companies in the past. The

problems have been primarily with integration. Also, the software required people to change their business processes too drastically.

An ERP implementation impacts people, systems, and the organization as a whole and barriers are expected from these areas since work processes are expected to be altered when ERP is introduced. Business processes, roles, and responsibilities undergo change. And when this happens, the organizations encounter a sticky issue called 'resistance to change'.

In the evaluation stage, users should articulate their business requirements and see whether a particular ERP solution meets their needs. This way one can close the gap between what the package offers and the business requirements. Implementation should not begin without this. Often, employees have high expectations and think ERP will solve most business problems. It is necessary to make realistic and accurate expectations before embarking on an ERP project. This is addressed by preparing a project charter stating the realistic expectations, and key performance parameters to be focused on during the project, and project measurement. Having defined this, it is necessary to communicate this to the stakeholders in the ERP project.

Some of the fears on ERP implementations are :

- Job redundancy.
- Loss of importance as information is no longer an individual prerogative.
- Change in job profile:
- An organizational fear of loss of proper control and authorization.
- Increased stress caused by greater transparency.
- Individual fear of loss of authority.

Since ERP introduces transparency in operations and brings about more discipline, people who are empowered are bound to oppose it. People who are very used to a particular system or a certain set of processes, would not accept an alternative like ERP so easily and would not adapt to the new system. Change management is about handling the issues arising due to differences in legacy processes/ systems and the new ERP system. Business processes may have to be re-engineered for ERP, something that is bound to draw disapproval, especially from function heads.

Balancing the expectations and fears is a very necessary part of the implementation process. The ground realities are:

- Changing the organization involves three levers-strategies, business process and change, and consequential organization change.
- In most companies in India, many process related key performance indicators have not been measured till now, either because the company did not feel it necessary or lacked the tools to do so. Measuring such indicators brings in new culture.

- The genetic nature of the ERP packages is such that there would be processes peculiar to some sectors and organizations, which may have to be kept out of the process.
- Some of the processes are better done manually.

ERP should be treated as a business project—not an IT project driven by the Information Systems. Changing the organization requires mindset change. Without a willingness to change, it would be a classic case of an old organization plus new technology leading to an expensive old organization. So, it is important to get the involvement of the function heads and top business executives. An organization must also be prepared for ERP and be clear about its requirements. This necessitates knowing the business objectives and goals, and mapping the processes to these. ERP is just the enabler that automates the entire process. The objectives for ERP must also be identified, documented, and communicated.

A successful ERP implementation is not the end of the road as far as change is concerned, and continuous improvements are required to reap the benefits. The expectations, fears and reality can most obviously be balanced during the process of implementation itself.

- (b) An **on-line real time (OLRT)** system processes a transaction as soon as it is entered. Practically, no delays occur during computer processing. The transaction recording and entry system may be created at the point of sale (POS) in the machine-readable form and entered directly into the computer. A system can be fully automated, and even the delay in entering the transaction could be eliminated.

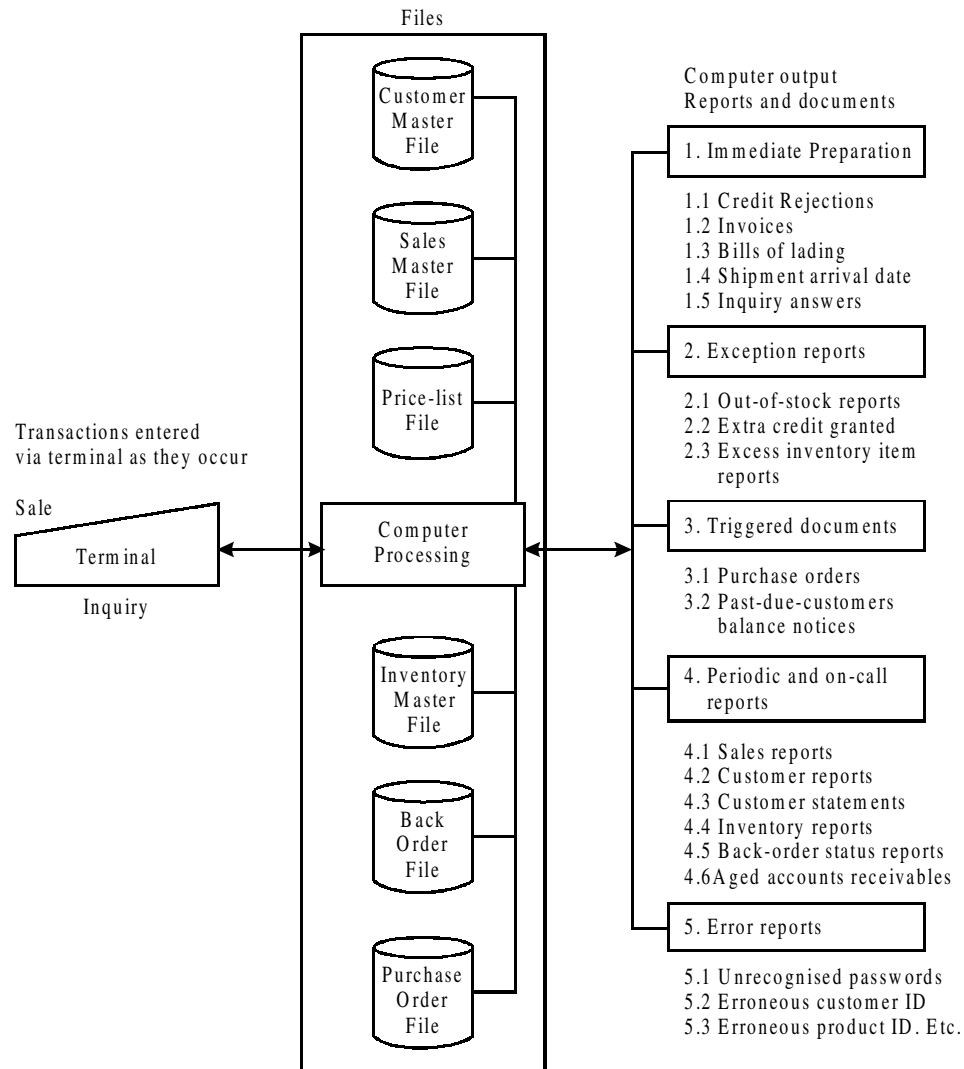
In an OLRT system, all files of the sub-systems related with a particular type of transaction processing must be electronically connected to the computer when a transaction of that type is entered into the machine. Generally, the files of an OLRT system reside on magnetic disks.

The OLRT systems operate (processing) entirely in a different manner compared to BATCH systems. In Batch systems, the transactions for a pre-defined period say a day, a week or a month are collected and then processed in one go. Whereas in OLRT systems, transactions are processed as and when they are created. These days, even the transactions can be created on telephone lines; e-mails, faxes etc. and the processing takes place without losing any time.

OLRT systems are very useful for enquiries. In Bank applications, the customer may be interested to know about the balance of his account, which may be either known through a telephone or directly by a machine, after entering few details.

In an OLRT system, there may be few user-input controls. Extensively programmed edit and logging controls are required to protect the computer files from erroneous or unauthorized transactions. It is also essential for important printed reports, such as control reports, exemption reports, or summaries, to be carefully reviewed by a user department employee who is not responsible for entering transactions.

(c) The system flow chart for an On-line, Real-time Sales order processing system is drawn as under:



Question 6

- (a) *Substantiate with reasons to the view that there is a steep rise in the Internet Computer fraud. Why many institutions are unable to contain it ?* (5+5 = 10 marks)
- (b) *Give an example of an Information Security Policy Statement.* (10 marks)

Answer

- (a) There is no doubt that there has been a steep rise in the **Internet computer frauds**. This is mainly due to a number of characteristics of Internet, which are likely to attract fraudsters to commit frauds.
- (i) It is unregulated in so far as who may set up a site. No license fees are payable to any central authority and no form of vetting is, or in practical terms ever could be, carried out on those persons or entities setting up sites.
 - (ii) An Internet site can be set up anywhere in the world at very low cost and can be reached from anywhere else in the world at low cost.
 - (iii) An impressive site with links to established companies or financial institutions may be more than an empty shell designed to attract and trap the unwary. There is no easy way of separating the genuine from the false.
 - (iv) The glamour and novelty of the Internet and the spurious credibility claimed by a site may cause otherwise prudent investors to become involved in fraudulent schemes.
 - (v) A site may, and probably will, operate outside the legal jurisdiction of the country in which the victim of the fraud resides.

The above factors make it extremely difficult to discover, in sufficient time to effect recovery or at all, the identity of the WWW Site operator.

Frauds on the Internet are proliferating as is evident by the examples released in the press.

- (i) The offices of a small Illions company created the Agency for Inter-American Finance on the WWW in late 1995. The WWW site boasted impressive graphics and was linked to the Internet by a Swiss Internet Service provider. AIF claimed to be based in Antigua and that it was a provider of investment capital for Latin American businesses. Later investigation revealed that AIR was a Panamanian shell company, and that the bond and guarantor were fake.
- (ii) "Fortuna Alliance" offered investors a return of \$5,000 per month for an investment of \$250. The USFTC began an investigation against this company for this improbable scheme. But then the investors had already lost \$6 million before FTC blocked access to the site.
- (iii) European Union Bank, which traded over the Internet, collapsed.

These are some common examples of Internet frauds:

- **Overpayment Scam:** In this very common scam type, a buyer will contact the seller and negotiate a deal on the merchandise. Many times, this buyer is located outside the country, and may be acting as a "broker" or a "third party" on behalf of another interested party. The buyer will send a cashier's cheque (or money order) for more than the asking price of the merchandise. The buyer will instruct the seller to send the difference for the overpayment. Unfortunately, the cashier's cheque or money order used to originally pay the buyer is counterfeit and will be returned to the seller with insufficient funds. The seller is then cheated out of his or her own cash, plus any merchandise that was sent.
- **Wire Fraud:** In this scam, the buyer will request permission to wire transfer money directly into the seller's bank account. By providing confidential bank account information to the buyer, seller's account may be compromised by unscrupulous parties. Companies should always use caution when providing any form of personal information.
- **Customs Scams:** There are recent reports from the IFCC involving Eastern European countries and high incidences of fraud. Many of the fraudulent buyers of items are located in these countries and often ask that the seller to ship in a manner that will avoid customs or taxes. Sellers should be wary of this type of behavior.

Even though there is an increase in Internet computer frauds, not many are reported for various reasons and many companies are unable to contain it due to following reasons:

- (i) Not everyone agrees on what constitutes computer fraud.
 - (ii) Many computer frauds go undetected.
 - (iii) 80-90% of the frauds data that are uncovered are not reported. Only the banking industry is required by law to report all frauds.
 - (iv) Most networks have a low level of security. It is estimated that two out of three sites have serious vulnerabilities, and most firewalls and other protective measures at the sites are ineffective.
 - (v) Many Internet pages give step-by-step instructions on how to perpetrate computer frauds and abuses. There are also thousands of pages on how to break into routers and disable web servers.
 - (vi) Law enforcement is unable to keep up with the growing number of computer frauds.
- (b) The purpose of the information security policy is to protect the organization's information assets from all types of threats, whether internal or external, deliberate or accidental. Information system security is critical to the organisation's survival.

A typical Information Security Policy Statement should ensure that

- ◆ Assets will be classified as to the level of protection required;
- ◆ Information will be protected against unauthorized access;

- ◆ Confidentiality of information will be assured;
- ◆ Integrity of information will be maintained;
- ◆ Personnel security requirements will be met;
- ◆ Physical, logical and environmental security (including communications security) will be maintained;
- ◆ Legal, regulatory, and contractual requirements will be met;
- ◆ Systems development and maintenance will be performed using a life cycle methodology;
- ◆ Business continuity plans will be produced, maintained, and tested;
- ◆ Information security awareness training will be provided to all staff;
- ◆ All breaches of information system security, actual or suspected, will be reported to, and promptly investigated by Information Systems Security;
- ◆ Violations of Information Security Policy will result in penalties or sanctions;
- ◆ Standards, practices, and procedures will be produced, and measures implemented to support the Information Security Policy. These may include, but are not limited to, virus protection, passwords, and encryption;
- ◆ Business requirements for the availability of information and information systems will be met;
- ◆ The roles and responsibilities regarding information security are defined for:
 - Executive management;
 - Information systems security professionals;
 - Data owners;
 - Technology providers;
 - Users;
 - Information systems auditors.
- ◆ The Information Systems Security function has direct responsibility for maintaining the Information Security Policy and providing guidance and advice on its implementation;
- ◆ All managers are directly responsible for implementing the Information Security Policy within their areas of responsibility, and for adherence by their staff; and
- ◆ It is the responsibility of each employee to adhere to the Information Security Policy.

Question 7

Write short notes on the following:

- (a) *Strategic and Tactical decisions*
- (b) *Business Process Re-engineering*
- (c) *Encryption*
- (d) *System Development Life-cycle.* (4×5 = 20 marks)

Answer

- (a) **Strategic and Tactical Decisions:** Decisions made at the strategic level of the organization to handle problems critical to its survival and success are called strategic decisions. They have a vital impact on the direction and functioning of the organization. Some of the examples are decision on plant location, introduction of new products, making major new fund – raising and investment operations, adoption of new technology etc. Much analysis and judgment go into making strategic decisions. Strategic decisions are made under conditions of partial knowledge and generally can not be programmed.

Tactical level decisions are to be taken by middle level of managerial hierarchy. At this level, managers plan, organize, lead and control the activities of other managers. A single strategic decision calls for a series of tactical decisions, which are of a relatively structured nature. Tactical decisions are relatively short, step-like spot solutions to breakdown strategic decisions into implementable packages.

The other features of tactical decisions are; they are more specific and functional; they are made in a relatively closed setting; information for tactical decisions is more easily available and digestible; they are less surrounded by uncertainty and complexity; decision variables can be forecasted and quantified without much difficulty and their impact is relatively localized and short-range. Tactical decisions are made with a strategic focus.

The distinction between strategic and operational decisions could be high-lighted by means of an example. Decisions on mobilisation of military resources and efforts and on overall deployment of troops to win a war are strategic decisions. Decisions on winning a battle are tactical decisions.

As in the case of programmed and non-programmed decisions, the dividing line between strategic and tactical decision is thin. For example, product pricing is tactical decision in relation to the strategic decision of design and introduction of a new product in the market. But product pricing appears to be a strategic decision to down-line tactical decisions on dealer discounts.

- (b) **Business Process Reengineering (BPR):** ERP is a result of a modern Enterprise's concept of how the Information System is to be configured to the challenging environments of new business opportunities. However, merely putting in place an information system is not enough. Every company that intends to implement ERP has to re-engineer its processes in one form or the other. This process is known as Business

Process Reengineering (BPR). BPR is the fundamental rethinking and radical redesign of processes to achieve dramatic improvement in critical, contemporary measure of performance such as cost, quality, service and speed.

Radical Redesign means BPR is reinventing and not enhancing or improving. According to BPR philosophy, whatever was being done in past, it was all wrong, so one has to reassemble the new system to redesign it afresh. There is no point in simplifying or automating a business process, which does not add any value to the customer; such business processes should be eliminated altogether.

BPR aims at major transformation of the business processes to achieve dramatic improvement. Here, the business objectives of the enterprise such as profits, customer – satisfaction through optimal cost, quality, deliveries etc. are achieved by transformation of the business processes which may, or may not, require the use of IT.

The concept of BPR when merges with the concept of IT, the business engineering emerges, which is the rethinking of Business Processes to improve speed, quality and output of materials or services. In other words, business engineering is the method of development of business processes according to changing requirements.

- (c) **Encryption:** Encryption refers to conversion of data into a secret code for storage in databases and transmission over networks. The sender uses an encryption algorithm to convert the original message called clear text into a coded equivalent called cipher text. At the receiving end, the cipher text is decoded (decrypted) back into clear text. The encryption algorithm uses a key, which is a binary number that is typically from 56 to 128 bits in length. The more bits in the key, the stronger the encryption method. Today, nothing less than 128 bit algorithms are considered truly secure. Two general approaches to encryption are private key and public key encryption.

Private Key Encryption: Data encryption standard (DES) is a private-key encryption technique designed in the early 1970s by IBM. The DES algorithm uses a single key known to both the sender and the receiver of the message. To encode a message, the sender provides the encryption algorithm with the key, which is used to produce a cipher text message. The message enters the communication channel and is transmitted to the receiver's location, where it is stored. The receiver decodes the message with a decryption program that uses the same key employed by the sender.

Public Key Encryption: The public key encryption technique uses two different keys: one for encoding messages and the other for decoding them. Each recipient has a private key that is kept secret and a public key that is published. The sender of a message uses the receiver's public key to encrypt the message. The receiver then uses his or her private key to decrypt the message. Users never need to share their private keys to decrypt messages, thus reducing the likelihood that it may fall into the hands of criminal.

- (d) **System Development Life Cycle:** The process of system development starts when management realise that a particular business needs improvement. The system

development life cycle method can be thought of as a set of activities that analysts, designers and users carry out to develop and implement an information system.

The system development life cycle method consists of the following activities:

- (i) **Preliminary investigation:** It is undertaken when users come across a problem or opportunity and submit a formal request for a new system to the MIS department. This activity consists of three parts; request clarification, feasibility study and request approval.
- (ii) **Requirements analysis or systems analysis:** In this stage, the analysts work closely with employees and managers of the organization for determining the information requirements of the users. Several fact-finding techniques and tools such as questionnaires, interviews, observing decision-maker behaviour and office environment, etc. are used for understanding the requirements of the users. As details are gathered, the analysts study the present system to identify its problems and shortcomings and identify the features which the new system should include to satisfy the new or changed user application environment.
- (iii) **Design of the system:** It produces the details that state how a system will meet the requirements identified in the previous step. The analyst designs various reports/outputs, data entry procedures, inputs, files and database. He also selects file structures and data storage devices. These detailed design specifications are then passed on to the programming staff for software development.
- (iv) **Acquisition and development of software:** In this stage, resource requirements such as specific type of hardware, software and services are determined. Subsequently, choices are made regarding which products to buy or lease from which vendors. Software developers may modify and then install purchased software or they may write new custom designed programs.
- (v) **System testing:** Before the information system can be used, it must be tested. Special test data are input for processing, and results are examined. If it is found satisfactory, it is eventually tested with actual data from the current system.
- (vi) **Implementation and maintenance:** After system is found to be fit, it is implemented with actual data. After implementation, the system is maintained; it is modified to adapt to changing users and business needs.

The Suggested Answers for Paper 7: Direct Taxes are based on the provisions applicable for A.Y.2004-05, which is the assessment year relevant for November 2004 exams.

PAPER – 7 : DIRECT TAXES

*Answer **all** questions*

Question 1

A & Co. Limited, engaged in the business of manufacturing, shows a net profit of Rs.65.00 lacs for the financial year ended 31-3-2004. A scrutiny of the Profit & Loss Account revealed the following:

- (i) Rent of Rs.2.40 lakhs from a commercial property owned by the company and let to a bank was included in the profit.*
- (ii) Loss of Rs.5 lakhs due to non-realisation of advances given to a wholly owned subsidiary Company engaged in the business of hire-purchase financing charged to Profit & Loss Account.*
- (iii) The Company used to include interest cost in valuation of its finished stock upto the financial year 2002-03. During the financial year 2003-04 the Company changed its accounting policy to adopt AS-2 (Valuation of Inventories) issued by the ICAI and excluded interest cost in valuation of finished stock. This has resulted in a decrease in the year's profit by Rs.15.40 lacs.*
- (iv) Municipal taxes on commercial property debited Rs.0.22 lacs, which were ultimately paid on 1-12-2004.*
- (v) The Company has received equity shares of AB Ltd. valued at Rs.1.25 lacs in exchange of equity shares of CD Ltd. in a scheme of amalgamation during the year. The shares in CD Ltd. were acquired in 1998-99 at a cost of Rs.0.40 lacs. The surplus has been credited to Profit & Loss account. Both AB and CD are Indian companies.*
- (vi) An executive, while on business trip abroad, died and gratuity paid voluntarily amounted to Rs.6.00 lacs.*
- (vii) As restructuring of its debt, the company has converted arrears of interest of Rs.5.00 lakhs on term loan into a new term loan with a revised repayment schedule. The company has paid Rs.0.50 lac towards such funded interest during the year.*
- (viii) Legal charges in connection with alteration of the Articles of Association Rs.1.50 lacs and for issue of bonus shares Rs.5.00 lacs.*
- (ix) The company has purchased scrap materials amounting to Rs.0.60 lacs, the payment for which was made in cash on 15th August, 2003.*
- (x) The profit, as shown above, includes Rs.5.00 lacs received from a Foreign Government for use of company's product. This was, however, not brought into India.*

Compute the net income of the company for the assessment year 2004-05 clearly indicating the basis of treatment of each item.
(16 marks)

Answer**Computation of net income of A & Co. Ltd. for the A.Y. 2004-2005**

Particulars	Rs. in lacs
I. Income from House Property (Working Note 1)	1.68
II. Profits and gains of business or profession (Working Note 2)	71.47
Gross Total Income	73.15
Less: Deduction under Chapter VI-A	-
Total Income	73.15

Working Note 1**Computation of income from house property**

Gross annual value (See Note 3 below)	2.40
Less: Municipal taxes are not allowable as deduction since they were not paid in the previous year.	-
Net Annual Value (NAV)	2.40
Less: 30% of NAV	0.72
Income from house property	1.68

Working Note 2**Computation of income under the head "Profits and gains of business or profession".**

Net profit as per profit and loss account	65.00
Add: Inadmissible expenditure	
(i) Loss on non-realization of advance to wholly owned subsidiary company does not arise in the normal course of business, since the wholly owned subsidiary company is engaged in providing finance to other borrowers. As far as A&Co. is concerned, its business is manufacturing and not financing. Hence, loss is to be disallowed.	5.00
(ii) Municipal taxes on commercial property is not allowable as deduction under this head of income.	0.22
(iii) Legal expenses of Rs 1.50 lacs for amendment of Articles of Association is an allowable expenditure. [Allahabad High Court in <i>CIT vs Modi Spinning & Weaving Mills Co Ltd. (1973) 89 ITR 304</i>].	-

However, the same paid in connection with the issue of bonus shares is a capital expenditure and hence not allowable. [*India Cements Ltd. vs CIT (1966) 60 ITR 52(SC)*]

	5.00	10.22
		75.22
Less: Admissible deductions and income not taxable/considered separately		
(i) Rent of commercial property let out on rent to a bank. This is taxable under the head "Income from House Property" and has been considered separately.	2.40	
(ii) Surplus on exchange of shares on amalgamation of companies – (See note 2 below)	0.85	
(iii) Interest on term loan should have been disallowed under section 43B in the earlier assessment years due to non-payment. Such interest has been converted into term loan. Since the company has paid Rs.0.50 lacs in the current year, the same is allowable as deduction in the light of the provisions of section 43B. It is assumed that the interest of Rs.5 lacs converted into term loan has not been debited in the profit and loss account.	0.50	3.75
Income under the head "Profits and gains from business or profession"		71.47

Note:-

1. Rs.5 lacs is received from a foreign Government for use of company's product. As the amount was not brought to India in convertible foreign exchange within the prescribed time, deduction u/s 80-O is not allowable.
2. Under section 47(vii) any transfer by a shareholder, in a scheme of amalgamation, of a capital asset, being shares held by him in the amalgamating company does not attract capital gains tax, if the transfer is made in consideration of the allotment of any shares in the amalgamated company and the amalgamated company is an Indian company.
3. Rent of commercial property has been taken as its gross annual value in the absence of other information.
4. A company can change its method of valuation of stock provided the change is made for *bona fide* reason and is followed consistently in future. The assessee changed its method of valuation of stock in line with the pronouncement of a professional body. Therefore, the genuineness of the change in method of valuation of stock cannot be questioned. Hence, even though the profit is lower by Rs.15.40 lacs, it would not have any impact on the computation of income.
5. Payment of gratuity Rs.6.00 lacs on account of death of an executive while on business trip is allowable as deduction. [*CIT vs. Laxmi Cement Distributors (P) Ltd. (1976) 104 ITR*]

711 (Gujarat)]. Since it has already been debited to the profit and loss account, no further adjustments are required.

6. Payment for scrap materials was made on 15th August, 2003, being the "Independence Day" on which banks are closed. Such payment is covered by Rule 6DD(k) of the Income-tax Rules. Therefore, the expenditure cannot be disallowed under section 40A(3).

Question 2

- (a) A private limited company has share capital in the form of equity share capital. The shares were held upto 31st March, 2002 by four members A, B, C and D equally. The company made losses/profits for the past three assessment years as follows:

Assessment Year	Business Loss Rs.	Unabsorbed Depreciation Rs.	Total Rs.
2000-2001	Nil	15,00,000	15,00,000
2001-2002	Nil	12,00,000	12,00,000
2002-2003	9,00,000	9,00,000	18,00,000
Total	9,00,000	36,00,000	45,00,000

The above figures have been accepted by the tax department.

During the previous year ended 31.3.2003, A sold his shares to Y and during the previous year ended 31.3.2004, B sold his shares to Z. The profits for the past two previous years are as follows:

31.3.2003 Rs.18,00,000 (before charging depreciation of Rs.9,00,000)

31.3.2004 Rs.45,00,000 (before charging depreciation of Rs.7,50,000)

Compute taxable income for A.Y.2004-05. Workings must form part of your answer.

(9 marks)

- (b) Given below is the summarized Profit and Loss Account of Sun and Sand Limited, engaged in the business of hotel approved by the prescribed authority:

	Rs. (in lacs)
Income	
Realised from services rendered to foreign tourists	75.00
Other business receipts	10.60
Capital Gains (short-term)	<u>3.50</u>
Total (A)	<u>89.10</u>
Expenses (Total)	37.50
Transfer to reserve under section 80HHD	<u>15.00</u>
Total (B)	<u>52.50</u>
Net Profit (A - B)	36.60

Following further information are given:

- (i) Expenses includes Rs.6.70 lacs being interest on term loan from bank. The amount remains unpaid as of date.
- (ii) Services rendered to foreign tourists include Rs.8.00 lacs received in convertible exchange after 30.9.2004 and Rs.1.00 lac by sale of articles from shops belonging to the company.
- (iii) Other business receipts includes Rs.4.00 lacs (INR) from an approved tour operator rendering services to foreigners.

Compute the amount of deduction that can be claimed by the company under section 80HHD. (5 marks)

Answer

- (a) A, B, C and D are the four shareholders of a private limited company. The shareholding pattern of the company as on 31.3.2002, 31.3.2003 and 31.3.2004 are as follows -

As on	A	B	C	D	Y	Z
	%	%	%	%	%	%
31.3.2002	25	25	25	25	-	-
31.3.2003	-	25	25	25	25	-
31.3.2004	-	-	25	25	25	25

Section 79 provides that, in case of a closely held company, no loss incurred in the previous year shall be carried forward and set off against the income of the subsequent previous year unless the shares carrying at least 51% of the voting power of the company are beneficially held on the last day of the previous year in which the loss is sought to be set off, by the same shareholders, who beneficially held the shares carrying at least 51% of the voting power on the last day of the previous year in which the loss was incurred.

Since shareholders holding at least 51% of the voting power are the same as on 31.3.2002 and 31.3.2003, the restriction imposed by section 79 is not applicable for A.Y.2003-04. Thus, the taxable income for the assessment year 2003-2004 would be:

Particulars	Rs.
Business profit	18,00,000
Less:- Current year's depreciation	9,00,000
	9,00,000
Less:- Brought forward business loss for the A.Y. 2002-2003	9,00,000
Taxable income	Nil

Unabsorbed depreciation for the last 3 assessment years can be carried forward to the next assessment year i.e. A.Y.2004-05. There is no brought forward business loss and section 79 is not applicable in case of carry forward of unabsorbed depreciation. Section 32 governs the carry forward and set off of depreciation for which the shareholding pattern is not relevant. Consequently, the income for A.Y.2004-05 will be determined as under -

Particulars	Rs.	Rs.
Business income		45,00,000
Less: Current year's depreciation		7,50,000
		37,50,000
Less: Unabsorbed depreciation:-		
Assessment year 2000-2001	15,00,000	
Assessment year 2001-2002	12,00,000	
Assessment year 2002-2003	9,00,000	36,00,000
Taxable Income for A.Y.2004-05		1,50,000

(b) **Computation of deduction available under section 80HHD
for Sun & Sand Ltd. for A.Y.2004-05**

Particulars	Rs. in lacs
Amounts received in foreign exchange from foreign tourists	70.00
(Refer Working Note 1)	
Total business receipts (75.00+ 10.60)	85.60
Profits of the business (Refer Working Note 2)	54.80
Profits for the purpose of section 80HHD:- $54.80 \times 70.00/85.60$	44.81
Deduction-u/s 80HHD for the A.Y. 2004-2005:	
(i) 15% of eligible profit	6.72
(ii) Transfer to reserve (restricted to 15% of eligible profit)	6.72
Total deduction available under section 80HHD for A.Y.2004-05	13.44

Working Note 1**Amount received in foreign exchange from foreign tourists**

Amount realised from services rendered to foreign tourists		75.00
Less:- Amount received in convertible foreign exchange after 30.9.2004	8.00	
Amounts realized on sale of articles from shops	1.00	9.00
		66.00
Add:- Amount received from an approved tour operator rendering services to foreigners (It is assumed that the other tour operator has furnished the certificate in the prescribed form to Sun & Sand Ltd.)		4.00
		70.00

Working Note 2**Profits of the business**

Profit as per profit and loss account		36.60
Add:- Disallowance u/s 43B:-		
Interest on term loan remaining unpaid up to the date of filing the return	6.70	
Transfer to reserve u/s 80HHD	15.00	21.70
		58.30
Less:- Short term capital gain		3.50
		54.80

Question 3

- (a) R purchased equity shares in P Ltd., a constituent of BSE-500 index on Mumbai Stock Exchange on 1st March, 2003. He sold the shares on 4th March, 2004 at a loss of Rs.10,000. He wants to set off the loss against other long-term capital gain during the year. Examine whether such set off is permissible. Both purchase and sale transactions were entered into on a recognized stock exchange. (4 marks)
- (b) Dinesh, an individual engaged in the business of finance, advances Rs.5 lacs to his HUF on interest at 12% p.a., which is the prevailing market rate. The HUF invests the amount in its business and earns profit of Rs.2 lacs from this money. Can the assessing officer add a sum of Rs.1,40,000 (i.e. Rs.2,00,000-Rs.60,000) as income of Dinesh under

section 64(2) of the Income-tax Act? Will the position remain the same, if Dinesh does not charge any interest? (4 marks)

- (c) *A domestic company is liable to pay minimum alternate tax under section 115JB for the Assessment Year 2003-04. While computing book profit under section 115JB the company claims provision for deferred tax charged to Profit & Loss account in accordance with Accounting Standard-22 of the Institute of Chartered Accountants of India, which is sought to be disallowed by the Assessing Officer. On what grounds you can contest such disallowance?* (4 marks)

Answer

- (a) According to section 10(36) (inserted by the Finance Act 2003 with effect from assessment year 2004-05), any income arising from the transfer of long-term capital asset being an eligible equity share in a company purchased on or after 1st March, 2003 and before 1st March, 2004 and held for a period of 12 months or more is exempted from income tax. Eligible equity share includes any equity share in a company, which is a constituent of BSE-500 index of Mumbai Stock Exchange on 1st March, 2003 and the transactions of purchase and sale of such share are entered into on a recognized stock exchange in India.

In this case the assessee has suffered a loss of Rs.10,000 by selling eligible equity shares. It is settled principle that where income from a particular source is exempted under any provision of the Act, the loss arising from such source is not eligible for set off against income from a taxable source. In the case of *JCIT vs. Thyagarajan.S.S (1981) 129 ITR 115 (Mad)*, the Madras High Court held that loss incurred by an assessee from a source, income from which is exempted, cannot be set off against income from a taxable source. In view of the same, the set off in the instant case is not permissible.

- (b) Section 64(2) shall be applicable only where an individual member of HUF converts his property into the property of HUF or throws it into the common stock of the HUF without adequate consideration. In this case, Dinesh does not transfer money to his HUF but only lends an amount of Rs.5 lakhs to his HUF at an interest of 12%, which is the prevailing market rate. This is a transaction of loan, which pre-supposes re-payment. Dinesh continues to be the owner of the amount lent. Thus, there is no transfer of property from Dinesh to the HUF. Therefore, the Assessing Officer cannot add the profit arising to HUF in the total income of Dinesh by invoking section 64(2).

Even if no interest is charged by Dinesh, the nature of transaction does not change. It still remains a loan transaction. Therefore, the position will not change, even if Dinesh does not charge any interest.

- (c) The Supreme Court in the case of *Apollo Tyres Ltd vs. CIT (2002) 255 ITR 273* held that the Assessing Officer has the limited power of making addition and deduction to net profit as provided for in the Explanation to section 115J (now section 115JB). The Apex Court held that the Assessing Officer does not have any jurisdiction to go beyond the net profit shown in the profit and loss account except to the extent provided in the *Explanation* to section 115JB.

As per clause (a) of the *Explanation* to section 115JB, for the purpose of computing book profit, the net profit as shown in the profit and loss account for the relevant previous year shall be increased by the amount of income tax paid or payable and the provision therefor. Clause (a) of the *Explanation* to section 115JB essentially refers to current tax liability. Section 2(43) defines 'tax' as income-tax chargeable under the provisions of the Income-tax Act. Deferred tax is not income tax chargeable under the Income-tax Act. Moreover, deferred tax provision is not in the nature of provision for meeting any liability, which is not ascertained. Therefore, the deferred tax provision in the accounts is neither a liability for the purpose of clause (a) nor in the nature of provision for meeting any unascertained liability for the purpose of clause (c) of the *Explanation* to section 115JB. As such, it only represents a necessary accounting adjustment as per Accounting Standard 22 to fall in line with the matching principle of accounting.

Therefore, the provision for deferred tax charged to profit and loss account cannot be added back to the net profit by the Assessing Officer for computing book profit.

Question 4

- (a) *J filed a return of income for the Assessment Year 1999-2000, in due time disclosing a total income of Rs.4 lakhs. The taxes due on the income were covered by taxes deducted at source, advance tax and self-assessment tax.*

The return was taken for scrutiny by the assessing officer, who made large additions to the income disclosed by J. On appeal, the High Court set aside the order of assessment and directed a fresh assessment to be made after hearing the parties. The court order had become final since neither party had preferred an appeal against it.

The assessing officer did not make any fresh assessment with the result that the assessment became barred by time.

J has filed a petition that since no assessment of his income had been made by the assessing officer, the entire taxes paid, including the pre-assessment payments, must be refunded to him.

Is he justified in making this claim? Discuss.

(4 marks)

- (b) *An assessment was completed by the Assessing Officer under section 143(3) on the basis of return submitted and other information furnished by the assessee. The Assessing Officer accepted the cost of the land after waiting for a reasonable period for report of the valuation officer to whom a reference was made. Subsequent to receiving the report from the valuer, it revealed that there was a variation by about Rs.3.00 lacs. On the basis of this valuation report, the Commissioner issued notice under section 263 to set aside the completed assessment.*

Justify the action of the Commissioner.

(3 marks)

- (c) *M filed return of income for Assessment Year 2003-04 claiming a refund of Rs.45,000. The said refund was granted and paid to the assessee on 1st March, 2004 after processing the return under section 143(1). Later on, the case was taken up for regular assessment by issue of notice under section 143(2) and the said assessment was*

completed on 16th August, 2004 resulting in demand of Rs.2500. Is the assessee liable to pay interest on the amount of refund already granted to him and if so, what is the amount of such interest? (3 marks)

- (d) A search was initiated in the premises of an assessee on 11th November, 2003 and it was concluded on 14th November, 2003. What is the period of limitation for issue of notice for making assessment of preceding six assessment years? In case assessment under Section 143(3) for assessment year 2001-02 and appeal before CIT(A) for assessment year 1999-2000 are pending on 11th November, 2003, what would be the fate of such pending assessment and appeal? (4 marks)

Answer

- (a) The Gujarat High Court held, in *Saurashtra Cement and Chemical Industries Ltd. v. ITO* (1992) 194 ITR 659, that the liability to pay income-tax arose under section 4(1) of the Act and did not depend upon an assessment order being made by the Assessing Officer. It depends upon the enactment of the annual Finance Act laying down the rates of taxation for the relevant assessment year. Thus, as soon as the rates are prescribed, the liability to pay tax crystallizes.

On filing of return under section 139, the provisions of section 140A also get activated, since if any taxes over and above those paid by way of advance tax and tax deducted at source remain, payment has to be made under section 140A before a valid return of income could be filed by an assessee. Payment of pre-assessment taxes does not depend on an assessment being made by the Assessing Officer.

In the present case, J had paid taxes on the basis of his own declaration of income. J's primary liability under section 4 of the Act is not absolved merely due to absence of a formal assessment. As decided by the Supreme Court in *CIT v. Shelley Products* (2003) 261 ITR 367, pre-assessment taxes paid on the basis of admitted income do not become refundable in the absence of an assessment. Hence J's contention is incorrect.

- (b) As per the facts of the case, the Assessing Officer completed the assessment before the valuation report was received. The valuation report was received subsequent to completion of the assessment. However, it may be noted that the said report forms part of the 'record', which the Commissioner may call for and examine under section 263(1). A perusal of the valuation report revealed a variation of Rs.3 lakhs and to that extent it can be said that the order of the Assessing Officer was prejudicial to the interest of revenue and also erroneous. The Commissioner is absolutely justified in issuing notice u/s 263 since the term "record" used in the said section includes all the records available at the time of examination by the Commissioner even though such records may not have been available at the time of regular assessment. This view was upheld by the Supreme Court in *CIT v. Shree Manjunathesware Packing & Camphor Works* (1998) 231 ITR 335.
- (c) As per section 234D, inserted from 1st June 2003 by the Finance Act 2003, where any refund is granted to the assessee after processing the return u/s 143(1) and later on, in the regular assessment there is no refund due or the amount refunded exceeds the amount refundable, the assessee shall be liable to pay simple interest at ½% for every

month or part of a month from the date of grant of refund to the date of such regular assessment on the whole or the excess amount so refunded.

The assessee was granted refund on 1.3.2004 after processing the return u/s 143(1). The regular assessment u/s 143(3) was completed on 16.8.2004 and resulted in tax payable of Rs.2,500. Therefore, no refund was due on regular assessment. Accordingly, the assessee is liable to pay interest u/s. 234D on Rs.45,000 at $\frac{1}{2}\%$ for 6 months (i.e. from 1st March, 2004 to 16th August 2004; part of a month is to be considered as full month).

Interest payable by the assessee u/s 234D works out to Rs.1,350 (i.e. Rs. 45,000 $\times \frac{1}{2}\%$ $\times$ 6 months).

- (d) Under section 153A, where a search is initiated u/s 132 or books of accounts, other documents or any assets are requisitioned u/s 132A after 31.5.2003, the Assessing Officer shall issue notice to such person requiring him to furnish within such period as may be specified in the notice, the return of income in respect of six assessment years immediately preceding the assessment year relevant to the previous year in which such search is conducted or requisition is made. No time limit has been prescribed for the Assessing Officer to issue such notice to the person in whose case search is initiated u/s 132 or requisition is made u/s 132A. However, the Assessing Officer has to complete the assessment within a period of two years from the end of the financial year in which the last of the authorizations for search was executed. In the instant case, it would be 31st March, 2006.

The second proviso to section 153A provides that assessment or reassessment, if any relating to any assessment year falling within the above period of six assessment years, pending on the date of initiation of search u/s 132 or making of requisition u/s 132A shall abate. Therefore, if assessment for assessment year 2001-02 was pending on 11.11.2003, being the date of initiation of search u/s 132, the same shall abate.

Section 153A provides that the assessment or reassessment pending on the date of initiation of search shall abate. The section, however, does not deal with the appeals which are pending on the date of initiation of search. Hence, the appeal for assessment year 1999-2000 pending on 11.11.2003 shall not abate. The appeal proceedings shall continue as such proceedings do not get affected by the search assessment.

Question 5

- (a) *Explain the incidence of taxation on mutual concerns.* (4 marks)
- (b) *A company engaged in the manufacturing of pharmaceutical products, commenced its business on 1.4.2003. During the financial years 2000-01 to 2002-03 it had incurred Rs.2.00 lacs annually as expenditure on salaries and purchase of raw materials for the purpose of research connected with its business. During the previous year 2003-04, it incurred on scientific research, revenue expenditure of Rs.2.00 lacs and a capital expenditure of Rs.3.50 lacs on purchase of plant and machinery. Since the result of the research was unsuccessful, the company sold its plant and machinery on 31.12.2003*

for Rs.8.00 lacs and closed its research activity. Compute the admissible deduction under Section 35 for the assessment year 2004-05. (4 marks)

- (c) A company engaged in textile manufacturing, debited to its Profit & Loss Account a sum of Rs.60,000, being the interest on loan of Rs.6,00,000 taken for financing its expansion scheme. The plant and machinery purchased for the project with the loan were not received during the year and those were still in transit at the end of the year. A sum of Rs.6,000 was paid to a broker who arranged the loan. Discuss the admissibility or otherwise of the interest on borrowing. (4 marks)

Answer

- (a) The concept of “mutuality” means that the contributors and beneficiaries are identical. Since one cannot make profit by dealing with oneself, there is no taxable profit involved wherever such concept applies. A mutual concern or association stands on the same principle. All the contributors to the common fund are entitled to participate in the surplus and all the participants to the surplus are contributors in the case of a mutual concern. The excess of income over expenditure in a year shall supplement the common fund for future utilization to the benefit of the contributors and the excess of expenditure over income shall be absorbed by the common fund.

Generally the surplus derived by a mutual concern is not chargeable to tax. Therefore, a trade, professional or similar association which functions on the principle of mutuality concept is not chargeable to tax, if there is any surplus on account of subscriptions, membership fees, entrance fees etc., exceeding the expenditure.

However, the following additional points need to be taken into consideration-

- (i) Where a mutual concern carries on the business of insurance, the profits therefrom are chargeable to tax. Section 44 provides that the profits for this purpose have to be computed in accordance with the method prescribed in the Rules contained in the First Schedule.
 - (ii) In the case of trade, professional or similar associations, the income derived from specific services performed for its members is chargeable to tax u/s 28(iii). However, if there is a loss on account of expenditure exceeding the subscription etc. from members, such shortfall shall be absorbed by the income chargeable to tax u/s 28(iii). This set off as per section 44A cannot exceed 50% of the total income of such associations as computed before allowing the set off.
 - (iii) In the case of a mutual concern, if income is derived both from mutual activity as well as from non-mutual activity, the exemption applies only to the income from the mutual activity. The income attributable to the non-mutual activity will be liable to tax as was held by the Gujarat High Court in *Sports Club of Gujarat Ltd. vs CIT (1987) 171 ITR 504*.
- (b) The assessee is a company engaged in the business of manufacture of pharmaceutical products. Therefore, it is entitled to deduction u/s.35(2AB) in respect of current year expenditure on scientific research on in-house research and development facility

approved by the prescribed authority. Applying the provisions of section 35, the admissible deduction for A.Y.2004-05 is computed as under –

Particulars	Rs. in lacs
Expenditure incurred during the earlier three years on salaries and purchase of raw materials for the purpose of research connected with the business – fully allowed in the year of commencement of business by virtue of <i>Explanation</i> to section 35(1)(i) – [Rs.2 lacs × 3]	6.00
Revenue expenditure on scientific research incurred during the previous year 2003-04	2.00
Capital expenditure on scientific research incurred during the previous year 2003-04	3.50
Total	5.50
Weighted deduction @ 150% on Rs.5.50 lacs u/s 35(2AB) [See Note below]	8.25
Admissible deduction u/s 35 for the A.Y.2004-05	14.25

Note – In the case of an assessee engaged in the business of manufacturing of pharmaceutical products, current year scientific research expenditure qualifies for a weighted deduction of 150%. It is assumed that such expenditure is on scientific research on in-house research and development facility as approved by the prescribed authority being Secretary, Department of Scientific and Industrial Research.

- (c) Interest paid in respect of capital borrowed for the purposes of business or profession is admissible u/s 36(1)(iii). As per the proviso to section 36(1)(iii) inserted by the Finance Act, 2003, from assessment year 2004-05, interest paid in respect of capital borrowed for acquiring an asset for extension of existing business or profession (whether capitalized in the books of account or not) for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use will not be allowed as deduction. In this case, the asset was not put to use till the end of the previous year. Therefore, interest of Rs.60,000 will not be allowed as deduction. However, the cost of the asset shall be increased by the amount of interest and depreciation shall be admissible on enhanced cost.

As regards the brokerage of Rs.6,000 paid to a broker for arranging the loan there are two possible views –

The first view is that since the definition of the term “interest” u/s 2(28A) includes service fee or other charges in respect of monies borrowed, “brokerage” can be considered to fall under the scope of the term “other charges” and is therefore included under the definition

of interest. Hence, brokerage of Rs.6,000 for arranging the loan will be treated in the same way as interest.

The alternate view is based on the High Court decision in *C.Moolchand v. CIT (1956) 29 ITR 449 (Hyd.)*, where it has been held that brokerage or commission paid to an agent for arranging a loan for the purpose of business is not allowable as deduction u/s 36(1)(iii), but is allowable under section 37(1). As per this view, Rs.6,000 paid to a broker for arranging a loan is allowable as a deduction under section 37(1).

Question 6

- (a) *R & Co. is a partnership firm consisting of two partners R and S. The partners decide to dissolve the firm on 31.3.2004. The firm owns a land which was purchased 15 years back. One of the decisions taken in the scheme of dissolution was that the land, whose present market value was ascertained at Rs.15,00,000, would be given to S. A suggestion was made to the firm that instead of making an allotment at the time of dissolution, the firm can gift the land to S by making book entries. Discuss the pros and cons of the decision and advise the firm suitably in this context. (6 marks)*
- (b) *Redemption of preference shares amounts to "transfer" within the meaning of Section 2(47) of the Income Tax Act, 1961 in the hands of the shareholder. Discuss. (4 marks)*

Answer

- (a) The question involves consideration of the following two issues:
- (i) Can immovable property be transferred from the firm to a partner without any registration?
 - (ii) Is it better to transfer the land on dissolution to a partner or to make a gift of the land to the partner?

If any immovable property is transferred by a firm to its partner, registration of the transfer of document is required in order to effect such a transfer and enable the partner to get a perfect title. This view was upheld by the Mumbai High Court in *C.I.T vs J.M.Mehta & Bros (1992) 214 ITR 716*. According to this decision, transfer of an immovable property by mere book entries will not be valid. However, in the event of dissolution of a firm and distribution of assets, there is no need for registration as was decided by the Supreme Court in *S. V. Chandra Pandian & Others vs S. V. Sivalinga Nadar & Others (1993) 212 ITR 592*. The decision is based on the principle that a firm is not a distinct legal entity, apart from the partners constituting it. Each and every partner has an undefined interest in each and every property of the firm. Therefore, it can be concluded that if the land is gifted, registration will be required and if the land is distributed on dissolution, registration will not be required.

Section 47 lists out certain transactions which are not regarded as transfer and one such transaction is gift. Therefore, gift of immovable property does not attract capital gains tax. Further, the Gift-tax Act has been abolished in respect of gifts made on or after 1.10.98.

On the other hand, if the land is allotted to the partner at the time of dissolution instead of making a gift, the firm would be subjected to capital gains tax liability. The fair market value as on the date of distribution shall be deemed to be the full value of consideration for computation of capital gains. The indexed cost of acquisition should be reduced from the sale consideration to arrive at the capital gains. The capital gains so computed shall be charged to tax in accordance with the provisions of section 112.

Thus, taking into account the above considerations, it is advisable for the firm to gift the land to partner S instead of allotting the same to him at the time of dissolution which will attract capital gains tax.

- (b) The definition of the term "transfer" u/s 2(47) is not an exhaustive definition but an inclusive one. "Transfer" in relation to capital asset includes, *inter alia*, sale, exchange or relinquishment of capital asset.

When shares are redeemed by a company, it only means that the concerned shareholder is giving up his or her ownership or claim with reference to the shares in favour of the company. The consideration received by the shareholder from the company is certainly for sale/relinquishment of the interest in the shares and therefore, the redemption of preference shares amounts to "transfer" and the gain arising therefrom, being the excess realization over the cost of acquisition, shall be charged to tax under the head "Capital Gains". This was upheld by the Supreme Court in *Anarkali Sarabhai vs CIT (1997) 224 ITR 422*. If the redemption is after a period of 12 months from the date of acquisition of shares by the shareholder, the long term capital gain shall be computed by deducting the indexed cost of acquisition. The resultant long term capital gain shall be charged to tax in accordance with the provisions of section 112.

Question 7

- (a) *S. Ltd. is engaged in export of goods manufactured by it and by others. During the year it has suffered loss in export of trading goods but earned good profit in export of manufactured goods. The company is of the view that it can claim deduction under Section 80HHC in respect of entire profit from export of manufactured goods ignoring the loss from export of trading goods, as Section 80HHC basically is an incentive provision. Discuss the correctness of the view.* (4 marks)
- (b) *US Ltd., a US company has a subsidiary, IND Ltd. in India. US Ltd. sells computer monitors to IND Ltd. for resale in India. US Ltd. also sells computer monitors to CMI Ltd., another computer reseller. It sells 50,000 computer monitors to IND. Ltd. at Rs.11,000 per unit. The price fixed for CMI Ltd. is Rs.10,000 per unit. The warranty in case of sale of monitors by IND Ltd. is handled by IND Ltd. However, for sale of monitors by CMI Ltd., US Ltd. is responsible for the warranty for 3 months. Both US Ltd. and IND Ltd. offer extended warranty at a standard rate of Rs.1,000 per annum. On these facts, how is the assessment of IND Ltd. going to be affected?* (8 marks)

Answer

- (a) As per section 80HHC(1), where an assessee, being an Indian company, is engaged in the business of export of any goods or merchandise, there shall be allowed, in computing the total income of the assessee, a deduction to the extent of 30% of the profits derived by the assessee from the export of such goods or merchandise. Section 80HHC(3)(c) provides that for the purpose of sub-section (1), if the assessee is engaged in export of both self-manufactured and trading goods, the **profits derived from such export** shall -
- (i) in respect of goods manufactured by the assessee, be the amount which bears to the adjusted profits of the business, the same proportion as the adjusted export turnover in respect of such goods bears to the adjusted total turnover of the business; **and**
 - (ii) in respect of trading goods, be the export turnover in respect of such trading goods as reduced by the direct and indirect costs attributable to export of such trading goods.

The issue here is whether for the purpose of computing deduction, loss from export of trading goods should be adjusted against the profits from export of manufactured goods. The said issue has been settled by the Supreme Court decision in the case of *IPCA Laboratory Ltd. vs Dy. CIT (2004) 135 Taxman 594*. The Apex Court held that in the case of an assessee who is engaged in export of both trading goods and manufactured goods, the deduction u/s 80HHC shall be calculated on the net profit after adjusting the loss from one against the profit from the other. In case of such exporter, the amount of deduction is to be computed in accordance with clause (c) of sub-section (3) of section 80HHC. Clause (c) is divided into two sub-clauses (i) and (ii), which deal with computation of profit from export of manufactured goods and trading goods respectively. Between these two sub-clauses the word "and" appears which, joins the two sub-clauses. The Supreme Court held that the opening words "profit derived from such export" together with the word "and" indicates that profits have to be computed by considering both the manufacturing export and trading export. Accordingly if there is any loss in one, the same cannot be ignored.

Therefore, in the case of an assessee exporting both self-manufactured goods as well as trading goods, the aggregate of the profits/losses from both should be taken into consideration and only if there is a positive net profit after aggregation, should the deduction under section 80HHC be allowed.

Hence, the contention of the assessee is not correct.

- (b) US Ltd., the foreign company and IND Ltd., the Indian company are associated enterprises since US Ltd holds not less than 26% voting rights in IND Ltd. (being a subsidiary of US Ltd., more than 50% of its voting rights would be held by US Ltd.). US Ltd. sells computer monitors to IND Ltd. for resale in India. US Ltd also sells identical computer monitors to CMI Ltd, which is not an associated enterprise. The price charged by US Ltd. for a similar product transferred in comparable uncontrolled transaction is,

therefore, identifiable. Therefore, Comparable Uncontrolled Price (CUP) method for determining arm's length price can be applied.

While applying CUP method, the price in comparable uncontrolled transaction needs to be adjusted to account for difference, if any, between the international transaction (i.e. transaction between US Ltd. and IND Ltd.) and uncontrolled transaction (i.e. transaction between US Ltd. and CMI Ltd.) and the price so adjusted shall be the arm's length price for the international transaction.

For sale of monitors by CMI Ltd., US Ltd. is responsible for warranty for 3 months. The price charged by US Ltd. to CMI Ltd. includes the charge for warranty for 3 months. Hence arm's length price for computer monitors being sold by US Ltd. to IND Ltd. would be:

Particulars	No.	Rs.
Sale price charged by US Ltd. to CMI Ltd.		10,000
Less: Cost of warranty included in the price charged to CMI Ltd. (Rs.1,000 x 3 /12)		250
Arm's length price		9,750
Actual price paid by IND Ltd. to US Ltd.		11,000
Difference per unit		1,250
No. of units supplied by US Ltd. to IND Ltd.	50,000	
Addition required to be made in the computation of total income of IND Ltd. (1,250 x 50,000)		6,25,00,000

Exemption under section 10A/10B and deduction under chapter VI-A will not be available in respect of increased income of Rs.6.25 crores.

Question 8

(a) *X Limited is engaged in the construction of residential flats. For the valuation date 31.3.2004, it furnishes the following data and requests you to compute the taxable wealth:*

- (i) *Land in urban area (Construction is not permitted as per Municipal Laws in force) Rs.35,00,000*
- (ii) *Motor-cars (used on hire by the company) Rs.7,00,000*
- (iii) *Jewellery (Investment) Rs.15,00,000. Loan taken for purchasing the same Rs.10,00,000*
- (iv) *Cash Balance (as per books) Rs.1,75,000*
- (v) *Bank Balances Rs.2,50,000*
- (vi) *Guest House (situated in a place which is 30 kms away from the local limits of the municipality) Rs.6,00,000*

(vii) Residential flats occupied by the Managing Director Rs.10,00,000. The managing director is on whole time appointment and is drawing remuneration of Rs.2,00,000 per month.

(viii) Residential house let out on hire for 200 days Rs.8,00,000

The computation should be supported with proper reasoning for inclusion or exclusion.

(6 marks)

(b) What are the various circumstances under which an assessee will be deemed to have concealed the particulars of his net wealth or furnished inaccurate particulars thereof?

(4 marks)

Answer

(a) **Computation of taxable wealth of X Limited as on 31.3.2004:**

	Particulars	Note No.	Rs. in lacs
(i)	Land in urban area	(1)	Nil
(ii)	Motor-cars used on hire	(2)	Nil
(iii)	Jewellery	(3)	15
(iv)	Cash balance	(4)	Nil
(v)	Bank balance	(5)	Nil
(vi)	Guest house	(6)	6
(vii)	Residential flat occupied by the Managing Director	(7)	10
(viii)	Residential house let out for 200 days	(8)	8
	Total wealth		39
	Less: Debts: Loan obtained for purchasing jewellery	(9)	10
	Taxable wealth as on 31.3.2004		29

Notes:

- (1) Land in urban area on which the construction is not permitted as per municipal laws in force is not an asset with in the meaning of "asset" as defined u/s 2(ea) and as such excluded from taxability.
- (2) Motor car held as stock in trade or used on hire is not taxable. It is taxable only if it is used for business purposes or personal purposes.
- (3) Jewellery is always taxable unless the same is held as stock in trade.
- (4) Cash on hand in excess of Rs.50000 as on the valuation date is taxable in the case of an individual or HUF. In other cases it is not taxable to the extent reflected in the books of account. In this case, since cash balance of Rs.1,75,000 is as per books of X Ltd., it is not taxable.

- (5) Bank balance is not an asset within the meaning of "asset" as defined in section 2(ea).
 - (6) Guest house situated 30 kms away from the local limits of the municipality is an asset and is therefore taxable. Taxability does not arise only in the case of a farm house situated beyond 25 kms from the local limits of any municipality.
 - (7) Residential flat which is allotted by a company to an employee or an officer or a director who is in whole time employment, having gross annual salary of Rs.5 lacs or more is an asset within the meaning of "asset" as defined in section 2(ea) of the Act. Accordingly, the residential flat occupied by the managing director is taxable since his annual remuneration is Rs.24 lacs.
 - (8) Any residential property which is let out for a minimum period of 300 days in the previous year is not an asset. In the given case, the residential house is taxable since it has been let out for only 200 days i.e. less than 300 days during the previous year.
 - (9) Debts incurred in relation to assets chargeable to wealth tax shall be allowed as deduction in the computation of net wealth. Accordingly loan obtained for purchase of jewellery shall be allowed as deduction since jewellery is assessable to wealth tax.
- (b) The circumstances under which an assessee will be deemed to have concealed the particulars of his net wealth or furnished inaccurate particulars thereof are follows:
- (i) Where a person fails to offer an explanation or offers an explanation which is found to be false in respect of any facts material to the computation of net wealth, he will be deemed to have concealed the particulars. Further, where such person offers an explanation which he is unable to substantiate and fails to prove that such explanation is bonafide and that all the facts relating to same and material to the computation of his net wealth have been disclosed by him, he will be deemed to have concealed the particulars - *Explanation 2* to section 18.
 - (ii) Where a person not previously assessed to wealth tax, fails, without reasonable cause, to furnish within the due date, a return of his net wealth which he is required to furnish and the Assessing Officer is satisfied that the person has assessable wealth, he shall be deemed to have concealed the particulars of his assets - *Explanation 3* to section 18.
 - (iii) Where the value of any asset returned by any person is less than 70% of the value of such asset as determined in an assessment u/s 16 or 17, such person shall be deemed to have furnished inaccurate particulars.
 - (iv) Where in the course of search u/s 37A, the assessee is found to be the owner of any money, bullion, jewellery or other valuable article or thing and such assets have been neither declared in the return of wealth nor recorded in the books of account, he shall be deemed to have concealed the particulars of such assets or furnished inaccurate particulars of such assets.

The Suggested Answers for Paper – 8 : Indirect Taxes are based on the provisions applicable for A.Y. 2004-05, which is the assessment year relevant for November 2004 exams.

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) *State briefly the provisions of the CENVAT Credit Rules, 2002 in respect of removal of inputs and capital goods on which CENVAT credit has been availed in any **two** of the following cases:*
- (i) *Capital goods removed in good condition after being put to use for a period of two years, in respect of which period, depreciation under the Income-tax Act, 1961 was claimed.*
 - (ii) *An input becomes a waste and is sold as scrap.*
 - (iii) *Sale of the factory along with the said inputs and capital goods. (2 x 2 = 4 marks)*
- (b) *Briefly explain the provisions of the Central Excise Act, 1944 pertaining to "Related persons". (4 marks)*
- (c) *Write a brief note on the following with reference to Notification Nos.8/2003-CE and 9/2003-CE dated 1.3.2003 relating to small scale units:*
- (i) *determination of 'value' for the purposes of the said notifications;*
 - (ii) *availability of CENVAT Credit on capital goods under the said notifications;*
 - (iii) *treatment in respect of 'Clearances of excisable goods without payment of duty' as specified in the said notifications. (1 + 2 + 3 = 6 marks)*
- (d) (i) *Discuss briefly with reference to the provisions of the Central Excise Act, 1944 whether the following process would amount to 'manufacture' :*
- XYZ Corporation is engaged in the process of mixing aluminium paste, metal lacquer and thinner resulting in the production of aluminium paint having a shelf life of 8-10 hours. (3 marks)*
- (ii) *Explain briefly whether duty liability under the Central Excise Act, 1944 will be attracted in the following case:*
- MN & Co. engaged in the manufacture of Vanaspati oil used activated clay for deodorizing, bleaching and decolouring of oil. As a result of this processing the activated clay was transformed into "spent earth" which was nothing but the residue of activated clay. The activated clay residue lost its absorbent character during the course of refining and bleaching of oil. Excise Department sought to classify the*

"spent earth" under Central Excise Tariff Chapter Heading No. 1507, which reads as:

"residues resulting from treatment of fatty substances or animal or vegetable waxes".
(3 marks)

Answer

- (a) (i) As per Rule 3(4) of the Cenvat Credit Rules, 2002 when capital goods on which Cenvat credit has been taken are removed *as such* from the factory, the manufacturer of the final products shall pay an amount equal to the credit availed in respect of such capital goods and such removal shall be made under the cover of an invoice. However, the rule does not provide for a situation where capital goods are removed in good condition after being put to use for some time. Therefore, provisions of Rule 3(4) of the Cenvat Credit Rules, 2002 will hold equally good in these situations also. Thus, where the capital goods are removed in good condition, the manufacturer of the final products shall pay an amount equal to the credit availed.
- (ii) If inputs becomes waste and sold as scrap, it cannot be said that input is cleared 'as such' [Rule 3(4) of the Cenvat Credit Rules 2002]. What is cleared is 'waste' and duty will be payable as if waste has been removed.
- (iii) If factory is sold, it does not amount to removal of inputs and capital goods. In such case, no duty is payable on inputs and capital goods [*Metzeller Automotive vs. CCE 2004 (167) ELT 208(Tri.)*].
- (b) Section 4(3)(b) of Central Excise Act, 1944 contains the provisions pertaining to related person. As per the provisions of this section 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 distributors; or
 - (iv) they are so associated that they have interest, directly or indirectly, in the business of each other.

Explanation - In this clause –

- (i) "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
 - (ii) "relative" shall have the meaning assigned to it in clause (41) of Section 2 of the Companies Act, 1956;
- (c) (i) The value for the purposes of the two notifications would mean the value fixed under section 4 or section 4A or the tariff value fixed under section 3(2).

- (ii) The units availing the benefit of Notification No.8/2003 (i.e. full exemption) cannot avail Cenvat credit on inputs. However, they can avail Cenvat credit on capital goods but the same can be utilized for payment of duty on final products only after the turnover reaches Rs. 100 lakhs.

The units availing the benefit of Notification No.9/2003 (opting for payment of 60% of normal duty) are allowed to avail and utilize Cenvat credit both on inputs and capital goods.

- (iii) As per paragraph 3A of Notification Nos. 8/2003 and 9/2003, "clearances of excisable goods without payment of duty" in the following cases only shall be excluded for the purpose of determining the aggregate value of clearances of excisable goods for home consumption:

- (a) to a unit in the Free Trade Zone
- (b) to a unit in the Special Economic Zone
- (c) to a 100% Export Oriented Undertaking
- (d) to a unit in the Electronic Hardware or Software Technology Park
- (e) supplies to United Nations or an international organization for their official use or supplied to projects funded by them on which exemption of duty is available in terms of Notification No.108/95-CE dated August, 28, 1995.

- (d) (i) The facts of the case are similar to the facts in the case of *T.N. State Transport Corporation Ltd. v. Contractor of Central Excise Madurai 2004 (166) ELT 433 (SC)*. In this case the Supreme Court had held that mixing of aluminum paste lacquer and thinner in exact proportions resulted in the formation of a separate and distinct product with an identity of its own and was known in the market as aluminum paint. It was held by the Court that the shelf life of 8-10 hours of the product was sufficient to market it. Therefore the mixing process would amount to manufacture.

- (ii) The facts of the given case are similar to the facts of the case of *CCEx. v. Markfed Vanspathi & Allied Industries 2003 (153) ELT 491(SC)* wherein the Supreme Court has held that merely because goods fall in a chapter heading under the Central Excise Tariff they do not become excisable unless there is manufacture and the goods are marketable. It was observed by the Apex Court that merely because the goods fell in the said tariff heading it could not be said that there was 'deemed manufacture'. The burden to prove that there was manufacture and what was manufactured was on the revenue. No evidence was placed to show that there was manufacture. Spent earth was earth on which duty had been paid. It remained earth even after the processing. Thus, if duty was to be levied again it would tantamount to levy of double duty on the same product, which was not permissible.

Question 2

- (a) (i) *PQR Ltd. who are in the manufacture of excisable goods had the practice of providing full reimbursement to all its dealers towards the value of damaged goods. The company used to charge a certain sum towards the cost of freight in the return of the damaged goods to it. No other consideration was received by the company. The Central Excise Department has issued a show cause notice that the return freight in respect of damaged goods has to be included in the assessable value for purposes of duty. Examine briefly the correctness in law of the show cause notice.*
(2 marks)
- (ii) *State briefly whether "damage discount" is permissible as a deduction for purpose of arriving at the assessable value under Section 4 of the Central Excise Act, 1944.*
(2 marks)
- (b) *Write a brief note on the following powers exercised through exemption notifications issued under the Central Excise Act, 1944:*
- (i) *Power not to recover duty of excise not levied or short-levied as a result of general practice, under Section 11C;*
- (ii) *Power to grant exemption from duty of excise under Section 5A. (2 + 3 = 5 marks)*
- (c) *Briefly enumerate the specified categories of persons/premises that have been exempted in terms of Rule 9(2) of the Central Excise Rules, 2002 from obtaining registration under Section 6 of the Central Excise Act, 1944.*
(6 marks)

Answer

- (a) (i) The facts in this case are similar to the facts in *Neelkamal Plastics Ltd., v. CCE, Noida (2004) 164 ELT 197 (Tribunal-Delhi)*. In this case the CESTAT had held that the amount collected by the company was related to the cost of return freight on the damaged goods and hence did not in any way represent the value of the goods. The assessee company did not receive any additional consideration for the sale nor were any clearances effected towards replacement without payment of duty. Therefore, the return freight was not liable to be added to the assessable value.
- (ii) It has been decided by the Supreme Court in *CCE v Vikram Detergent Ltd. 2001 (127) ELT 641 (SC)* that "damage discount" is in the nature of a refund or benefit to the buyer by way of compensation for damage, breakage or losses suffered by the goods after removal from the factory and is not eligible for deduction.
- (b) (i) Under section 11C, if the Central Government is satisfied
- (a) that a practice was, or is, generally prevalent regarding levy of duty of excise (including non-levy thereof) on any excisable goods; and
- (b) that such goods were, or are, liable

- (i) to duty of excise, in cases where according to the said practice the duty was not, or is not being, levied, or
- (ii) to a higher amount of duty of excise than what was, or is being, levied, according to the said practice,

then, the Central Government may, by notification in the Office Gazette, direct that the whole of the duty of excise payable on such goods or as the case may be, the duty of excise in excess of that payable on such goods, but for the said practice, shall not be required to be paid in respect of the goods on which the duty of excise was not, or is not being, levied, or was, or is being, short-levied, in accordance with the said practice.

- (ii) Under section 5A, the Central Government is empowered to grant exemption in public interest either absolutely or subject to conditions (either before or after removal) from the whole or any part of the duty of excise payable. Notifications issued under section 5A (1) are not applicable to 100% EOU/FTZ/SEZ unless otherwise specified. This is because such units are exempted under other notifications issued specially for them.

The Central Government in public interest can issue a special order under circumstances of an exceptional nature stating reasons thereof and exempting excisable goods from payment of duty. The date of effect of the notification will be the date of its issue.

The Central Government, if it considers it necessary or expedient so to do, can insert an explanation in such notification or order, by notification in the Official Gazette at any time within one year of issue of the notification for the purpose of clarifying the scope or applicability of such notification.

- (c) Rule 9(2) empowers the Board to issue notification for giving exemption from registration subject to conditions and safeguards. Accordingly the Central Board of Excise and Customs by Notification no. 36/2001 C.E. (N.T.) dated 26.6.2001 has exempted the following specified categories of persons/premises from obtaining registration:
 - (i) Persons who manufacture the excisable goods, which are chargeable to nil rate of excise duty or are fully exempt from duty by a notification.
 - (ii) Small-scale unit availing the slab exemption based on value of clearances under a notification.
 - (iii) In respect of final products falling under chapter 61 or 62 the job-worker need not get registered if the principal manufacturer undertakes to discharge the duty liability.
 - (iv) Persons manufacturing excisable goods by following the warehousing procedure under the Customs Act, 1962 subject to the following conditions:
 - a. the said excisable goods and any intermediary or by-product including the waste and refuse arising during the process of manufacture of the said goods under the Customs Bond are either destroyed or exported out of the country to

the satisfaction of the Assistant Commissioner of Customs or the Deputy Commissioner of Customs, in charge of the Customs Bonded Warehouse;

- b. the manufacturer shall file a declaration in the specified form in triplicate for claiming exemption under this notification;
- c. no drawback or rebate of duty of excise paid on the raw materials or components used in the manufacture of the said goods, shall be admissible.
- (v) The person who carries on wholesale trade or deals in excisable goods (except first and second stage dealer, as defined in CENVAT Credit Rules, 2002).
- (vi) A 100% EOU, or a unit in FTZ or SEZ including STP/EHTP licensed or appointed, as the case may be, under the provisions of the Customs Act, 1962.
- (vii) Persons who use excisable goods for any purpose other than for processing or manufacture of goods availing benefit of concessional duty exemption notification.

Question 3

- (a) *Briefly explain the procedure with respect to "Provisional Assessment" under the Central Excise Rules, 2002.* (4 marks)
- (b) *Write a brief note on "Export under bond to Nepal where payment is in freely convertible foreign currency" with reference to the Central Excise Act, 1944 and the Rules. (5 marks)*
- (c) *With reference to Rules 12 and 17(3) of the Central Excise Rules, 2002 and Rule 7(5) of the CENVAT Credit Rules, 2002 explain in brief the main contents of the Returns to be filed with the Central Excise Department by an assessee in Form E.R. -1, E.R.-2 and E.R.-3.* (6 marks)

Answer

- (a) As per Rule 7 of the Central Excise Rules, 2002, provisional assessment can be resorted to when the duty cannot be determined at the point of clearance of the goods. The rule read with the guidelines issued by the Board on 1.9.2001, sets out the procedure for provisional assessment as follows:

The assessee should make a detailed request to Divisional Assistant/Deputy Commissioner of Central Excise, indicating:-

- (a) Specific grounds and documents and information for want of which final assessment cannot be made.
- (b) Periods for which provisional assessment is required.
- (c) Rate of duty or the value or both, as the case may be, proposed to be applied by assessee for provisional assessment; and
- (d) Undertaking to appear before Assistant/Deputy Commissioner within 7 days or such date fixed by him, and furnish all relevant information and documents within the time specified by the Assistant/Deputy Commissioner in his order, so as to enable the proper

officer to finalize the provisional assessment.

On receipt of such application, the Assistant/Deputy Commissioner will examine it to ascertain whether provisional assessment is necessary at all. If the reasons/ grounds are not sufficient, he may ask the assessee to appear before him on an appointed day and time, and if he is satisfied that provisional assessment is not necessary, he may pass a reasoned order rejecting the same and also ordering the rate of duty or the value, to be applied by the assessee.

Where the Deputy/Assistant Commissioner of Central Excise is satisfied with the genuineness of the assessee's request he will issue a specific order directing provisional assessment clearly stating:-

- a. The grounds on which Provisional Assessment has been ordered.
 - b. The rate and /or value, as the case may be, at which duty has to be provisionally paid.
 - c. The amount of differential duty for which bond is to be executed covering the period, if any, during which assessee paid duty provisionally under the deeming provisions, after applying the rate and/ or value specified in (b) above.
 - d. The amount of security or surety as may be fixed by Assistant Commissioner keeping in view the instructions issued by the Board from time to time.
- (b)** Export under bond to Nepal where payment is in freely convertible currency, shall be subject to following conditions, namely:-
- (i) The importer in Nepal, shall open an irrevocable letter of credit in favour of the exporter in India, before the export takes place. However, this is not necessary in the case of export of –
 - (a) All excisable goods other than consumer goods and
 - (b) Motor vehicles,
 if they are exported without payment of duty as-
 - (i) 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; and
 - (ii) 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;
 - (ii) the exporter shall furnish a bond in the prescribed form before the Deputy/Assistant Commissioner of the Central Excise having jurisdiction over the factory, warehouse, or the approved premises or such other officer as authorized by the Board in this behalf, from where the goods are removed for export to Nepal,

- (iii) After the exports are effected the exporter shall furnish a certificate of remittances from the Reserve Bank of India or an authorized bank in India, showing that full payment for the goods has been duly received in freely convertible currency. On receipt of such a certificate and on the satisfaction that the goods have been exported in terms of the bond, the bond accepting authority shall discharge the exporter of his liabilities under the bond.
- (c) Rule 12 of Central Excise Rules, 2002 provides that every assessee shall submit to the Superintendent of Central Excise a monthly return in Form ER-1, of production and removal of goods and other relevant particulars, within ten days after the close of the month to which the return relates. However, an assessee availing exemption under a notification based on the value of clearances in a financial year (SSI), and textile units in textile sector manufacturing yarn, unprocessed fabrics and readymade garments falling under Chapter 50, 51, 52, 53, 54, 55, 58, 60, 61 or 62 shall file a quarterly return in Form ER-3, of production and removal of goods and other relevant particulars, within twenty days after the close of the quarter to which the return relates.

Rule 7(5) of Cenvat Credit Rules, 2002 requires the manufacturer to submit within ten days from the close of each month, a monthly return in the prescribed form to the Superintendent of Central Excise. In case of a manufacturer availing of an exemption based on the value of clearances, the form has to be submitted within twenty days of the close of every quarter.

Under Rule 17(3), 100% EOU units, units in FTZ or SEZ are required to submit a monthly return in the Form ER 2 in respect of the goods manufactured in, and receipt of inputs and capital goods, in the unit. The return is to be submitted to the Superintendent of Central Excise within 10 days from the close of the month to which the return relates.

Following are the requirements of returns:

- (i) The return should be on basis of 6 digit Tariff Heading. If same product attracts different rates of duty, all rates should be mentioned separately, even if such different rates are within the same month.
- (ii) If goods are cleared for export under bond, these should be indicated separately.
- (iii) Quantity should be indicated by relevant abbreviations i.e. kg. Mt etc.
- (iv) Value indicated should be as per section 4, 4A or tariff value as applicable. In case of exports, ARE-1/ ARE-2 invoice value should be indicated.
- (v) If duty on some invoices is paid on provisional basis, the details are required to be given in the ER-1 return.
- (vi) Details of CENVAT Credit availed and utilised has to be provided in Form ER-1 and ER-3.

Question 4

- (a) *State briefly against whom prosecution may be launched in the case of "offences by companies" under Section 9AA of the Central Excise Act, 1944.* (3 marks)

- (b) Write short notes on the following with reference to the Central Excise Act, 1944 and the Rules made thereunder:
- (i) Duty payment "under protest"
 - (ii) "Refund claim" under Section 11B. (3 x 2 = 6 marks)
- (c) State in brief the provisions relating to "Invoice" under Rule 11 of the Central Excise Rules, 2002. (6 marks)

Answer

- (a) As per provisions of section 9AA prosecution may be launched against any person, director, manager, secretary or other officers of a company, who is responsible for the conduct of the business of the company/firm and is found guilty of the offence under the Central Excise Act/Rules.

The provision makes every person in charge of the business of the company at the time of the commission of the offence to be guilty of the offence besides the company itself. However, it will be a defence for such a person that the offence was committed without his knowledge or that he has exercised due diligence to prevent the commission of the offence.

The section also deems any director, manager, secretary or other officer to be guilty where the offence is attributable to their consent or connivance or neglect. The term company includes a firm and association of individuals and the term director will mean a partner in relation to a firm.

The term "in charge of and responsible to the company" would mean that the person was in overall control of the day to day affairs of the company.

- (b) (i) **Duty payment under protest:**

Section 11B of the Central Excise Act, 1944 provides that the time limit of one year for claiming of refund of Central Excise duty shall not apply where the duty has been paid under protest.

As per the Supplementary Instructions issued by Central Board of Excise and Customs, any assessee who desires to pay duty under protest, may do so by following the procedure mentioned below:

- (a) The assessee shall inform the Superintendent or Inspector of Central Excise in writing giving reasons for paying duty under protest and dated acknowledgement will be given to him.
- (b) The assessee shall mark invoices or monthly/quarterly returns indicating the goods on which duty is paid 'under protest'. If it is a lump-sum duty payment in respect of past demand, he may record the fact of duty payment under protest in the Personal Ledger Account, CENVAT Account and the Daily Stock Account.

- (c) If a case is appealed against by the assessee or where the appeal period for further appeal is available, he may continue to pay duty under protest. However, if decision is not in his favour and he exhausts the appellate remedy or does not appeal within stipulated period, he shall not have any right to pay duty under protest.

(ii) Refund Claim

Any person claiming refund of excise duty may make an application for refund of such duty to the Assistant/Deputy Commissioner of Central Excise before the expiry of one year from the relevant date. The meaning of the term “relevant date” has been set out in the Explanation (B) to Section 11B. The application shall be accompanied by such evidence to establish that the excise duty in relation to which such refund is claimed has been paid by the applicant and the incidence of such duty has not been passed on by him to any other person. However, the limitation of one year shall not apply if duty has been paid under protest.

If the Assistant/Deputy Commissioner of Central Excise is satisfied that the whole or any part of the duty of excise paid by the applicant is refundable, he may make an order accordingly and the amount so determined shall be credited to the Fund. However, the excise duty as determined by the Assistant/Deputy Commissioner of Central Excise shall be paid to the applicant, instead of being credited to the Fund, if such amount is relatable to—

- (a) rebate of duty of excise on excisable goods exported out of India or on excisable materials used in the manufacture of goods which are exported out of India;
 - (b) unspent advance deposits lying in balance in the applicant’s account current maintained with the Commissioner of Central Excise;
 - (c) refund of credit of duty paid on excisable goods used as inputs in accordance with the rules or any notifications;
 - (d) the duty of excise paid by the manufacturer, if he had not passed on the incidence of such duty to any other person;
 - (e) the duty of excise borne by the buyer, if he had not passed on the incidence of such duty to any other person;
 - (f) the duty of excise borne by any other such class of applicants as the Central Government may, by notification in the Official Gazette, specify.
- (c)** (1) No excisable goods shall be removed from a factory or a warehouse except under invoice signed by the owner or his authorized agent.
- (2) However, textile yarns, fabrics and readymade garments can be cleared on proforma invoice. In case of cigarettes, which are under physical control, invoice should be countersigned by the Excise officer.

- (3) The invoice shall be serially numbered and shall contain the registration number, name of the consignee, description, classification, time and date of removal, rate of duty, quantity and value, of goods and the duty payable thereon.
- (4) The invoice should be prepared in triplicate in the following manner:
 - (i) The original copy being marked as ORIGINAL FOR BUYER
 - (ii) The duplicate copy being marked as DUPLICATE FOR TRANSPORTER
 - (iii) The triplicate copy being marked as TRIPLICATE FOR ASSESSEE
- (5) Only one copy of invoice book shall be in use at a time, unless otherwise allowed by the Assistant/Deputy Commissioner of Central Excise.
- (6) The owner or working partner or the Managing Director or the Company Secretary or any person duly authorized for this purpose shall authenticate each foil of the invoice book, before being brought into use.
- (7) Before making use of the invoice book, the serial numbers of the same shall be intimated to the Superintendent of Central Excise having jurisdiction over the factory of the assessee.
- (8) The provisions of rule 11 shall apply in all respects to goods supplied by first stage dealer or a second stage dealer.

Question 5

- (a) *State briefly as to who can make an application for "Advance Ruling" under Section 23A of the Central Excise Act, 1944.* (3 marks)
- (b) *Discuss briefly the power of the Appellate Tribunal to order "rectification of mistake" under Section 35C of the Central Excise Act, 1944.* (3 marks)
- (c) *Explain briefly the provisions relating to "Special Audit" in certain cases under section 14A of the Central Excise Act, 1944.* (4 marks)
- (d) *State the provisions of Rule 17 of the Central Excise Rules regarding removal of goods by a 100% Export Oriented Undertaking for Domestic Tariff Area.* (5 marks)

Answer

- (a) The following persons can be "applicants" under section 23A(c) of the Central Excise Act, 1944:
 - (i) a non-resident setting up a joint venture in India in collaboration with a non-resident or a resident; or
 - (ii) a resident setting up a joint venture in India in collaboration with a non-resident; or
 - (iii) a wholly owned subsidiary Indian company, of which the holding company is a foreign company,

who proposes to undertake any business activity in India and makes application for advance ruling.

- (b) As per section 35C(2), the Appellate Tribunal may, at any time within six months from the date of the order, with a view to rectifying any mistake apparent from the record, amend, any order passed by it and shall make such amendments if the mistake is brought to its notice by the Commissioner of Central Excise or the other party to the appeal.

However, an amendment which has the effect of enhancing an assessment or reducing a refund or otherwise increasing the liability of the other party, shall not be made unless the Appellate Tribunal has given notice to the other party of its intention to do so and has allowed him a reasonable opportunity of being heard.

- (c) If at any stage of enquiry, investigation or any other proceedings before him, any Central Excise Officer not below the rank of an Assistant/Deputy Commissioner of Central Excise having regard to the nature and complexity of the case and the interest of revenue, is of the opinion that the value has not been correctly declared or determined by a manufacturer or any person, he may, with the previous approval of the Chief Commissioner of Central Excise, direct such manufacturer or such person to get the accounts of his factory, office, depots, distributors or any other place, as may be specified by the said Central Excise officer, audited by a Cost Accountant, nominated by the Chief Commissioner of Central Excise in this behalf.

The Cost Accountant shall submit the audit report duly signed and certified to the said Central Excise Officer within the period specified by him or the period further extended on an application made to him. However, in any case the aggregate of the original and the extended period cannot exceed 180 days. The manufacturer shall be given an opportunity of being heard in respect of any material gathered on the basis of audit and proposed to be utilized in any proceedings.

- (d) Where any goods are removed from a 100% Export Oriented Undertaking to domestic tariff area, such removal shall be made under an invoice by following the procedure specified in rule 11, and on payment of appropriate duty before removal of goods by debiting the account current required to be maintained for this purpose.

The unit shall maintain in the prescribed form, an appropriate account relating to production, description of goods, quantity removed, and the duty paid.

The unit shall submit a monthly return in the prescribed form (Form E.R.-2) to the Superintendent of Central Excise within ten days from the close of the month to which the return relates, in respect of excisable goods manufactured in, and receipt of inputs and capital goods in the unit.

PART B

Question 6

- (a) Explain briefly with reference to the provisions of the Customs Act, 1962 any **two** of the following :
- (i) Goods
 - (ii) Person in charge
 - (iii) Foreign going vessel. (2 x 2 = 4 marks)
- (b) (i) C & Co. imported second hand machinery and declared the transaction value in the Bill of Entry filed for purposes of assessment of import duty. The Assistant Commissioner of Customs ignored the transaction value and based on Chartered Engineer' s certificate showing that the machinery was in working condition and had a residual life of 10 years he completed the assessment under Rule 8 of the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988 after allowing maximum depreciation of 70%.
- Discuss briefly giving reasons whether the action of the Assistant Commissioner is valid in law. (3 marks)
- (ii) Due to congestion in the ports or non-availability of deep draught all ports are not navigable unto the jetty. Goods have to be discharged or transshipped at the outer anchorage with the help of barges. The charges associated with the delivery of cargo at outer anchorage are called "barging/lighterage charges". State giving reasons whether such charges have to be included for purposes of determination of assessable value under the Customs Valuation (Determination of price of Imported Goods) Rules, 1988. (3 marks)
- (c) Explain briefly the provisions of Rule 3 of the General Rules for the Interpretation of the First Schedule to the Customs Tariff Act, 1975. (4 marks)
- (d) State briefly the provisions of the Customs Act, 1962 relating to filing of "Import Bill of Entry". (6 marks)

Answer

- (a) (i) As per Section 2(22) of the Customs Act, 1962:
- "goods" include –
- (a) vessels, aircrafts and vehicle;
 - (b) stores;
 - (c) baggage;
 - (d) currency and negotiable instruments; and
 - (e) any other kind of movable property.

(ii) As per Section 2(31) of the Customs Act, 1962:

“person-in-charge” means,-

- (a) in relation to a vessel, the master of the vessel;
- (b) in relation to an aircraft, the commander or pilot-in-charge of the aircraft;
- (c) in relation to a railway train, the conductor, guard or other person having the chief direction of the train;
- (d) in relation to any other conveyance, the driver or other person-in-charge of the conveyance.

(iii) “foreign-going vessel or aircraft” means any vessel or aircraft for the time being engaged in the carriage of goods or passengers between any port or airport in India to any port or airport outside India, whether touching any intermediate port or airport in India or not, and includes-

- (i) any naval vessel of a foreign Government taking part in any naval exercise;
- (ii) any vessel engaged in fishing or any other operations outside the territorial waters of India;
- (iii) any vessel or aircraft proceeding to a place outside India for any purpose whatsoever.

(b) (i) The facts in this case are similar to the facts in *Tolin Rubber Pvt. Ltd. v. COC, Cochin* (2004) 163 ELT 289 (SC). In this case the Supreme Court stated that the value of the goods has to be determined as per Rule 4(1) of the Customs Valuation Rules, 1988 and only in circumstances specified under Rule 4(2) the transaction value as per Rule 4(1) has to be rejected and further determination has to be made as per Rule 8. The assessing authority had not provided any reasons for rejecting the transaction value. It was held by the Supreme Court that the Bill of Entry as made by the company and the transaction value as declared by it had to be accepted by the Department.

Applying the same ratio to the given situation, it could be said that the action of the Assistant Commissioner in the instant case is not valid in law.

(ii) As per *M.F. (D.R.) Circular No. 29/2004-Cus., dated 13.04.2000*, the barging/lighterage charges borne by the importer in bringing the goods from the outer anchorage to the landmass should be included in the assessable value as “extended cost of transportation” under Rule 9(2)(a) of the Customs Valuation Rules, 1988. The value of the goods is deemed to be the price at which such goods are ordinarily sold or offered for sale for delivery at the time and place of importation in the course of international trade. The importation gets completed when the goods reach the landmass of the country and not at the outer anchorage point. Therefore, all the expenses incurred by the importer in bringing the goods to the landmass of the country will be includible in the assessable value.

- (c) Rule 3 is to be applied when classification cannot be decided by Rules 1 and 2.

Rule 3 of General Rules for the Interpretation of Customs Tariff provides that when by application of Rule 2(b) or for any other reason, goods are prima facie classifiable under two or more headings, classification shall be effected as follows:

- (a) The heading which provides most specific description shall be preferred to the heading providing a more general description. However, when two or more headings each refer to part only of the materials or substances contained in mixed or composite goods or to part only of the items in a set put up for retail sale, those headings are to be regarded as equally specific in relation to those goods, even if one of them gives a more complete or precise description of goods.
- (b) Mixtures, composite goods consisting of different materials or made up of different components, and goods put up in sets for retail sale which cannot be classified by reference to (a), shall be classified as if they consisted of material which gives them their essential character, in so far as this criterion is applicable.
- (c) When the goods cannot be classified by reference to (a) or (b) they shall be classified under the heading which occurs last in numerical order among those which equally merit consideration.
- (d) It is the duty of the importer of any goods to make an application to the proper officer for clearance of the goods. The goods may be cleared for home consumption or for deposit in a warehouse or for transit or transshipment. Therefore, there are three types of bills of entries prescribed for these three different purposes.

Form I (white) - for home consumption

Form II (yellow) - for warehousing

Form III (green) - for ex-bond clearance for home consumption

The form, of the bill of entry is governed by Bill of Entry (Forms Regulations, 1976). Normally the Bill of Entry is in four copies:

- (a) Original meant for the customs authorities for assessment and collection of duty;
- (b) Duplicate, indented as an authority to the custodian of the cargo to release cargo;
- (c) Triplicate, as a copy for record for the importer; and
- (d) Quadruplicate, as a copy to be presented to the bank

A facility has now been provided for clearance of the goods by making an electronic declaration to the Customs Computer System through network facility. The bill of Entry (Electronic Declaration) Regulations, 1995, provide the details.

The importer is required to declare in the Bill of Entry amongst other things –

- the particulars of packages,
- the descriptions of the goods, in terms of the description given in the Customs Tariff.

According to Section 46(3) a bill of entry is to be normally filed after the delivery of the import manifest (vessel/aircraft)/import report (vehicle). However, the bill of entry can be presented even before the delivery of the import manifest if vessel is expected to arrive within 30 days from the date of such presentation.

Question 7

- (a) State whether the principle of "unjust enrichment" applies to refund of export duty under the Customs Act, 1962. (2 marks)
- (b) Write short notes on the following with reference to the Customs Act, 1962:
- Duty on pilfered goods
 - Reimportation of goods. (2 x 2 = 4 marks)
- (c) XYZ Co., the assessee, has claimed before the Customs Authority that since the exports of goods in its case attracted no duty, the value, for purposes of Customs Act, 1962, to be declared shall be the value of the goods, which he expects to receive on sale of goods in the overseas market.
Briefly discuss giving reasons whether the stand taken by XYZ Co. is correct. (3 marks)
- (d) State in brief the features of "Special Economic Zone" with reference to the Customs Act, 1962. (6 marks)

Answer

- (a) The Tribunal in the case of *Commissioner of Customs, Bangalore v. Ken Agritech Pvt. Ltd.* 2004 (166) E.L.T 339 (Tri. – Bang.) has held that the provisions relating to unjust enrichment introduced in section 27 by way of amendment in the Customs Act could only apply to refund of import duty under the said section. Since refund of export duty is dealt with under section 26 of the Act and the same has not been amended by the Parliament, the provisions relating to unjust enrichment introduced under section 27 could not be made applicable to refund of export duty under the said section 26.
- (b) (i) **Duty on pilfered goods**
As per section 13 of Customs Act, 1962, if any imported goods are pilfered after the unloading thereof and before the proper officer has made an order for clearance for home consumption or deposit in a warehouse, the importer shall not be liable to pay the duty leviable on such goods. However, where such goods are restored to the importer after pilferage, the importer becomes liable to pay duty.
- (ii) **Re-importation of goods**
As per section 20, if goods are imported into India after exportation therefrom, such goods shall be liable to duty and be subject to all the conditions and restrictions, if any, to which goods of the like kind and value are liable or subject, on the importation thereof.

- (c) This issue has been addressed to by the Supreme Court in the case of *M/s. Om Prakash Bhatia v. Commissioner of Customs, Delhi 2003 (155) E.L.T. 423*. The Apex Court observed that for finding the true export value of the goods, section 14 of the Customs Act, 1962 has to be read along with section 2(41) which defines the word 'value'. Value in relation to any goods means the value thereof determined in accordance with the provisions of section 14(1). Section 14 specifically provides that in case of assessing the value for purpose of export, value is to be determined at the price at which such or like goods are ordinarily sold or offered for sale at the place of exportation in the course of international trade where the seller and buyer have no interest in the business of each other and the price is the sole consideration for the sale. Therefore, for determining the export value of the goods, the method of determining the value under section 14 has to be followed even if no duty is leviable on the export of goods. Hence, the contention of XYZ Co. in the instant case will be rejected.

(d) Features of Special Economic Zone

The main features of SEZ are as follows :

- (a) SEZ may be set up in the public, private, joint sector or by State Government as notified by the Ministry of Commerce and Industry.
- (b) The Central Government is empowered to make rules regarding the requirements relating to goods or class of goods admissible to SEZ, nature of operations and the conditions to be fulfilled and the procedure to be followed.
- (c) Any goods admitted to a special economic zone from the domestic tariff area shall be chargeable to export duties at such rates as are leviable on such goods when exported. However, this would be subject to the rules made in this regard under Section 76F.
- (d) Any goods removed from special economic zone for home consumption shall be chargeable to duties of customs including anti-dumping, countervailing and safeguard duties under Customs Tariff Act, 1975 as leviable on such goods when imported.
- (e) SEZ units may be set up for :
 - (i) Manufacture of goods,
 - (ii) Rendering of services,
 - (iii) Production,
 - (iv) Processing,
 - (v) Assembling,
 - (vi) Trading,
 - (vii) Repair, re-making, re-conditioning, and re-engineering,

- (viii) Making of gold/silver/platinum jewellery and articles thereof or in connection therewith.
- (f) Goods going into the SEZ area from Domestic Tariff Area (DTA) shall be treated as deemed exports.
- (g) Goods coming from the SEZ area into DTA shall be treated as if the goods are being imported.

Question 8

- (a) *Explain briefly the procedure for clearance of warehoused goods for home consumption under Section 68 of the Customs Act, 1962.* (3 marks)
- (b) *State in brief with reference to the provisions of Section 129A of the Customs Act, 1962 the matters relating to which no appeal shall lie before the Appellate Tribunal.* (3 marks)
- (c) *Enumerate briefly the penalties under Section 114 of the Customs Act, 1962 for attempt to export goods improperly.* (4 marks)
- (d) *Explain the manner of filing drawback claim under the Duty Drawback Rules pursuant to Section 74 of the Customs Act, 1962.* (5 marks)

Answer

- (a) The importer of any warehoused goods may clear them for home consumption under section 68 of the Customs Act, 1962, if-
 - (a) a bill of entry for home consumption in respect of such goods has been presented in the prescribed form;
 - (b) the import-duty leviable on such goods and all penalties, rent, interest, and other charges payable in respect of such goods have been paid; and
 - (c) an order for clearance of such goods for home consumption has been made by the proper officer.

However, the owner of any warehoused goods may, at any time before an order for clearance of goods for home consumption has been made in respect of such goods, relinquish his title to the goods upon payment of rent, interest, other charges and penalties that may be payable in respect of the goods and upon such relinquishment, he shall not be liable to pay duty thereon.
- (b) As per section 129A, no appeal shall lie to the Appellate Tribunal and the Appellate Tribunal shall not have jurisdiction to decide any appeal in respect of any order passed by the Commissioner (Appeals) under section 128A; if such order relates to, -
 - (a) any goods imported or exported as baggage;
 - (b) any goods located in a conveyance for importation into India, but which are not unloaded at their place of destination in India, or so much of the quantity of such

goods as has not been unloaded at any such destination if goods unloaded at such destination are short of the quantity required to be unloaded at that destination;

- (c) payment of drawback as provided in Chapter X, and the rules made thereunder.
- (c) The person involved in commission or omission, in relation to any goods, which renders such goods liable to confiscation under section 113, or abets the same, shall be liable to penalties under section 114 in different types of cases as follows :
 - (i) in the case of goods in respect of which any prohibition is in force under this Act or any other law for the time being in force, to a penalty not exceeding three times the value of the goods as declared by the exporter or the value as determined under this Act, whichever is greater;
 - (ii) in the case of dutiable goods, other than prohibited goods, to a penalty not exceeding the duty sought to be evaded on such goods or 5000/-, whichever is greater;
 - (iii) in the case of any other goods, to a penalty not exceeding the value of the goods as declared by the exporter or the value as determined under this Act, whichever is the greater.
- (d) (i) In the case of exports other than by post, a formal drawback claim, in the prescribed form, should be filed with the proper officer of Customs, within three months of the date of let export order (under section 51) and claim should be accompanied by
 - (a) triplicate copy of the Shipping Bill or Bill of Export in proof of export;
 - (b) Bill of entry or other document in proof of payment of import duty
 - (c) Export invoice and packing specification
 - (d) Bill of lading or airway bill as proof of effective export
 - (e) Permission of RBI etc.
 - (f) Import invoice and packing specification
 - (g) Any other document necessary
- (ii) The drawback department shall scrutinize these documents and issue a deficiency memo for further details or documents required and the exporter shall furnish them forthwith.
- (iii) The customs department shall pay to the exporters, or an agent specially authorized by the exporter to receive the drawback amount, the eligible drawback and interest if any.
- (iv) If there is any erroneous or excess payment of drawback, it shall be demanded and if the exporters fail to pay the demand, it can be recovered in the manner prescribed under section 142.

- (v) The Central Government can relax the provisions of these rules, in appropriate cases, on sufficient cause being shown by the exporter in individual cases.

In the case of exports by post, the outer cover should bear in bold letters an inscription "Drawback Export"; a declaration/claim in the prescribed form should be submitted along with parcel; and the date of receipt of this claim in the Customs department from the postal authorities, will be deemed to be the date of filing of the drawback claim.

PART C

Question 9

- (a) Answer any **four** of the following with reference to the Finance Act, 1994 as amended relating to applicability of service tax:

- (i) One professionally qualified engineer with one non-professionally qualified engineer rendering engineering consultancy services under the name and style of ABC Consultancy Pvt. Ltd.
- (ii) Business Auxiliary services provided by a Commission Agent.
- (iii) An institute providing pre-school coaching and training.
- (iv) Ship repair services including dry docking within port premises.
- (v) Blood test and analysis services provided by a commercial pathology laboratory.

(2 x 4 = 8 marks)

- (b) Answer any **two** of the following with reference to the provisions of the Finance Act, 1994 as amended relating to service tax:

- (i) Services rendered after 1.7.2003 under a maintenance contract of machinery entered into prior to the effective date i.e., 1. 7 .2003 and in respect of which the bill has been raised and the value in full received from the customer prior to 1.7.2003.
- (ii) What is the date of payment of service tax where the amount of service tax is paid by cheque and is presented to the designated bank on April 25, 2004 and realised by the bank on April 27, 2004? Whether any interest and penalty is attracted in this case?
- (iii) Whether service tax credit availed on input services during the period April 1, 2004 to April 24, 2004 can be utilized for the payment of service tax on the output services provided for the month/quarter ended March, 2004, which is due for payment on April 25, 2004.

(2 x 2 = 4 marks)

- (c) Briefly discuss the provisions of the Finance Act, 1994 as amended relating to service tax with respect to any **one** of the following taxable services:

- (i) Event Management
- (ii) Video Tape Production Services.

(3 marks)

Answer

- (a) (i) Service tax shall be applicable on ABC Consultancy Pvt. Ltd. as consulting engineer includes self-employed, professionally qualified engineer who may or may not employ others to assist him or it could be an engineering firm whether organized as a sole proprietorship, partnership, a private or public limited company [Commissioner of Central Excise, New Delhi, Trade Notice No. 53 – C.E. (Service Tax)/97, dated 04.07.1997].
- (ii) Service tax shall not be attracted as the business auxiliary service provided by commission agent has been exempted vide *Notification no. 13/2003-S.T. dated 20.6.2003 w.e.f. 1.7.2003*.
- (iii) An institute providing pre-school coaching and training has been specifically excluded from the definition of Commercial training or coaching center under clause (27) of section 65 of the Finance Act, 1994. Thus, service tax shall not be attracted on it.
- (iv) As per *CBE&C Circular No. 67/16/2003-ST dated 10.11.2003* ship repair services including dry docking within port premises come within the ambit of port services and thus are chargeable to service tax.
- (v) Any testing or analysis services provided in relation to human being or animals are specifically excluded from the definition of technical testing and analysis under clause (106) of section 65 of the Finance Act, 1994. Thus, service tax will not be attracted on this service.
- (b) (i) *Notification no. 11/2003 S.T. dated 20.6.2003* exempts the service rendered in relation to maintenance or repair under a contract which was entered in to prior to 1.7.2003, if the bill for the service is raised prior to 1.7.2003 and the value of the service is received prior to 1.7.2003. Thus, in this case no service tax will be charged.
- (ii) As per sub-rule 2A of Rule 6 of the Service Tax Rules, 1994 the date of presentation of cheque to the designated bank, subject to realization is the date of payment. Thus, in this case the date of payment will be 25th April, 2004 as the cheque has been realized on 27th April, 2004.
- The cheque is deposited before due date and has been realized a day or two after. In such a case the date of presentation of cheque is the date of payment i.e. 25.4.2004. Hence, no interest and penalty is chargeable as there is no delay in payment of service tax [*Eicher Consultancy Services vs. CCE 2003 (157) EL T 432*].
- (iii) The proviso to sub-rule 1 of Rule 4 of the Service Tax Credit Rules, 2002 provides that while paying service tax on the output service, the service tax credit shall be utilized only to the extent such credit is available on the last day of a month/quarter, for payment of service tax relating to the month/quarter, as the case may be. Hence,

the credit availed in the month of April 2004 cannot be utilized for paying service tax for the month of March 2004.

(c) (i) Event Management

Event management means any service provided in relation to planning, promotion, organising or presentation of any arts, entertainment, business, sports or any other event and includes any consultation provided in this regard [Section 65(40)]. The scope of the taxable service includes any service provided to a client by an event manager in relation to event management. [Section 65(105)(zu)]

Event Manager means any person who is engaged in providing any service in relation to event management in any manner. [Section 65(41)] The value of the taxable service shall be the gross amount charged by the service provider for such service rendered by him.

(ii) Video Tape Production Services

The taxable service shall include any service provided to a client by a video production agency in relation to video tape production, in any manner [Section 65(105)(zi)]. Video production agency means any professional videographer or any commercial concern engaged in the business of rendering services relating to video tape production. [Section 65(119)]

Video tape production means the process of any recording of any programme, event or function on a magnetic tape and includes editing thereof in any manner.[Section 65(120)]. The value of the taxable service shall be the gross amount charged by the service provider for the service rendered by him but does not include the cost of unrecorded magnetic tape or such other storage devices if any sold to the client during the course of providing the service.

SUMMARY OF EXAMINERS' COMMENTS ON THE PERFORMANCE OF CANDIDATES

PAPER – 5 : COST MANAGEMENT

General Comments

The performance of the candidates in both theory and practical questions needs improvement. It has been observed by the examiners that quite a few students tend to lose marks in spite of knowing the answers because of poor presentation. Students are advised to understand the application of the various theoretical concepts for successfully applying them while solving numerical questions.

Specific Comments

Question 1.(a) This was a theory part requiring candidates to explain the meaning and limitations of back flushing in a JIT system. Many students confused 'back flushing' with 'just in time'. A few students, who got the meaning of 'back flushing' right, were unable to explain the problems associated with the concept.

(b) This was theory part requiring students to explain 'skimming price strategy'. A few candidates confused 'skimming pricing' with 'penetrative pricing'.

(c) This was a practical question part. Students were required to use the knowledge of concepts related to Decision making and Marginal costing. A clear concept of Capacity and its effective utilization was needed to answer this question. The following types of mistakes were committed by a majority of candidates;

Were unable to compute correctly the available capacity for executing the export order.

Many candidates were unable to arrive at the alternative use of spare capacity.

Question 2. (a) This theory part required candidates to explain advantages and limitations of Zero Based Budgeting. Examiners have noted that though many of the candidates appeared to possess the basic knowledge, they were unable to express the same in the paper. Otherwise the question was satisfactorily attempted.

(b) This theory part required candidates to explain the concept of 'benchmarking code of conduct'. Many of the candidates were able to explain 'benchmarking', however, most of them failed to give the right answer for the code of conduct.

(c) This theory question part required candidates to explain the main features of ERP. The question was answered reasonably well by most of the candidates.

(d) This was a practical question part requiring students to prepare various functional budgets from the information given in the question. The students while answering this question part committed the following types of mistakes;

The figure of production was incorrectly computed in many cases.

Quite a few candidates were unable to draw correctly the material usage budget.

Some candidates failed to compute the units of material to be purchased and the cost their off.

Few candidates failed to compute correctly the total labour hours and total wages.

Question 3.(a) This was a practical question part requiring candidates to have a sound knowledge of concepts related to the traditional and activity based costing. While answering

the question the following types of mistakes were committed by the examinees;

Wrong calculation of machine hour rate.

Cost/units of driver not correctly computed.

Many candidates were unable to compute correctly the difference in Product costs using the two different types of cost accounting techniques.

(b) This practical question part required examinees to formulate and solve a linear programming problem in order to determine a product mix on a weekly basis. Most of the candidates were able to formulate the problem correctly. However, many failed thereafter and got the wrong solution.

Question 4.(a) This was a theory part requiring candidates to have a sound knowledge of relevant cost and its use in decision-making. Most of the candidates have answered this part well.

(b) This was a practical question part requiring candidates to calculate capacity, activity and efficiency ratios and also establish their relationship. Some of the candidates made the following types of mistakes;

Wrong computation of standard hours produced and actual hours worked.

Use of wrong formula while computing various ratios.

(c) This practical question part required candidates to calculate the transportation cost per ton-km from the given information. A few candidates computed incorrectly the variable and the fixed costs for distance X and Y. Otherwise; this question part was satisfactorily answered.

Question 5.(a) This practical question part was from the area of transfer pricing. Candidates were required to compute the profitability of the given profit centres and the company as a whole in different capacity utilisation scenarios. They were also required to comment upon the company's transfer pricing policies. Most of the candidates were able to attempt this question part correctly; however many were not able to offer their comments satisfactorily.

(b) This practical question part required candidates to determine the critical path from a given network. Candidates were also required to find the probability that the project will be completed in the scheduled completion time. The following types of mistakes have been noticed by the examiners;

Some candidates did not compute earliest finish, latest finish and slack correctly.

A few candidates wrongly computed the probability of the given project being completed on schedule.

Question 6.(a) This theory question part required candidates to write about the characteristics and benefits of product life cycle along with its meaning. It has been observed that quite a few candidates discussed the concept of product life cycle from the marketing point of view rather than the cost accounting/management viewpoint.

(b) This practical question part was done well by most of the candidates.

(c) This practical question part was from the area of Simulation. Most of the candidates were not able to reach the correct inventory cost under the two alternatives.

PAPER – 6: MANAGEMENT INFORMATION AND CONTROL SYSTEMS**General Comments**

The overall performance of the candidates was satisfactory. In majority of the cases, the answers given by candidates lacked quality, content and precision. The examiners were of the view that candidates should go through the study material thoroughly to have a complete understanding of the concepts.

Specific Comments

Question 1. (a) Being a compulsory question, every candidate attempted it. Definitions of conventional audit trail and on-line systems were presented well by most of the candidates. However, majority of them could not cite proper reasons to justify why conventional audit trail is difficult in on-line systems.

(b) A large percentage of candidates exhibited poor knowledge of Section 2 of the Information Technology Act, 2000.

Question 2. (a) Answers given by majority of the candidates relating to Production planning control system, were incomplete and inadequate.

Question 3. (a) Very few candidates could correctly define the terms “2-tier and 3-tier architecture”.

(b) Control techniques to ensure security were not presented well by the candidates. Majority of them lacked conceptual clarity.

(c) A large number of candidates wrote vague and general answers to describe risks that should be considered during transition from the mainframe to client/server.

Question 4. (c) Most of the candidates failed to discuss various functions served by system evaluation.

Question 5. (a) Majority of the examiners could not give proper reasons and key points to describe expectations, fears and ground realities that a corporate management faces during the post implementation phase of ERP.

(c) Very few candidates could draw systems flowchart for an online, real-time sales order processing correctly. Majority of the candidates could not distinguish between systems flowchart and program flowchart.

Question 6. (b) A large percentage of the candidates failed to present an example of an Information security policy statement. Performance to this part of the question was very poor.

Question 7. In majority of the cases, candidates failed to present comprehensive short notes covering all important aspects concerning the respective topics.

PAPER – 7 : DIRECT TAXES**General Comments**

The students have not studied the provisions of the Income-tax Act and Wealth-tax Act thoroughly. As a result, their answers were vague and general. They were not familiar with the recent amendments. Many students have not given proper notes and assumptions in support of their answers. The presentation of answers was also very poor in many cases.

Most students do not start the answer to each question on a fresh page. Further, some students attempt to answer different parts of the same question at random instead of answering them one after the other consecutively. The handwriting of some of the students is very poor and not legible.

Specific Comments

Question 1.

- (i) Most of the students have confused gratuity paid voluntarily on death of an executive on business trip with compensation paid on voluntary retirement and they have wrongly treated 1/5th of the expenditure as allowable during the year. Some students have also linked it with payment out of gratuity fund.
- (ii) Many students have not been able to state the reasons for deduction or addition of various items of income or expense, which was specifically required in the question. Some of the instances for which explanations were not given are:
 - (a) Disallowance of non-realisation of advance given to wholly owned subsidiary.
 - (b) Allowability of arrears of interest paid during the year.
- (iii) Most of the students have wrongly treated legal charges in connection with alteration of Articles and for issue of bonus shares as preliminary expenses to be amortised under section 35D.
- (iv) The students have wrongly disallowed 20% of expenditure on purchase of scrap material although such payment was made on the Independence day (public holiday) which is covered in Rule 6DD (k)

Question 2. (a) Some students have wrongly made the computation by applying the provisions of section 78, which are applicable for carry forward and set off of losses in case of change in the constitution of firm. Further, some students have made a mistake in the order of set off of brought forward loss and unabsorbed depreciation.

(b) Some of the students were unable to apply the provisions of section 80HHD correctly and made mistakes in computing the amount received in foreign exchange from foreign tourists, profits of the business and total business receipts. Further, many students were not aware of the correct percentage of deduction under section 80HHD for A.Y.2004-05 i.e. 15%.

Question 3. (a) Many students were not aware of the fact that a loss from a source, the income of which is exempt cannot be set off against income from taxable source as per the decision of Madras High Court in *JCIT vs. Thyagarajan.S.S. (1981) 129 ITR 115*.

(b) Most of the students have not brought out in their answer that advance of money cannot be regarded as transfer of asset, since it is a transaction of loan which pre-supposes repayment.

Question 4. (a). Although the conclusion given by most students were correct, the reasons given by them were not satisfactory. Some of the reasons, given by the students are as follows:

- (i) Assessing Officer can re-open the assessment (The question clearly states that assessment had become barred by time);

(ii) The assessee can prefer further appeal (The question clearly states that the court order had become final since neither party had preferred appeal against it).

(b) Though the students have correctly answered that the Commissioner can issue notice under section 263, they were unable to give specific reasons. Most students have failed to explain that "record" includes all the records available at the time of examination by the commissioner though such records may not have been available at the time of regular assessment.

(c) Majority of students have correctly stated that interest is payable on refund granted to assessee after processing the return under section 143(1). But many students were unable to state the correct rate of interest i.e. $\frac{1}{2}\%$. Also, some of the students made the mistake of calculating interest on Rs.2500 instead of Rs.45000. Further, some students were not aware that the part of the month should be taken as full month for the purpose of period of interest

(d) Most of the students are unaware of the fact that the period of limitation for issue of notice for making assessment in respect of search cases is not specified in the Act. Further, many students have stated that both assessment and appeals pending on the date of search shall abate whereas as per the Act, the appeals will not abate.

Question 5. (a) Most of the students were not clear about the concept of mutual concerns. The answers were generally vague.

(b) Many students have wrongly taken expenditure incurred on scientific research for three years before the commencement of business as Rs.2 lakhs, whereas the question clearly states that it is Rs.2 lakhs annually, therefore amounting in total to Rs.6 lakhs i.e. (Rs.2 lakhs $\times$ 3 years).

(c) Most of the students were not aware of the fact that the Finance Act 2003 specifically provides for capitalisation of interest on borrowings for acquiring an asset (for extension of existing business or profession) till the asset is first put to use. They have answered on the basis of general accounting principles especially on the basis of Accounting Standard-16.

Question 6. (a) The students were unable to bring out the following points in their answers:

1. Transfer of immovable property by mere book entries is not valid. Gift of an immovable property by a firm requires registration of the document. No capital gains is attracted in the hands of the firm.
2. Immovable property allotted to the partner at the time of dissolution of the firm does not require registration of the document. However, it attracts capital gains.

(b) Most of the students have simply stated that the redemption of preference shares amounts to "transfer" without giving proper reasons.

Question 7. (a) Many students have correctly referred to the case IPCA laboratories Ltd. However, some students could not clearly explain the reasons given by the Apex Court in arriving at the decision and hence, their answers were incomplete and not satisfactory.

(b) Majority of the students have not understood clearly the concept of Associated Enterprise, Comparable Uncontrolled Price Method and adjustment on account of difference in

transactions. Therefore, they have not been able to arrive at the correct increase in the total income of IND Ltd.

Question 8. (a) 1. Many students have not been able to distinguish between cash balance and bank balance and have wrongly stated that the bank balance recorded in the books is not an asset whereas the bank balance itself is not a asset.

2. The students are unaware of the fact that guest house is taxable irrespective of its location. They have confused it with farmhouse situated beyond 25 kms from the limits of municipality which is not taxable.

3. Most of the students were not clear that one house or a part of the house owned by an individual or HUF only is exempt under section 5(vi) and no such exemption is available in respect of any house owned by a company.

(b) Majority of students were unaware of the provisions of section 18 of the Wealth Tax Act relating to circumstances under which an assessee will be deemed to have concealed the particulars of his net wealth or furnished inaccurate particulars thereof.

PAPER – 8 : INDIRECT TAXES

General comments

Overall performance was not up to the mark. Students did not devote proper time for reading the question paper and thus wrote what was not asked for. The answers were vague, lengthy and not up to the point. It was observed that the students wrote very long answers for the initial questions and answered the last few questions in great haste. It is advised that the students should answer all questions in a balanced and planned manner. Students are advised to improve their presentation skills and follow an analytical approach while answering the questions. They should also consider the maximum marks allotted to each question while writing its answer.

Specific comments

Question 1. (a) Majority of the students did not follow this question. The significance of inputs and capital goods removed *as such* was not known to most of the students. Question clearly stated that Cenvat credit has been availed and the provisions for removal had been asked. However, the students discussed in detail about the availment of credit without referring to the provisions regarding removal of inputs and capital goods as such.

(c) This question was also not understood by most of the students. Majority of them were not clear about the SSI exemption notifications especially regarding 'determination of value' and 'clearances of excisable goods without payment of duty'.

Question 2. (a) This question was based on recent case laws. Students who had studied the same were able to answer it correctly.

(b) Only a part of the question was answered correctly. Section 5A was not fully discussed.

Question 3. (b) Students were not aware of the procedure for Export under bond to Nepal where payment is in freely convertible currency.

(c) Most of the students were not aware of the contents of the Form ER-1, 2 and 3.

Question 4. (b) Short notes on 'Duty payment under protest' and 'Refund claim' were not clear and up to the point.

Question 5. (b) Students were not aware of the provisions of section 35C.

(c) Provisions of special audit under section 14A of Central Excise Act, 1944 were asked in the question. However, students wrote about general audit.

(d) Provisions of Rule 17 of Central Excise Rules, 2002 regarding removal of goods by 100% EOU for Domestic Tariff Area were not known to majority of the students.

Question 6. (a) Students explained the terms in a general way without referring to the provisions of the Customs Act, 1962.

(b) Majority of the students were not clear about the assessment under Rule 8.

(c) Students wrote very lengthy and vague answers to this question. They did not answer in points.

(d) Most of the students did not mention about electronic filing of bill of entry.

Question 7. (a) Only one line answer was required in this question with quoting of correct section. However, students wrote very long answers based upon guess work and general idea.

(b) Provisions of section 20 regarding re-importation of goods was not known to a fairly large number of students.

(c) Valuation of goods for export does not involve Valuation Rules. However, most of the students discussed the Rules in detail.

(d) Most of the students failed to write about SEZ correctly.

Question 8. (b) Students were not conversant with the matters relating to which no appeal shall lie before the Appellate Tribunal.

(c) It was observed that most of the students did not study the provisions of penalties as very few of them were able to answer this question correctly.

(d) Manner of filing drawback claim was asked in this question but majority of the students explained about drawback provisions.