

SUGGESTED ANSWERS

FINAL COURSE

NOVEMBER - 2006



BOARD OF STUDIES

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

PAPER – 1 : ADVANCED ACCOUNTING

Answer **all** questions.

Working notes should form part of the answer.

Question 1

On 31st March, 2004 Bee Ltd. became the holding company of Cee Ltd. and Dee Ltd. by acquiring 450 lakhs fully paid shares in Cee Ltd. for Rs. 6,750 lakhs and 240 lakhs fully paid shares in Dee Ltd. for Rs. 2,160 lakhs. On that date, Cee Ltd. showed a balance of Rs. 2,550 lakhs in General Reserve and a credit balance of Rs. 900 lakhs in Profit and Loss Account. On the same date, Dee Ltd. showed a debit balance of Rs. 360 lakhs in Profit and Loss Account while its Preliminary Expenses Account showed a balance of Rs. 30 lakhs.

After one year, on 31st March, 2005 the Balance Sheets of three companies stood as follows:

	(All amounts in lakhs of Rupees)		
Liabilities	Bee Ltd.	Cee Ltd.	Dee Ltd.
Fully paid equity shares of Rs. 10 each	27,000	7,500	3,000
General Reserve	33,000	3,150	—
Profit and Loss Account	9,000	1,200	750
15 lakh fully paid 9.5%			
Debentures of Rs. 100 each	—	—	1,500
Loan from Cee Ltd.	—	—	75
Bills Payable	—	—	150
Sundry Creditors	<u>14,100</u>	<u>2,700</u>	<u>930</u>
	<u>83,100</u>	<u>14,550</u>	<u>6,405</u>

	(All amounts in lakhs of Rupees)		
Assets	Bee Ltd.	Cee Ltd.	Dee Ltd.
Machinery	39,000	7,500	2,100
Furniture and Fixtures	6,000	1,500	600
Investments:			
450 lakhs shares in Cee Ltd.	6,750	—	—
240 lakhs shares in Dee Ltd.	2,160	—	—
3 lakhs debentures in Dee Ltd.	294	—	—
Stocks	16,500	3,000	1,500
Sundry Debtors	9,000	1,350	1,290

Cash and Bank balances	3,201	1,050	900
Loan to Dee Ltd.	—	90	—
Bills Receivable	195	60	—
Preliminary Expenses	—	—	15
	<u>83,100</u>	<u>14,550</u>	<u>6,405</u>

The following points relating to the above mentioned Balance Sheets are to be noted:

- All the bills payable appearing in Dee Ltd.'s Balance Sheet were accepted in favour of Cee Ltd. out of which bills amounting to Rs. 75 lakhs were endorsed by Cee Ltd. in favour of Bee Ltd. and bills amounting to Rs. 45 lakhs had been discounted by Cee Ltd. with its bank.
- On 29th March, 2005 Dee Ltd. remitted Rs. 15 lakhs by means of a cheque to Cee Ltd. to return part of the loan; Cee Ltd. received the cheque only after 31st March, 2005.
- Stocks with Cee Ltd. includes goods purchased from Bee Ltd. for Rs. 200 lakhs. Bee Ltd. invoiced the goods at cost plus 25%.
- In August, 2004 Cee Ltd. declared and distributed dividend @ 10% for the year ended 31st March, 2004. Bee Ltd. credited the dividend received to its Profit and Loss Account.

You are required to prepare a Consolidated Balance Sheet of Bee Ltd. and its subsidiaries Cee Ltd. and Dee Ltd. as at 31st March, 2005. (16 Marks)

Answer

Consolidated Balance Sheet of Bee Ltd. and its subsidiaries Cee Ltd. and Dee Ltd. as at 31st March, 2005

Liabilities	Rs. in lakhs	Assets	Rs. in lakhs
Share Capital		Fixed Assets	
Authorised	<u>?</u>	Goodwill (W.N. 3)	246
Issued and subscribed		Machinery	48,600
Fully paid equity shares of Rs. 10 each	27,000	Furniture and Fixtures	8,100
Minority interest (W.N. 2)	5,487	Current Assets, Loans and Advances:	
Reserves and Surplus		(A) Current Assets	
General Reserve (W.N. 4)	33,360	Stock	21,000
Profit and Loss A/c (W.N. 4)	10,040	Less: Unrealised profit	<u>40</u> 20,960
Secured Loans		Sundry debtors	11,640
Debentures	1,200	Cash and bank balances	5,151

<i>Current Liabilities</i>			Cash in transit	15
Acceptances	150		(B) <i>Loan and Advances</i>	
Less: Mutual owing	<u>105</u>	45	Bills receivable	255
Sundry creditors		<u>17,730</u>	Less: Mutual owing (W.N. 5)	<u>105</u> <u>150</u>
		<u>94,862</u>		<u>94,862</u>

Working Notes:1. *Analysis of reserves and profits of subsidiaries:*

		<i>Pre-acquisition capital profit</i>	<i>Post-acquisition General Reserve</i>	<i>Rs. in lakhs Profit and Loss Account</i>
Cee Ltd.				
General reserve		2,550	600	
Profit and loss account on 31.3.2004	900			
Less: Dividend	<u>750</u>	<u>150</u>	<u>—</u>	<u>1,050</u>
		<u>2,700</u>	<u>600</u>	<u>1,050</u>
Share of Bee Ltd. (60%)		1,620	360	630
Minority interest (40%)		1,080	240	420

		<i>Pre-acquisition capital profit</i>	<i>Post-acquisition Preliminary Expenses written off</i>	<i>Rs. in lakhs Profit and Loss Account</i>
Dee Ltd.				
Profit and loss account		(360)		1,110
Preliminary expenses		<u>(30)</u>	<u>15</u>	<u>—</u>
Less: Dividend		<u>(390)</u>	<u>15</u>	<u>1,110</u>
Share of Bee Ltd. (80%)		(312)	12	888
Minority interest (20%)		(78)	3	222

2. *Minority Interest*

(Rs. in lakhs)

Cee Ltd.

Share capital		3,000	
Capital (pre-acquisition) profits	1,080		
Revenue (post-acquisition) profits:			
General reserve	240		
Profit and loss account	<u>420</u>	<u>1,740</u>	4,740

Dee Ltd.

Share capital		600	
Capital (pre-acquisition) profits/(losses)	(78)		
Revenue (post-acquisition) profits	222		
Add: Preliminary expenses written off	<u>3</u>	<u>225</u>	<u>147</u>
			<u>747</u>
			<u>5,487</u>

3. *Cost of Control*

(Rs. in lakhs)

Cee Ltd.

Investment	6,750		
Less: Dividend received and wrongly credited to profit and loss account	<u>450</u>	6,300	
Less: Paid-up share capital (60%)	4,500		
Capital profits	<u>1,620</u>	<u>6,120</u>	180

Dee Ltd.

Investment in shares	2,160		
in debentures	<u>294</u>	2,454	
Less: Paid-up share capital (80%)	2,400		
Nominal value of debentures	300		
Capital profits	<u>(312)</u>	<u>2,388</u>	<u>66</u>
Cost of control - Goodwill			<u>246</u>

4. Consolidated general reserve and profit and loss account

	General reserve	Profit and loss account
Bee Ltd.	33,000	9,000
Less: Wrong dividend credited	<u>—</u>	<u>450</u>
	33,000	8,550
Cee Ltd.	360	630
Dee Ltd. (888 + 12)	<u>—</u>	<u>900</u>
	33,360	10,080
Less: Unrealised profit on stock	<u>—</u>	<u>40</u>
	<u>33,360</u>	<u>10,040</u>

5. Mutual owing regarding bills

Rs. (150 – 45) lakhs = Rs. 105 lakhs.

6. Unrealised profit

$$\left(\text{Rs. } 200 \times \frac{25}{125} \right) \text{ lakhs} = \text{Rs. } 40 \text{ lakhs}$$

7. Amount of dividend wrongly credited to profit and loss account by Bee Ltd.

60% of Rs. 750 lakhs = Rs. 450 lakhs.

Question 2

- (a) On the basis of the following Profit and Loss Account of Zed Limited and the supplementary information provided thereafter, prepare Gross Value Added Statement of the company for the year ended 31st March, 2005. Also prepare another statement showing reconciliation of Gross Value Added with Profit before Taxation.

Profit and Loss Account of Zed Limited for the year ended 31st March, 2005.

	Amount (Rs. in lakhs)	Amount (Rs. in lakhs)
Income		
Sales		5,010
Other Income		<u>130</u>
		5,140
Expenditure		
Production and Operational Expenses	3,550	
Administrative Expenses	185	
Interest	235	
Depreciation	<u>370</u>	<u>4,340</u>

<i>Profit before Taxation</i>	800
<i>Provision for Taxation</i>	<u>280</u>
<i>Profit after Taxation</i>	520
<i>Credit Balance as per last Balance Sheet</i>	<u>40</u>
	<u>560</u>

Appropriations

<i>Transfer to General Reserve</i>	100
<i>Preference Dividend (Interim) paid</i>	50
<i>Proposed Preference Dividend (Final)</i>	50
<i>Proposed Equity Dividend</i>	300
<i>Balance carried to Balance Sheet</i>	<u>60</u>
	<u>560</u>

Supplementary Information

Production and Operational Expenses consist of:

<i>Raw Materials and Stores consumed</i>	1,900
<i>Wages, Salaries and Bonus</i>	610
<i>Local Taxes including Cess</i>	220
<i>Other Manufacturing Expenses</i>	<u>820</u>
	<u>3,550</u>

Administrative Expenses consist of:

<i>Salaries and Commission to Directors</i>	60
<i>Audit Fee</i>	24
<i>Provision for Bad and Doubtful Debts</i>	20
<i>Other Administrative Expenses</i>	<u>81</u>
	<u>185</u>

Interest is on:

<i>Loan from Bank for Working Capital</i>	35
<i>Debentures</i>	<u>200</u>
	<u>235</u>

- (b) The Institute for Global Management Research maintains a combined Development Fund in respect of which the following information is available for the year ended 31st March, 2005:

	Rs.
<i>Government. Grants received for acquisition of land</i>	60,00,000
<i>Private Grants received for construction of buildings</i>	30,00,000
<i>Foreign Private Grant for purchase of computing equipment USD</i>	<u>5,00,000</u>
<i>Transfer from unrestricted fund for purchase of furniture</i>	10,00,000
<i>Cost of assets so far acquired:</i>	

Land	59,00,000
Buildings in progress (payments to Contractors)	15,00,000
Furniture	3,00,000

The USD grant has been received into a bank account in USA on 29.3.2005 and is expected to be utilized therefrom for purchases to be made abroad. The rate of exchange on 31.3.2005 is 1 USD = Rs. 44.

You are required to prepare

- A Statement showing changes in the Development Fund for the year; and
- Balance Sheet of the Development Fund as at 31.3.2005. (12 + 8 = 20 Marks)

Answer

**(a) Gross Value Added Statement of Zed Ltd.
for the year ended 31st March, 2005**

	Rs. in lakhs	Rs. in lakhs
Sales		5,010
Less: Cost of raw materials, stores and other services consumed (1,900 + 820)	2,720	
Administrative expenses (185 – 60)	125	
Interest on loan from bank for working capital	<u>35</u>	<u>2,880</u>
Value added by manufacturing and trading activities		2,130
Add: Other income		<u>130</u>
Total value added		<u>2,260</u>

Application of Value Added

	Rs.in lakhs	Rs. in lakhs	%
To pay employees			
Wages, salaries and bonus		610	26.99
To pay directors			
Salaries and commission to Directors		60	2.66
To pay Government			
Local taxes including cess	220		
Income tax	<u>280</u>	500	22.12
To pay providers of capital			
Interest on debentures	200		
Preference dividend	100		
Equity dividend	<u>300</u>	600	26.55

To provide for the maintenance and expansion of the company:

Depreciation	370		
Transfer to general reserve	100		
Retained profits Rs.(60 – 40) lakhs	<u>20</u>	<u>490</u>	<u>21.68</u>
		<u>2,260</u>	<u>100</u>

**Statement showing Reconciliation between
Gross Value Added with Profit before Taxation**

	<i>Rs. in lakhs</i>	<i>Rs. in lakhs</i>
Profit before taxation		800
<i>Add back:</i>		
Wages, salaries and bonus	610	
Salaries and commission to Directors	60	
Local taxes including cess	220	
Interest on debentures	200	
Depreciation	<u>370</u>	<u>1,460</u>
Gross Value Added		<u>2,260</u>

**(b) The Institute for Global Management Research
Statement of Changes in Development Fund**

	<i>Rs.</i>	<i>Rs.</i>
<i>Receipts</i>		
Government grants	60,00,000	
Private grants	30,00,000	
Foreign private grant (in USD 5,00,000)	2,20,00,000	
Transfer from unrestricted fund	<u>10,00,000</u>	3,20,00,000
<i>Deductions/Transfers</i>		
Cost of land acquired	59,00,000	
Furniture purchased	<u>3,00,000</u>	<u>62,00,000</u>
Balance as at 31.3.2005		<u>2,58,00,000</u>

Development Fund
Balance Sheet as at 31.3.2005

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Fund balance	2,58,00,000	Buildings in progress	15,00,000
		Bank balances	
		in India	23,00,000
		outside India	<u>2,20,00,000</u>
	<u>2,58,00,000</u>		<u>2,43,00,000</u>
			<u>2,58,00,000</u>

Working Note:**Bank Account (in India)**

	<i>Rs.</i>		<i>Rs.</i>
To Government grant	60,00,000	By Land	59,00,000
To Private grant	30,00,000	By Furniture	3,00,000
To Transfer	10,00,000	By Payments to contractors for buildings	15,00,000
		By Balance c/d	<u>23,00,000</u>
	<u>1,00,00,000</u>		<u>1,00,00,000</u>

Question 3

The following abridged Balance Sheet as at 31st March, 2005 pertains to Glorious Ltd.

<i>Liabilities</i>	<i>Rs. in lakhs</i>	<i>Assets</i>	<i>Rs. in lakhs</i>
<i>Share Capital:</i>		<i>Goodwill, at cost</i>	420
180 lakh Equity shares of Rs. 10 each, fully paid up	1,800	<i>Other Fixed Assets</i>	11,166
90 lakh Equity shares of Rs. 10 each, Rs. 8 paid up	720	<i>Current Assets</i>	2,910
150 lakh Equity shares of Rs. 5 each, fully paid-up	750	<i>Loans and Advances</i>	933
<i>Reserves and Surplus</i>	5,628	<i>Miscellaneous Expenditure</i>	171
<i>Secured Loans</i>	4,500		
<i>Current Liabilities</i>	1,242		
<i>Provisions</i>	<u>960</u>		
	<u>15,600</u>		<u>15,600</u>

You are required to calculate the following for each one of the three categories of equity shares appearing in the above mentioned Balance Sheet:

- (i) Intrinsic value on the basis of book values of Assets and Liabilities including goodwill;
- (ii) Value per share on the basis of dividend yield.

Normal rate of dividend in the concerned industry is 15%, whereas Glorious Ltd. has been paying 20% dividend for the last four years and is expected to maintain it in the next few years; and

- (iii) Value per share on the basis of EPS.

For the year ended 31st March, 2005 the company has earned Rs. 1,371 lakh as profit after tax, which can be considered to be normal for the company. Average EPS for a fully paid share of Rs. 10 of a Company in the same industry is Rs. 2. (16 Marks)

Answer

(i) Intrinsic value per share on the basis of book values	Rs. in lakhs	Rs. in lakhs
Goodwill		420
Other Fixed Assets		11,166
Current Assets		2,910
Loans and Advances		<u>933</u>
		15,429
Less: Secured loans	4,500	
Current liabilities	1,242	
Provisions	<u>960</u>	<u>6,702</u>
		8,727
Add: Notional call on 90 lakhs equity shares @ Rs. 2 per share		<u>180</u>
		<u>8,907</u>

$$\text{Value per equivalent share of Rs.10 each} = \frac{\text{Rs.8,907 lakhs}}{345 * \text{lakhs shares}} = \text{Rs.25.82 (approx)}$$

Hence, intrinsic values of each equity share are as follows:

Value of fully paid-up share of Rs. 10 = Rs. 25.82

Value of partly paid-up share of Rs. 8 = Rs. 25.82 – Rs. 2 = Rs. 23.82

Value of fully paid-up share of Rs. 5 = $\text{Rs.25.82} \times \frac{5}{10} = \text{Rs.12.91}$

*Calculation of equivalent number of equity shares of Rs. 10 each:

	<i>Shares in lakhs</i>
Fully paid shares of Rs. 10 each	180
Partly-paid shares after notional call	90
Fully paid shares of Rs. 5 each, $\left[\frac{\text{Rs. 150 lakhs}}{\text{Rs. 10}} \times \text{Rs. 5} \right]$	<u>75</u>
	<u>345</u>

(ii) Value per share on dividend yield basis:

Value of fully paid-up share of Rs. 10 = $\frac{20}{15} \times \text{Rs. 10} = \text{Rs. 13.33}$ (approx)

Value of partly paid-up share of Rs. 8 = $\frac{20}{15} \times \text{Rs. 8} = \text{Rs. 10.67}$ (approx)

Value of fully paid-up share of Rs. 5 = $\frac{20}{15} \times \text{Rs. 5} = \text{Rs. 6.67}$ (approx)

(iii) Value per share on the basis of EPS:

Profit after tax = Rs. 1,371 lakhs

Total share capital = Rs. (1,800 + 720 + 750) lakhs = Rs. 3,270 lakhs

Earning per rupee of share capital = Rs. $\frac{1,371 \text{ lakhs}}{3,270 \text{ lakhs}} = \text{Re. 0.419}$ (approx)

Earning per fully paid share of Rs. 10 = Re. $0.419 \times 10 = \text{Rs. 4.19}$

Earning per share of Rs. 10 each, Rs. 8 paid-up = Re. $0.419 \times 8 = \text{Rs. 3.35}$ (approx)

Earning per share of Rs. 5, fully paid-up = Re. $0.419 \times 5 = \text{Rs. 2.10}$ (approx)

Value of fully paid share of Rs. 10 = Rs. $\frac{4.19}{2} \times 10 = \text{Rs. 20.95}$

Value of share of Rs. 10, Rs. 8 paid-up = Rs. $\frac{3.35}{2} \times 10 = \text{Rs. 16.75}$

Value of fully paid share of Rs. 5 = Rs. $\frac{2.10}{2} \times 10 = \text{Rs. 10.50}$

Question 4

- (a) Venus Ltd. has an asset, which is carried in the Balance Sheet on 31.3.2005 at Rs. 500 lakhs. As at that date the value in use is Rs. 400 lakhs and the net selling price is Rs. 375 lakhs.

From the above data:

- (i) Calculate impairment loss.
 - (ii) Prepare journal entries for adjustment of impairment loss.
 - (iii) Show, how impairment loss will be shown in the Balance Sheet.
- (b) Himalaya Ltd. in the past three years spent Rs. 75,00,000 to develop a Drug to treat Cancer, which was charged to Profit and Loss Account since they did not meet AS 8 criteria for capitalization. In the current year approval of the concerned Government Authority has been received. The Company wishes to capitalize Rs. 75,00,000 and disclose it as a prior period item. Is it correct? Give reason for your views.
- (c) Bottom Ltd. entered into a sale deed for its immovable property before the end of the year. But registration was done with registrar subsequent to Balance Sheet date. But before finalisation, is it possible to recognise the sale and the gain at the Balance Sheet date? Give your view with reasons. (6 + 5 + 5 = 16 Marks)

Answer

- (a) (i) Impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Thus, Impairment loss = Carried amount – Recoverable amount*

= Rs. 500 lakhs – Rs. 400 lakhs = Rs. 100 lakhs

*Recoverable amount is higher of asset's net selling price Rs. 375 lakhs and its value in use Rs. 400 lakhs.

∴ Recoverable amount = Rs. 400 lakhs

(ii)

Journal Entries

Particulars		Dr. Amount Rs. in lakhs	Cr. Amount Rs. in lakhs
(i)	Impairment loss account	Dr. 100	
	To Asset account		100
	(Being the entry for accounting impairment loss)		

(ii)	Profit and loss account	Dr.	100	
	To Impairment loss account			100
	(Being the entry to transfer impairment loss to profit and loss account)			

(iii) **Balance Sheet of Venus Ltd. as on 31.3.2005**

	<i>Rs. in lakhs</i>
Asset less depreciation	500
Less: Impairment loss	<u>100</u>
	<u>400</u>

- (b) AS 8 'Accounting for Research and Development' stands withdrawn w.e.f. 1st April, 2003 i.e. the date from which AS 26 'Intangible Assets' becomes mandatory. In any case, under either standard, the condition for recognition of a research and development asset has to be fulfilled when the expenditure was incurred. If the recognition conditions are not fulfilled the amount has to be charged to the profit and loss account. Once the amount is charged to the profit and loss account, such amount cannot be restated later as a research and development asset when the condition for recognition get fulfilled. The company therefore cannot capitalize Rs. 75,00,000 even as a prior period item.
- (c) Yes, it is possible for the Bottom Ltd. to recognize the sale and the gain at the balance sheet date according to AS 9* 'Revenue Recognition'. It is evident that the significant risks and rewards of ownership had passed before the balance sheet date and the delay in transfer of property was merely because of formality in getting the transfer deed registered. Further the registration post the balance sheet date confirms the condition of sale at the balance sheet date as per AS 4 'Contingencies and Events occurring after the Balance Sheet Date'.

Question 5

- (a) In view of the provisions of Accounting Standard 25 on Interim Financial Reporting, on what basis will you calculate, for an interim period, the provision in respect of defined benefit schemes like pension, gratuity etc. for the employees?
- (b) Briefly describe the significance of Environmental Accounting.
- (c) A Company has its share capital divided into shares of Rs. 10 each. On 1st April, 2004 it granted 10,000 employees' stock options at Rs. 40, when the market price was Rs. 130. The options were to be exercised between 16th December, 2004 and 15th March, 2005. The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year.

Show Journal Entries.

(5 + 5 + 6 = 16 Marks)

Answer

- (a) Accounting Standard 25 suggests that provision in respect of defined benefit schemes like pension and gratuity for an interim period should be calculated on year-to-date basis by using the actuarially determined rates at the end of the prior financial year, adjusted for significant market fluctuations since that time and for significant curtailments, settlements or other significant one-time events.
- (b) 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.

(c)

Journal Entries

	Particulars		Dr. Rs.	Cr. Rs.
2004				
April 1	Employee Compensation Expense	Dr.	9,00,000	
	To Employee Stock Options Outstanding			9,00,000
	(Being grant of 10,000 stock options to employees at Rs. 40 when market price is Rs. 130)			
2005				
16th	Bank account	Dr.	3,80,000	
Dec. to 15th	Employee stock options outstanding	Dr.	8,55,000	
	To Equity share capital			95,000
March	To Securities premium			11,40,000
	(Being allotment to employees of 9,500 equity shares of Rs. 10 each at a premium of Rs. 120 per share in exercise of stock options by employees)			
March 16	Employee stock options outstanding	Dr.	45,000	
	To Employee compensation expense			45,000
	(Being entry for lapse of stock options for 500 shares)			

March 31	Profit and Loss account	Dr.	8,55,000	
	To Employee compensation expense			8,55,000
	(Being transfer of employee compensation expense to profit and loss account)			

Question 6

- (a) While closing its books of account on 31st March, 2005 a Non-Banking Finance Company has its advances classified as follows:

	Rs.in lakhs
Standard assets	16,800
Sub-standard assets	1,340
Secured positions of doubtful debts:	
– upto one year	320
– one year to three years	90
– more than three years	30
Unsecured portions of doubtful debts	97
Loss assets	48

Calculate the amount of provision, which must be made against the Advances.

- (b) In May, 2004 Speed Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2005 and the building was put to its use immediately thereafter. Interest on the actual amount used for construction of the building till its completion was Rs. 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st March, 2005 amounted to Rs. 25 lakhs.

Can Rs. 25 lakhs be treated as part of the cost of factory building and thus be capitalized on the plea that the loan was specifically taken for the construction of factory building?

- (c) Distinguish between “Timing differences” and “Permanent differences” referred to in AS 22 on Accounting for Taxes, giving 2 examples of each. (8 + 4 + 4 = 16 Marks)

Answer

- (a) ` Calculation of provision required on advances as on 31st March, 2005

	Amount Rs. in lakhs	Percentage of provision	Provision Rs. in lakhs
Standard assets	16,800	NIL	NIL
Sub-standard assets	1,340	10	134

Secured portions of doubtful debts—

—upto one year	320	20	64
— one year to three years	90	30	27
—more than three years	30	50	15
Unsecured portions of doubtful debts	97	100	97
Loss assets	48	100	<u>48</u>
			<u>385</u>

- (b) As per para 19 of AS 16 'Borrowing Costs', capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. Therefore, interest on the amount that has been used for the construction of the building upto the date of completion (January, 2005) i.e. Rs. 18 lakhs alone can be capitalized. It cannot be extended to Rs. 25 lakhs.
- (c) As per AS 22, timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.

Examples:

- Unabsorbed depreciation and carry forward of losses which can be set-off against future taxable income.
- Statutory dues deferred for payment under Section 43B of the Income-Tax Act.

"Permanent Differences" are the differences between taxable income and accounting income for a period that originate in one period but do not reverse subsequently.

Examples:

- Agricultural income.
- Donations/contributions disallowed for tax purposes.

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

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

Figures in the margin indicate marks allotted to each question.

Working notes should form part of the answer.

Question 1

- (a) Engineers Ltd. is in the business of manufacturing nut bolts. Some more product lines are being planned to be added to the existing system. The machinery required may be bought or may be taken on lease. The cost of machine is Rs. 20,00,000 having a useful life of 5 years with the salvage value of Rs. 4,00,000 (consider short term capital loss/gain for the Income tax). The full purchase value of machine can be financed by bank loan at the rate of 20% interest repayable in five equal instalments falling due at the end of each year. Alternatively, the machine can be procured on a 5 years lease, year-end lease rentals being Rs. 6,00,000 per annum. The Company follows the written down value method of depreciation at the rate of 25 per cent. Company's tax rate is 35 per cent and cost of capital is 14 per cent.

- (i) Advise the company which option it should choose – lease or borrow.
(ii) Assess the proposal from the lessor's point of view examining whether leasing the machine is financially viable at 14 per cent cost of capital.

Detailed working notes should be given.

- (b) Determine the risk adjusted net present value of the following projects:

	X	Y	Z
Net cash outlays (Rs.)	2,10,000	1,20,000	1,00,000
Project life	5 years	5 years	5 years
Annual Cash inflow (Rs.)	70,000	42,000	30,000
Coefficient of variation	1.2	0.8	0.4

The Company selects the risk-adjusted rate of discount on the basis of the coefficient of variation:

Coefficient of Variation	Risk-Adjusted Rate of Return	P.V. Factor 1 to 5 years At risk adjusted rate of discount
0.0	10%	3.791
0.4	12%	3.605
0.8	14%	3.433
1.2	16%	3.274
1.6	18%	3.127
2.0	22%	2.864
More than 2.0	25%	2.689

(14 + 6 = 20 Marks)

Answer**(a) Discounting Factor:**

Cost of finance 20% - Tax 35% = 13%.

(i) PV of cash outflows under leasing alternative

<i>Year-end</i>	<i>Lease rent after taxes P.A.</i>	<i>PVIFA at 13%</i>	<i>Total P.V.</i>
1 – 5	Rs. 3,90,000	3.517	Rs. 13,71,630

PV of cash outflows under buying alternative

<i>Year end</i>	<i>Loan Instalment</i>	<i>Tax advantage on Interest</i>	<i>Tax advantage on Depreciation</i>	<i>Net Cash Outflow</i>	<i>PVIF at 13%</i>	<i>Total PV</i>
1	6,68,673	1,40,000	1,75,000	3,53,673	0.885	3,13,001
2	6,68,673	1,21,193	1,31,250	4,16,230	0.783	3,25,908
3	6,68,673	98,624	98,438	4,71,611	0.693	3,26,826
4	6,68,673	71,542	73,828	5,23,303	0.613	3,20,785
5	6,68,673	38,819	55,371	5,74,483	0.543	<u>3,11,944</u>
Total PV outflows						15,98,464
Less: PV of Salvage Value (Rs. 4,00,000 * 0.543)						<u>2,17,200</u>
						13,81,264
Less: PV of tax saving on short term capital loss (4,74,609 – 4,00,000) * 35% * .543						14,179
NPV of Cash outflow						13,67,085

Working Notes:**(1) Schedule of Debt Payment**

<i>Year-end</i>	<i>Opening balance</i>	<i>Interest @ 20%</i>	<i>Repayment</i>	<i>Closing Balance</i>	<i>Principal Amount</i>
1	20,00,000	4,00,000	6,68,673	17,31,327	2,68,673
2	17,31,327	3,46,265	6,68,673	14,08,919	3,22,408
3	14,08,919	2,81,784	6,68,673	10,22,030	3,86,889
4	10,22,030	2,04,406	6,68,673	5,57,763	4,64,267
5	5,57,763	1,10,910*	6,68,673	0	5,57,763

*Balancing Figure

(2) Schedule of Depreciation

Year	Opening WDV	Depreciation	Closing WDV
1	20,00,000	5,00,000	15,00,000
2	15,00,000	3,75,000	11,25,000
3	11,25,000	2,81,250	8,43,750
4	8,43,750	2,10,938	6,32,812
5	6,32,812	1,58,203	4,74,609

- (3) $EMI = Rs.20,00,000 / \text{Annuity for 5 years @ } 20\% = \text{i.e. } Rs.20,00,000 / 2.991$
 $= Rs. 6,68,673.$

Advice: Company is advised to borrow and buy not to go for leasing as NPV of cash outflows is lower in case of buying alternative.

Note: Students may note that the cost of capital of the company given in the question is 14% at which cash flows may also be discounted, the question is however, silent whether this cost of capital is pre-tax or post tax. If it is assumed that this is after tax cost and the cash flows are discounted at this rate there is no change in the advice to the company i.e. borrow and buy. However, if it is assumed that the cost of capital is pre-tax and the same is adjusted with the tax rate to discount the cash flows, the advice to the company changes to leasing.

(ii) Evaluation from Lessor's Point of View

	(1)	(2)	(3)	(4)	(5)
Lease Rent	6,00,000	6,00,000	6,00,000	6,00,000	6,00,000
Less: Depreciation	5,00,000	3,75,000	2,81,250	2,10,938	1,58,203
EBT	1,00,000	2,25,000	3,18,750	3,89,062	4,41,797
Less: Tax @ 35%	35,000	78,750	1,11,563	1,36,172	1,54,629
EAT	65,000	1,46,250	2,07,187	2,52,890	2,87,168
Add: Depreciation	5,00,000	3,75,000	2,81,250	2,10,938	1,58,203
Cash Inflows	5,65,000	5,21,250	4,88,437	4,63,828	4,45,371
PV factor @ 14%	0.877	0.769	0.675	0.592	0.519
PV of inflows	4,95,505	4,00,841	3,29,695	2,74,586	2,31,148

Evaluation:

Aggregate PV of cash inflows	17,31,775
Add: PV of salvage value $(4,00,000 \times 0.519)$	2,07,600
Add: Tax shelter on short-term capital loss $(4,74,609 - 4,00,000) \times 0.35 \times 0.519$	<u>13,553</u>

PV of all cash inflows	19,52,928
Cost of the machine	20,00,000
NPV	−47,072

Hence, leasing at this rate is not feasible.

Working Note: Depreciation @ 25% WDV.

Cost = Rs. 20,00,000

				(Amount in Rs.)
			Depreciation	Balance
1	20,00,000		5,00,000	15,00,000
2	15,00,000		3,75,000	11,25,000
3	11,25,000		2,81,250	8,43,750
4	8,43,750		2,10,938	6,32,812
5	6,32,812		1,58,203	4,74,609

(b) Statement showing the determination of the risk adjusted net present value

Projects	Net cash outlays	Coefficient of variation	Risk adjusted discount rate	Annual cash inflow	PV factor 1-5 years	Discounted cash inflow	Net present value
	Rs.			Rs.		Rs.	Rs.
(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii) = (v) × (vi)	(viii) = (vii) – (ii)
X	2,10,000	1.20	16%	70,000	3.274	2,29,180	19,180
Y	1,20,000	0.80	14%	42,000	3.433	1,44,186	24,186
Z	1,00,000	0.40	12%	30,000	3.605	1,08,150	8,150

Question 2

- (a) Sun Moon Mutual Fund (Approved Mutual Fund) sponsored open-ended equity oriented scheme "Chanakya Opportunity Fund". There were three plans viz. 'A' – Dividend Re-investment Plan, 'B' – Bonus Plan & 'C' – Growth Plan.

At the time of Initial Public Offer on 1.4.1995, Mr. Anand, Mr. Bacchan & Mrs. Charu, three investors invested Rs. 1,00,000 each & chosen 'B', 'C' & 'A' Plan respectively.

The History of the Fund is as follows:

Date	Dividend %	Bonus Ratio	Net Asset Value per Unit (F.V. Rs. 10)		
			Plan A	Plan B	Plan C
28.07.1999	20		30.70	31.40	33.42
31.03.2000	70	5 : 4	58.42	31.05	70.05
31.10.2003	40		42.18	25.02	56.15
15.03.2004	25		46.45	29.10	64.28
31.03.2004		1 : 3	42.18	20.05	60.12
24.03.2005	40	1 : 4	48.10	19.95	72.40
31.07.2005			53.75	22.98	82.07

On 31st July all three investors redeemed all the balance units.

Calculate annual rate of return to each of the investors.

Consider:

1. Long-term Capital Gain is exempt from Income tax.
 2. Short-term Capital Gain is subject to 10% Income tax.
 3. Security Transaction Tax 0.2 per cent only on sale/redemption of units.
 4. Ignore Education Cess.
- (b) Following information is available in respect of dividend, market price and market condition after one year.

Market condition	Probability	Market Price	Dividend per share
		Rs.	Rs.
Good	0.25	115	9
Normal	0.50	107	5
Bad	0.25	97	3

The existing market price of an equity share is Rs. 106 (F.V. Re. 1), which is cum 10% bonus debenture of Rs. 6 each, per share. M/s. X Finance Company Ltd. had offered the buy-back of debentures at face value.

Find out the expected return and variability of returns of the equity shares.

And also advise-Whether to accept buy back after?

(12 + 8 = 20 Marks)

Answer

(a)	Mrs. Charu	Plan A Dividend Reinvestment		
				(Amount in Rs.)
Date	Investment	Rate	Units	Balance
01.04.1995	1,00,000.00	10.00	10,000.00	10,000.00
28.07.1999	20,000.00	30.70	651.47	10,651.47
31.03.2000	74,560.29	58.42	1,276.28	11,927.75
30.10.2003	47,711.00	42.18	1,131.13	13,058.88
15.03.2004	32,647.20	46.45	702.85	13,761.73
31.03.2004	N.A.	N.A.	N.A.	13,761.73
24.03.2005	55,046.92	48.10	1,144.43	14,906.16
Redemption value $14,906.16 \times 53.75$				8,01,206.10
Less: Security Transaction Tax (S.T.T) is .2%				<u>1,602.41</u>
Net amount received				7,99,603.69
Less: Short term capital gain tax @ 10%				
1,144.43 (53.64 – 48.10)		6,340		
i.e. $53.75 - \text{S.T.T. } .2\%$				<u>634</u>
Net of tax				7,98,969.69
Less: Investment				<u>1,00,000.00</u>
				<u>6,98,969.69</u>

$$\text{Annual average return (\%)} = \frac{6,98,969}{1,00,000} \times \frac{12}{124} \times 100 = 67.64$$

Mr. Anand**Plan B – Bonus**

<i>(Amount in Rs.)</i>			
<i>Date</i>	<i>Units</i>	<i>Balance</i>	<i>NAV per unit</i>
01.04.1995	10,000	10,000	10
31.03.2000	12,500	22,500	31.05
31.03.2004	7,500	30,000	20.05
24.03.2005	7,500	37,500	19.95

Redemption value $37,500 \times 22.98$	8,61,750.00
Less: Security Transaction Tax (S.T.T) is .2%	<u>1,723.50</u>
Net amount received	8,60,026.50
Less: Short term capital gain tax @ 10%	
$7,500 \times (22.93 - 19.95)$	22,350
i.e. $22.98 - \text{S.T.T. } .2\%$	<u>2,235.00</u>
Net of tax	8,57,791.50
Less: Investment	<u>1,00,000.00</u>
Net gain	<u>7,57,791.50</u>

$$\text{Annual average return (\%)} = \frac{7,57,791}{1,00,000} \times \frac{12}{124} \times 100 = 73.33$$

Mr. Bacchan**Plan C – Growth***(Amount in Rs.)*

Redemption value $10,000 \times 82.07$	8,20,700.00
Less: Security Transaction Tax (S.T.T) is .2%	<u>1,641.40</u>
Net amount received	8,19,058.60
Less: Short term capital gain tax @ 10%	<u>0.00</u>
Net of tax	8,19,058.60
Less: Investment	<u>1,00,000.00</u>
Net gain	<u>7,19,058.60</u>

$$\text{Annual average return (\%)} = \frac{7,19,058}{1,00,000} \times \frac{12}{124} \times 100 = 69.59$$

(b) The Expected Return of the equity share may be found as follows:

Market Condition	Probability	Total Return	Cost (*)	Net Return
Good	0.25	Rs. 124	Rs. 100	Rs. 24
Normal	0.50	Rs. 112	Rs. 100	Rs. 12
Bad	0.25	Rs. 100	Rs. 100	Rs. 0

$$\text{Expected Return} = (24 \times 0.25) + (12 \times 0.50) + (0 \times 0.25)$$

$$= \left(\frac{12}{100} \right) \times 100 = 12\%$$

The variability of return can be calculated in terms of standard deviation.

$$\begin{aligned}
 V SD &= 0.25 (24 - 12)^2 + 0.50 (12 - 12)^2 + 0.25 (0 - 12)^2 \\
 &= 0.25 (12)^2 + 0.50 (0)^2 + 0.25 (-12)^2 \\
 &= 36 + 0 + 36 \\
 SD &= \sqrt{72} \\
 SD &= 8.485 \text{ or say } 8.49
 \end{aligned}$$

(*) The present market price of the share is Rs. 106 cum bonus 10% debenture of Rs. 6 each; hence the net cost is Rs. 100 (There is no cash loss or any waiting for refund of debenture amount).

M/s X Finance company has offered the buy back of debenture at face value. There is reasonable 10% rate of interest compared to expected return 12% from the market. Considering the dividend rate and market price the creditworthiness of the company seems to be very good. The decision regarding buy-back should be taken considering the maturity period and opportunity in the market. Normally, if the maturity period is low say up to 1 year better to wait otherwise to opt buy back option.

Question 3

- (a) (i) What is interest rate risk, reinvestment risk & default risk & what are the types of risk involved in investments in G-Sec.?
- (ii) What is a Repo and a Reverse Repo?
- (b) You as a dealer in foreign exchange have the following position in Swiss Francs on 31st October, 2004:

	Swiss Francs
Balance in the Nostro A/c Credit	1,00,000
Opening Position Overbought	50,000
Purchased a bill on Zurich	80,000
Sold forward TT	60,000
Forward purchase contract cancelled	30,000
Remitted by TT	75,000
Draft on Zurich cancelled	30,000

What steps would you take, if you are required to maintain a credit Balance of Swiss Francs 30,000 in the Nostro A/c and keep as overbought position on Swiss Francs 10,000?

- (c) The following information is relating to Fortune India Ltd. having two division, viz. Pharma Division and Fast Moving Consumer Goods Division (FMCG Division). Paid up

share capital of Fortune India Ltd. is consisting of 3,000 Lakhs equity shares of Re. 1 each. Fortune India Ltd. decided to de-merge Pharma Division as Fortune Pharma Ltd. w.e.f. 1.4.2005. Details of Fortune India Ltd. as on 31.3.2005 and of Fortune Pharma Ltd. as on 1.4.2005 are given below:

Particulars	Fortune Pharma Ltd. Rs.	Fortune India Ltd. Rs.
Outside Liabilities		
Secured Loans	400 lakh	3,000 lakh
Unsecured Loans	2,400 lakh	800 lakh
Current Liabilities & Provisions	1,300 lakh	21,200 lakh
Assets		
Fixed Assets	7,740 lakh	20,400 lakh
Investments	7,600 lakh	12,300 lakh
Current Assets	8,800 lakh	30,200 lakh
Loans & Advances	900 lakh	7,300 lakh
Deferred tax/Misc. Expenses	60 lakh	(200) lakh

Board of Directors of the Company have decided to issue necessary equity shares of Fortune Pharma Ltd. of Re. 1 each, without any consideration to the shareholders of Fortune India Ltd. For that purpose following points are to be considered:

1. Transfer of Liabilities & Assets at Book value.
2. Estimated Profit for the year 2005-06 is Rs. 11,400 Lakh for Fortune India Ltd. & Rs. 1,470 lakhs for Fortune Pharma Ltd.
3. Estimated Market Price of Fortune Pharma Ltd. is Rs. 24.50 per share.
4. Average P/E Ratio of FMCG sector is 42 & Pharma sector is 25, which is to be expected for both the companies.

Calculate:

1. The Ratio in which shares of Fortune Pharma are to be issued to the shareholders of Fortune India Ltd.
2. Expected Market price of Fortune India Ltd.
3. Book Value per share of both the Companies immediately after Demerger.

(5 + 7 + 8 = 20 Marks)

Answer

- (a) (i) **Interest Rate Risk:** Interest Rate Risk, market risk or price risk are essentially one and the same. These are typical of any fixed coupon security with a fixed period to

maturity. This is on account of inverse relation of price and interest. As the interest rate rises the price of a security will fall. However, this risk can be completely eliminated in case an investor's investment horizon identically matches the term of security.

Re-investment Risk: This risk is again akin to all those securities, which generate intermittent cash flows in the form of periodic coupons. The most prevalent tool deployed to measure returns over a period of time is the yield-to-maturity (YTM) method. The YTM calculation assumes that the cash flows generated during the life of a security is reinvested at the rate of YTM. The risk here is that the rate at which the interim cash flows are reinvested may fall thereby affecting the returns.

Default Risk: This type of risk in the context of a Government security is always zero. However, these securities suffer from a small variant of default risk i.e. maturity risk. Maturity risk is the risk associated with the likelihood of government issuing a new security in place of redeeming the existing security. In case of Corporate Securities it is referred to as credit risk.

G. Secs are usually referred to as risk free securities. However, these securities are subject to only one type of risk i.e. interest rate risk. Subject to changes in the overall interest rate scenario, the price of these securities may appreciate or depreciate.

- (ii) A Repo deal is one where eligible parties enter into a contract another to borrow money at a predetermined rate against the collateral of eligible security for a specified period of time. The legal title of the security does changes. The motive of the deal is to fund a position. Though the mechanics essentially remains the same and the contract virtually remains the same, in case of reverse Repo deal the underlying motive of the deal is to meet the security/instrument specific needs or to lend the money. Indian Repo market is governed by Reserve Bank of India. At present Repo is permitted between 64 players against Central and State Government Securities (including T-Bills) at Mumbai.

(b) Exchange Position/Currency Position:

<i>Particulars</i>	<i>Purchase Sw. Fcs.</i>	<i>Sale Sw. Fcs.</i>
Opening Balance Overbought	50,000	
Bill on Zurich	80,000	
Forward Sales – TT		60,000
Cancellation of Forward Contract		30,000
TT Sales		75,000
Draft on Zurich cancelled	<u>30,000</u>	
	1,60,000	1,65,000
Closing Balance Oversold	<u>5,000</u>	
	<u>1,65,000</u>	<u>1,65,000</u>

Cash Position (Nostro A/c)

	Credit	Debit
Opening balance credit	1,00,000	
TT sales	<u>1,00,000</u>	<u>75,000</u>
	1,00,000	75,000
Closing balance (credit)	<u>1,00,000</u>	<u>25,000</u>
	<u>1,00,000</u>	<u>1,00,000</u>

The Bank has to buy spot TT Sw. Fcs. 5,000 to increase the balance in Nostro account to Sw. Fcs. 30,000.

This would bring down the oversold position on Sw. Fcs. As Nil.

Since the bank requires an overbought position of Sw. Fcs. 10,000, it has to buy forward Sw. Fcs. 10,000.

(c) Share holders' funds

<i>Particulars</i>	<i>Fortune India Ltd.</i>	<i>Fortune Pharma Ltd.</i>	<i>Fortune India (FMCG) Ltd.</i>
Assets	70,000	25,100	44,900
Outside liabilities	<u>25,000</u>	<u>4,100</u>	<u>20,900</u>
Net worth	<u>45,000</u>	<u>21,000</u>	<u>24,000</u>

1. Calculation of Shares of Fortune Pharma Ltd. are to be issued to shareholders of Fortune India Ltd.

	<i>Fortune Pharma Ltd.</i>
Estimated Profit (Rs. in lakhs)	1,470
Estimated market price (Rs.)	24.5
Estimated P/E	25
Estimated EPS (Rs.)	0.98
No. of shares lakhs	1,500

Hence, Ratio is 1 share of Fortune Pharma Ltd. for 2 shares of Fortune India Ltd.

2. Expected market price of Fortune India Ltd.

	<i>Fortune India (FMCG) Ltd.</i>
Estimated Profit (Rs. in lakhs)	11,400
No. of equity shares (Rs. in lakhs)	3,000

Estimated EPS (Rs.)	3.8
Estimated P/E	42
Estimated market price (Rs.)	159.6

3. Book value per share

	<i>Fortune Pharma Ltd.</i>	<i>Fortune India (FMCG) Ltd.</i>
Net worth (Rs.in lakhs)	21,000	24,000
No. of shares (Rs. in lakhs)	1,500	3,000
Book value of shares	Rs. 14	Rs. 8

Question 4

- (a) What are the investors' rights & obligations under the Mutual Fund Regulations? Explain different methods for evaluating the performance of Mutual Fund.
- (b) The Investment portfolio of a bank is as follows:

<i>Government Bond</i>	<i>Coupon Rate</i>	<i>Purchase rate (F.V. Rs. 100 per Bond)</i>	<i>Duration (Years)</i>
<i>G.O.I. 2006</i>	<i>11.68</i>	<i>106.50</i>	<i>3.50</i>
<i>G.O.I. 2010</i>	<i>7.55</i>	<i>105.00</i>	<i>6.50</i>
<i>G.O.I. 2015</i>	<i>7.38</i>	<i>105.00</i>	<i>7.50</i>
<i>G.O.I. 2022</i>	<i>8.35</i>	<i>110.00</i>	<i>8.75</i>
<i>G.O.I. 2032</i>	<i>7.95</i>	<i>101.00</i>	<i>13.00</i>

Face value of total Investment is Rs. 5 crores in each Government Bond.

Calculate actual Investment in portfolio.

What is a suitable action to churn out investment portfolio in the following scenario?

- Interest rates are expected to lower by 25 basis points.
- Interest rates are expected to raise by 75 basis points.

Also calculate the revised duration of investment portfolio in each scenario.

- (c) You sold Hong Kong Dollar 1,00,00,000 value spot to your customer at Rs. 5.70 & covered yourself in London market on the same day, when the exchange rates were

US\$ 1 = H.K.\$ 7.5880 7.5920

Local inter bank market rates for US\$ were

Spot US\$ 1 = Rs. 42.70 42.85

Calculate cover rate & ascertain the profit or loss in the transaction ignore brokerage.

(8 + 8 + 4 = 20 Marks)

Answer**(a) Investors' rights and obligations under the Mutual Fund Regulations:**

Important aspect of the mutual fund regulations and operations is the investors' protection and disclosure norms. It serves the very purpose of mutual fund guidelines. Due to these norms it is very necessary for the investor to remain vigilant. Investor should continuously evaluate the performance of mutual fund.

Following are the steps taken for improvement and compliance of standards of mutual fund:

1. All mutual funds should disclose full portfolio of their schemes in the annual report within one month of the close of each financial year. Mutual fund should either send it to each unit holder or publish it by way of an advertisement in one English daily and one in regional language.
2. The Asset Management Company must prepare a compliance manual and design internal audit systems including audit systems before the launch of any schemes. The trustees are also required to constitute an audit committee of the trustees which will review the internal audit systems and the recommendation of the internal and statutory audit reports and ensure their rectification.
3. The AMC shall constitute an in-house valuation committee consisting of senior executives including personnel from accounts, fund management and compliance departments. The committee would on a regular basis review the system practice of valuation of securities.
4. The trustees shall review all transactions of the mutual fund with the associates on a regular basis.

Investors' Rights:

1. Unit holder have proportionate right in the beneficial ownership of the schemes assets as well as any dividend or income declared under the scheme.
2. Receive dividend warrant within 42 days.
3. AMC can be terminated by 75% of the unit holders.
4. Right to inspect major documents i.e. material contracts, Memorandum of Association and Articles of Association (M.A. & A.A) of the AMC, Offer document etc.
5. 75% of the unit holders have the right to approve any changes in the close ended scheme.
6. Every unit holder have right to receive copy of the annual statement.

Legal limitations to investors' rights:

1. Unit holders cannot sue the trust but they can initiate proceedings against the trustees, if they feel that they are being cheated.

2. Except in certain circumstances AMC cannot assure a specified level of return to the investors. AMC cannot be sued to make good any shortfall in such schemes.

Investors' Obligations:

1. An investor should carefully study the risk factors and other information provided in the offer document. Failure to study will not entitle him for any rights thereafter.
2. It is the responsibility of the investor to monitor his schemes by studying the reports and other financial statements of the funds.

The criteria for evaluating the performance is as follows:

1. Sharpe Ratio

The excess return earned over the risk free return on portfolio to the portfolio's total risk measured by the standard deviation. This formula uses the volatility of portfolio return.

$$S = \frac{\text{Return of portfolio} - \text{Return of risk free investment}}{\text{Standard Deviation of Portfolio}}$$

2. Treynor Ratio

This ratio is similar to the Sharpe Ratio except it uses Beta of portfolio instead of standard deviation.

$$T = \frac{\text{Return of portfolio} - \text{Return of risk free investment}}{\text{Beta of Portfolio}}$$

3. Jensen's Alpha

The comparison of actual return of the fund with benchmark portfolio with the same risk. Normally, for the comparison of portfolios of mutual funds this ratio is applied and compared with market return. It shows the comparative risk and reward from the said portfolio. Alpha is the excess of actual return compared with expected return.

(b) Calculation of Actual investment of Portfolio

<i>Security</i>	<i>Purchase price</i>	<i>Investment (Rs. in lakhs)</i>
GOI 2006	106.50	532.50*
GOI 2010	105.00	525.00
GOI 2015	105.00	525.00
GOI 2022	110.00	550.00
GOI 2032	101.00	505.00
	Total	<u>2,637.50</u>

$$* \frac{\text{Rs. 5 crores}}{\text{Rs. 100} \times 1,00,000} \times \text{Rs. 106.50}$$

$$\text{Average Duration} = \frac{3.5 + 6.5 + 7.5 + 8.75 + 13.00}{5}$$

$$= \frac{39.25}{5} = 7.85$$

Suitable action to churn out investment portfolio in following scenario.

To reduce risk and to maximize profit or minimize losses.

- (1) Interest rates are expected to be lower by 25 basis points in such case increase the average duration by purchasing GOI 2032 and Disposing of GOI 2006.

$$\begin{aligned} \text{Revised average duration shall be} &= \frac{39.25 - 3.5 + 13}{5} \\ &= \frac{48.75}{5} = 9.75 \text{ years} \end{aligned}$$

- (2) Interest rates are expected to rise by 75 basis points in such case reduce the average duration by (*) Purchasing GOI 2010 and disposing of GOI 2032.

$$\begin{aligned} \text{Revised average duration shall be} &= \frac{39.25 - 13 + 6.5}{5} \\ &= \frac{32.75}{5} = 6.55 \text{ years} \end{aligned}$$

(*) Purchasing of GOI 2006 is not beneficial as maturity period is very short and 75 basis points is comparatively higher change.

- (c) The bank (Dealer) covers itself by buying from the market at market selling rate.

Rupee – Dollar selling rate	= Rs. 42.85
Dollar – Hong Kong Dollar	= HK \$ 7.5880
Rupee – Hong Kong cross rate	= Rs. 42.85 / 7.5880
	= Rs. 5.6471

Profit / Loss to the Bank

Amount received from customer (1 crore × 5.70)	Rs. 5,70,00,000
Amount paid on cover deal (1 crore × 5.6471)	<u>Rs. 5,64,71,000</u>
Profit to Bank	<u>Rs. 5,29,000</u>

Question 5

- (a) The following data are available for a bond

Face value	Rs. 1,000
Coupon Rate	16%
Years to Maturity	6
Redemption value	Rs. 1,000
Yield to maturity	17%

What is the current market price, duration and volatility of this bond? Calculate the expected market price, if increase in required yield is by 75 basis points.

- (b) Explain the terms ESOS and ESPS with reference to the SEBI guidelines for The Employees Stock Option Plans (ESOPs).
- (c) Your client is holding the following securities:

Particulars of Securities	Cost Rs.	Dividends/Interest Rs.	Market price Rs.	Beta
<i>Equity Shares:</i>				
Gold Ltd.	10,000	1,725	9,800	0.6
Silver Ltd.	15,000	1,000	16,200	0.8
Bronze Ltd.	14,000	700	20,000	0.6
GOI Bonds	36,000	3,600	34,500	1.0

Average return of the portfolio is 15.7%, calculate:

- (i) Expected rate of return in each, using the Capital Asset Pricing Model (CAPM).
- (ii) Risk free rate of return. (8 + 4 + 8 = 20 Marks)

Answer

(a) 1. Calculation of Market price:

$$YTM = \frac{\text{Coupon interest} + \left(\frac{\text{Discount or premium}}{\text{Years left}} \right)}{\frac{\text{Face Value} + \text{Market value}}{2}}$$

Discount or premium – YTM is more than coupon rate, market price is less than Face Value i.e. at discount.

Let x be the market price

$$0.17 = \frac{160 + \left\{ \frac{(1,000 - x)}{6} \right\}}{\frac{1,000 + x}{2}}$$

$$x = \text{Rs. } 960.26$$

Alternatively, the candidate may attempt by

$$\begin{aligned} & 160 (\text{PVIFA } 17, 6) + 1,000 (\text{PVIFA } 17, 6) \\ &= 160 (3.589) + 1,000 (.390) \\ &= 574.24 + 390 \\ &= 964.24 \end{aligned}$$

2. Duration

Year	Cash flow	P.V. @ 17%	Proportion of bond value	Proportion of bond value x time (years)
1	160	.855	136.8	0.142
2	160	.731	116.96	0.122
3	160	.624	99.94	0.104
4	160	.534	85.44	0.089
5	160	.456	72.96	0.076
6	1160	.390	<u>452.4</u>	<u>0.467</u>
			<u>964.4</u>	<u>4.236</u>

Duration of the Bond is 4.236 years

3. Volatility

$$\text{Volatility of the bonds} = \frac{\text{Duration}}{(1 + \text{yields})} = \frac{4.236}{1.17}$$

$$= 3.62$$

4. The expected market price if increase in required yield is by 75 basis points.

$$= \text{Rs. } 960.26 \times .75 (3.62/100)$$

$$= \text{Rs. } 26.071$$

Hence expected market price is Rs. 960.26 – Rs. 26.071 = Rs. 934.189

Hence, the market price will decrease

This portion can also be alternatively done as follows

$$= \text{Rs. } 964.4 \times .75 (3.62/100)$$

$$= \text{Rs. } 26.18$$

then the market price will be

$$= \text{Rs. } 964.4 - 26.18 = \text{Rs. } 938.22$$

(b) ESOS and ESPS**ESOS****1. Meaning**

Employee Stock Option Scheme means a scheme under which the company grants option to employees.

ESPS

Employee Stock Purchase Scheme means a scheme under which the company offers shares to employees as a part of public issue.

2. Auditors' Certificate

Auditors' Certificate to be placed at each AGM stating that the scheme has been implemented as per the guidelines and in accordance with the special resolution passed.

No such Certificate is required.

3. Transferability

It is not transferable.

It is transferable after lock in period.

4. Consequences of failure

The amount payable may be forfeited. If the option are not vested due to non-fulfillment of condition relating to vesting of option then the amount may be refunded to the employees.

Not applicable.

5. Lock in period

Minimum period of 1 year shall be there between the grant and vesting of options. Company is free to specify the lock in period for the shares issued pursuant to exercise of option.

One year from the date of allotment. If the ESPS is part of public issue and the shares are issued to employees at the same price as in the public issue, the shares issued to employees pursuant to ESPS shall not be subject to any lock in.

(c) Particulars of Securities	Cost Rs.	Dividend	Capital gain
Gold Ltd.	10,000	1,725	–200
Silver Ltd.	15,000	1,000	1,200
Bronz Ltd.	14,000	700	6,000
GOI Bonds	36,000	3,600	–1,500
Total	75,000	7,025	5,500

Expected rate of return on market portfolio

$$\frac{\text{Dividend Earned} + \text{Capital appreciation} \times 100}{\text{Initial investment}}$$

$$= \frac{\text{Rs. 7,025} + \text{Rs. 5,500} \times 100}{75,000}$$

$$= 16.7\%$$

Risk free return

$$\text{Average of Betas} = \frac{0.6 + 0.8 + 0.6 + 1.0}{4}$$

Average of Betas = 0.75

Average return = Risk free return + Average Betas (Expected return – Risk free return)

15.7 = Risk free return + 0.75 (16.7 – Risk free return)

Risk free return = 12.7%

Expected Rate of Return for each security is

Rate of Return = $R_f + B (R_m - R_f)$

Gold Ltd. = $12.7 + .6 (16.7 - 12.7)$ = 15.10%

Silver Ltd. = $12.7 + .8 (16.7 - 12.7)$ = 15.90%

Bronz Ltd. = $12.7 + .6 (16.7 - 12.7)$ = 15.10%

GOI Bonds = $12.7 + 1.0 (16.7 - 12.7)$ = 16.70%

Question 6

- (a) What is securitisation? What are its various instruments?
- (b) *M/s Transindia Ltd. is contemplating calling Rs. 3 crores of 30 year's, Rs. 1,000 bond issued 5 years ago with a coupon interest rate of 14 per cent. The bonds have a call price of Rs. 1,140 and had initially collected proceeds of Rs. 2.91 crores due to a discount of Rs. 30 per bond. The initial floating cost was Rs. 3,60,000. The Company intends to sell Rs. 3 crores of 12 per cent coupon rate, 25 years bonds to raise funds for retiring the old bonds. It proposes to sell the new bonds at their par value of Rs. 1,000. The estimated floatation cost is Rs. 4,00,000. The company is paying 40% tax and its after cost of debt is 8 per cent. As the new bonds must first be sold and their proceeds, then used to retire old bonds, the company expects a two months period of overlapping interest during which interest must be paid on both the old and new bonds. What is the feasibility of refunding bonds?*
- (c) Write a brief note on external Commercial borrowings. (5 + 10 + 5 = 20Marks)

Answer

- (a) Securitisation is a process of pooling and repackaging homogeneous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represents ownership interest in or are secured by a segregated income producing asset or a pool of assets. The pool of assets collateralizes securities. These assets are generally secured by personal or real property.

Process: Assets are originated through receivables, leases, housing loans, or any other form of debt.

Once a suitably large portfolio of assets has been originated, the assets are analysed as a portfolio and then sold or assigned to a third party known as SPV formed for the specific purpose of funding the asset.

The administration of the asset is sub-contracted back to the originator by the SPV.

The SPV issues securities to fund the purchase of assets. Performance of these securities is directly linked to the performance of assets.

Parties: Parties to the securitisation are originator, SPV, investors, obligors, rating agencies, administrator, agent and trustee, structures.

Instruments of securitisation includes Pass Through Certificate (PTC), Pay Through Securities (PTS) and Stripped securities. Securities may be asset backed and mortgaged back.

(b) NPV for bond refunding

	<i>Rs.</i>
PV of annual cash flow savings (W.N. 2)	
$(3,49,600 \times \text{PV/FA } 8.25) \text{ i.e. } 10.675$	37,31,980
Less: Initial investment (W.N. 1)	<u>29,20,000</u>
NPV	8,11,980

Recommendation: Refunding of bonds is recommended as NPV is positive.

Working Notes:

(1) Initial investment:

(a) Call premium

Before tax $(1,140 - 1,000) \times 30,000$	42,00,000	
Less tax @ 40%	<u>16,80,000</u>	
After tax cost of call prem.		25,20,000

(b) Floatation cost 4,00,000

(c) Overlapping interest

Before tax $(.14 \times 2/12 \times 3 \text{ crores})$	7,00,000	
Less tax @ 40%	<u>2,80,000</u>	4,20,000

(d) Tax saving on unamortised discount on old bond $25/30 \times 9,00,000 \times .4$
(3,00,000)

(e) Tax savings from unamortised floatation

Cost of old bond $25/30 \times 3,60,000 \times .4$	<u>(1,20,000)</u>	
		<u>29,20,000</u>

(2) Annual cash flow savings:

(a) Old bond

(i) Interest cost $(.14 \times 3 \text{ crores})$	42,00,000	
Less tax @ 40%	<u>16,80,000</u>	25,20,000

- | | | | |
|-------|---|--|----------------|
| (ii) | Tax savings from amortisation of discount | | |
| | $9,00,000/30 \times .4$ | | (12,000) |
| (iii) | Tax savings from amortisation of floatation | | |
| | cost $3,60,000/30 \times .4$ | | <u>(4,800)</u> |
| | Annual after cost payment of Debt (A) | | 25,03,200 |
-
- | | | | |
|------|---|------------------|------------------|
| (b) | New bond | | |
| (i) | Interest cost before tax ($.12 \times 3$ crores) | 36,00,000 | |
| | Less tax @ 40% | <u>14,40,000</u> | |
| | After tax interest | 21,60,000 | |
| (ii) | Tax savings from amortisation of floatation | | |
| | cost ($.4 \times 4,00,000/25$) | <u>(6,400)</u> | <u>21,53,600</u> |
| | Annual after tax payment | | <u>3,49,600</u> |
- (c) ECB include bank loans, supplier credit, securitised instruments, credit from export credit agencies and borrowings from multilateral financial institutions. These securitised instruments may be FRNs, FRBs etc. Indian corporate sector is permitted to raise finance through ECBs within the framework of the policies and procedures prescribed by the Central Government. Multilateral financial institutions like IFC, ADB, AFIC, CDC are providing such facilities while the ECB policy provides flexibility in borrowing consistent with maintenance of prudential limits for total external borrowings, its guiding principles are to keep borrowing maturities long, costs low and encourage infrastructure/core and export sector financing which are crucial for overall growth of the economy. The government of India, from time to time changes the guidelines and limits for which the ECB alternative as a source of finance is pursued by the corporate sector. During past decade the government has streamlined the ECB policy and procedure to enable the Indian companies to have their better access to the international financial markets.
- The government permits the ECB route for variety of purposes namely expansion of existing capacity as well as for fresh investment. But ECB can be raised through internationally recognized sources. There are caps and ceilings on ECBs so that macro economy goals are better achieved. Units in SEZ are permitted to use ECBs under a special window.

PAPER – 3 : ADVANCED AUDITING

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

Question 1

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

- (a) ABC Ltd. commenced construction of a flyover in Mumbai in January, 2004 under BOLT scheme. The same was completed in February, 2005. Due to seasonal heavy rains in July, 2004 in the area, the work on the flyover had to be suspended for 1 month. The company accordingly suspended borrowing costs of Rs. 12.50 lakhs for that month from capitalization. (5 Marks)
- (b) P Ltd. of whom you are the Statutory Auditor appoints M/s XYZ as Branch Auditors for one of its branches. M/s XYZ conducted the audit of the branch without visiting the branch and instead getting the books at the H.O. M/s XYZ has submitted their Branch Audit Report to you. (5 Marks)
- (c) LM Ltd. has 2 divisions L and M. The finished products of division L are transferred to division M where further processing is carried out before sale to customers. To achieve transparency and accountability between the divisions, division L raises an invoice on division M at cost plus normal margins. At the year end the unrealized profits on inter-division stocks are eliminated. However, the transfers are recorded at the invoice value as sales and purchases in the respective divisions for the purpose of preparing the Profit and Loss Account. Suitable disclosures, for this are given in then 'Notes to Accounts'. (5 Marks)
- (d) T Pvt. Ltd. is an unlisted closely held company with turnover less than Rs.50 crores. While finalizing the accounts, Mr. M the Director (finance) disputed the applicability of AS 20 to the company. (3 Marks)

Answer

- (a) **Capitalisation of Borrowing Costs:** Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for intended use or sale are interrupted. According to AS-16, "Borrowing Costs", capitalisation of such borrowing costs should be suspended during extended periods in which active development is interrupted. The standard, however, clarifies that capitalisation of borrowing costs is not suspended when a temporary delay is necessary as a part of the process or substantial technical and administrative work is being carried out. Thus, the test as to whether or not to capitalise the borrowing costs depends primarily upon the nature of interruption of activities during "extended periods".

In the instant case, it has been mentioned that the construction activity was interrupted due to seasonal rain and hence being regular feature. Though the rain was heavy, the period cannot be considered as an "extended period" leading to substantial delay in suspension of construction activities. Therefore, borrowing cost of Rs.12.50 lakhs

incurred by ABC Ltd. should be capitalized. Hence, suspension of capitalization by the company is not a correct treatment and statutory auditor should report accordingly.

- (b) **Branch Auditor's Report:** As per provisions of the Companies Act, 1956, the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. It is not necessary for branch auditor M/s XYZ to visit the branch and conduct the audit only at branch's premises. It is a matter of professional judgement for the branch auditor to decide as to whether he needs to visit the branch. At the same time, the statutory auditor has the right to visit branch offices and to have access to the books of accounts and vouchers maintained at the branch office in this case.

In any case, the principal auditor i.e. the statutory auditor of Head Office P Ltd. is entitled to rely on the work of branch auditor unless there are special circumstances to make it essential for him to visit the branch and examine the books of account and voucher records. As per basic principles governing an audit, the principal auditor is entitled to rely upon the work performed by others provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. As per AAS 10, "Using the work of another auditor", the principal auditor is not required to evaluate professional competence because branch auditor happens to be member of ICAI. The statutory auditor is also required to deal with the Branch Auditor's report in the manner, he considers necessary. Therefore, the statutory auditor is required to deal with M/s XYZ's report in the manner it considers fit under the circumstances.

- (c) **Revenue Recognition:** As per the definition of the term "Revenue" in AS 9, "Recognition", revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them.

As per the clarification issued by ICAI, the use of the word "enterprise" in the above definition clearly implies that the transfers within the enterprise cannot be considered as fulfilling the definition of the term "revenue". Thus, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with AS 9. Further, in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole. Thus, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers.

In the instant case, therefore, LM Ltd cannot recognise inter-division transfers from L to M as sales and the same will have to be eliminated during finalisation. If not so done, the statutory auditor will have to qualify his report.

- (d) **Applicability of Accounting Standard:** AS 20, "Earning Per Share", came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity

shares are listed on a recognised stock exchange in India. As such AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20. Part IV of Schedule VI to the Companies, Act, 1956, requires, among other things, disclosure of earnings per share. Accordingly, every company, which is required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

Accordingly the company, T Pvt. Ltd should compute and disclose EPS according to AS 20. Therefore, the contention of Director (Finance) is incorrect. The auditor will have to ensure that EPS is disclosed as per AS 20 or else the auditor should appropriately modify the audit report.

Question 2

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

- (a) *Mr. S, a Chartered Accountant published a book and gave his personal details as the author. These details also mentioned his professional experience and his present association as partner with M/s RST, a firm.* (5 Marks)
- (b) *Mr C accepted the statutory audit of M/s PSU Ltd., whose net worth is negative for the year 2003-04. The audit was to be conducted for the year 2004-05. The audited accounts for the year 2004-05 showed liability for payment of tax audit fees of Rs.15,000 in favour of Mr E, the previous auditor.* (5 Marks)
- (c) *M/s PQR, a firm of Chartered Accountants with 5 partners has accepted the audit of ABC Pvt. Ltd. for 2004-05 at an audit fee of Rs.2,500. ABC Pvt. Ltd was incorporated in April, 2002, but had commenced operations in January, 2005.* (4 Marks)
- (d) *Mr. P, a Chartered Accountant in practice entered into a partnership with Mr. L, an advocate for sharing of fees for work sent by one to the other. However, due to some disputes, the partnership was dissolved after 1 month without any fees having been received.* (4 Marks)

Answer

- (a) **Soliciting Professional Work:** Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 refers to professional misconduct of a member in practice if he solicits client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means. Therefore, members should not adopt any indirect methods to advertise their professional practice with a view to gain publicity and thereby solicit clients or professional work. Such a restraint must be practised so that members may maintain their independence of judgement and may be

able to command the respect of their prospective clients. While elaborating forms of soliciting work, the Council has specified that a member is not permitted to indicate in a book or an article, published by him, the association with any firm of chartered accountants. In this case, Mr S a chartered accountant, published the book and mentioned his professional experience and his association as a partner with M/s RST, a firm of chartered accountants.

Mr. S being a chartered accountant in practice has committed the professional misconduct by mentioning that at present he is a partner in M/s. RST, a chartered accountants firm.

- (b) **Accepting Appointment as an Auditor:** As per notification issued by the Council under Clause (ii) of Part II of the Second Schedule, a member of the Institute of Chartered Accountants of India in practice shall be deemed to be guilty of professional misconduct if he accepts appointment as auditor of an entity in case the undisputed audit fee of another chartered accountant for carrying out the statutory audit under Companies Act, 1956 or various other statutes has not been paid.

As per the proviso, such prohibition shall not apply in case of a sick unit where a sick unit is defined to mean “where the net worth is negative”.

In the instant case, though the undisputed fees are unpaid, Mr C would still not be guilty of professional misconduct since the M/s PSU Ltd. is a sick unit having negative net worth for the year 2003-04.

- (c) **Accepting audit below certain fees:** Under Clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council has notified that if a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he on behalf of the firm in which he is a partner consisting of 4-8 partners with at least one partner holding a certificate of practice for five years or more accepts or carries out any audit work involving receipt of audit fees of an amount less than Rs.3,000 / Rs.5,000 depending on the population of the city in which it is located. It has been further provided that such a restriction shall not apply to audit of newly formed firms relating to 2 accounting years from the date of commencement of their operations.

In the instant case, though the audit fees of Rs.2,500/- less than that prescribed, but in view of the fact that operations have been commenced by the company M/s ABC Pvt. Ltd. only in January 2005, M/s PQR, chartered accountant, would not be hit by this notification and therefore, would not be guilty of any professional misconduct.

- (d) **Partnership with non-chartered accountants:** As per clause 4 of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant will be guilty of professional misconduct if he enters into partnership with any person other than a chartered accountant in practice or a person resident without India who but for his residence abroad would be entitled to be registered as a member under Clause (v) of sub-section (1) of section 4 or whose qualification are recognized by the Central Government or the Council for the purpose of permitting such partnership.

This clause puts a restriction on entering into partnership with a non-chartered accountant for the practice of the profession of chartered accountancy. In the instant case since Mr. P, a chartered accountant, has entered into partnership with Mr. L, an advocate, he would be guilty of professional misconduct irrespective of the fact that no work or fee was shared and the partnership was dissolved after one month since the clause does not permit entering into partnership.

Question 3

Answer the following"

- (a) *Enumerate (in brief) the basic principles governing an audit.* (5 Marks)
- (b) *Briefly explain the objectives of Operational Audit.* (5 Marks)
- (c) *While examining the going concern assumption of an entity, what important indications should be evaluated and examined?* (6 Marks)

Answer

- (a) AAS 1, "Basic Principles Governing an Audit", describes the basic principles which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out. Basic principles are:
 - (i) **Integrity, Objectivity and Independence:** The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being compatible with integrity and objectivity.
 - (ii) **Confidentiality:** The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.
 - (iii) **Skills and Competence:** The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing.
 - (iv) **Work performed by others:** When the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose.
 - (v) **Documentation:** The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

- (vi) **Planning:** The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on a knowledge of the client's business.
- (vii) **Audit evidence:** The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.
- (viii) **Accounting System and Internal Control:** The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal controls normally contribute to such assurance.
- (ix) **Audit conclusions and reporting:** The auditor should review and assess the conclusions drawn from the audit evidence obtain and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

(b) Objectives of Operational Audit

The scope and quality of operational auditing is predominantly dependent upon management attitudes. An open minded management with broad vision, can appreciate the need of operational auditing and to give it the necessary freedom and sanction to perform what it is capable of performing. Also, the qualities and the sense of perspectives of the operational auditor can mould operational audit in the right shape. Therefore, there is a possibility of operational auditing having different objectives to fulfil in different considerations. Generally, operational audit objectives include:

- (i) **Appraisal of controls:** The most significant gain an organisation can derive from operational auditing is probably in the area of appraisal of controls. Internal controls, because of their unobtrusive omnipresence in the organisation, provide the essential hinges to ensure proper performance in each functional or organisational area for accomplishing the desired organisational objective.
- (ii) **Evaluation of performance:** In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to measure the effectiveness, efficiency and economy with which the operations are being carried on. The principal basis of performance evaluation can be productivity, personnel, workload, cost and quality. In the area of productivity, the operational auditor can undertake such tests as input-output ratios for materials and labour in quantitative terms.
- (iii) **Appraisal of objectives and plans:** Everything in an organisation is the product of basic plans and objectives set by the management. If the management policy favours installation of controls or specifies the extent of controls whether satisfactory or not, controls would have to stay within the policy frame. Therefore, the basic thing that should be evaluated is management policies, plans and objectives. Operational auditor may look into the aspects like whether objectives

are clearly spelt out and properly communicated to the personnel responsible for implementation and whether the personnel have understood the objectives in the sense meant by the management. Also, he can take note of any apparent conflict in the objectives for its effect on operations.

- (iv) **Appraisal of organisational structure:** Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. Therefore, this is also another important area for appraisal by the operational auditor. In evaluating organisational structure, the aspects that may be considered by the operational auditor whether the organisational structure in conformity with management objectives and is drawn up on the basis of matching of responsibility and authority.
- (c) **Evaluating Going Concern Assumption:** AAS 16, "Going Concern", requires that while planning a performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements. In assessing such a risk, the auditor should examine the following indications.

I. Financial indications:

- ◆ Negative net worth or negative working capital
- ◆ Excessive use of short term borrowing for long term assets
- ◆ Fixed term borrowings approaching maturity without prospect of renewal or repayment.
- ◆ Adverse key financial ratio
- ◆ Substantial operating losses
- ◆ Substantial negative cash flow from operations
- ◆ Arrears or discontinuance of dividend payment
- ◆ Inability to pay creditors in time
- ◆ Default in compliance with loan agreements
- ◆ Change from credit to cash term with suppliers
- ◆ Inability to arrange finance for new development need
- ◆ Arrangement with creditors for reduction in liabilities

II. Operating Indications:

- ◆ Turnover and departure of key management personnel without replacement
- ◆ Loss of market, franchise, license or key supplier
- ◆ Labour difficulties or shortage of important supplies

III. Other indications:

- ◆ Non-compliance with statutory requirements
- ◆ Legal cases with possibility of adverse judgement which could not be met
- ◆ Changes in legislations or government policy
- ◆ Sickness of the entity under any statutory definition.

Question 4

Answer the following:

- (a) *What are the statements of facts that an auditor has to report u/s 227 of the Companies Act, 1956?* (4 Marks)
- (b) *Illustrate, as a statutory auditor, how would you give a report where all qualifications are not quantifiable.* (4 Marks)
- (c) *Under CARO, 2003 how, as a statutory auditor would you comment on the following:*
- (i) *Fixed assets comprising 1/3rd of the total assets have been disposed off during the year.* (4 Marks)
 - (ii) *A Term Loan was obtained from a bank for Rs.75 lakhs for acquiring R&D equipment, out of which Rs.12 lakhs was used to buy a car for use of the concerned director, who was overlooking the R&D activities.* (4 Marks)

Answer

- (a) Statements of Facts u/s 227 of the Companies Act, 1956: Section 227 of the Companies Act, 1956, deals with contents of the audit report. Some of these aspects on which the auditor is required to report which constitute statements of fact are as under:
- (i) Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit.
 - (ii) Whether the report on the accounts of any branch office audited u/s 228 has been forwarded to him and how has he dealt with the same in preparing the auditor's report.
 - (iii) Whether the company's balance sheet and profit and loss account dealt with by his report are in agreement with the books of account.
 - (iv) Whether any director is disqualified from being appointed u/s 274(1)(g) of the Companies Act, 1956.
 - (v) Whether cess payable u/s 441A has been paid and if not, the details of amount not paid. (This clause has not yet become operative).
- (b) **An illustrative Format of Audit Report:** AAS 28 "The Auditor's Report on Financial Statements", states that there may be circumstances when it is not practicable to quantify the effect of modification in the audit report accurately, the auditor may do so on the

basis of estimates made by the management after carrying out such audit tests as are possible and clearly indicate the fact that the figures are based on management estimates. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

The following illustration of a qualification where quantification was not possible will explain the point:

“(2) No provision has been made in respect of product warranties outstanding at the year end. The amount of provision required in this behalf could not be ascertained.”

In the above situation, the overall paragraph would appear as follows:

“We further report that, without considering item mentioned in paragraph (2) above, the effect of which could not be determined, had the observations made by us in paragraph (1) (not reproduced) and (2) above been considered, the profit for the year would have been Rs.500.41 lacs (as against the reported figure of Rs.596.07 lacs), reserves and surplus would have been Rs.685.43 lacs (as against the reported figure of Rs.781.09 lacs) and total fixed assets would have been Rs.200.00 lacs (as against the reported figure of Rs.229.05 lacs)”

Subject to the above in our opinion.....

- (c) (i) **Disposal of Fixed Assets:** Under CARO, 2003, an auditor is required to state if substantial part of the fixed assets have been disposed off during the year, whether it has affected the going concern. This clause requires the auditor to carry out adequate audit procedures to satisfy himself that the company shall be able to continue as going concern for the foreseeable future despite the sale of substantial part of the fixed assets.

Accordingly, in the instant case, the auditor should satisfy himself as to whether disposal off of 1/3rd of fixed assets during the year had any effect on the going concern assumption on account of such sale of fixed assets. The Auditor is required to exercise his professional judgement to determine whether disposal off of one-third of total assets constitutes substantial part or not. Depending upon the judgement arrived at by the auditor, he shall report whether substantial part of fixed assets have been disposed off or not during the year and it has affected or not affected the going concern status of the company. Alternatively, in case the auditor is of the opinion that it constitutes substantial sale but the going concern assumption is appropriate because of mitigating factors then he has to ensure that the same are disclosed in the financial statements or else he shall have to modify the auditor report. The manner of reporting shall also be modified appropriately in case the going concern assumption is resolved or not.

- (ii) **Utilisation of Term Loans:** Under CARO, 2003, an auditor is required to comment whether term loans were applied for the purpose for which the loans were obtained.

The auditor should examine the terms and conditions of the term loan with the actual utilisation of the loans. If the auditor finds that the fund has not been utilized for the purpose for which they were obtained, the report should state the fact.

In the instant case, since term loan taken for the purpose of R&D equipment has been utilized for purchase of car which has no relation with R&D equipment. Therefore, car though used for R&D Director cannot be considered as R&D equipment. The auditor should state the fact in his report that the out of term loan of R&D lack, Rs.12 lakhs was not utilised for the purpose of acquiring the R & D equipment.

Question 5

Answer the following:

- (a) *“Like every other audit, a systematic planning for cost audit is also necessary”. Indicate the matters to be included in a Cost Audit Programme. (10 Marks)*
- (b) *Enumerate some of the areas of concern in an audit of indirect taxes. (6 Marks)*

Answer

- (a) Matters to be included in Cost Audit Programme: It is a true statement that like any other audit a systematic planning for cost audit is also necessary. Therefore, the cost audit programme should include all the usual broad steps that a financial auditor includes in his audit programme. This would require that the various aspects like what to be done, when to be done and by whom to be done are adequately taken care of. However, looking to the basic difference in cost audit and financial audit as allocation and apportionment of expenses, statutory requirement etc. should require special consideration. Cost audit, in order to be effective, should be completed at one time as far as practicable. Based on above factors a set of procedures and instructions are evolved which may be termed the cost audit programme. Matters to be included in the Cost Audit Programme may be divided into following two stages:

- (i) Review of Cost accounting record: This will include:
- ◆ Method of costing in use
 - ◆ Method of accounting for raw material, stores and spares, wastage
 - ◆ System of recording wages, salary, etc.
 - ◆ Basis of allocation of overheads to cost centres and absorption by product and services
 - ◆ Treatment of expenses on finance, R&D, royalty, etc.
 - ◆ Method for depreciation accounting
 - ◆ Method of stocktaking and valuation
 - ◆ System of budgetary control

(ii) Verification of cost statement and other data: This will mainly cover:

- ◆ Licensed, installed and utilized capacity
- ◆ Operating and financial ratio
- ◆ Production data
- ◆ Consumption of material and actual expenses
- ◆ Sales realization
- ◆ Abnormal non-recurring and special cost
- ◆ Reconciliation with financial books

Some other factors which need to be brought into cost audit programme includes system of cost accounting, range of products, areas to be covered etc. indicating allocation of manpower and the time to be taken for computing the audit.

(b) Audit of Indirect Taxes: Same areas of concern in an audit of indirect taxes would be:

- (i) Non availment or short / excess availment of control or export incentives.
- (ii) Goods imported duty free or payment at concessional rates without properly complying with conditions.
- (iii) Valuation Issues – valuation not in line with customs rules.
- (iv) Applicability of the relevant control excise exemptions.
- (v) Valuation of goods not removed in normal course using valuation methods not in line with Central Excise Valuation Rules.
- (vi) Ignoring Liability under Service Tax on services provided or availed.
- (vii) Procedural non-compliance.
- (viii) Passing on of duty suffered on imported goods and of locally manufactured goods in excess of actual.

Question 6

Answer the following:

- (a) *As a tax auditor, which are the accounting ratios required to be mentioned in the report in case of manufacturing entities? Explain in detail any one of the above ratios and how does it help the tax auditor in his analytical review.* (8 Marks)
- (b) *What are the steps to be taken by an auditor for the audit of re-insurance ceded?* (8 Marks)

Answer

- (a) The ratios which are to be calculated for manufacturing entities are:
 - ◆ Gross profit / Turnover

- ◆ Net Profit / Turnover
- ◆ Stock-in-trade/Turnover
- ◆ Material consumed / Finished goods provided

Ratio analysis constitutes a substantive auditing procedure designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. Such assessment is necessary in organisation having large volumes of transactions and in the organisation following mechanised accounting system where it is not possible to check each and every transaction. It has the merit of bringing to focus the abnormal deviations and unexpected variations which the normal routine checking in auditing may fail to reveal. Ratios highlight only symptoms and that too as of a particular day and the auditor should study these symptoms properly, correlate them and reach definite conclusions or identify areas for further enquiries. The auditor should by relating sales with the net profit, various items of direct and indirect costs and gross profit gather information about the profitability and operating efficiency of an enterprise; variations in any of these ratios in a particular year should be inquired by the auditor. The fall in the gross profit ratio and profitability ratio should alert the auditor who should ask the management for the reasons thereof and which should be carefully examined by him. The auditor should by relating sales with the net profit, various items of direct and indirect costs and gross profit gather information about the profitability and operating efficiency of an enterprise; variations in any of these ratios in a particular year should be inquired by the auditor. The fall in the gross profit ratio and profitability ratio should alert the auditor who should ask the management for the reasons thereof and which should be carefully examined by him.

These ratios have to be given for the business as a whole and not product wise. While calculating these ratios, the tax auditor should assign a meaning to the terms used in the above ratios having due regard to the generally accepted accounting principles all the ratios mentioned in the clause are to be calculated in terms of value only.

The relationship of stock-in-trade to turnover over a period of time would reveal whether the entity has been accumulating stocks or there is a decline in the same. The auditor may obtain data for about 7-10 years, compute ratio of stock-in-trade/turnover and plot it on a graph paper over a period of time. This may give rise to several possibilities such as parallel horizontal lines, vertical rising line or a vertical falling line. A study of this relationship would reveal whether stocks are being accumulated or they are dwindling over a period. Such an information would provide an input to tax auditor as to whether figures of either stock or turnover are being manipulated. Sometimes, while studying the relationship, it may show sudden decline or increase at a point of time would reflect that there is definitely something wrong with the figures of stock. Therefore, a close examination of such ratios helps the tax auditor to focus on major deviations and consequently reasons for the same.

(b) Steps in Audit of Reinsurance ceded:

- (i) Evaluate internal control system in the area of reinsurance ceded to ensure determination of correct amount for reinsurance ceded, proper valuation of assets and liabilities arising out of reinsurance transaction and adherence to legal provisions and regulations.
- (ii) Ascertain whether adequate guidelines and procedures are established with respect to obtaining reinsurance.
- (iii) Reconcile reinsurance underwriting returns received from various units with the figures of premium, claims paid and outstanding claims for the company as a whole.
- (iv) Examine whether commission on reinsurance ceded is as per the terms of the agreement with the re-insurers.
- (v) Examine the computation of profit commission for automatic treaty arrangements in the light of the periodic accounts rendered and in relation to outstanding loss pertaining to the treaty.
- (vi) Examine whether loss recoveries have been claimed and accounted on a regular basis.
- (vii) Examine whether outstanding losses recoverable have been confirmed by re-insurers.
- (viii) Examine whether remittances to foreign re-insurers are as per foreign exchange regulations.
- (ix) Examine whether confirmations have been obtained regarding balances with re-insurers.
- (x) Review individual accounts of re-insurers to evaluate whether any provision/write off or write back is required.

Question 7

Answer the following:

- (a) *Your client is contemplating taking over a manufacturing concern and desires that in the course of due diligence review, you should look specifically for any hidden liabilities and overvalued assets.*

State (in brief) the major areas you would examine for the above. (8 Marks)

- (b) *Enumerate the risks and internal control characteristics in an audit conducted in Computer Information Systems (CIS) environment. (8 Marks)*

Answer

- (a) Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any hidden liabilities or overvalued assets are concerned, this shall form part of such a

review. Normally, cases of hidden liabilities and overvalued assets are not apparent from books of accounts and financial statements. Review of financial statements does involve examination from the view point of extraordinary items, analysis of significant deviations, etc. However, in order to investigate hidden liabilities, the auditor should pay his attention to the following areas:

- ◆ Any show cause notice, which have not matured into demands but may be material and important.
- ◆ Contingent liabilities not shown in books
- ◆ Letters of comforts given to banks and financial institutions
- ◆ Company may have sold some subsidiaries / businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer.
- ◆ Product and warranty liabilities, product returns & discounts, liquidated damages, etc.
- ◆ Tax liability under direct and indirect taxes.
- ◆ Long pending sales tax assessment.
- ◆ Cases of custom duty where only provisional assessment has been made and final assessment is yet to completed.
- ◆ Agreement to buy back shares at a stated price.
- ◆ Future lease liabilities.
- ◆ Claims against the company including third party claims.
- ◆ Unfunded retirement benefit of employees.
- ◆ Labour claims under negotiations.

Regularly Overvalued assets: The auditor shall have to specifically examine the following areas:

- ◆ Uncollectable receivables.
- ◆ Obsolete, slow and non-moving inventories and inventories valued above net realizable value, if any.
- ◆ Obsolete and unused plant and machinery and their spares.
- ◆ Assets value which have impaired due to sudden fall in market value.
- ◆ Assets shown in books above market value due to capitalization of expenditure / foreign exchange fluctuation or capitalisation of revenue expenditure.
- ◆ Assets under litigation.
- ◆ Investment shown at cost whose market value is much lower.
- ◆ Investment carrying very low rate of return.

- ◆ Infructuous project expenditure.
 - ◆ Intangibles of no value.
- (b) The risks and internal control characteristics in CIS environment as per AAS 29, "Audit in a Computer Information Systems Environment", include the following:
- ◆ *Lack of transaction trails:* Some computer information systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, there may not be a complete trail. Accordingly, errors embedded in an application's program logic may be difficult to detect on a timely basis by manual (user) procedures.
 - ◆ *Uniform processing of transactions:* Computer processing uniformly processes like transactions with the same processing instructions. Thus, the clerical errors ordinarily associated with manual processing are virtually eliminated. Conversely, programming errors (or other systemic errors in hardware or software) will ordinarily result in all transactions being processed incorrectly.
 - ◆ *Lack of segregation of functions:* Many control procedures that would ordinarily be performed by separate individuals in manual systems may become concentrated in a CIS environment. Thus, an individual who has access to computer programs, processing or data may be in a position to perform incompatible functions.
 - ◆ *Potential for errors and irregularities:* The potential for human error in the development, maintenance and execution of computer information systems may be greater than in manual systems, partially because of the level of detail inherent in these activities. Also, the potential for individuals to gain unauthorised access to data or to alter data without visible evidence may be greater in CIS than in manual systems.

In addition, decreased human involvement in handling transactions processed by computer information systems can reduce the potential for observing errors and irregularities. Errors or irregularities occurring during the design or modification of application programs or systems software can remain undetected for long periods of time.

- ◆ *Initiation or execution of transactions:* Computer information systems may include the capability to initiate or cause the execution of certain types of transactions, automatically. The authorisation of these transactions or procedures may not be documented in the same way as that in a manual system, and management's authorisation of these transactions may be implicit in its acceptance of the design of the computer information systems and subsequent modification.
- ◆ *Dependence of other controls over computer processing:* Computer processing may produce reports and other output that are used in performing manual control procedures. The effectiveness of these manual control procedures can be dependent on the effectiveness of controls over the completeness and accuracy of

computer processing. In turn, the effectiveness and consistent operation of transaction processing controls in computer applications is often dependent on the effectiveness of general computer information systems controls.

- ◆ *Potential for increased management supervision:* Computer information systems can offer management a variety of analytical tools that may be used to review and supervise the operations of the entity. The availability of these analytical tools, if used, may serve to enhance the entire internal control structure.
- ◆ *Potential for the use of computer-assisted audit techniques:* The case of processing and analysing large quantities of data using computers may require the auditor to apply general or specialised computer audit techniques and tools in the execution of audit tests.

Question 8

Write short notes on (any **four**):

- (a) *Categories of Non-banking Finance Companies (NBFCs)*
- (b) *Recognition of Deferred Tax Assets*
- (c) *Valuation of Investments “held to maturity” by banks*
- (d) *Contract Notes (Under Stock Exchange Trading Regulations)*
- (e) *Record of Audit Assignments (as required by ICAI regulations)* (4 × 4 = 16 Marks)

Answer

(a) **Categories of Non-banking Finance Companies (NBFCs):**

As per Reserve Bank of India Act, 1934, NBFC is one whose principal business is that of receiving deposit or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing, etc. Categories of such companies are:

- (a) Equipment leasing company engaged in equipment leasing or financing of such activity.
- (b) Hire purchase company engaged in hire purchase transaction or financing of such transaction.
- (c) Investment company engaged in acquisition of securities and trading of securities to earn a profit.
- (d) Loan company engaged in providing finance by making loans and advances, or otherwise for any activity other than its own.
- (e) Residuary non-banking company which receives deposits under scheme or arrangement, by whatever name called, in one lump sum or in installments by way of contributions or subscriptions or by sale of units or other instruments or in any manner.

- (b) **Recognition of Deferred Tax Assets:** Deferred Tax Assets (DTA) are to be recognised as laid down by AS 22 "Accounting for Taxes on Income" a DTA arises on account of a timing difference in which the taxable income is more than the book income. A deferred tax asset (and the corresponding tax saving) should be recognised only after applying the test of prudence. Thus, where the enterprise does not have unabsorbed depreciation and carried forward losses as per the tax laws, deferred tax assets should be recognised and carried forward to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realized. In other words, no deferred tax asset should be created if there is no reasonable certainty about the requisite future taxable income. The existence or absence of a reasonable level of certainty would normally be determined by examining the past record of the enterprise and by making realistic estimates of profits for the future.

A much stricter test of prudence has to be satisfied where the enterprise has unabsorbed depreciation or carried forward losses under tax laws. In such a situation, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realized. The existence of unabsorbed depreciation or carried forward losses under tax laws is strong evidence that future taxable income may not be available. Therefore, in such a situation, the enterprise can recognise deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient taxable income or there is other convincing evidence of virtual certainty of availability of sufficient taxable income against which deferred tax assets can be realized.

ICAI has stated that virtual certainty refers to the extent of certainty which, for all practical purposes, can be considered certain. Determination of virtual certainty of availability of sufficient future taxable income is a matter of judgement which will have to be made on a case-to-case basis.

- (c) **Valuation of Investments "Held to Maturity":**

The banks are required to classify their entire investment portfolio into three categories: held to maturity (HTM), available for sale (AFS), and held for trading (HFT). Securities acquired with the intention to hold them up to maturity should be classified under HTM category. Thus, this category will comprise only debt securities (e.g., debentures, redeemable bonds, government securities), preference shares and similar securities having a defined period of maturity, except that equity shares of subsidiaries/joint ventures have also to be included in HTM category.

- (i) These investments need not be Marked to Market and will be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortized over the period remaining to maturity. For instance if a bond is acquired at say Rs.90 and it is redeemable at Rs.100 after three years, the discount, i.e., Rs.10 should also be amortised as income over the next three years unless there is significant uncertainty of receipt of full face value on maturity.

- (ii) Any diminution, other than temporary should be recognised in the value of their investments in subsidiaries/JVs and provided for. Such diminution should be determined and provided for each investment individually.
- (d) **Contract Notes (Under Stock Exchange Trading Regulations):** Contract note is a document through which a contractual obligation is established between a member and a client. Every member of the stock-exchange has to issue contract notes to his clients for the trades executed on their behalf. The auditor should apply appropriate audit procedure to satisfy himself that:
- ◆ Contract notes have been serially numbered
 - ◆ No serial number has been left blank
 - ◆ Format is as prescribed by the regulations on the exchange
 - ◆ Duplicate copies /counterfoils of contract notes are maintained
 - ◆ Brokerage charged in contract notes is within the permissible limits and is indicated separately including service tax
 - ◆ It is signed by an authorised person
 - ◆ It has been issued in respect of all transactions
 - ◆ Transaction identification trade identification and trade execution time has been printed on the contract note issued
 - ◆ SEBI Registration No., Settlement No., Settlement Dates have been mentioned
 - ◆ PAN No. of the member and client has been mentioned on contract note where if required
 - ◆ All clauses specified by the Exchange have been printed on the reverse of the contract notes.
- (e) **Record of Audit assignments:** In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India issued a notification which specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the “specified number of audit assignments of the companies under Section 224 and /or Section 228 of the Companies Act, 1956. As a part of this notification, to meet its requirements, a CA in practice as well as a firm in practice shall maintain a record of the audit assignments accepted as laid out in notification issued by the Council of the ICAI under Part II of Second Schedule to the Chartered Accountants Act, 1949 in respect of ceiling on audits containing following particulars:
- (i) Name of Company Audit/ Assignment.
 - (ii) Regn. No.
 - (iii) Date of appointment with Registrar of Companies.
 - (iv) Date of acceptance.
 - (v) Date on which form 23B filed.

PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE

Question Nos. 1, 2 and 3 are compulsory.

*Answer any **four** questions from the rest of the questions.*

Question 1

Answer any two of the following

- (a) *The Board of Directors of ABC Ltd. met thrice in the year 2004 and the 4th Meeting, though called, could not be held for want of quorum.*

Examine with reference to the relevant provisions of the Companies Act, 1956, the following:

- (i) *Whether any provisions of the Companies Act, 1956 have been contravened?*
 - (ii) *Is a Director bound to attend the Board Meetings and when his frequent absence from the Board Meeting may be excused? (5 Marks)*
- (b) *Describe the provisions of the Securities Contracts (Regulation) Act, 1956 regarding the powers of the Central Government to supersede the Governing Body of a recognized Stock Exchange and the consequences of such supersession. (5 Marks)*
- (c) (i) *Delhi Stock Exchange wants to establish additional trading floor. Advise.*
- (ii) *Complaints of unethical practices have been received against members of a recognized Stock Exchange by the Government. Examine whether the government has any power to suspend the business of such a recognized Stock Exchange. (5 Marks)*

Answer

- (a) (i) As per Section 285 of the Companies Act, 1956, a company must hold a meeting of its Board of Directors at least once in every three calendar months and there should be at least four directors' meeting every year. However, the Central Government may by notification in the official Gazette, direct these provisions will not apply in relation to any class of companies or will apply in relation thereto subject to such exceptions, modifications or conditions as may be specified in the notification. But in the terms of Section 288(2), a company shall not be deemed to have contravened the provisions of Section 285 where the meeting had been called but could not be held for want of a quorum.
- (ii) Though a director is not so bound to attend the Board meetings, nonetheless, he will be guilty of breach of duty if he fails to attend the Board meetings with reasonable regularity without sufficient cause being shown for his non-attendance. Willful non-attendance on his part may give rise to his liability on ground of negligence if it is patently prejudicial either to the company or to the general body of shareholders. Fairly frequent absence from the Board meetings may, however, be excused if the entire control is exercised by a single director or if the Board is pretty large in number (*Re Denhom & Co. D.25 ch. D. 752 Marquis of Bute's Case (1892)2 Ch. 100*). The fewer the directors, the more onerous is the duty to attend.

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

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

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

- (i) The members of the governing body of such Stock Exchange ceases to hold office as such members on and from the date of notification.
 - (ii) The person or persons appointed by the Central Government may exercise and perform all the powers and duties of the governing body which has been so superseded.
 - (iii) The property of the Stock Exchange as deemed necessary and so specified in writing by such person or persons to carry on the business of the Stock Exchange shall vest in such person or persons.
- (c) (i) According to Section 13A of Securities Contracts (Regulation) Act, 1956, a Stock Exchange may establish additional trading floor with the prior approval of the Securities Exchange Board of India with the terms and conditions stipulated by the said Board. 'Additional Trading Floor' means a trading facility offered by a recognized stock exchange outside its area of operation to enable the investors to buy and sell securities through such trading floor under the regulatory frame work of that Stock-Exchange.
- (ii) Section 12 of the Securities Contracts (Regulation) Act, 1956 deals with the powers of the Central Government to suspend business of recognized Stock Exchange. Central Government, if it deems fit, is vested with power to suspend business for a period not exceeding 7 days by notification in Gazette. Central Government also have power to extend this period by a like notification. However, such power can be exercised by the Central Government, if it is of opinion that an emergency has arisen and it is expedient so to do.

Question 2

Answer any two of the following:

- (a) Explain the meaning of "Capital Account Transaction" under the Foreign Exchange Management Act, 1999. State whether there are any restrictions in respect of the following transactions:
- (i) Drawal of Foreign Exchange for payments due on account of amortisation of loans in ordinary course of business.
 - (ii) Purchase by a person resident outside India of shares of a company in India engaged in plantation activities. (7 Marks)
- (b) TKM Exporters of New Delhi are engaged in Export Business. It made certain exports, but failed to realize and repatriate to India the foreign exchange due on its exports. The Adjudicating Authority imposed a penalty under the provisions of Foreign Exchange Management Act, 1999 (FEMA). Being aggrieved by this penalty, the said exporter seeks your advice as to the authority to which appeal can be made and the time limit for making such appeals. You are required to advise on the matter. (7 Marks)
- (c) (i) In a proceeding before the Competition Commission of India involving two pharmaceutical companies, the plaintiff requested the presiding officer to call upon the services of experts from the pharmaceutical sector to determine the truth of the allegations leveled by it against the respondent. The respondent opposed the request on the ground that such action can not be taken by the Competition Commission. You are required to state with reference to the provisions of the Competition Act, 2002, whether the contention of the respondent is tenable.
- (ii) The Central Government has formed an opinion that Mr. CBM (a member of the Competition Commission of India) has acquired such financial interest that it may affect prejudicially his functions as a member of the Competition Commission and it wants to remove him from his office. You are required to state with reference to the provisions of the Competition Act, 2002, whether the Central Government can do so and if yes, how? (7 Marks)

Answer

- (a) As per provisions of section 2(e) of the Foreign Exchange Management Act, 1999 (FEMA) "Capital Account Transaction" means a transaction which alters (a) the assets and liabilities, including the contingent liabilities, outside India of persons resident in India or (b) the assets and liabilities in India of persons resident outside India.

It also includes the following as stated in section 6(3) of FEMA:

- (i) Transfer or issue of any foreign security by a person resident in India.
- (ii) Transfer or issue of any security by a person resident outside India.
- (iii) Transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India.

- (iv) Any borrowing or lending in foreign exchange in whatever form or by whatever name called.
- (v) Any borrowing or lending in India rupees in whatever form or by whatever name called between a person resident in India and a person resident outside India.
- (vi) Deposits between persons resident in India and persons resident outside India.
- (vii) Export, import or holding of currency or currency notes.
- (viii) Transfer of immovable property outside India, other than a lease not exceeding five years, by a person resident in India.
- (ix) Acquisition or transfer of immovable property in India, other than a lease not exceeding five years, by a person resident outside India.
- (x) Giving a guarantee or surety in respect of any debt, obligation or other liability incurred (a) by a person resident in India and owed to a person resident outside India or (b) by a person resident outside India.

(i) Amortisation of Loans:

Under provisions of FEMA, 1999 subject to Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000 as amended by Foreign Exchange Management (Permissible Capital Account Transactions) (Amendment) Regulations, 2004 all capital account transactions are prohibited unless permitted by proviso to section 6(2) of FEMA. The proviso specifically permits drawal of foreign exchange for payments due on account of amortisation of loans in ordinary course of business. Hence, there is no restriction in FEMA in this regard.

(ii) Purchase of Shares of Company engaged in Plantation activities:

According to Section 6(2) of FEMA, 1999 the Reserve Bank of India is empowered to specify in consultation with the Central Government, the classes of capital account transactions which are permissible and the limits upto which the foreign exchange shall be admissible for such transactions. Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000 completely prohibits certain capital account transactions. One such transaction is foreign investment in India in any company, firm or proprietary concern engaged in or proposed to be engaged in agriculture or plantation activities. Hence, purchase by a person resident outside India of shares of a company in India engaged in plantation activities is not permissible.

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

Appeal to Special Director (Appeals)

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

Appeal to Appellate Tribunal

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

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

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

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

- (ii) Section 11(2) of the Competition Act, 2002 empower the Central Government to remove, by an order, a member of the Competition Commission of India from his office if such member has acquired such financial interest as is likely to affect prejudicially his functions as a Member of the Competition Commission. However, provisions of Section 11(3) of the said Act puts some restrictions on such powers of the Central Government. According to this section, in case as stated in the question, the Central Government wants to remove a member of the Competition Commission

from his office on the above ground it has to make a reference to the Supreme Court. The Supreme Court shall hold an enquiry in accordance with the procedure formulated by it and then report that the member in question ought to be removed from his office on such ground.

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

Question 3

Answer any two of the following:

- (a) *An investor has complained to SEBI that he has not received the payment due to him from the stock-broker registered with Calcutta Stock Exchange Association Ltd. The complainant has requested SEBI to take appropriate action against the stock-broker. You are required to state with reference to the provisions of Securities and Exchange Board of India Act, 1992 the answer to the following:*

- (i) *What action SEBI can take against the stock-broker on the complaint as stated above?*
- (ii) *What is the procedure to be adopted and what are the factors that will be taken into account while taking such action?* (8 Marks)

- (b) *Following information is available from the records of Star Chemicals & Engineering Ltd.:*

- (i) *The Company is a closely held unlisted Company.*
- (ii) *The paid up share capital of the Company since 1st April, 1999 is Rs.3.00 crores and its net worth as at 31st March, 2005 was Rs.5.00 crores as per audited Balance Sheet.*
- (iii) *The Net Tangible Assets of the Company as per last 3 (three) audited Balance Sheet as at 31st March, 2003, 2004 and 2005 were Rs.4.00 crores, 4.50 crores and 5.00 crores respectively, out of which monetary assets were less than Rs.50 lacs in each of three years.*
- (iv) *The Company was incorporated in 1996 and commenced its business on 1st April, 1996 and since then it has earned good profits and it has not incurred any loss in any year in past.*
- (v) *The Company has not declared any dividend so far, but according to the profits earned so far, the management could have declared the dividend in each of the last five years.*
- (vi) *The name of the Company was changed from Star Engineering Ltd. to its present name with effect from 1st October, 2004.*

The Company wants to make a public issue of shares to raise Rs.20.00 crores by issuing equity shares at premium. For the purpose of including the information in the prospectus, the company has prepared its accounts for 12 months ended 30th September, 2005 showing segment-wise revenue, which reveals that revenue from

Chemical segment is more than the revenue from Engineering segment.

You are required to state the relevant guidelines issued by SEBI and your conclusion whether the company can make the desired issue of equity shares based on the facts stated above. (8 Marks)

- (c) (i) *Explain the rules relating to interpretation of Statutes, when the terms "notwithstanding" and "Subject to" are used in any provision of an Act.*
- (ii) *State the effect of the words "notwithstanding anything contained in this Act" used in Section 408 of the Companies Act, 1956, which vests certain powers in the Central Government to prevent oppression or mismanagement* (8 Marks)

Answer

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

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

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

- (a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default.
 - (b) the amount of loss to an investor or group of investors as a result of the default.
 - (c) the repetitive nature of the default.
- (b) The relevant guidelines issued by SEBI in respect of issue of shares by an unlisted company are laid down in Chapter II of the SEBI (Disclosure and Investor Protection) Guidelines, 2000 as amended vide SEBI/CFD/DIL/DIP/Circular No.11 dated August 14, 2003.

According to Para 2.2.1 of the said Guidelines, an unlisted company can make an initial public offer of equity shares if the following conditions are fulfilled:

- (a) The company has net tangible assets of at least Rs.3 crores in each of the preceding 3 full years (of 12 months each), of which not more than 50% is held in monetary assets.

Provided that if more than 50% of the net tangible assets are held in monetary

assets, the company has made firm commitments to deploy such excess monetary assets in its business/project;

- (b) The company has a track record of distributable profits in terms of Section 205 of the Companies Act, 1956, for at least three (3) out of immediately preceding five (5) years;

Provide further that extraordinary items shall not be considered for calculating distributable profits in terms of Section 205 of the Companies Act, 1956.

- (c) The company has a net worth of at least Rs.1 crore in each of the preceding 3 full years (of 12 months each);
- (d) In case the company has changed its name within the last one year, at least 50% of the revenue for the preceding 1 full year is earned by the company from the activity suggested by the new name; and
- (e) The aggregate of the proposed issue and all previous issues made in the same financial year in terms of size (i.e., offer through offer document + firm allotment + promoters' contribution through the offer document), does not exceed five (5) times its pre-issue net worth as per the audited balance sheet of the last financial year)

In the case given in the question, all the conditions are fulfilled. The Company has net tangible assets exceeding Rs.3.00 crores in each of the preceding three years and it has monetary assets which are less than 50% thereof. The company has a track record of having distributable profit in last three out of last five years. The declaration of dividend is not essential. The company has a net worth of more than Rs.1 crore in each of the preceding three full years. The company has changed its name by including the word "Chemicals" therein and as per the information provided, the revenue earned by the company from this activity is more than 50% of the total revenue earned by it during the preceding one full year of 12 months. Finally, the issue size is Rs.20.00 crores, which is less than five times its pre-issue net worth of Rs.5.00 crores. The company is free to price their equity shares. Hence, the company can raise Rs.20.00 crores through public issue of equity shares at a premium.

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

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

term "subject to".

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

Question 4

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

	As at 31.03.2003	As at 31.03.2004	As at 31.03.2005
	Rs.	Rs.	Rs.
<i>Paid up capital</i>	50,00,000	50,00,000	75,00,000
<i>General Reserve</i>	40,00,000	42,50,000	50,00,000
<i>Credit Balance in Profit & Loss Account</i>	5,00,000	7,50,000	10,00,000
<i>Debenture Redemption Reserve</i>	15,00,000	20,00,000	25,00,000
<i>Secured Loans</i>	10,00,000	15,00,000	30,00,000

On going through other records of the Company, the following is also determined:

<i>Net Profit for the year (as calculated in accordance with the provisions of Section 349 & 350 of the Companies Act, 1956</i>	12,50,000	19,00,000	34,50,000
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In the ensuing Board Meeting scheduled to be held on 5th November, 2005, among other items of agenda, following items are also appearing:

- (i) To decide about borrowing from Financial institutions on long-term basis.
(ii) To decide about contributions to be made to Charitable funds.

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

institution and the amount upto which the Board of Directors can contribute to Charitable funds during the financial year 2005-06 without seeking the approval in general meeting.
(8 Marks)

- (b) *Examine the validity of the following with reference to the relevant provisions of the Companies Act, 1956 and/or decided case laws:*
- (i) *Mr. G, a Director of Sam Limited was interested in a contract to be entered into by the company. The Articles of Association of Sam Limited contained a clause, which prohibited the directors from voting on the resolution in respect of any contract in which he is interested. The matter in respect of the said contract was put up for approval of the shareholders in a general meeting. The general meeting was attended by Mr. G and he also voted on the resolution. Mr. G, claims that he has a right to vote on the resolution in the general meeting.*
 - (ii) *The Articles of Association of Big Limited provide that a meeting of the Board of Directors of the company shall be held at 11.00 a.m. on the last day of every quarter ending 31st March, 30th June, 30th September, and 31st December. Relying on which a clause in the articles, the company did not send notices to the directors in respect of the board meeting held on 30th September, 2005. Some of the directors have questioned the validity of the board meeting on the ground that individual notices have not been sent to the directors.*
(7 Marks)

Answer

- (a) (i) **Borrowing from Financial Institutions:** As per Section 293(1)(d) of the Companies Act, 1956, the Board of Directors of a public company or a private company which is a subsidiary of a public company, without obtaining the approval of shareholders in a general meeting, can borrow the funds 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, 2005, the figures relevant for this purpose are the figures as per the Balance Sheet as at 31.03.2005. According to the above provisions, the Board of Directors of PTL Ltd. can borrow, without obtaining approval of the shareholders in a general meeting, upto an amount calculated as follows:

	Rs.
Paid up Capital	7,500,000
General Reserve (being free reserve)	5,000,000
Credit Balance in Profit & Loss Account (to be treated as free reserve)	1,000,000

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

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

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

Net Profit for the year (as calculated in accordance with the provisions of Sections 349 & 350 of the Companies Act, 1956:

	Rs.
For the financial year ended 31.12.2003	12,50,000
For the financial year ended 31.12.2004	19,00,000
For the financial year ended 31.12.2005	<u>34,50,000</u>
TOTAL:	<u>66,00,000</u>
Average of net profits during three preceding financial years	<u>22,00,000</u>
Five per cent thereof	<u>1,10,000</u>

Since this amount is higher than Rs.50,000/-, the Board of Directors of PTL Ltd. can make contribution to charitable funds upto Rs.1,10,000/- during the financial year 2005-06 without obtaining the approval of shareholders in a general meeting.

- (b) (i) When a director exercises his voting right as a shareholder, he is free to vote in his own best interests like any other shareholder. An article in the articles of association prohibiting a director from voting on a resolution in respect of a contract in which he is interested does not debar him from voting thereon as a shareholder in

a general meeting [*East Pant Du United Lead Mining Co. Ltd. vs. Merry Weather* (13 WR 216)]. A shareholder may vote as he pleases even when his interests are different from or opposed to those of the company. Shareholders are not trustees for the company or for one another. [*North-West Transportation Co. vs. Beaty* (1887) 12 APP CAS 569 (PC)]. The restriction in the article pertaining to voting applies only to the board meetings and not to the general meetings.

In view of the above legal pronouncements, there cannot be any restriction on the voting right of a director in a general meeting where he is voting as a shareholder. Hence the contention of Mr. G is correct.

- (ii) If the articles of association of Big Limited provides that a meeting of the board directors shall be held on the last day of each quarter, it is not necessary that separate notices are required to be served on the directors. It was held in the case of *Arunachalam Chettiar vs. Kaleswarar Mills Ltd.* [(1956) 26 Comp. Cas. 431] that where the articles of the company provide that there will be a meeting of the board of directors on the first Saturday of every month, there will be no necessity of service of notice to individual director and such clause in the articles of association is sufficient compliance of section 286(1) of the Companies Act, 1956. In view of the said judgement, the clause in the article is sufficient compliance of the requirement of sending the notice for a board meeting and the contention of some of the directors is not legally valid. However, as a good secretarial practice, notice for every board meeting should be sent to all the directors eligible to receive the notice.

Question 5

- (a) *A group of shareholders has approached you for advice regarding the affairs of LPM Paper Mills Ltd. According to them, the management of the company is not carrying out its functions in accordance with the prudent commercial practice and if the affairs of the company are allowed to run in future in the same manner, the company's solvency would be in danger. They want that a Special Audit be conducted to find out the actual nature of the transactions.*
- (i) *You are required to state with reference to the provisions of the Companies Act, 1956, as to when a special audit can be directed and by whom.*
- (ii) *Draft an application to be submitted to the appropriate authority in this respect.*
(8 Marks)
- (b) (i) *State the provisions of the Companies Act, 1956 regarding the appointment of auditors in the following cases:*
- (a) *A Company, whose Annual General Meeting was held on 30th September, 2005, but it failed to appoint the auditor.*
- (b) *A Company, whose financial year shall end on 31st December, 2005 and whose auditor (appointed in last Annual General Meeting held on 30th March, 2005) had died on 15th October, 2005.*

- (ii) *State the considerations under the Companies Act, 1956 upon which the Central Government can prohibit the appointment of Sole Selling Agents in certain cases.*
(7 Marks)

Answer

- (a) (i) **Provisions regarding Special Audit:** Section 233A of the Companies Act, 1956 deals with the matter relating to Special Audit. The special audit can be ordered by Central Government under certain circumstances. The circumstances are enumerated below:

If the Central Government is of the opinion:

- (i) that the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or
- (ii) that any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or
- (iii) that the financial position of any company is such as to endanger its solvency.

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

- (ii) DRAFT APPLICATION

Dated_____

To,
The Secretary,
Department of Company Affairs,
Ministry of Company Affairs,
Government of India,
(Address)
New Delhi

Sir,

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

We are of the view that certain expenditures which are being incurred by the company are not related to the business of the company and the company is not getting any benefit out of such expenses. Moreover, we have the apprehension that there are certain business transactions which are being entered into by the directors

with the concerns which are owned by the relatives of the Directors and the prices charged for such transaction are not comparable with the prices charged by other parties for similar transactions. (Students may state any other circumstances also).

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

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

It is, therefore, prayed that the Central Government be pleased to appoint, pursuant to Section 233A of the Companies Act, 1956, a Special Auditor to properly audit the accounts of the Company and find the real nature of the transactions and determine the losses so far sustained and being sustained by the company on this account.

Yours faithfully,

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

Shareholder

- (b) (i) (a) The appointment of auditors in the case of company's failure to appoint an auditor at its Annual General Meeting is dealt with by Sections 224(3) and (4) of the Companies Act, 1956. The said sections state that where at an annual general meeting, no auditors are appointed or re-appointed, the company shall, within seven days of such non-appointment give notice to the Central Government and the Central Government may appoint a person to be the auditor of the company to fill the vacancy caused by such non-appointment. It may be noted that now these powers are exercised by the Regional Director by delegation.
- (b) The situation as stated in the question is covered by the provisions of Section 224(6) of the Companies Act, 1956. Clause (a) of the said section states that the Board of Directors may fill any casual vacancy in the office of an auditor. Accordingly, in the case of death of the auditor, the Board of Directors of the company can appoint the auditor. This is called the filling up of the casual vacancy. However, as per clause (b) of the said section any auditor appointed in a casual vacancy shall hold office until the conclusion of the next annual general meeting.
- (ii) As per section 294AA of the Companies Act, 1956 where the Central Government is of opinion that the demand for goods of any category, to be specified by that Government, is substantially in excess of the production or supply of such goods and that the services of sole selling agents will not be necessary to create a market for such goods, the Central Government may, by notification in the Official Gazette,

declare that sole selling agents shall not be appointed by a company for the sale of such goods for such period as may be specified in the declaration.

In view of the provisions of the said section, the Central Government has to take following two considerations into account while prohibiting the appointment of sole selling agents:

- (1) Whether the demand for goods of any category is in excess of the production or supply; and
- (2) that the services of sole selling agents will not be necessary to create a market for such goods.

Question 6

- (a) (i) *The existing Inter-state Cooperative Society seeks your advice regarding the papers to be submitted to the Registrar of Companies for its registration as a Producer Company under the provisions of the Companies Act, 1956. You are required to prepare a list of such papers.*
- (ii) *A group of individuals eligible to form a Producer Company within the meaning of the Companies Act, 1956 has entrusted you with the job of preparing the Memorandum of Association of the proposed Producer Company. You are required to state the matters, which are required to be included in such Memorandum of Association. (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 of 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.*

Also state whether Mr. Raj can be appointed as a Small Shareholders' Director if he is already a Small Shareholders' Director in two other companies. (7 Marks)

Answer

- (a) (i) As per Section 581J of the Companies Act, 1956, any Inter-State Co-operative Society with objects not confined to one State may make an application to the Registrar of Companies for registration as Producer Company.

The application for registration as a producer Company is to be submitted along with the following:

- (a) a copy of the special resolution, of not less than two-third of total members of Inter-State Co-operative Society, for its incorporation as a Producer Company under the Companies Act;
- (b) a statement showing:
 - (i) Names and addresses or the occupation of the directors and Chief Executive, if any, by whatever name called, of such inter-State Co-

operative Society, and

- (ii) list of members of such Inter-State Co-operative Society;
 - (c) a statement indicating that the Inter-State Co-operative Society is engaged in any one or more of the objects specified in Section 581B of the Companies Act, 1956;
 - (d) a declaration by two or more directors of the Inter-state co-operative society certifying that particulars given in the above statements are correct.
- (ii) As per Section 581F of the Companies Act, 1956, the Memorandum of Association of a Producer Company has to state the following:
- (a) the name of the company with “Producer Company Limited” as the last words of the name of such Company;
 - (b) the State in which the registered office of the Producer Company is to situate;
 - (c) the main objects of the Producer Company confirming to the objects specified in Section 581B of the Companies Act, 1956;
 - (d) the names and addresses of the persons who have subscribed to the memorandum of Association;
 - (e) the amount of share capital with which the Producer Company is to be registered and division thereof into shares of a fixed amount;
 - (f) the names, addresses and occupations of the subscribers being producers, who shall act as the first directors in accordance with section 581J(2) of the Companies Act, 1956;
 - (g) that the liability of its members is limited;
 - (h) opposite to the subscriber’s name the number of shares each subscriber takes (Each subscriber must take at least one share);
 - (i) in case the objects of the Producer Company are not confined to one State, the States to whose territories the objects extend.
- (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.
 - (2) Small Shareholder for this purpose means a shareholder holding shares of nominal value of Rs.20,000 or less.
 - (3) Small Shareholders who intend to propose Mr. Raj as a Small Shareholders’

Director have to leave a notice of their intention with T.R.G. 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, folio number in case of shares being held in physical form, Depository Participant ID No. and Shareholder's ID No. in case of shares being held in dematerialized form of Mr. Raj, whose name is to be proposed as a Small Shareholders' Director.
- (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 scrutinising 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 reappointed 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.

Rule 7 of the Companies (Appointment of the Small Shareholders' Director) Rules, 2001 puts a restriction on number of directorships to be held by a person as Small Shareholders' Director. According to this rule, no person shall hold office at the same time as Small Shareholders' Director in more than two companies. Hence, if Mr. Raj is already a Small Shareholders' Director in two other companies, he cannot be appointed as such in TRG Ltd.

Question 7

- (a) *The Central Government came into possession of certain facts and documents, which indicated that some of the managerial personnel of a Company concerned with the management of the affairs thereof are acting in a manner, which is not desirable and if allowed to carry on, it is likely to cause serious injury to the interest of the trade, industry and business to which the company pertains. You are required to state the circumstances and manner in which the Central Government can initiate the process of removal of managerial personnel under the provisions of the Companies Act, 1956.*

(8 Marks)

- (b) *OGC Ltd. was a supplier of raw material to SAM Ltd., which could not make payment to OGC Ltd. owing to huge losses and financial constraints. Ultimately, SAM Ltd. went into liquidation and Official Liquidator was appointed. OGC Ltd. filed a suit for recovery of its dues. The Court awarded a decree in favour of OGC Ltd. Armed with the Court's*

decree, OGC Ltd. approached the Official Liquidator to pay the amount to it in preference over dues of the workmen. The workmen protested the demand of OGC Ltd. and contended that their dues rank pari passu with the Secured Creditors and will override all other claims of other creditors even where a decree has been passed.

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

(7 Marks)

Answer

(a) As per provisions of Section 388B of the Companies Act, 1956, if in the opinion of the Central Government, there are circumstances suggesting:

- (a) that any person concerned in the conduct and management of the affairs of a company is or has been in connection therewith guilty of fraud, misfeasance, persistent negligence or default in carrying out his obligations and functions under the law, or breach of trust; or
- (b) that the business of a company is not or has not been conducted and managed by such person in accordance with sound business principles or prudent commercial practices, or
- (c) that a company is or has been conducted and managed by such person in a manner which is likely to cause or has caused, serious injury or damage to the interest of the trade, industry or business to which such company pertains; or
- (d) that the business of a company is or has been conducted and managed by such person with intent to defraud its creditors, members or any other persons or otherwise for a fraudulent or unlawful purpose or in a manner prejudicial to public interest.

Then, in any of the above circumstances the Central Government may state a case in the form of an application against the such person and refer the same to the Company Law Tribunal with a request that the Company Law Tribunal may enquire into the case and record a decision as to whether or not such person is a fit and proper person to hold the office of Director or any other office connected with the conduct and management of any company.

The Company Law Tribunal is empowered to record its decision under the provisions of Section 388D of the Companies Act, 1956 and such decision shall be recorded by it after concluding the hearing of the case in which such person shall join as the respondent.

Section 388E of the Companies Act, 1956 states that the Central Government shall, by order, remove from office any director or any other person concerned in the conduct and management of the affairs of a company, against whom a decision of the Company Law Tribunal under Section 388D has been recorded.

NOTE: Powers of the Company Law Board has been transferred to the National Company Law Tribunal by the Companies (Second Amendment) Act, 2002 and assented

by the President of India on 13.01.2003. This will take effect from the date of full enforcement. Till then, powers being currently exercised by the Company Law Board shall continue to be exercised.

- (b) The problem given in the question is covered by the provisions of Section 529A of the Companies Act, 1956 read with Sections 529 and 530 of the said Act. The effect of combined reading of these sections is that the workmen of the company become secured creditors by operation of law to the extent of the workmen's dues and are entitled to proportional payment along with other secured creditors. If there is no secured creditor then the workmen of the company become unsecured preferential creditors under the said Section 529A to the extent of the workmen's dues. The purpose of the said section 529A is to ensure that the workmen should not be deprived of their legitimate claims in the event of the liquidation of the company and the assets of the company would remain charged for the payment of workmen's dues and such charge will be pari passu with the charge of other secured creditors. There is no other statutory provision overriding the claim of the secured creditors except the said Section 529A.

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

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

In view of the above stated legal position, the contention of the workmen of SAM Ltd. is valid and the Official Liquidator will have to pay them in priority over the decreed dues of OCG Ltd.

Question 8

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

(8 Marks)

- (b) *Following transactions are made by a public company. You are required to examine the same whether these transactions can be termed as Loans to Directors requiring the approval of the Central Government as required under Section 295 of the Companies Act, 1956:*
- (i) *A salary advance of Rs.5,000 to an employee, who is the wife of the managing director of the company.*
 - (ii) *Sale of company's flat to a director at prevailing market price, out of which the director pays 50% (fifty per cent) immediately and contracts to pay balance amount in 10 equal annual instalments.*

- (iii) *Making a deposit with the landlord under a licence arrangement for securing a residential accommodation for the managing director of the company.*
- (iv) *Loan to its 100% (One hundred per cent) subsidiary company.* (7 Marks)

Answer

- (a) HPC Ltd. can demerge its food processing business with an associate company, BCD Ltd. by obtaining the approval of Company Law Tribunal (CLT earlier such power was vested in High Court and the High Court can continue to exercise such power till the CLT becomes fully functional) as provided in section 394 of the Companies Act, 1956 for this purpose, HPC Ltd. is required to take the following steps:
- (1) HPC Ltd., known as “Transferor Company” for this purpose, has to prepare a scheme under which its properties and liabilities in respect of food processing business will be transferred to BCD Ltd., known as “Transferee Company” for this purpose. Such scheme must contain the consideration for transfer, known as “Exchange Ratio”.
 - (2) An application under Section 391(1) of the said Act must be made to CLT for an order convening meetings of creditors and/or members.
 - (3) Notice(s) of the meeting(s) must be sent to members/creditors as per the direction of CLT. Such notice must be accompanied by a statement under Section 393(1) of the said Act setting forth the terms of the compromise or arrangement and explaining its effect in general and in particular, the effect on the interests of Managerial Personnel.
 - (4) To hold the said meetings and pass necessary resolution approving the scheme subject to the confirmation of CLT. It may be noted that the resolution must be passed by a majority in number representing $\frac{3}{4}$ in value of the members/creditors as required under Section 391(2) of the said Act.
 - (5) Thereafter, HPC Ltd. is required to move to CLT jointly with BCD Ltd. for approval of the scheme disclosing all material facts relating to the Company. (Proviso to section 391(2). CLT as required under section 394A shall give notice to the Central Government and shall take into consideration any representation received from Central Government before passing any order on the application made to it for approval of the scheme.
 - (6) On receipt of CLT's order, HPC Ltd. is required to file a certified copy of the order with the Registrar of Companies (ROC) for registration within 30 days after making of the order by CLT. [(Section 394(3)]. This is very important since the non-filing of the order with ROC would make the approval order ineffective.
 - (7) Lastly, to proceed to give effect to the scheme as approved by CLT in the manner as directed by it.
- (b) (i) As per the decision of the Madras High Court in the case of *M.R. Electronics Components Ltd. vs. Asst. Registrar of Companies* [(1987) 61 Comp. Cases 8], a salary advance totalling Rs.5,000/- made to an employee of the company who

happens to be the wife of the managing director does not per se amount to a loan so as to violate Section 295 of the Companies Act, 1956. In view of this decision of the Madras High Court, salary advance of Rs.5,000/- to an employee who is the wife of the managing director is not hit by Section 295 requiring the approval of the Central Government. The said judgement also stated that the burden of proving that the transaction is sham lies on the prosecution.

- (ii) The Bombay High Court in a petition in the case of *Dr. Fredie Ardeshir Mehta Vs. Union of India [(1991) 70 Comp. Cases 210]* held that a company selling one of its flats to one of its directors on receiving half price in cash and agreeing to accept the balance in instalments does not give loan to its director. It is a credit sale. It cannot be described even as an indirect loan. Thus, as per this judicial pronouncement, the transaction as stated in the question does not amount to a loan to director and hence does not require the approval of Central Government as contemplated in Section 295.
- (iii) Where a company secures residential accommodation for its managing director's use by purchase or by entering into a licence arrangement under which the company has to deposit a certain amount with the land lord, to secure compliance of the licence agreement, such deposit or the cost of purchase of property cannot be regarded as loan or advance to the managing director attracting the provisions of Section 295. The said transaction cannot be termed as a book debt also attracting the provisions of Section 296. It is no concern of the managing director on what terms the company secures premises for his residential accommodation.
- (iv) As per Section 295(2)(b) of the Companies Act, 1956 loan by a holding company to its subsidiary company is outside the purview of the provisions of Section 295(1) and hence no prior approval of the Central Government is required for such loans.

Question 9

- (a) *PNT Ltd. is a company, which is listed with Mumbai Stock Exchange. Its 18th Annual General Meeting was held at Mumbai on 30th September, 2005 in respect of financial year ended 31st March, 2005, whereat all the usual business required to be conducted by a company under the provisions of the Companies Act, 1956 were carried out. Following further information is also available:*
 - (i) *The Company has total 8 Directors (including the Chairman) out of which 2 Directors are not liable to retire by rotation.*
 - (ii) *The Company has its registered office at Mumbai and a branch at Kolkata.*
 - (iii) *From the audited annual accounts for year ended 31st March, 2005, it is observed that Directors have proposed a dividend of 20% on equity share capital.*
 - (iv) *75% of the shares of the Company are held in dematerialized form and balance in physical form.*
 - (v) *The accounts of Kolkata Branch of the Company are audited by a firm of Chartered Accountants, who are not the Statutory Auditors of the Company.*

Based on the above, you are required to draft the Minutes of the proceedings of the Annual General Meeting of PNT Ltd. (10 Marks)

- (b) S Ltd. is a subsidiary company of H Ltd. The Financial year of H Ltd. is from 1st April to 31st March whereas the financial year of S Ltd. is 1st July to 30th June every year. This is now causing difficulties particularly in view of the requirement of reporting and circulating the consolidated annual accounts as required by Accounting Standard AS 21. The Board of Directors of H Ltd. decides that the accounting year of S Ltd. for the year 1st July, 2005 to 30th June, 2006 be extended from present 12 months to 21 months, i.e. 1st July, 2005 to 31st March, 2007, so that the financial years of the holding company and the subsidiary company end on the same date.

State the provisions of the Companies Act, 1956 in this respect. (5 Marks)

Answer

(a)

PNT LIMITED

MINUTES OF THE PROCEEDING OF THE 18TH ANNUAL GENERAL MEETING OF THE MEMBERS OF THE COMPANY HELD AT _____ MUMBAI ON 30TH SEPTEMBER, 2005 AT _____ A.M.

PRESENT

Mr. _____	Chairman & Managing Director
Mr. _____	Wholetime Director
Mr. _____	Director (Audit Committee Chairman)
Mr. _____	Director
Mr. _____	Director
Mr. _____	Director
Mr. _____	Director
Mr. _____	Director
Mr. _____	Member
Mr. _____	Member
Mr. _____	Member
Mr. _____	Member
Mr. _____	Member
Mr. _____	Member (Through Proxy)
Mr. _____	Member (Through Proxy)
Mr. _____	Representative of _____ Limited U/s 187
Mr. _____	Secretary

SUMMARY OF MEMBERS' ATTENDANCE:

1) In Person _____ As per signatures obtained on attendance Slips

2) By Proxy _____ As per signatures obtained on attendance Slips

Mr. _____, Chairman took the chair to conduct the Meeting.

The Chairman declared that _____ valid proxies representing _____ Equity Shares have been received in the required form.

The Chairman further declared that necessary quorum being present, the meeting could proceed with the stipulated business.

The Register of Directors' Shareholding maintained under Section 307 of the Companies Act, 1956 was placed before the Meeting and was kept open and accessible to all concerned during the continuance of the Meeting.

With the consent of the members present, the Notice convening the Meeting was taken as read.

Since the Directors' Report and Audited Annual Accounts were circulated before hand, the same were taken as read with the permission of the members present.

Thereupon, at the direction of the Chairman, Secretary of the Company read out the Auditors' Report.

At this stage, the Chairman briefed the members about the affairs and activities of the Company.

ITEM NO.1

Adoption of Balance Sheet & Profit & Loss Accounts, Auditors' & Directors Report thereon:

The Chairman placed before the Meeting the Auditors' and the Directors' Report and the Audited Annual Accounts of the Company for the year ended 31st March, 2005 for consideration and adoption and proposed the following Ordinary Resolution, which was seconded by Mr. _____.

"RESOLVED THAT the Audited Balance Sheet as at 31st March, 2005 and the Profit & Loss account for the year ended on that date together with the Reports of the Auditors and that of the Directors thereon, as circulated among the members and placed before the meeting be and is hereby received, considered, approved and adopted."

The Chairman then invited the members for their comments. Some members participated in the discussions and sought some clarifications. The same were duly explained by the Chairman and the Audit Committee Chairman.

Thereafter, the Resolution was put to vote on a show of hands and the same was declared carried unanimously.

ITEM NO.2

Following resolution was proposed as Ordinary Resolution

Proposed by: Mr. _____ Seconded by Mr. _____

“RESOLVED THAT as recommended by the Directors, Dividend @ 20% on Equity Share for the year ended 31st March, 2005 on _____ Equity Shares of Rs. _____ each, be and is hereby declared and the same be paid subject to the provisions of Section 206A of the Companies Act, 1956 to those members or their mandatees whose names stand registered on the Company’s Register of Members:

- i) as Beneficial Owners as at the date of this Annual General Meeting as per the lists to be furnished by National Securities Depository Limited and the Central Depository Services (India) Ltd in respect of the shares held in Electronic form, and
- ii) as Members in the Register of Members of the Company after giving effect to valid share transfers in physical form lodged with the Company or the Registrar & Share Transfer Agent of the Company before the date of start of the Book Closing as announced.

The Resolution was put to vote on a show of hands and the same was declared carried unanimously.

ITEM NO.3

Election of Mr. _____ as Director

Following resolution was proposed as Ordinary Resolution

Proposed by: Mr. _____ Seconded by: Mr. _____

“RESOLVED THAT Mr. _____, Director, retiring by rotation, under the provisions of Article _____ of the Articles of Association of the Company, being eligible, be and is hereby re-elected as a Director of the Company.”

The Resolution was put to vote on a show of hands and was declared carried unanimously.

ITEM NO.4

Election of Mr. _____ as Director.

Following resolution was proposed as Ordinary Resolution

Proposed by: Mr. _____ Seconded by Mr. _____

“RESOLVED THAT Mr. _____, Director, retiring by rotation, under the provisions of Article _____ of the Articles of Association of the Company, being eligible, be and is hereby re-elected as a Director of the Company.”

The Resolution was put to vote on a show of hands and was declared carried unanimously.

ITEM NO.5

(a) Appointment of M/s _____ as Auditors

Following resolution was proposed as Ordinary Resolution

Proposed by: Mr. _____ Seconded by: Mr. _____

"RESOLVED THAT pursuant to the provisions of Section 224A of the Companies Act, 1956, M/s _____, Chartered Accountants, be and are hereby re-appointed Auditors of the Company to hold office as such from the conclusion of this meeting until the conclusion of the next Annual General Meeting and the Board of Directors be and are hereby authorised to fix their remuneration and re-imbursement of out-of-pocket expenses as per recommendation of the Audit Committee.

The Resolution was put to vote on a show of hands and was declared carried unanimously.

(b) Appointment of M/s _____ as Branch Auditors

Following resolution was proposed as Ordinary Resolution

Proposed by: Mr. _____ Seconded by: Mr. _____

"RESOLVED THAT pursuant to the provisions of Section 224A read with Section 228(3) of the Companies Act, 1956, M/s _____, Chartered Accountants be and are hereby re-appointed Branch Auditors of the Company's Kolkata Branch to hold office as such from the conclusion of this meeting until the conclusion of the next Annual General Meeting and the Board of Directors be and are hereby authorized to fix their remuneration and re-imbursement of out-of-pocket expenses as per recommendation of the Audit Committee.

The Resolution was put to vote on a show of hands and was declared carried unanimously.

There being no other business to transact, the meeting ended with a vote of thanks to the Chair.

Date:

CHAIRMAN

(b) Section 213(1) of the Companies Act, 1956 states as follows:

Where it appears to the Central Government desirable for a holding company or a holding company's subsidiary to extend its financial year so that the subsidiary's financial year may end with that of the holding company, and for that purpose to postpone the submission of the relevant accounts to a general meeting, the Central Government may on the application or with the consent of the board of directors of the company whose financial year is to be extended, direct that in the case of that company, the submission of accounts to a general meeting, the holding of an annual general meeting or the making of an annual return, shall not be required to be submitted held or made earlier than the dates specified in the direction notwithstanding anything to the contrary in the Companies Act, 1956 or in any other Act for the time being in force.

Thus, the management can extend the financial year of S. Ltd. from 12 months to 21 months as mentioned in the question with the approval of the Central Government.

SUMMARY OF EXAMINERS' COMMENTS ON THE PERFORMANCE OF CANDIDATES

PAPER – 1 : ADVANCED ACCOUNTING

General Comments

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

Specific Comments

Question 1. Holding Company Accounts: The performance of the candidates was not upto the mark. While calculating cost of control, many candidates did not consider the paid-up value of debentures amounting Rs. 3 lakhs. Most of the candidates erred in the treatment of preliminary expenses of Dee Ltd. which resulted in incorrect analysis of revenue and capital profits of Dee Ltd. Some candidates did not prepare the consolidated balance sheet taking care of the format given under the Companies Act. Few among them showed inadequate knowledge of AS 21 'Consolidated Financial Statements'.

Question 2.(a) Gross Value Added Statement: This part of the question was answered satisfactorily by most of the candidates. However, few candidates wrongly deducted provision for bad and doubtful debts from administrative expenses at the time of calculating the amount of gross value added.

(b) Development Fund: Most of the candidates performed fairly well in this part of the question. Some candidates wrongly showed building in progress amounting Rs. 15,00,000 in the deductions column of the statement of changes in the development fund.

Question 3. Valuation of Shares: The candidates have performed badly in this question. Some of the candidates ignored notional call on 90 lakhs equity shares @ Rs. 2 per share while calculating the intrinsic value of shares. Many candidates could not arrive at the correct value per share on the basis of EPS.

Question 4.(a) AS 28: Some candidates could not calculate the correct amount of impairment loss. Few among them were not able to give correct journal entries for adjustment of impairment loss.

(b) AS 26: Candidates showed lack of knowledge of AS 26 'Accounting for Intangible Assets'. Most of the candidates gave the answer correctly stating that the amount of Rs. 75,00,000 cannot be capitalized and disclosed as a prior period item but failed to substantiate their answers with adequate reasoning.

(c) **AS 9:** There was a good attempt by the candidates in this part of the question as compared to other parts. Some candidates were not able to justify their answer with provisions of AS 9.

Question 5.(a) AS 25 : The candidates have performed very poorly in this part of the question. Most of them gave a vague answer that provision for pension and gratuity should be calculated on a proportionate basis, instead of using the actuarially determined rates at the end of prior financial year.

(b) **Environmental Accounting:** The performance of the candidates, in this part of the question, was average. However, few candidates defined the term 'environmental accounting' instead of describing the significance of environmental accounting.

(c) **Accounting for employees stock option plan:** The candidates exhibited poor knowledge on this topic. Except few, no candidate was able to give correct journal entries required in this part of the question.

Question 6.(a) Non-Banking Finance Companies: The performance of the candidates in this part of the question was good. Most of them calculated the correct amount of required provision.

(b) **AS 16:** Most of the candidates answered this part of the question satisfactorily.

(c) **AS 22:** Average performance was observed in this part of the question. However, some of the candidates have interchanged the meanings of the terms 'timing differences' and 'permanent differences'.

PAPER – 2 : MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS

General Comments

- (i) Performance of candidates was generally poor. Candidates did not follow logical and systematic approach for solving the question paper.
- (ii) Students did not write the answers of the sub-questions of the same question at the same place rather it was scattered at different places. Hence, difficulty was experienced in linking the question. Students of a professional course like C.A. are expected to answer the question in a systematic and logical order.
- (iii) Conceptual understanding was generally lacking.
- (iv) Candidates demonstrated lack of adequate preparation on their part. The overall performance was not satisfactory.
- (v) Some of the students did not attempt the full question paper.
- (vi) The use of English language and the presentation of answers was poor and unsatisfactory.

- (vii) Students' standard of preparation need to be improved.
- (viii) Cases of overwriting were noticed in large numbers.
- (ix) Many students gave wrong question numbers.
- (x) On the one and the same sheet, multiple questions were solved.
- (xi) Handwriting was not legible.
- (xii) At many places workings were not found to be part of the answers.
- (xiii) Attempt to the theoretical questions was generally unsystematic and conclusions/opinions relating to practical questions was not properly explained.

Specific Comments

Question 1.(a) Most of the candidates could answer to this question properly. The answers showed a systematic approach in most cases. However, some of the candidates could not calculate NPV in both buy and lease options. They failed to calculate tax shelter, cash outflows and lessor's point of view.

(b) Majority of candidates were able to solve this question correctly.

Question 2.(a) Answers to this question were generally not satisfactory. It appears that the question was not properly understood. Few candidates were able to calculate NAV properly especially in the case of Mrs. Charu & Bacchan. It was an arithmetical problem but most of the candidates failed to work out this problem. Either the candidates gave wrong answers or left the answers incomplete. Majority of students were not aware of the treatment of different schemes in Mutual Funds. They could not calculate the units secured under different schemes.

(b) Very few candidates could solve this question correctly. Only few candidates calculated expected return and variability of return correctly. Calculation of standard deviation was confused and wrong. For the decision about buy back of debenture at face value, different reasons were given, however, those were not acceptable.

Question 3.(a) Answers to this part of the question were generally satisfactory. Most of the candidates wrote about interest rate risk correctly. However, about re-investment risk, default risk, G-sec, Repo & Reverse Repo, it seems that the candidates did not have the correct conception.

(b) Answers to this part of the question showed an unsystematic approach and in most cases were generally not satisfactory. The answers were given in a vague manner. Many students did not know the concept of Nostro account and failed to understand the adjustments of exchange position.

(c) Most candidates could get few steps right, very few got the answer correct. Even though, overall attempt was poor, many candidates however, calculated the number of shares, estimated market price and book value of Fortune Pharma Ltd. correctly.

Question 4.(a) Being a theory question, most of the students were able to write few points correctly.

(b) Except calculating actual investment properly, other points were not touched by candidates. Students were not able to calculate the revised duration of investment.

(c) Few students were able to calculate this question properly.

Question 5.(a) Most of the candidates calculated Market Price, duration, volatility, expected market price wrongly.

(b) It seems that students were not able to understand this question properly and in their opinion both the terms of ESOS and ESPS were interchangeable.

(c) This question was not also properly understood and dealt with by the students. Most of the calculations done by them were wrong. Most of the candidates ignored the capital appreciation in working out expected rate of return in each, using the Capital Asset Pricing Model (CAPM). Very few could calculate risk free rate of return.

Question 6.(a) Most of the candidates confused the term securitisation with loan against securities. This shows lack of preparation on the part of students even in respect of contemporary issues. They are perhaps unaware about the recent developments in financial management arena.

(b) Few candidates attempted this question and solved it wrongly.

(c) Students answered this question that ECB means borrowings from Banks, Financial Institutions, issue of financial instruments like commercial papers etc. They thus demonstrated their lack of preparation relating to current developments in financial markets. Their answers were vague and did not match with the expectations of a professional course.

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. In particular, there appears to be lack of knowledge of auditing standards.
2. Lack of Knowledge of relevant provisions of the Companies Act, 1956.
3. Candidates wrote answers without first analysing the exact requirement of each question.
4. Lack of command over language.

Specific Comments

Question 1.(a) Generally candidates failed to write focused answer having regard to relevant provisions of AS 16, "Borrowing Costs". Some candidates went on to explain disclosure requirements.

(b) It was a simple question involving application of practical exposure but candidates wrote lengthy answers and did not refer to relevant AAS.

(c) Majority of candidates were not aware about the clarification issued by the ICAI in respect of divisional transfers and hence wrote wrong answer.

(d) Some candidates could not write properly as to application of AS 20 *vis a vis* requirement of Part IV of Schedule VI to the Companies Act, 1956.

Question 2(b) Many candidates were not aware of the provisions relating to negative net worth of an entity and hence wrong answer.

(c) Many candidates were not aware that restrictions relating to acceptance of audit below certain audit fees were not applicable in case of entities for two years from the date of commencement of their operations.

(d) Some candidates wrongly quoted Clause 9 of the First Schedule to the Chartered Accountants Act.

Question 4.(b) Majority of the candidates were unable to formulate an audit report where all qualifications are not quantifiable. Most of them referred to non quantification of payments relating to retirement benefits. Some candidates wrote vague answers as to the fact that due to non confirmation of sundry debtors the exact amount of provision cannot be worked out.

Question 6.(a) Some candidates were not able to bring out the significance of ratios in the overall context of tax audit.

Question 8.(a) Majority of candidates were not aware about the categories of non-banking finance companies.

(b) Provisions of AS 22, "Accounting for Taxes on Income" were not specified by many candidates.

(c) Many candidates were not aware that such investments are to be carried at acquisition cost.

(e) Most of the candidates were not aware about the format in which record of audit assignments has to be maintained in respect of audit of companies in a notification issued by the ICAI.

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

The overall performance was 'average'. Candidates in general were not adequately prepared for the examination. Application of the law in practical situations, procedural requirements,

English writing and drafting skills, was found lacking. Candidates did not refer to the relevant provisions of law in support of their answers. Sufficient reading of the material, Bare Acts, analysis of various case laws, need to be adhered to in their preparation.

Specific Comments

Question 1. Though the answer to the question on Company Law was written generally correct, many of the candidates did not refer to Section 285 and 288 of the Companies Act, 1956. Answer to questions on SCRA, 1956 was average and relevant provisions of the Act, were not referred to (i.e., Section 11, 12 and 13A).

Question 2. The answers to problems on FEMA, 1999 were generally correct. However, filings of Appeal before Appellate Tribunal and time limits were not stated correctly (Section 17 & 19). The performance to the question on Competition Act, 2002 was fair.

Question 3. The performance to the questions relating to SEBI Act, 1992 and SEBI (DIP) Guidelines, 2000 was not upto the mark. The answers to questions on interpretation of statutes was average.

Question 4. The general performance was satisfactory. However, many candidates got confused and mixed up the provisions of Section 372A with that of section 293 of the Companies Act, 1956. The performance to the second part of the question on the validity of participation by an interested director at the Board/General Meeting and provisions relating to Board meeting was moderately fair.

Question 5. Drafting an application to the Central Government bringing notice of state of the affairs of the company and request for special audit under section 237A of the Companies Act, 1956 was not upto the mark.

Question 6. The general performance was not good. Most of the candidates did not write the matter as per section 581J and 581F of the Act, 1956 dealing with Producer Companies.

Question 7. Most of the candidates did not write the complete answer as per Section 388B to 388D of the Companies Act, 1956. To the second part of the question, answers did not draw reference to section 529A of the Companies Act, 1956 and the case law.

Question 8. The performance to both parts of the question was not good. Candidates did not answer the question with reference to section 391-394 of the Companies Act, 1956.

Question 9. Most of the candidates lacked the drafting ability. Minutes of the annual general meeting seem to be completely unaware/unseen by the candidates. The performance to the second part of the question on Section 213 of the Companies Act, 1956 was not good.

PAPER – 5 : COST MANAGEMENT

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

Working notes should form part of the answer.

Wherever appropriate, suitable assumptions should be made.

Question 1

- (a) Briefly describe the different methods of Transfer Pricing.
- (b) How Pareto analysis is helpful in pricing of product in the case of firm dealing with multi-products?
- (c) Kitchen King company makes a high-end kitchen range hood 'Maharaja'. The company presents the data for the year 2003 and 2004:

	2003	2004
1. Units or maharaja produced and sold	40,000	42,000
2. Selling Price per unit in Rs.	1,000	1,100
3. Total Direct Material (Square feet)	1,20,000	1,23,000
4. Direct material cost per square feet in Rs.	100	110
5. Manufacturing Capacity (in units)	50,000	50,000
6. Total Conversion cost in Rs.	1,00,00,000	1,10,00,000
7. Conversion cost per unit of capacity (6)/(5)	200	220
8. Selling and customer service capacity	300	290
	customer	customer
9. Total selling and customer service cost in Rs.	72,00,000	72,50,000
10. Cost per customer of selling and customer service capacity (9)/(8)	24,000	25,000

Kitchen King produces no defective units, but it reduces direct material used per unit in 2004. Conversion cost in each year depends on production capacity defined in terms of Maharaja units that can be produced. Selling and Customer service cost depends on the number of customers that the selling and service functions are designed to support. Kitchen King has 230 customers in 2003 and 250 customers in 2004.

You are required

- Describe briefly key elements that would include in Kitchen King's Balance Score Card.
- Calculate the Growth, Price-recovery and productivity component that explain the change in operating income from 2003 to 2004. (3+3+18 = 24 Marks)

Answer

- (a) The methods of pricing usually employed in industry when goods or services are transferred from one unit to the other can be broadly classified under the following three categories:
- (i) Pricing at cost or variants of cost e.g. manufacturing cost; standard cost; full cost and full cost plus mark up.
 - (ii) Pricing at market price.
 - (iii) Pricing at bargained or negotiated price.
- (b) In the case of firm dealing with multi products, it would not be possible for it to analyse price-volume relationship for all of them. Pareto Analysis is used for analysing the firm's estimated sales revenue from various products and it might indicate that approximately 80% of its total sales revenue is earned from about 20% of its products. Such analysis helps the top management to delegate the pricing decision for approximately 80% of its product to the lower level of management, thus freeing them to concentrate on the pricing decisions for products approximately 20% of which is essential for the company's survival. Thus, a firm can adopt more sophisticated pricing methods for small proportion of products that jointly account for 80% of total sales revenue. For the remaining 80% products, which account for 20% of the total sales value the firm may use cost based pricing method.
- (c) Kitchen King's Score card should describe its product differentiation strategy. The key points that should be included in its balance score card are
- Financial Prospective – Increase in operating income by charging higher margins on Maharaja.
 - Customer Prospective – Market share in high-end kitchen range market and customer satisfaction.
 - Internal business perspectives: Manufacturing quality, order delivery time, on time delivery and new product feature added.
 - Learning and Growth prospective: Development time for designing new end product and improvement in manufacturing process.

Operative Income:

	<i>(Amount in 000 Rs.)</i>	
	2003	2004
Revenue (40000×1000: 42000×1100)	40000	46200
Direct Material	12000	13530
Conversion cost	10000	11000
Selling and Customer service	7200	7250
Total cost	29200	31780
Operative Income	10800	14420

Change in operating Income 36, 20,000 (F)

A. Growth Component

- (a) Revenue effect = Output Price in 2003{Actual units sold in 04 – Actual units sold in 03}
= Rs.1, 000 (42,000 units – 40,000 units)

= Rs.20, 00,000 (F)

- (b) The cost effect = Input price in 2003{Actual units of input to produce 2003 output less Actual units of input which would have been used to produce year 2004 output on the basis of 2003}

$$(i) \text{ Direct Material} = \text{Rs.}100 [1, 20,000\text{sqft} - 1, 20,000\text{sqft} \times \frac{42,000 \text{ units}}{40,000 \text{ units}}] \\ = \text{Rs.}6, 00,000 (A)$$

- (ii) Conversion cost and selling and customer service will not change since adequate capacity exists in 2003 to support 2004 output and customers. Hence variance

$$\text{Conversion cost} = 200(50000 - 50000) = 0$$

$$\text{S \& Customer Service} = 25000(300 - 300) = 0$$

Increase in operating effect of Growth component is Rs14, 00,000 (F)

B. Price recovery Component:

- (i) Revenue effect = Actual output in 2004 [Selling price per unit in 2004 less Selling price per unit in 2003]
= 42,000units (Rs.1, 100 – Rs1, 000) = Rs.42, 00,000 (F)

- (ii) Cost effect = Unit of input based on 2003 actual that would have been used to produce 2004 output {Input prices per unit in 2003 less Input prices per unit in 2004}

$$(a) \text{ Direct material} = 1, 26,000\text{sqft} (\text{Rs.}100/\text{sqft} - \text{Rs.}110/\text{sqft}) \\ = \text{Rs.}12, 60,000 (A)$$

$$(b) \text{ Conversion Cost} = 50,000 \text{ units} (\text{Rs.}200/\text{unit} - \text{Rs.}220/\text{unit}) \\ = \text{Rs.}10, 00,000 (A)$$

$$(c) \text{ S \& Custr Service} = 300 \text{ customers} (\text{Rs.}24, 000 - \text{Rs.}25,000) \\ = \text{Rs.}3,00,000 (A) \\ = \text{Rs.}25, 60,000 (A)$$

Increase in Operating income due to Price Recovery is Rs.16, 40,000 (F) {Rs.42, 00,000 – Rs.25, 60,000}

(C) *Productivity Component*

Productivity component = Input Prices in 04{Actual units of input which would have been used to produce year 2004 output on the basis of 2003 actual less Actual Input}

- (i) *Direct Material*: Rs.110/sqft (1, 26,000 units – 1, 23,000 units) = Rs.3, 30,000(F)
 (ii) *Conversion Cost*: Rs.200/unit (50,000 units – 50,000 units) = 0
 (iii) *Selling & Customer* = Rs.25, 000 (300 customers – 290 customers)
 = Rs.2,50,000 (F)
 = Rs. 5,80,000 (F)

The change in operating income from 2003 to 2004 is analysed as follows:

(Amount in 000 Rs.)

	2003	Growth component	Price recovery	Cost effect of productivity component	2004
Revenue	40000	2000 (F)	4200 (F)	-----	46200
Cost	29200	600 (A)	2560 (A)	580 (F)	31780
Operating Income	10800	1400(F)	1640 (F)	580 (F)	14420

Question 2

Rainbow Ltd. manufactures paint in batches. The company uses standard costing system and the variances are reported weekly. You have taken the account sheet for study for variance analysis discussion. While working coffee was spilled on these sheets and only following could have been retrieved:

Dr.		Cr.
	<i>Raw Material -1</i>	
<i>Beg. Balance</i>	0	18,000
	<i>Closing Balance</i>	6,000
	<i>Raw Material -2</i>	
<i>Beg. Balance</i>	18,000	
	<i>Closing Balance</i>	41,400
	<i>Work in Progress</i>	
<i>Beg. Balance</i>	0	
<i>Raw Material -2</i>	72,000	<i>Closing Balance</i> 0

<i>Sundry Creditors</i>	
	1,27,200
<i>Wages outstanding</i>	
51,750	
<i>Quantity Variance-Material-1</i>	
1,200	
<i>Price Variance-Material-2</i>	
	6,600
<i>Efficiency Variance-Labour</i>	
	7,200

Other information's are: standard cost of Material – 2 is Rs180 per litre and standard quantity is 5 litres. Standard wages rate is Rs24 per hour and a total 2,300 hours were worked during the week. 1,000 kg of Material -1 and 550 litres of Material-2 were purchased. Sundry creditors are for material acquisition, and wages outstanding pertain to direct labour.

You are required to compute Material-1 Rate Variance, Material-2 Quantity Variance & Labour Spending Variance, Standard hours allowed for production and purchase value of Material-1 for variance analysis discussion.

(b) Write short note on pricing by service sector.

(c) Write short note on 'Zero Base Budgeting' as an approach towards productivity improvement.' (11+4+4 = 19 Marks)

Answer

(a) Material – 1 Rate Variance = Standard cost of material purchased – Actual cost
= Rs24, 000 – Rs21, 600 = Rs2, 400 (F)

Material – 2 Quantity Variance = $SR \times SQ - SR \times AQ$
= Rs900 × 80 units – Rs75, 600
= Rs3, 600 (A)

Labour Spending Variance = $SR \times AH - AR \times AH$
= Rs24/per hour × 2300 hours – Rs51, 750
= Rs3, 450 (A)

Labour Efficiency Variance = $SR \times (SH - AH)$
– 7200 = 24 (SH – 2300)
SH = 2000 Hrs.

	<i>Rs</i>
Total Cost of material purchased	1,27,200
Less: Purchase Value of Material – 2	1,05,600
Cost of material –1	21,600

Working Notes:

- (1) Standard Cost of Material – 2 actually consumed in production = Rs72, 000 (Given)
 Standard cost of Material – 2 per unit: 5 litres × Rs.180 = Rs900
 $\therefore$ No of units produced = Rs.72, 000 / Rs900 = 80 units
 Total material – 1 used in production = Rs.18, 000 (Given)
 Add Closing Inventory = Rs.6, 000 (Given)
 Less Opening Inventory = 0
 Hence Standard Cost of Material – 1 purchased = Rs24, 000
- (2) Standard Rate of Material -1 = Rs.24, 000 / 1,000kg = Rs.24 per kg
 Standard Cost of Material – 1 = Rs.18, 000
 Add favourable Quantity Variance = Rs.1, 200
 Material – 1 allowed = Rs.19, 200
 Standard quantity of Material – 1 allowed = Rs19, 200/Rs24 = 800 Kg.
 Standard quantity per unit = 800kg/80units = 10 kg
 Standard purchase price for Material – 2 = (550liters × Rs180) = Rs.99, 000
 Add unfavourable Rate Variance = Rs.6, 600
 Actual cost Price of Material – 2 = Rs.1, 05, 600
- (3) Opening balance of Material – 2 = Rs.18, 000
 Add Standard Cost of Purchase (550 litres × Rs180) = Rs.99, 000
 Less Closing Balance = Rs.41, 400
 Material-2 Consumed at Standard cost = Rs.75, 600
- (b) The service has no physical existence and it must be priced and billed to customers. Most service organizations use a form of time and material pricing to arrive at the price of a service. Service companies such as appliance repair shops, automobile repair business arrives at prices by using two computations, one for labour and other for material and parts. If material and parts are not part of service being performed, then only direct labour costs are used as basis for determining price. For professionals such as accountants and consultants a factor representing all overhead costs is applied to the

base labour costs to establish a price for the service, which are generally worked out on the basis of rate per man hour.

- (c) Zero Base Budgeting (ZBB) is an expenditure control device where without reference to the past budget figures or achievements each division head has to justify the requirement of funds for each head of expenditure and prepare the budget accordingly. ZBB is defined as "An operating, planning and budgeting process which requires each manager to justify the entire budget request in detail from scratch (hence zero base) and shifts the burden of proof to each manager who has to justify why he should spend any money at all."

ZBB provides a basis for evaluating decision package on basis of cost-benefit considerations. It focuses attention on output in relation to value of money. It reduces inefficiency and achieves high level of effectiveness. It can be applied to cost reduction programmes. Scarce resources can be utilised effectively. Ineffective entries are eliminated and duplicate activities are easily identified. Thus wasteful expenditure is reduced or eliminated fully. It leads to increase in staff participation creating greater motivation and job satisfaction. All these aspects will ultimately result in greater productivity of the resources and organization performance by way of higher profit at lower costs.

Question 3

- (a) *X Video Company sells package of blank video tapes to its customer. It purchases video tapes from Y Tape Company @ Rs140 a packet. Y Tape Company pays all freight to X Video Company. No incoming inspection is necessary because Y Tape Company has a superb reputation for delivery of quality merchandise. Annual demand of X Video Company is 13,000 packages. X Video Co. requires 15% annual return on investment. The purchase order lead time is two weeks. The purchase order is passed through Internet and it costs Rs2 per order. The relevant insurance, material handling etc Rs3.10 per package per year. X Video Company has to decide whether or not to shift to JIT purchasing. Y Tape Company agrees to deliver 100 packages of video tapes 130 times per year (5 times every two weeks) instead of existing delivery system of 1,000 packages 13 times a year with additional amount of Rs0.02 per package. X Video Co. incurs no stock out under its current purchasing policy. It is estimated X Video Co. incurs stock out cost on 50 video tape packages under a JIT purchasing policy. In the event of a stock out, X Video Co. has to rush order tape packages which costs Rs4 per package. Comment whether X Video Company should implement JIT purchasing system.*

Z Co. also supplies video tapes. It agrees to supply @ Rs13.60 per package under JIT delivery system. If video tape purchased from Z Co., relevant carrying cost would be Rs3 per package against Rs3.10 in case of purchasing from Y Tape Co. However Z Co. doesn't enjoy so sterling a reputation for quality. X Video Co. anticipates following negative aspects of purchasing tapes from Z Co.

- *To incur additional inspection cost of 5 paisa per package.*

- Average stock out of 360 tapes packages per year would occur, largely resulting from late deliveries. Z Co. cannot rush order at short notice. X Video Co. anticipates lost contribution margin per package of Rs8 from stock out.
 - Customer would likely return 2% of all packages due to poor quality of the tape and to handle this return an additional cost of Rs25 per package.
 - Comment whether X Video Co places order to Z Co
- (b) A Pharmaceutical company produces formulations having a shelf life of one year. The company has an opening stock of 30,000 boxes on 1st January, 2005 and expected to produce 1, 30,000 boxes as was in the just ended year of 2004. Expected sale would be 1, 50,000 boxes. Costing department has worked out escalation in cost by 25% on variable cost and 10% on fixed cost. Fixed cost for the year 2004 is Rs40 per unit. New price announced for 2005 is Rs100 per box. Variable cost on opening stock is Rs40 per box. You are required to compute breakeven volume for the year 2005.

(12+7 = 19 Marks)

Answer

- (a) (i) **Comparative Statement of cost for purchasing from Y Co Ltd under current policy & JIT**

Particulars	Current Policy	JIT
	Rs	Rs
Purchasing cost	18,20,000	18,20,260
	(13,000 × 140)	(13,000 × 140.02)
Ordering cost	26.00	260.00
	(2×13 orders)	(2×130 orders)
Opportunity carrying cost	10,500.00	1,050.15
	(1/2×1000×140×15%)	(1/2×100×140.02×15%)
Other carrying cost(Insurance, material handling etc)	1,550.00	155.00
	(1/2×1000×3.10)	
Stock out cost		200
		(4 × 50)
Total relevant cost	18,32,076	18,21,925.15

Comments: As may be seen from above, the relevant cost under the JIT purchasing policy is lower than the cost incurred under the existing system. Hence, a JIT purchasing policy should be adopted by the company.

(ii) Statement of cost for purchasing from Z Co Ltd.

Particulars	Rs.
Purchasing cost	1,76,800
	(13,000x13.60)
Ordering Cost	260.00
	(2x130 orders)
Opportunity Carrying Cost	102.00
	(1/2x100x13.60x 15%)
Other Carrying Cost	150.00
	(1/2x100x3.00)
Stock out Cost	2,880
	(8x360)
Inspection Cost	650.00
	(13,000 x .05)
Customer Return Cost	6,500.00
	(13,000 x 2% x 25)
Total Relevant Cost	1,87,342

Comments : The comparative costs are as follows,

Under current policy	Rs 18,32,076.00
Under purchase under JIT	Rs 18,21,925.10
Under purchase from Z Co Ltd	Rs 1,87,342.00

Packages should be bought from Z Co as it is the cheapest.

- (b)** Shelf life is one year hence opening stock of 30,000 boxes is to be sold first. Contribution on these boxes is $30,000(100 - 40) = \text{Rs}18,00,000$

In the question production of 2004 is same as in 2005. Hence fixed cost for the year 2004 is Rs52, 00,000 (1, 30,000x40). Therefore fixed cost for the year 2005 is Rs57, 20,000 (52, 00,000 + 10% of 52, 00,000).

Variable Cost for the year 2005 (Rs.40 + 25% of Rs.40) = Rs50 per Unit

Hence Contribution per unit during 2005 is Rs.50 (100 – 50)

Break even volume is the volume to meet the fixed cost i.e. fixed cost equals to contribution. Therefore, remaining fixed cost of Rs.39, 20,000 (57, 20,000 – 18, 00,000) to be recovered from production during 2005.

Production in 2005 to reach BEP = $3920000 / 50 = 78,400$ units

Therefore BEP for the year 2005 is 1, 08,400 boxes (30000 + 78400)

Question 4

- (a) Critically examine "It is prudent to hold large inventories in an inflationary economy".
- (b) A businessman employs 20 sewing machinists, but he is aware that ten are the better workers than others. He is considering to conduct a training programme for his ten less efficient machinists to increase their efficiency to be equal to that achieved by "better" workers. Relevant data are as follows;
- There is one sewing machine for each machinist.
 - All the machinists are engaged on similar work and are paid Rs2.20 each good garment produced on piece work system.
 - To rectify each rejected garment costs Rs4, this work is done by subcontractor.
 - Garment machining department operates 2,000 hours a year.
 - Average output of per machinist (on the basis of all 20 machinists) is 12 good garments with one rejected per worker per hour. However 10 less efficient machinists' averages only 10 good garments with 1.5 rejected per worker per hour.
 - Depreciation of each sewing machine is Rs10, 000 per year and the variable cost of power, cleaning and preventive maintenance is Rs5 per hour per machine.
 - Fixed production overhead other than depreciation is Rs20 per machine hour.
 - Selling price per garment is Rs18.
 - Direct material cost per garment is Rs12.
 - Training will not reduce productive hours.
 - There is no problem in selling increased output.

You are required

- (a) To prepare a statement of comparative costs for the "better" worker and the "less efficient" workers excluding material costs.
- (b) To find out the benefit derived over a one year period, if Rs1,00,000 is spent on a training course for the "less efficient" workers to match the efficiency with the "better" workers.
- (c) Explain the concept of activity based costing. How ABC system supports corporate strategy? (4+11+4=19 Marks)

Answer

- (a) In an inflationary economy, prices rise rapidly. Holding large inventories will affect the inventory carrying cost including interest on funds blocked. However, there are other risks like obsolescence, deterioration in quality, limited shelf-life in case of certain materials etc. In addition to these risks, cheaper substitutes may be available at a later date. New sources of supply may be available at competitive rate or else price may fall. Hence speculation should be avoided.

The funds so blocked may be invested for expansion or diversification, which may result into higher profitability than the benefit arising from holding large inventory. Hence normal level of inventory may be held to avoid stock-out leading to loss of production. In view of above points all inventory control techniques may be applied for deciding the amount to be invested in inventory. Inflationary economy is one factor. There are several other considerations for deciding the quantum of inventory.

- (b) (a) Average output of all 20 machinist is 12 good units and 1 rejected piece while average output of 10 "less efficient" workers is 10 good units and 1.5 rejected pieces. Hence average output of 10 "better worker" is 14 good units and 0.5 rejected piece.

Statement showing annual comparative cost for the "better machinist" and the "less efficient" machinist excluding direct material cost.

	Better Worker	Less Efficient worker
Good Units		
(14×2000×10 efficient workers)	2,80,000	
(10×2000×10 less efficient worker)		2,00,000
Rejects after correction		
(2000 hrs ×0.5×10)	10,000	
(2000 hrs ×1.5×10)		30,000
	Rs	Rs
Labour cost		
(280000×2.20)	616000	
(200000×2.20)		440000
Rectification Cost		
(10000×4)	40000	
(30000×4)		120000
Variable production cost		
(2000×5×10)	100000	100000
(a)	756000	660000
(b) Sales		
(290000×18)	5220000	
(230000×18)		4140000

Direct material (290000×12)	3480000			
(230000×12)			2760000	
Variable Cost as per (a)	756000	4236000	660000	3420000
Contribution		984000		720000
After training increase in contribution (984000 – 720000)			264000	
Cost of training			100000	
Benefit from training			164000	

- (c) ABC is an accounting methodology that assigns costs to activities rather than products and services. This enables resources and overhead costs to be more accurately assigned to products and services that consume them when compared to traditional methods where either labour or machine hrs are considered as absorption basis over cost centres. In order to correctly associate costs with products and services, ABC assigns cost to activities based on their resources. It then assigns cost to 'Cost objects', such as products and customers, based on their use of activities. ABC can track the flow of activities in organization by creating a link between the activity and the cost objects.

ABC supports corporate strategy in many ways such as:

- ABC system can effectively support the management by furnishing data, at the operational level and strategic level. Accurate product costing will help the management to compare the profits of various customers, product lines and to decide on price strategy etc.
- Information generated by ABC system can also encourage management to redesign the products.
- ABC system can change the method of evaluation of new process technologies, to reduce setup times, rationalization of plant lay out in order to reduce or lower material handling cost, improve quality etc.
- ABC system will report on the resource spending.
- ABC analysis helps managers' focus their attention and energy on improving activities and the actions allow the insights from ABC to be translated into increased profits.
- Performance base accurate feedback can be provided to cost centre managers.
- Accurate information on product costs enables better decisions to be made on pricing, marketing, product design and product mix.

Question 5

- (a) A Company is organised into two divisions. Division X produces a component, which is used by division Y in making of a final product. The final product is sold for Rs540 each. Division X has capacity to produce 2,500 units and division Y can purchase the entire production. The variable cost of division X in manufacturing each component is Rs256.50.

Division X informed that due to installation of new machines, its depreciation cost had gone up and hence wanted to increase the price of component to be supplied to division Y to Rs297, however division Y can buy the component from outside the market at Rs270 each. The variable cost of division Y in manufacturing the final product by using the component is Rs202.50 (excluding component cost).

Present the statement indicating the position of each Division and the company as whole taking each of the following situations separately:

- (i) If there is no alternative use for the production facility of X, will the company benefit, if division Y buys from outside suppliers at Rs270 per component.
 - (ii) If internal facilities of X are not otherwise idle and the alternative use of the facilities will bring an annual cash saving of Rs50,625 to division X, should division Y purchase the component from outside suppliers?
 - (iii) If there is no alternative use for the production facilities of division X and the selling price for the component in the outside market drops by Rs20.25, should division Y purchase from outside supplier?
 - (iv) What transfer price would be fixed for the component in each of the above circumstances?
- (b) A small project is composed of seven activities, whose time estimates are listed below. Activities are identified by their beginning (i) and ending (j) node numbers.

Activity (I-j)	Estimated durations (in days)		
	Optimistic	Most likely	Pessimistic
1-2	2	2	14
1-3	2	8	14
1-4	4	4	16
2-5	2	2	2
3-5	4	10	28
4-6	4	10	16
5-6	6	12	30

- (a) Draw the project network.
- (b) Find the expected duration and variance for each activity. What is the expected project length?

(c) If the project due date is 38 days, what is the probability of meeting the due date ?

Given:	z	0.50	0.67	1.00	1.33	2.00
	P	0.3085	0.2514	0.1587	0.0918	0.0228

(12+7=19 Marks)

Answer

(a) (i) When component is purchased by division Y from outside

(a)	Rs	(Rs.)
Division Y sales 2500×540		13,50,000
Less: cost of purchase 2500×270	6,75,000	
Variable cost 2500×202.50	5,06,250	11,81,250
Division Y contribution		1,68,750
Division X contribution		Nil
Total contribution		1,68,750

(b) When component is purchased from division X

(b)		(Rs.)
Division X		
Sales 2500×297	7,42,500	
Less variable cost 2500×256.50	6,41,250	1,01,250
Division Y		
Sales 2500×540	13,50,000	
Less: Variable cost		
Purchase cost 2500×297	7,42,500	
Variable cost of division Y 2500×202.50	5,06,250	1,01,250
Total contribution		2,02,500

Thus it will be beneficial for the company as whole to buy component from division X.

(ii) When there is alternative use of Division X with given cash saving

		(Rs.)
Division X Contribution from alternative use of facilities		50,625
Division Y sales 2500×540	13,50,000	
Less: Cost of purchase 2500×270	6,75,000	

Variable cost 2500×202.50	5,06,250	
Division Y contribution		1,68,750
Company's total contribution		2,19,375

(iii) When there is no alternative use of Division X & selling price of component reduces in the market

Rs

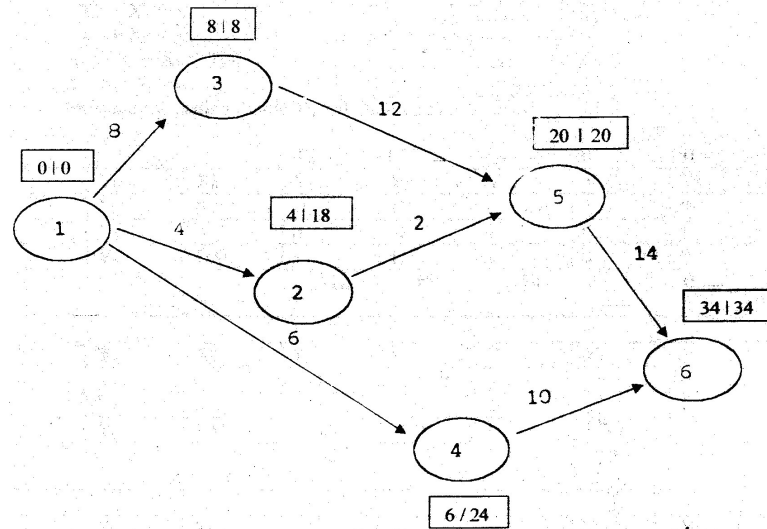
Division Y sales 2500×540	13,50,000	
Less: Cost of purchase 2500×249.75	6,24,375	
Variable cost 2500 × 202.20	5,06,250	
Total contribution		2,19,375

It is beneficial to buy component from outside.

(iv) Transfer price

- Where there is no alternative use of capacity of division X, then variable cost i.e. Rs256.50 per component will be charged
- If facilities of division X can be put to alternative use then variable cost Rs256.50+ opportunity cost Rs20.25 =Rs276.75 will be transfer price.
- If market price gets reduced to Rs. 249.75 and there is no alternative use of facilities of Division X the variable cost Rs256.50 per component should be charged.

(c) Activity	Estimated durations (in days) = $\frac{a + 4m + b}{6}$			$\sigma^2 = \left(\frac{b-a}{6}\right)^2$	
(I – j)	a	m	b		
1-2	2	2	14	4	4
1-3	2	8	14	8	4
1-4	4	4	16	6	4
2-5	2	2	2	2	0
3-5	4	10	28	12	16
4-6	4	10	16	10	4
5-6	6	12	30	14	16



The critical path is 1-----3-----5-----6

(b) The expected duration of the project $8+12+14 = 34$ days

(c) Variance of project length is $\sigma^2 = 4 + 16 + 16 = 36$

The standard normal deviate is:

$$Z = \frac{\text{due date} - \text{expected date of completion}}{\sqrt{\text{variance}}}$$

$$Z = \frac{26 - 34}{6} = \frac{8}{6} = -1.33 \text{ probability of meeting the due date is } 0.0918 \text{ or } 9.18\%$$

(d) When due date is 38 days

$$Z = \frac{38 - 34}{6} = \frac{4}{6} = 0.67 \text{ Probability meeting the date is } 0.2514 \text{ or } 25.14\%.$$

Question 6

(a) Three grades of coal A, B and C contains phosphorus and ash as impurities. In a particular industrial process, fuel up to 100 ton (maximum) is required which could contain ash not more than 3% and phosphorus not more than .03%. It is desired to maximize the profit while satisfying these conditions. There is an unlimited supply of each grade. The percentage of impurities and the profits of each grade are as follows:

Coal	Phosphorus (%)	Ash (%)	Profit in Rs. (per ton)
A	.02	3.0	12.00
B	.04	2.0	15.00
C	.03	5.0	14.00

You are required to formulate the Linear-programming (LP) model to solve it by using simplex method to determine optimal product mix and profit.

- (b) A Publishing house has bought out a new monthly magazine, which sells at Rs. 37.5 per copy. The cost of producing it is Rs. 30 per copy. A Newsstand estimates the sales pattern of the magazine as follows:

Demand Copies	Probability
$0 < 300$	0.18
$300 < 600$	0.32
$600 < 900$	0.25
$900 < 1200$	0.15
$1200 < 1500$	0.06
$1500 < 1800$	0.04

The newsstand has contracted for 750 copies of the magazine per month from the publisher.

The unsold copies are returnable to the publisher who will take them back at cost less Rs. 4 per copy for handling charges.

The newsstand manager wants to simulate of the demand and profitability. The of following random number may be used for simulation:

27, 15, 56, 17, 98, 71, 51, 32, 62, 83, 96, 69.

You are required to-

- Allocate random numbers to the demand patten forecast by the newsstand.
- Simulate twelve months sales and calculate the monthly and annual profit/loss.
- Calculate the loss on lost sales. (11+8=19 Marks)

Answer

- (a) Let X_1 , X_2 and X_3 respectively be the amounts in tons of grades A, B, and C used. The constraints are

- (i) Phosphorus content must not exceed 0.03%

$$.02 X_1 + .04 X_2 + 0.3 X_3 \leq .03 (X_1 + X_2 + X_3)$$

$$2X_1 + 4 X_2 + 3X_3 \leq 3 (X_1 + X_2 + X_3) \text{ or } -X_1 + X_2 \leq 0$$

- (ii) Ash content must not exceed 3%

$$3X_1 + 2 X_2 + 5 X_3 \leq 3 (X_1 + X_2 + X_3) \text{ or } -X_2 + 2X_3 \leq 0$$

- (iii) Total quantity of fuel required is not more than 100 tons. $X_1 + X_2 + X_3 \leq 100$

The Mathematical formulation of the problem is

Maximize $Z = 12 X_1 + 15X_2 + 14 X_3$

Subject to the constraints:

$$- X_1 + X_2 \leq 0$$

$$- X_2 + X_3 \leq 0$$

$$X_1 + X_2 + X_3 \leq 100$$

$$X_1, X_2, X_3 > 0$$

Introducing slack variable $X_4 > 0, X_5 > 0, X_6 > 0$

			12	15	14	0	0	0
C_b	Y_b	X_b	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6
0	Y_4	0	-1	1*	0	1	0	0
0	Y_5	0	0	-1	2	0	1	0
0	Y_6	100	1	1	1	0	0	1
	Z		-12	-15	-14	0	0	0

C_b	Y_b	X_b	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6
15	Y_2	0	-1	1	0	1	0	0
0	Y_5	0	-1	0	2	1	1	0
0	Y_6	100	2*	0	1	-1	0	1
	Z		-27		-14	15	0	0

C_b	Y_b	X_b	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6
15	Y_2	50	0	1	1/2	1/2	0	1/2
0	Y_5	50	0	0	5/2*	1/2	1	1/2
12	Y_1	50	1	0	1/2	-1/2	0	1/2
	Z		0	0	-1/2	3/2	0	27/2

C_b	Y_b	X_b	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6
15	Y_2	40	0	1	0	2/5	-1/5	2/5
14	Y_3	20	0	0	1	1/5	2/5	1/5
12	Y_1	40	1	0	0	-3/5	-1/5	2/5
	Z		0	0	0	8/5	1/5	68/5

The optimum solution is $X_1 = 40, X_2 = 40$ and $X_3 = 20$ with maximum $Z = 1360$.

(b) (i) Allocation of random numbers

<i>Demand</i>	<i>Probability</i>	<i>Cumulative probability</i>	<i>Allocated RN</i>
0<300	0.18	0.18	00—17
300 < 600	0.32	0.50	18—49
600 < 900	0.25	0.75	50—74
900 < 1200	0.15	0.90	75—89
1200 <1500	0.06	0.96	90—95
1500 < 1800	0.04	1.00	96—99

(ii) Simulation: twelve months sales, monthly and annual profit/loss

<i>Month</i>	<i>RN</i>	<i>Demand</i>	<i>Sold</i>	<i>Return</i>	<i>Profit on sales (Rs.)</i>	<i>Loss on return (Rs.)</i>	<i>Net (Rs.)</i>	<i>Loss on lost units</i>
1	27	450	450	300	3375	12000	2175	
2	15	150	150	600	1125	2400	-1275	
3	56	750	750	--	5625	--	5625	
4	17	150	150	600	1125	2400	-1275	
5	98	1650	750	--	5625	---	5625	900
6	71	750	750	--	5625	--	5625	
7	51	750	750	--	5625	--	5625	
8	32	450	450	300	3375	1200	2175	
9	62	750	750	--	5625	--	5625	
10	83	1050	750	--	5625	--	5625	300
11	96	1650	750	--	5625	--	5625	900
12	69	750	750	--	5625		5625	
					54000	7200	46800	2100

(iii) Loss on lost sale $2100 \times 7.5 = \text{Rs}15750$.

PAPER – 6 : MANAGEMENT INFORMATION AND CONTROL SYSTEMS

Question No. 1 is compulsory.

Answer **any four** questions from the remaining **six** questions.

Question 1

- (a) Discuss various factors that render manual audit method ineffective in IS audit. (5 Marks)
- (b) Briefly describe the various objectives to be met while performing an IS audit. (5 Marks)
- (c) "No Company, big or small, can ignore the opportunity opened by the Internet." What are the various methods by which Internet can be accessed ? What are the considerations for choosing the right alternative? (5 Marks)
- (d) Mention any five security management steps an Internet user should take to protect from Cyber crime and computer security threats. (5 Marks)

Answer

- (a) The audit methods that are effective for manual audits prove ineffective in many IS audits because of the following factors:
 - (i) **Electronic evidence:** Essential evidence is not physically retrievable by most auditors, and it is not readable in its original electronic form.
 - (ii) **Terminology:** The tools and techniques used in automated applications are described in terms that are difficult for the non-EDP auditor to understand.
 - (iii) **Automated processes:** The methods of processing are automated rather than manual, making it difficult for the non-EDP auditor to comprehend processing concepts and the logic of these concepts.
 - (iv) **New risks and controls:** Threats to computer systems and the countermeasures to those threats are new to non-EDP auditors, and the magnitude of the risks and the effectiveness of the controls are not understood.
 - (v) **Reliance on controls:** In manual systems, the auditor can place some reliance on hard-copy evidence regardless of the adequacy of the controls. Whereas, in automated systems, the electronic evidence is only as valid as the adequacy of controls.
- (b) While performing an IS audit, auditors should ascertain that the following objectives are met:
 - (i) Security provisions protect computer equipments, programs, communications and data from unauthorized access, modifications or destruction.
 - (ii) Program development and acquisition is performed in accordance with management's general and specific authorization.
 - (iii) Program modifications have the authorization and approval of the management.
 - (iv) Processing of transactions, files, reports and other computer records is accurate

and complete.

(v) Source data that is inaccurate or improperly authorised is identified and handled according to prescribed managerial policies.

(vi) Computer data files are accurate, complete, and confidential.

(c) The various methods by which Internet can be accessed are:

- Internet Service Provider (ISP)
- Online Services
- Direct communication through a gateway.
- Use of someone else's gateway

The following points are to be considered for choosing the right alternative:

- Whether accessing the Internet for the company or limited official use at distant location,
- Type of services needed,
- Monthly usage time,
- Budgeted spending,
- Data rate wanted.

(d) The following security management steps may be taken by an Internet user to protect from cyber crimes and other computer security threats:

- (i) Use antivirus and firewall software and update it often to keep destructive programmes off the computer.
- (ii) Don't allow online merchants to store the credit card information for further purchases.
- (iii) Use a hard-to-guess password that contains a mix of numbers and letters and change it frequently.
- (iv) Use different passwords for different websites and applications to keep hackers guessing.
- (v) Use the most up-to-date version of the web browsers, e-mail software and other programmes.
- (vi) Send credit card numbers only to secure sites; look for a padlock or key icon at the bottom of the browser.
- (vii) Confirm that the site through which you are doing business is a secure site.
- (viii) Use a security programme that gives you control over "cookies" that send information back to website.
- (ix) Install firewall software to screen traffic if you use digital subscriber line (DSL) or a cable modem to connect to the Internet.
- (x) Don't open e-mail attachments unless you know that the source of the incoming message is trustworthy.

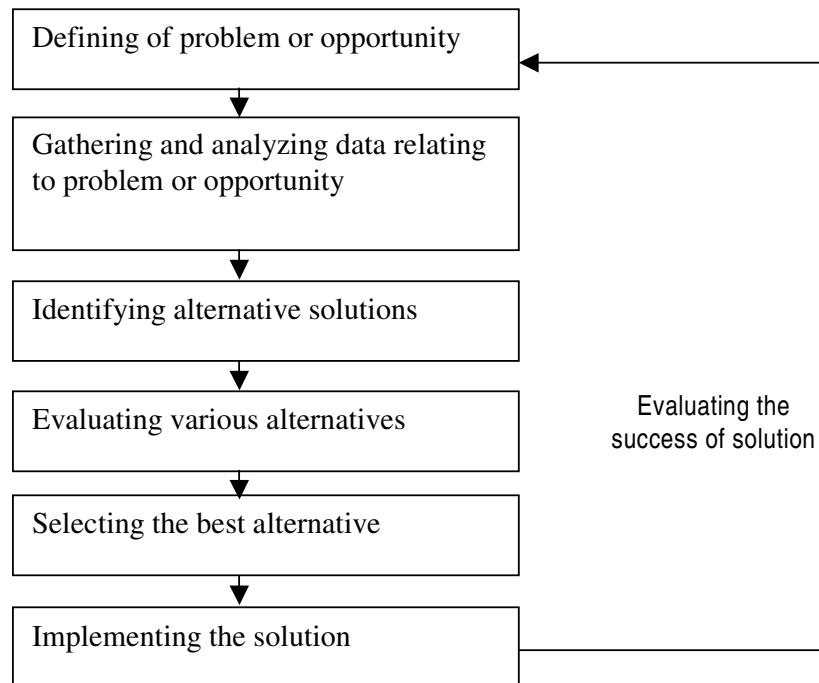
Question 2

- (a) How system approach can be used for solving problems ? (10 Marks)
- (b) Define the term system stress and system change. (5 Marks)
- (c) What are the fact finding techniques used by a system analyst ? (5 Marks)

Answer

- (a) The system approach to management is in fact a way of thinking about management problems. It visualizes an organization as a group of interacting and interdependent parts with a purpose. Managers are not in a position to deal with individual parts separately since action of one part is going to affect other parts. Each problem should be examined in its entirety to the extent possible and economically feasible from the point of view of the overall system of which the problem under consideration is one part. Under this approach, a manager should make conscious attempt to understand the relationship among various parts of the organization and their role in supporting the overall performance of the organization. Before solving problem in any financial area, or in any specific sector of the organization, he should understand fully how the overall system would respond to changes in its component parts.

To understand how the system approach to problem solving is applied, let us consider the problem of long delays between receipts of orders and delivery in some hypothetical company. To seek a solution for the problems by applying systems approach, we would make use of the following steps as shown in the figure given below:



- (i) **Defining of the problem:** The problem involved here is of inordinate delay between the receipt of orders and their delivery. This problem affects the vendor in various ways, e.g., a bad reputation, loss of customers, reduction in profits etc.
 - (ii) **Gathering and analyzing data:** The problem of delay may be because of following reasons:
 - (a) Excessive orders in the hand of vendors
 - (b) Shortage of power
 - (iii) **Identification of alternative solutions:** To overcome the stated problem by system approach, suppose the following two solutions exist:
 - (a) Refusals of orders, in case the total size of the orders exceeds the plant capacity of one shift.
 - (b) To run the plant in double shift to meet the commitment in time. Any shortfall in power supply may be met by installing a generator.
 - (iv) **Evaluation of alternative solutions:** Out of the two solutions as stated above, the second solution say accounts for an overall increase in the profitability of the concern after off-setting additional cost for the generator produced power. It also helps in retaining customers and growth of the concern.
 - (v) **Selection of the best alternative:** Under this step, the management closely examines the alternatives and chooses the best alternative. In this case, the second alternative is finally chosen.
 - (vi) **Implementation of the solution:** The implementation of the solution requires the necessary policy changes. Besides this, the resources required to run the plant in double shift and installation of the generator are also to be arranged. Finally, appropriate procedures are developed to exercise smooth production and timely supply to customers. The concerned officers are accordingly instructed.
- (b) Systems, whether they be living or artificial systems, organisational systems, information systems, or systems of controls, change because they undergo stress. A stress is a force transmitted by a system's supra-system that causes a system to change, so that the supra-system can better achieve its goals. In trying to accommodate the stress, the system may impose stress on its subsystems, and so on.

There are two basic forms of stress which can be imposed on a system, separately or concurrently:

1. A change in the goal set of the system. New goals may be created or old goals may be eliminated.
2. A change in the achievement levels desired for existing goals. The level of desired achievement may be increased or decreased.

For example, the goal set for a computer system may change if a requirement is imposed by management (the supra-system) for system data to be shared among multiple users

rather than be available only to a single user.

When a supra-system exerts stress on a system, the system will change to accommodate the stress, or it will become pathological; that is, it will decay and terminate.

Systems accommodate stress through a change in form; there can be structural changes or process changes. For example, a computer system under stress for more shareability of data may be changed by the installation of terminals in remote locations – a structural change. Demands for greater efficiency may be met by changing the way in which it stores data – a process change.

It is very unlikely that system changes to accommodate stress will be global change to its structure and processes. Instead, those responsible for the change will attempt to localize it by confining the adjustment processes to only one or some of its subsystems.

- (c) **Fact Finding Techniques:** Various fact-finding techniques which are used by the system analyst for determining users' needs are discussed below:
- (i) **Documents:** Document means manuals, input forms, output forms, diagrams of how the current system works, organization charts showing hierarchy of users and manager responsibilities, job descriptions for the people who work with the current system, procedure manuals, program codes for the applications associated with the current system etc. Documents are a very good source of information about user needs and the current system. They are easy to collect, convey a lot of information and provide relatively objective data. The analyst should ensure that the documents which he is collecting are current, accurate and contain up-to-date information.
 - (ii) **Questionnaires:** Users and managers are asked to complete questionnaire about the information system when the traditional system development approach is chosen. The main strength of questionnaires is that a large amount of data can be collected through a variety of users quickly. Also, if the questionnaire is skillfully drafted, responses can be analysed rapidly with the help of a computer.
 - (iii) **Interviews:** Users and managers may also be interviewed to extract information in depth. The data gathered through interviews often provide systems developer with a complete picture of the problems and opportunities. Interviews also give analyst the opportunity to note user reaction first-hand and to probe for further information.
 - (iv) **Observation:** In prototyping approaches, observation plays a central role in requirement analysis. Only by observing how users react to prototype of a new system, the system can be successfully developed. In traditional approach, the analyst should visit the user site to watch how the work was taking place. Such a surprise visit often helps the analyst in getting a clear picture of the user's environment and to determine why a request for a new system was submitted.

Question 3

- (a) *What is an Executive Information system ? Discuss its various purposes. (10 Marks)*
- (b) *Discuss various issues that should be considered while designing systems input. (10 Marks)*

Answer

- (a) An Executive Information System (EIS) is a tool that provides direct online access to relevant information in a useful and navigable format. Relevant information is timely, accurate, and actionable information about aspects of a business that are of particular interest to the senior manager. The useful and navigable format of the system means that it is specifically designed to be used by individuals with limited time, limited key boarding skills and little direct experience with computers. An EIS is quite easy to navigate so that managers can identify broad strategic issues and then explore the information to find the root causes of those issues.

Executive Information Systems can be used for wide range of applications. In government, EIS have been constructed to track data about ministerial correspondence, case management, workers productivity, finances and human resources etc. EIS have also been used to monitor information about competitors in the news media and data bases of public information etc.

EIS require large amounts of capacity and processing power within both the system and the network since information is in summary format by pictorial or graphical means. However, EIS has the facility to “drill down” to other levels of information to see the details. The ability to manipulate data, to project “what if” outcomes and to work with modeling tools. Within the system are also evident in EIS.

Purposes of EIS:

- (i) The primary purpose of an EIS is to support managerial learning about an organisation, its work processes and its interaction with the external environment. Informed managers can ask better questions and make better decisions.
- (ii) Second purpose for an EIS is to allow timely access to information. All of the information contained in an EIS can typically be obtained by a manager through traditional methods. However, the resources and time required to manually compile information in a wide variety of formats and in response to ever changing requirements often inhibit managers from obtaining this information. Often, by the time a useful report can be compiled, the strategic issues facing the manager change, and the report can not be used. Timely access also influences learning. When a manager obtains the answer to a question, that answer typically sparks other related questions in the manager's mind. This way learning cycle continues unbroken.
- (iii) Third purpose of an EIS is commonly misperceived. An EIS has a powerful ability to direct management attention to specific areas of the organization or specific business problems. Some managers look upon this as an opportunity to discipline subordinates.
- (iv) Sometimes misaligned reporting systems can result in inordinate management attention to things that are not so important. An EIS system can provide information that is actually important and represents a balanced view of the organisation's objectives.

- (b) Various issues that should be considered while designing systems input are briefly discussed below:

Input design consists of developing specifications and procedures for data preparation, developing steps which are necessary to put transactions data into a usable form for processing, and data-entry, i.e., the activity of putting the data into the computer for processing.

A starting point for the input design process is a review of the information compiled during the requirement analysis phase. The analyst must review facts related to the current system such as what data are entered, who enters them, where they are entered, and when they are entered. This review highlights basic problems and difficulties with the present system. An understanding of the present system's input directs attention to those areas needing improvement for more efficient data entry.

- (i) **Content:** The analyst is required to consider the types of data that are needed to be gathered to generate the desired user outputs. This can be quite complicated because the new system often means new information and new information often requires new sources of data. Some times, the data needed for a new system are not available within the organization. Hence, the system designer has to prepare new documents for collecting such information.
- (ii) **Timeliness:** In data processing, it is very important that data is inputted to computer in time because outputs cannot be produced until certain inputs are available. Hence, a plan must be established regarding when different types of inputs will enter the system. Timely input of data is very important in transaction processing systems.
- (iii) **Media:** Another important input consideration includes the choice of input media and subsequently the devices on which to enter the data. Various user input alternatives are available in the market such as workstations, magnetic disc, OCR, pen-based computers and voice input etc. A suitable medium may be selected depending on the application to be computerized.
- (iv) **Format:** After the data contents and media requirements are determined, input formats are considered. While specifying the record formats, for instance, the type and length of each data field as well as any other special characteristics must be defined. Designing input formats often requires the assistance of a professional programmer or database administrator.
- (v) **Input Volume:** Input volume refers to the amount of data that has to be entered in the computer system at anyone time. In some decision-support systems and many real-time transaction processing systems, input volume is light. In batch-oriented transaction processing systems, input volume could be heavy which involves thousands of records, that are handled by a centralized data entry department using key-to-tape or key-to-disk systems.

Question 4

- (a) *Discuss various stages through which an in-house creation of program has to pass.* (10 Marks)
- (b) *What are the benefits achieved by implementing the ERP packages ?* (10 Marks)

Answer

- (a) An in-house creation of programs commonly involves the following six stages:
- (i) **Program analysis:** In this stage, the programmer ascertains for a particular application (e.g. up-dating of the stock file) the outputs required (i.e. the updated stock file, listing of replenishment orders etc.), the inputs available (i.e. the stock master file, the receipts and issues transactions file) and the processing (i.e. updating the physical balance, computing stock value for various items et.). The programmer then determines whether the proposed application should be programmed at all. It may be possible that the proposal is shelve for modification on technical grounds.
 - (ii) **Program design:** In this stage, the programmer develops the general organization of the program as it relates to the main functions to be performed. Out of several other tools available to him, input, output, file layouts, and flowcharts are quite useful at this stage. These layouts and flowcharts etc. are provided to the programmer by the systems analyst.
 - (iii) **Program coding:** The logic of the program outlined on the flowcharts is converted into program statements or instructions at this stage. For each language, there are specific rules concerning format and syntax. It is highly desirable that the programs are simple to understand. Each coded instruction is then entered on to a magnetic media. These coded instructions known as source programs are then translated into a machine language by an interpreter or a compiler. These translators have diagnostic capabilities i.e., they point out the syntax errors in the program.
 - (iv) **Debug the program:** The process of debugging a programme refers to correcting programming language syntax and diagnostic errors so that the program 'compiles cleanly'. A clean compile means that the program can be successfully converted from the source code written by the programmer into machine language instructions. Once the programmer gets a clean compile, the program is ready for execution. Thereafter, a careful and thorough testing of program is done using structured walk throughs. A careful and thorough testing of each program is imperative to the successful installation of any system. The programmer should plan the testing to be performed including all possible exceptions. A long of test results and all conditions successfully tested should be kept.
 - (v) **Program documentation:** The writing of narrative procedures and instructions for people who will use software is done throughout the program life cycle. Managers and users should carefully review documentation in order to ensure that the software and the system behave as the documentation indicates. If they do not,

documentation should be revised. User documentation should also be reviewed for understandability.

- (vi) **Programme maintenance:** The requirements of business data processing applications are subject to continual change. This calls for modification of the various programmes. There are, usually separate categories of programmers called maintenance programmers who are entrusted with this task. There is a difficult task of understanding and then revising the programmes they did not write. This should bring out the necessity of writing simple programs which could be easily understood.

These six stages are known as the program development life cycle.

- (b) The benefits accruing to any business enterprise by implementing an ERP are unlimited. Following are some of the benefits achieved by implementing the ERP package:
 - (i) gives accounts payable personnel increased control of invoicing and payment processing and thereby boosting their productivity and eliminating their reliance on computer personnel for these operations.
 - (ii) Reduces paper documents by providing on-line formats for quickly entering and retrieving information.
 - (iii) Improves timeliness of information by permitting posting daily instead of monthly.
 - (iv) Greater accuracy of information with detailed content, better presentation satisfactory for the auditors.
 - (v) Improved cost control.
 - (vi) Faster response and follow-up on customers.
 - (vii) More efficient cash collection, say, material reduction in delay in payments by customers.
 - (viii) Better monitoring and quicker resolution of queries.
 - (ix) Enables quick response to changes in business operations and market conditions.
 - (x) Helps to achieve competitive advantage by improving its business processes.
 - (xi) Improves supply-demand linkage with remote locations and branches in different countries.
 - (xii) Provides a unified customer database usable by all applications.
 - (xiii) Improves international operations by supporting a variety of tax structures, invoicing schemes, multiple currencies, multiple period accounting and languages.
 - (xiv) Improves information access and management throughout the enterprise.
 - (xv) Provides solution for problems like Y2K and Single Monetary Unit or Euro Currency.

Question 5

- (a) *What kind of controls can be incorporated in the system to make frauds difficult to perpetrate ?* (10 Marks)

- (b) *Discuss various ways in which audit trail can be used to support security objectives ?*
(5 Marks)
- (c) *Explain the importance of source documents and associated control techniques.*
(5 Marks)

Answer

- (a) Various controls can be designed to make fraud difficult to perpetrate. These controls help to ensure the accuracy, integrity and safety of system resources. Some of these controls are briefly discussed below:
- (i) **Develop a strong system of internal controls:** The overall responsibility for a secure and adequately controlled system lies with top management. Manager typically delegate the design of adequate control systems to systems analysts, designers and end users. The corporate information security officer and the operations staff are responsible for ensuring that control procedures are followed.
 - (ii) **Segregate duties:** There must be an adequate segregation of duties to prevent individuals from stealing assets and covering up their tracks.
 - (iii) **Require vacations and rotate duties:** Many fraud schemes require the ongoing attention of the perpetrator. If mandatory vacations were coupled with a temporary rotation of duties, such ongoing fraud schemes would fall apart.
 - (iv) **Restrict access to computer equipment and data files:** Computer frauds can be reduced significantly if access to computer equipment and data files is restricted. Only authorised users should be allowed to use the computer system, and legitimate users should be authenticated before they are allowed to use the system.
 - (v) **Encrypt data and programmes:** Another way to protect data is to translate it into a secret code, thereby making it meaningless to anyone without the means to decipher it.
 - (vi) **Protect telephone lines:** Computer hackers generally use telephone lines to transmit viruses and to access, steal and destroy data. One effective method to protect telephone lines is to attach an electronic lock and key to them. When new telephone system is installed, default password should be changed.
 - (vii) **Protect the system from viruses:** Some good virus protection programs are available. These programs are designed to remain in computer memory and search for viruses trying to infiltrate the system. The intrusion is detected when there is an unauthorized attempt to access an executable program. Virus detection program which spots an infection soon after it starts is more reliable than virus protection programs.
 - (viii) **Control sensitive data:** To protect its sensitive data, an organization should classify all of its data according to importance and confidentiality and then apply and enforce appropriate access restrictions. Controls can be placed over data files to prevent or discourage copying. Sensitive and confidential information, backup

tapes and systems documentation should be locked up at night and should not be left out on desks. Servers and PCs should be locked when not in use. Companies should never store all of their data in one place or give an employee access to all of it. Closed circuit televisions can be used to monitor areas where sensitive data or easily stolen assets are handled.

- (ix) **Control laptop Computers:** Special care should be given to laptops because thieves are increasingly breaking into cars and hotel rooms to steal laptops for the confidential information they contain. One of the control methods is to install software that makes it impossible for the computer to boot up without password. Laptops should be password protect and data on hard disk should be encrypted so that if a laptop is stolen, then data cannot be used.
- (b) Audit trails can be used to support security objectives in three ways:
 - (i) **Detecting unauthorized access to the system:** Detecting unauthorised access can occur in real time or after the fact. The primary objective of real-time detection is to protect the system from outsiders who are trying to breach system controls. A real-time audit trail can also be used to report on changes in system performance that may indicate infestation by a virus or worm.

Depending upon how much activity is being logged and reviewed, real-time detection can impose a significant overhead on the operating system, which can degrade operational performance. After-the-fact detection logs can be stored electronically and reviewed periodically or as needed. When properly designed, they can be used to determine if unauthorised access was accomplished, or attempted and failed.
 - (ii) **Facilitating the reconstruction of events:** Audit analysis can be used to reconstruct the steps that led to events such as system failures, security violations by individuals or application processing errors. Knowledge of the conditions that existed at the time of a system failure can be used to assign responsibility and avoid similar situations in the future. Audit trail analysis also plays an important role in accounting control. For example, by maintaining a record of all changes to account balances, the audit trail can be used to reconstruct accounting data files that were corrupted by a system failure.
 - (iii) **Promoting personal accountability:** Audit trails can be used to monitor user activity at the lowest level of detail. This capability is a preventive control that can be used to influence behaviour. Individuals are likely to violate an organisation's security policy if they know that their actions are recorded in an audit log.
- (c) In systems that use physical source documents to initiate transactions, careful control must be exercised over these instruments. Source document fraud can be used to remove assets from the organization. For example, an individual with access to purchase orders and receiving reports could fabricate a purchase transaction to a non-existent supplier. If these documents were entered into the data processing stream along with a fabricated vendor's invoice, the system could process these documents as if a legitimate

transaction had taken place. In the absence of other compensating controls to detect this type of fraud, the system would create an account payable and subsequently write a cheque for payment.

To control against this type of exposure, the organization must implement control procedures over source documents to account for each document, as described below:

- (i) **Use pre-numbered source documents:** Source documents should come pre-numbered from the printer with a unique sequential number on each document. Source document numbers permit accurate accounting of document usage and provide an audit trail for tracing transactions through accounting records.
- (ii) **Use source documents in sequence:** Source documents should be distributed to the users and used in sequence. This requires the adequate physical security be maintained over the source document inventory at the user site. When not in use, documents should be locked away. At all times, access to source documents should be limited to authorized persons.
- (iii) **Periodically audit source documents:** Missing source documents should be identified by reconciling document sequence numbers. Periodically, the auditor should compare the numbers of documents used to date with those remaining in inventory plus those voided due to errors. Documents not accounted for should be reported to management.

Question 6

- (a) *What are the various Tangible and Intangible benefits that can result from the development of a computerised system ?* (10 Marks)
- (b) *What are the advantages of using pre-written application packages?* (5 Marks)
- (c) *What are the duties of certifying authorities with respect to digital signature ?* (5 Marks)

Answer

- (a) The benefits which result from developing new or improved information systems that utilize computer can be subdivided into tangible and intangible benefits. Tangible benefits are those that can be accurately measured and are directly related to the introduction of a new system, such as decrease in data processing cost. Intangible benefits such as improved business image are harder to measure and define. Benefits that can result from the development of a computerized system are summarized below:
 - (i) Increase in sales or profit (improvement in product or service quality)
 - (ii) Decrease in data processing costs (elimination of unnecessary procedures and documents)
 - (iii) Decrease in operating costs (reduction in inventory carrying costs)
 - (iv) Decrease in required investment (decrease in inventory investment required)
 - (v) Increased operational ability and efficiency (improvement in production ability and efficiency)

- (vi) New or improved information availability (more timely and accurate information and new types and forms of information)
- (vii) Improved abilities in computation and analysis
- (viii) Improved customer service (more timely service)
- (ix) Improved employee morale (elimination of burdensome and boring job tasks)
- (x) Improved management decision-making (better information and decision analysis)
- (xi) Improve competitive position (faster and better response to actions of competitors)
- (xii) Improved business and community image (progressive image as perceived by customers, investors etc.)

Intangible though, it is important to put a rupee and paise tag to each benefit for purposes of profit and loss statement. The analyst has to quantify the benefits in monetary terms.

(b) Advantages of using pre-written application packages:

The four most compelling advantages of using pre-written application packages are summarised 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 specialised application field and hence can provide better software. In contrast, in-house programs 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 realising a lower cost from each application user. Thus, an 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) Duties of Certifying Authorities: [Section 30]

- (i) This section provides that every Certifying Authority shall follow certain procedures in respect of Digital Signatures as given below:
 - (a) make use of hardware, software and procedures that are secure from intrusion and misuse;

- (b) provide a reasonable level of reliability in its services which are reasonably suited to the performance of intended functions;
- (c) adhere to security procedures to ensure that the secrecy and privacy of the digital signatures are assured and
- (d) observe such other standards as may be specified by regulations.
- (ii) Every Certifying authority shall also ensure that every person employed by him complies with the provisions of the Act, or rules, regulations or orders made thereunder.
- (iii) A certifying authority must display its licence at a conspicuous place of the premises in which it carries on its business and a Certifying Authority whose licence is suspended or revoked shall immediately surrender the licence to the controller.
- (iv) Section 34 further provides that every Certifying Authority shall disclose its Digital Signature Certificate which contains the public key corresponding to the private key used by that Certifying Authority and other relevant facts.

Question 7.

Write short notes on the following:

- (a) *Server-centric model*
- (b) *Analysis and design work bench*
- (c) *Business Engineering*
- (d) *System maintenance.*

(4×5 = 20 Marks)

Answer

- (a) **Sever centric computing** is a model in which applications are deployed, managed, supported and executed 100% on a server. The client handles data entry and information display. It uses a multi-user operating system and a method for distributing the presentation of an application's interface to a client device. With server-based computing, client devices, whether 'fat' or 'thin' have instant access to business critical applications via the server-without application rewrites or download. This means improved efficiency when deploying business-critical applications. In today's environment, this server-based computing model is very useful for growing enterprises because it provides them with the tools and capabilities they need to be successful.

Traditionally used for centralised business applications such as general ledger, payroll etc., this model now includes web-based applications where the user browse through data over the network.

- (b) **Analysis and design work benches** are designed to support the analysis and design stages of the software process where models of the system are created. The components of this model are:
- (i) Diagram editors to create DFD, structured chart, etc.

- (ii) Design, analysis and checking tools which process the design and then submit reports on errors and anomalies.
 - (iii) Repository query languages which allow the designer to find designs and associate design information in the repository.
 - (iv) A data dictionary which maintains information about entities used in a system design.
 - (v) Report definition and general tools which generate system documentation after taking information from store.
 - (vi) Forms definition tools which allow screen and document formats to be specified.
 - (vii) Import / Export facilities.
 - (viii) Code generators which generate code from the design captured in central store.
- (c) **Business Engineering** has come out of merging of two concepts namely Information Technology and Business Process Reengineering. Business Engineering is the rethinking of Business Processes to improve speed, quality and output of materials or services. The emphasis of business engineering is the concept of Process Oriented Business Solutions enhanced by the client-server computing in information technology. The main point in business engineering is the efficient redesigning of company's value added chains. Value added chains are a series of connected steps running through a business which when efficiently completed, add value to enterprise and customers. Information technology helps to develop business models, which assist in redesigning of business processes.
- In short, Business Engineering is the method of development of business process according to changing requirements.
- (d) **System Maintenance:** Most information systems require at least some modification after development. The need for modification arises from a failure to anticipate all requirements during system design and/or from changing organisational requirements. The changing organizational requirements continue to impact most information systems as long as they are in operation. Consequently periodic systems maintenance is required for most of the information systems. Systems maintenance involves adding new data elements, modifying reports, adding new report, changing calculation etc.
- Maintenance can be categorized in the following two ways:
- (i) Scheduled maintenance is anticipated and can be planned for. For example, the implementation of a new inventory coding scheme can be planned in advance.
 - (ii) Rescue maintenance refers to previously undetected malfunctions that were not anticipated but require immediate solution. A system that is properly developed and tested should have few occasions of rescue maintenance.

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

PAPER – 7 : DIRECT TAXES

*Answer **all** questions*

Question 1

The net profits of XYZ Ltd. for the year ended 31st March, 2005, after debiting/crediting the following items, were Rs.9 lakhs:

- (a) The company had taken on lease an old building for the purposes of locating its business. Due to old age of the building, it was demolished and a new building put up, which was used for purposes of XYZ's business from September, 2004. The cost of the new building Rs.10 lakhs was written off as revenue expenditure. The lessor permitted the company to have an extension of the lease by another twenty years.*
- (b) Rs.1 lakh was paid as an annual fee for technical services to a foreign collaborator under an agreement approved by the Government.*
- (c) The company collected Rs.3 lakhs from its customers by way of sales tax in the year 1986-87 and had remitted it to the State Government in due time. On the levy being challenged in the High Court, the Court held the collection as illegal and the State Government in February, 2005 refunded the amount to the company.*
- (d) Land development charges of Rs.1.5 lakhs were paid to the State Industrial Development Corporation on allotment of a commercial plot.*
- (e) A criminal case was filed against a Director of the company, in his official capacity. The company spent legal expenses of Rs.50,000 defending him in the proceedings. The Director was acquitted of the charges at the end.*
- (f) The company issued in the year bonus shares to its shareholders and for that purpose had to enhance the authorised capital. Fees of Rs.1.5 lakhs were paid to the Registrar of Companies in this regard. These have been written off in the accounts as revenue expenses.*
- (g) The company paid Rs.70,000 as interest on deposits to some of the non-resident buyers on advances received from them. No tax at source was deducted on the payment.*
- (h) Overdraft interest of Rs.40,000 was paid to the company's bank to enable the company to pay its income tax dues.*
- (i) The opening and closing stocks of the year were Rs.90,000 and Rs.1,17,000 respectively and were undervalued by 10% on cost.*
- (j) Some investments were held by the company (not as stock in trade), which had to be depreciated by Rs.4.8 lakhs due to a directive from the Government.*

The balance on 1st April, 2004 to the Profit and Loss Account, shown separately in the Balance Sheet, was a debit of Rs.2 lakhs.

The company had the following claims brought forward from the prior years:

Business losses relating to

<i>Assessment year 1994-95</i>	<i>Rs.8 lakhs</i>
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<i>Assessment year 2002-03</i>	<i>Rs.4 lakhs</i>
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*Losses under the head capital gains -**Long-term*

<i>Assessment year 2003-04</i>	<i>Rs.3 lakhs</i>
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Unabsorbed depreciation

<i>(as per IT records as well as the books of the company)</i>	<i>Rs.12.50 lakhs</i>
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Required to :

- (a) Calculate the total income of XYZ Ltd. for the assessment year 2005-06 [Your answer should clearly indicate the reasons for the treatment of the individual items given above.]
- (b) Examine the applicability of section 115JB of the Income-tax Act to the company for the same assessment year. (16 Marks)

Answer**(a) Computation of total income of XYZ Ltd. for the A.Y.2005-06**

	Particulars	Rs.	Rs.
	Net profit as per profit and loss account		9,00,000
Add :	Cost of the new building written off is a capital expenditure – hence disallowed.	10,00,000	
	Land development charges paid to State Industrial Development Corporation is a capital expenditure – hence disallowed	1,50,000	
	Fees paid to ROC for increasing authorized capital is a capital expenditure – hence disallowed	1,50,000	
	Interest on deposit to non-resident buyers without deduction of tax at source – disallowed under section 40(a)(i)	70,000	
	Interest to bank on overdraft for payment of income-tax dues – disallowed as per Supreme Court's decision in <i>East India Pharmaceutical Works Ltd. v. CIT (1997) 224 ITR 627</i>	40,000	
	Depreciation on investments not held as stock-in-trade	4,80,000	
	Under valuation of stock (1,17,000-90,000) x 10/90	3,000	18,93,000
			<u>27,93,000</u>
Less:	Depreciation on building @10% on Rs.10 lakhs (See Notes 1 & 2)		<u>1,00,000</u>

Business Income	26,93,000	
<i>Less:</i> Set-off of business loss and unabsorbed depreciation		
Business loss of A.Y.1994-95 cannot be set-off against business income of the current year, since business loss can be carried forward for a maximum period of 8 years only.	-	
Business loss of A.Y.2002-03	4,00,000	
Long-term capital loss of A.Y.2003-04 cannot be set-off against business income since as per section 74, long-term capital loss can be set-off only against long-term capital gains.		
Unabsorbed depreciation	12,50,000	16,50,000
Total Income		10,43,000

(b) Tax on total income as computed under the Income-tax Act	Rs.
Tax on total income of Rs.10.43 lakhs	3,65,050
Add: Surcharge @ 2.5%	9,126
	3,74,176
Add: Education cess @ 2%	7,484
Tax on total income	3,81,660

Computation of tax as per section 115JB

Net profit as per profit and loss account	9,00,000
<i>Less:</i> Business loss of Rs.2 lakhs, since it is lower than the unabsorbed depreciation of Rs.12.50 lakhs	2,00,000
Book Profit	7,00,000
7.5% of book profit	52,500
Add: Surcharge @ 2.5%	1,313
	53,813
Add: Education cess @ 2%	1,076
	54,889

Since the income-tax payable on the total income of the company computed under the Income-tax Act is not less than 7.5% of its book profit, section 115JB will not apply for A.Y.2005-06.

Notes:

1. As per *Explanation 1* to section 32(1), where an assessee carries on business or profession in a building which is not owned by him but in respect of which he holds a lease or other right of occupancy, depreciation is to be allowed on account of any capital expenditure incurred by the assessee on construction of any structure for improvement/renovation of the building as if the structure is a building owned by the assessee. Therefore, depreciation is allowable on the capital expenditure of Rs.10 lakhs incurred by XYZ Ltd. towards the cost of the new building put up after demolition of the old building.
2. The rate of depreciation on buildings is 10%. Since it is put to use for more than 182 days during the previous year 2004-05, full depreciation is allowable.
3. Payment of annual fees for technical services to a foreign collaborator is an allowable business expense and has been correctly charged to profit and loss account. Therefore, no adjustment is required.
4. Sales tax refund from the Government has to be treated as a revenue receipt. Since it has been correctly credited to profit and loss account, no adjustment is required.
5. Land development charges paid to SIDC on allotment of a commercial plot is a capital expenditure [*Jaswant Trading Co. v. CIT (1995) 212 ITR 293 (Raj)*]
6. Section 37(1) does not make any distinction between expenditure incurred in civil litigation and that incurred in criminal litigation. If the expenditure is *bona fide* incurred wholly and exclusively for the purpose of the business, it is allowable as deduction [*CIT v. Birla Cotton Spinning & Weaving Mills Ltd. (1971) 82 ITR 166 (SC)*]. Therefore, in this case, since legal expenses were incurred by the company for defending the Director in a criminal case filed against him in his official capacity, it is allowable as deduction.
7. Fees paid to Registrar of Companies for enhancement of authorised capital is a capital expenditure and not deductible under section 37(1) [*Punjab State Industrial Development Corporation Ltd. v. CIT 225 ITR 792 (SC)*].
8. Since no tax has been deducted at source on payment of interest to non-residents, interest paid will not be allowed as a deduction as per section 40(a)(i).
9. Interest paid to bank on overdraft for payment of income-tax dues is not an expenditure incurred wholly and exclusively for the purpose of business and is hence, not deductible under section 37(1) as per the Supreme Court's decision in *East India Pharmaceutical Works Ltd. v. CIT (1997) 224 ITR 627*.
10. The under valuation of both opening and closing stocks will have an impact on the profits for the year and accordingly, the difference in valuation of stock has to be credited to profit and loss account to the extent of 10% of cost.
11. Value of investment written down is on capital account and hence not allowed, even if such write down was on a directive from the Government.

Question 2

- (a) Can penalty under section 271(1)(c) of the Income-tax Act for concealment of income or particulars thereof be imposed on “intangible” additions to income made by the Assessing Officer.

Can these additions be utilised by the assessee to explain investments made in the subsequent years?

Is there any time limit for initiation of penalty proceedings in such cases? Discuss.

(5 Marks)

- (b) State the cases where the benefit of indexation of costs is not available for determination of capital gains. (5 Marks)
- (c) A charitable trust, whose income can be exempt under section 11 of the Income-tax Act, was formed on 1st March, 2004. For the accounting year ended 31st March, 2005, it earned an income of Rs.60,000.

It filed with the Commissioner of Income-tax its application for registration on 30th March, 2005 explaining that for good and sufficient reasons, it was prevented from filing the application by the due date.

State:

- (i) *by which date the application for registration should have been filed;*
- (ii) *whether such an application could have been filed before the formation of the trust;*
- (iii) *in the absence of an order of registration from the Commissioner, can the trust be deemed to be registered;*
- (iv) *the steps to be taken by the trust to secure exemption from income-tax;*
- (v) *whether a certificate of registration once granted can be cancelled and if so, the conditions therefor.* (5 Marks)

Answer

- (a) In many cases, the Assessing Officer makes additions to the returned income purely on account of certain technical reasons. For example, he calculates the total income of the assessee by assuming a certain rate of gross profit or yield, or he disallows a portion of certain expenses on estimated basis. These are called intangible additions. The Supreme Court, in *Anantharam Veerasighaiah and Co. v. CIT (1980) 123 ITR 457* observed that the secret profits or undisclosed income of an assessee earned in an earlier assessment year, commonly described as intangible additions, are also the real income of the assessee. Therefore, the assessee can explain the unexplained investment etc. of the current year to have been met out of intangible additions made in the past.

Explanation 2 to section 271(1) enables the Assessing Officer to initiate penalty proceedings in respect of intangible additions made in the past which are claimed by the

assessee to be a source of any receipt, deposit or outgoing or investment in any subsequent year. The penalty proceedings shall be initiated for the assessment year in which such intangible additions were made and shall be leviable only on such intangible additions made in the past years which have been claimed to be a source of receipt, deposit, outgoing or investment of the subsequent year.

According to section 271(1A), where any penalty is imposable by virtue of *Explanation 2* to section 271(1), the proceedings for imposition of such penalty may be initiated at any time, even if assessment proceedings in the course of which such penalty could have been initiated have been completed.

(b) In the following cases, the benefit of indexation is not available for determination of capital gains on transfer of long-term capital assets –

1. Transfer of bonds/debentures other than capital indexed bonds issued by the Government (*Proviso 3* to section 48).
2. Transfer of shares or debentures acquired by a non-resident in foreign currency in an Indian company (*Proviso 1 and 2* to section 48).
3. Transfer of undertaking or division in a slump sale (Section 50B)
4. Transfer of units of Unit Trust of India or a Mutual Fund specified under section 10(23D) purchased in foreign currency by an overseas financial organisation referred to as offshore funds (Section 115AB)
5. Transfer of Global Depository Receipt purchased in foreign currency by an individual resident in India and employee of an Indian company or its subsidiary engaged in specified knowledge based industry or service (Section 115ACA).
6. Transfer of securities by Foreign Institutional Investors (Section 115AD).
7. Transfer of a foreign exchange asset by a non-resident Indian (Section 115D)

Further, indexation benefit is not available on capital gains arising on transfer of a depreciable asset since such capital gains would always be short-term capital gains.

(c) (i) The person in receipt of income of the trust should make an application for registration in the prescribed form and in the prescribed manner to the Commissioner of Income-tax before the expiry of a period of 1 year from the date of creation of the trust.

The last date for making an application for registration in this case is, therefore, 28th February, 2005.

The Commissioner may, however, condone the delay if he is satisfied, for reasons to be recorded in writing, that the person in receipt of income was prevented for sufficient reasons from making the application before the expiry of one year from the date of creation of trust.

(ii) No. The application for registration u/s 12A cannot be filed before the formation of the trust.

- (iii) As per section 12AA(2), every order granting or refusing registration should be passed before the expiry of 6 months from the end of the month in which the application was received under section 12A. However, the Act does not provide for deeming registration of a trust in the absence of an order of registration from the Commissioner.
- (iv) The following are the steps to be taken by the trust to secure exemption from income-tax -
 - (1) The trust should be registered with the Commissioner of Income-tax under section 12A.
 - (2) The accounts of the trust for the previous year must be audited by a Chartered Accountant if its total income exceeds Rs.50,000, without giving effect to the provisions of section 11 and section 12. The audit report in the prescribed form, duly signed and verified by the Chartered Accountant, should be furnished along with the return of income of the trust for the relevant assessment year.
 - (3) At least 85% of the income is required to be applied for the approved purposes.
 - (4) The unapplied income and the money accumulated or set apart should be invested or deposited in the specified forms or modes.
- (v) Yes, the certificate of registration can be cancelled by the Commissioner. According to section 12AA, if the Commissioner is satisfied that the activities of the trust are not genuine or are not being carried out in accordance with the objects of the trust, he shall, after giving the trust a reasonable opportunity of being heard, pass an order in writing canceling the registration of the trust.

Question 3

- (a) *Tarun Shipping Co. Ltd., having its registered office in Mumbai, plies two ocean-going vessels which it owns. The registered tonnage of the two vessels are 47,549 tonnes and 800 kgs and 25,759 tonnes and 400 kgs respectively. In the accounting year 2004-05, the first vessel was operated for 360 days and the second for 199 days.*

The accounts of the company reveal the following results :

- | | |
|--|----------------|
| (i) Profit from core shipping activity | Rs.60.50 lakhs |
| (ii) Profit from incidental activity | Rs.15,000 |

the tax payable by the company for the assessment year 2005-06, taking note of the new provisions of the law relating to taxation of income of shipping companies. Also indicate the specified conditions for the applicability of the new procedure. (6 Marks)

- (b) *M, an individual, was carrying on a business as sole proprietor. On his death, his legal heirs decide to continue the same business by forming a firm.*

At the time of death, M had a determined business loss of Rs.2 lakhs, under the

provisions of the Income-tax Act, to be carried forward.

Does the firm, consisting of all the legal heirs of M, get a right to have this loss adjusted against its current income? Discuss. (4 Marks)

- (c) X Ltd., is a company engaged in the business of growing, manufacturing and selling of tea.

For the accounting year ended 31st March, 2005, its composite business profits, before an adjustment under section 33AB of the Income-tax Act, were Rs.60 lakhs. In the year, it deposited Rs.25 lakhs with NABARD.

The company has a business loss of Rs.10 lakhs brought forward from the previous year.

The company withdrew in February, 2005 Rs.20 lakhs from the deposit account to buy a non-depreciable asset for Rs.18 lakhs and could not use the balance before the end of the accounting year. The withdrawal and the purchase were under a scheme approved by the Tea Board.

The non-depreciable asset was sold in November, 2005 for Rs.29 lakhs.

Indicate clearly the tax consequences of the above transactions and the total income for the relevant years. (5 Marks)

Answer

- (a) Computation of tax payable by Tarun Shipping Company Ltd. for the A.Y.2005-06

Particulars	Rs.	Rs.
Taxable income (See Working Note below)		59,35,040
Tax @ 35%		20,77,264
Add: Surcharge @ 2.5%		51,932
		21,29,196
Add: Education cess @ 2%		42,584
Total tax payable		21,71,780

Working Note – Computation of Tonnage Income [Section 115VG]

Particulars	Ship I Rs.	Ship 2 Rs.
First 1,000 tons (1000 x 46/100)	460	460
Next 9,000 tons (9,000 x 35/100)	3,150	3,150
Next 15,000 tons (15,000 x 28/100)	4,200	4,200
Balance [(22,500/800) x 19/100]	4,275	152
	12,085	7,962

Tonnage income -

Ship 1 (12,085 × 360)	43,50,600
Ship 2 (7,962 × 199)	15,84,438
	59,35,038
Taxable income (rounded off)	59,35,040

Note: Tonnage is to be rounded off to the nearest multiple of 100 tons. Hence, the first vessel will pay for 47,500 tons and the second for 25,800 tons.

As per section 115VF, the tonnage income computed under section 115VG would be deemed to be the profits chargeable under the head “Profits and gains of business or profession”. This is, however, subject to fulfillment of the conditions mentioned below in the next paragraph. Then, the relevant shipping income referred to in section 115-VI(1), which includes the profit from core shipping activity (i.e. Rs.60.50 lakhs) and the profit from incidental activity (Rs.15,000), shall not be chargeable to tax.

The following are the conditions to be fulfilled by the company for applicability of the tonnage tax scheme -

- (i) An option to get assessed under Chapter XII-G has to be filed by the company.
 - (ii) The company is required to credit to a reserve account called Tonnage Tax Reserve Account, at least 20% of the book profits derived from its core and incidental activities to be utilized before the expiry of a period of 8 years for acquisition of a new ship for the purposes of the business of the company. Until the acquisition of a new ship, the amount can be utilized for the purposes of the business of operating qualifying ships. However, the amount should not be used for distribution of dividends or profits or for remittance outside India as profit or for creation of assets outside India.
- (b) Section 78(2) provides that where a person carrying on any business or profession has been succeeded in such capacity by another person, otherwise than by inheritance, then the successor is not entitled to carry forward and set-off the loss of the predecessor against his income. This implies that the only exception is when the business passes on to another by inheritance.

The Apex Court, in *CIT v. Madhukant M. Mehta (2001) 247 ITR 805*, has held that where the business is succeeded by inheritance, the legal heirs are entitled to the benefit of carry forward of the loss of the predecessor. Even if the legal heirs constitute themselves as a partnership firm, the benefit of carry forward and set off of the loss of the predecessor should be made available to the firm.

In this case, the business of M was continued by his legal heirs after his death by constituting a firm. Hence, the exception given in section 78(2) along with the decision of the Apex Court discussed above apply in this case. Therefore, the firm is entitled to carry forward the business loss of Rs.2 lakhs of M.

(c) (i) **Computation of total income of X Ltd. for A.Y.2005-06**

Particulars	Rs.
Composite profits before allowing deduction under section 33AB	60,00,000
Less: Deduction u/s 33AB	
[Lower of 40% of Rs.60 lakhs (i.e. Rs.24 lakhs) or the actual amount deposited with NABARD (i.e. Rs.25 lakhs)]	24,00,000
	<u>36,00,000</u>
As per Rule 8 of Income-tax Rules, 40% of this sum is subject to income-tax and the balance 60% is treated as agricultural income. Hence, the business income is 40% of Rs.36 lakhs	14,40,000
Add: Non-utilisation of amount withdrawn: Rs.2 lakhs [i.e.(Rs.20 lakhs – Rs.18 lakhs)]	
40% is taxable as business income (the balance 60% is treated as agricultural income).	80,000
Business income	<u>15,20,000</u>
Less: Business loss brought forward from the previous year	<u>10,00,000</u>
Total income	<u>5,20,000</u>

(ii) **Computation of total income of X Ltd. for A.Y.2006-07**

Particulars	Rs.
Business income (See Note 2)	7,20,000
Capital gains (Short-term) (See Note 1)	11,00,000
Total Income	<u>18,20,000</u>

Note 1 - Computation of capital gains

Particulars	Rs.
Sale proceeds	29,00,000
Less: Cost of acquisition	<u>18,00,000</u>
Short term capital gains (since the period of holding is less than 36 months)	<u>11,00,000</u>

Note 2 - Computation of business income

Since the asset is sold within 8 years, the cost of the asset i.e. Rs. 18 lakhs should be treated as income since the same has been allowed as deduction in the F.Y.2004-05.

However, out of this Rs.18 lakhs, 60% would be agricultural income and the balance 40% i.e. Rs.7.2 lakhs would be business income of P.Y.2005-06. This is because deduction under section 33AB was allowed in P.Y.2004-05 before disintegration of income into agricultural income and non-agricultural income.

Question 4

- (a) *T and Q are individuals, who constitute an Association of persons, sharing profit and losses in the ratio of 2:1. For the accounting year ended 31st March, 2005, the Profit and Loss account of the business was as under:*

<i>Figures are in Rs. '000s</i>			
<i>Cost of goods sold</i>	<i>4,250</i>	<i>Sales</i>	<i>4,900</i>
<i>Remuneration to:</i>		<i>Dividend from companies</i>	<i>25</i>
<i>T</i>	<i>130</i>	<i>Capital gains -</i>	
<i>Q</i>	<i>170</i>	<i>Long-term</i>	<i>640</i>
<i>Employees</i>	<i>256</i>		
<i>Interest to:</i>			
<i>T</i>	<i>48.3</i>		
<i>Q</i>	<i>35.7</i>		
<i>Other expenses</i>	<i>111.7</i>		
<i>Sales-tax penalty due</i>	<i>39</i>		
<i>Net profit</i>	<i>524.3</i>		
	<i>5,565</i>		<i>5,565</i>

Additional information furnished :

- (i) *Other expenses included :*
- entertainment expenses of Rs.35,000;*
 - wristwatches costing Rs.2,500 each were given to 12 dealers, who had exceeded the sales quota prescribed under a sales promotion scheme;*
 - employer's contribution of Rs.6,000 to the Provident Fund was paid on 14th January, 2005.*
 - Rs.30,000 was paid in cash to an advertising agency for publicity.*

- (ii) Outstanding sales tax penalty was paid on 15th October, 2005. The penalty was imposed by the Sales-tax Officer for non-filing of returns and statements by the due dates.

T and Q had, for this year, income from other sources of Rs.94,000 and Rs.32,000 respectively.

Required to :

- (i) Compute the total income of the AOP for the assessment year 2005-06;
 (ii) Ascertain the tax liability of the Association for that year; and
 (iii) Ascertain the tax liability for that year of the individual members. (8 Marks)
- (b) M, an individual, is 70 years of age. He is a sitting member of the State Assembly of Karnataka and for the financial year 2004-05 received the following amounts from the Assembly Secretariat :

- (i) Basic pay Rs.3,000 p.m.
 (ii) Constituency allowance Rs.8,000 p.m.
 (iii) Telephone allowance Rs.4,000 p.m.
 (iv) Electricity allowance Rs.3,000 p.m. [from June, 2004 onwards]

He owns a house in Delhi which has been let out at Rs.5,000 p.m. He received rent for 10 months only, the house having remained vacant for two months. Municipal taxes of Rs.1,200 were paid by the tenant. Interest of Rs.14,000 was paid by M on the amount borrowed by him to buy the house.

M has an agricultural income of Rs.55,000.

Compute his tax liability for the relevant assessment year. (7 Marks)

Answer

- (a) (i) **Computation of total income of the AOP for A.Y.2005-06**

Particulars	Rs.	Rs.
Profit & gains of business (See Working Note below)		2,88,300
Long term capital gain		6,40,000
Income from other sources[Dividend is exempt u/s 10(34), assuming that it is received from domestic companies]		-
Total income		9,28,300

Working Note -

Computation of profits and gains of business

Net profit as per profit & loss account	5,24,300
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Add: Inadmissible payments

Interest to members T & Q (Rs.48,300 + Rs.35,700)	84,000	
Advertising [Disallowance u/s 40A(3) (20% of Rs.30,000 being a cash payment)]	6,000	
Remuneration to members T & Q (Rs.1,30,000 + Rs.1,70,000)	3,00,000	
Sales tax penalty due (See Note 3 below)	39,000	4,29,000
		9,53,300

Less: Income not taxable under this head

Dividend from companies	25,000	
Long term capital gain	6,40,000	6,65,000

Profits and gains of business**2,88,300****(ii) Computation of tax liability of the AOP for A.Y.2005-06**

Particulars	Rs.	Rs.
Long-term capital gain (Rs.6,40,000@20%)		1,28,000
Other income (Rs.2,88,300@30%)		86,490
Tax on total income		2,14,490
Add: Surcharge @10%		21,449
		2,35,939
Add: Education cess @2%		4,719
Total tax due		2,40,658

Notes –

- Since one of the members has individual income more than the basic exemption limit, the AOP will be assessed at the maximum marginal rate. The maximum marginal rate includes the surcharge applicable in relation to the highest slab of income in case of an individual and as such surcharge shall be chargeable at the rate of 10%.
Since the AOP is taxed at maximum marginal rate, share income of the members are not taxable in their hands individually.
- Since the employer's contribution to PF has been paid during the previous year 2004-05 itself, it is allowable as deduction.
- Penalty imposed for delay in filing sales tax return is not deductible since it is on account of infraction of the law requiring filing of the return within the

specified period. – *CIT v. Ratanchand Bholanath (S.S) (1986) 160 ITR 500 (M.P.)*

(iii) **Computation of tax liability of members T & Q for the A.Y.2005-06**

	T.		Q
Tax on Rs.94,000	Rs.7,800	Tax on Rs.32,000	Nil
Less: Rebate u/s 88D	<u>Rs.7,800</u>		
Net tax payable	<u>Nil</u>		

Note – While calculating tax liability of member T, rebate under section 88D has to be allowed since his total income does not exceed Rs.1 lakh. Section 88D provides a rebate of the entire amount of income-tax payable by a resident individual having total income not exceeding Rs.1 lakh. It is logical to assume that T is a resident.

(b) **Computation of total income of Mr.M for A.Y.2005-06**

Particulars	Rs.	Rs.
Income from house property		
Gross Annual Value (GAV) [See Note 1 below]	50,000	
Municipal taxes (not allowed since it is borne by tenant)	-	
Net annual value (NAV)	50,000	
Less: Deduction u/s 24		
(a) 30% of NAV	15,000	
(b) Interest on borrowed capital	<u>14,000</u>	
	29,000	21,000
Income from Other Sources [See Note 2 below]		
Basic Pay	36,000	
Constituency allowance (Rs.8,000 x 12)	96,000	
Electricity allowance (Rs.3,000 x 10)	30,000	
Telephone allowance (Rs.4,000 x 12)	48,000	
	<u>1,74,000</u>	
Less: Exempt u/s 10(17)[Rs.2000 p.m.]	24,000	1,50,000
Total Income		<u>2,07,000</u>

Note – 1. In the absence of other information, rent received has been taken as the Gross Annual Value.

2. The pay and allowances of a member of the State Assembly would be taxable under the head "Income from other sources", since there is no employer-employee relationship in this case.

Computation of tax liability of Mr. M for A.Y. 2005-06

Particulars	Rs.	Rs.
Tax on agricultural income plus non-agricultural income i.e. on Rs.2,62,000 (being Rs.55,000 + Rs.2,07,000)	52,600	
Less: Tax on agricultural income plus basic exemption limit i.e. on Rs.1,05,000 (being Rs.55,000 + Rs.50,000)	10,000	
Tax on non-agricultural income		42,600
Less: Rebate under section 88B (tax payable subject to a maximum of Rs.20,000)		20,000
Tax Payable		22,600
Add: Education cess @2%		452
Total tax payable		23,052

Question 5

- (a) State whether the provisions of section 41(1) of the Act can be applied to a case, where refund of excise duty has been obtained by the assessee on the basis of a decision of the CEGAT and where the matter has been taken up in further appeal to the Court by the Central Excise Department. (4 Marks)
- (b) Does the Settlement Commission have the power to reduce or waive interest levied under sections 234A, 234B and 234C of the Income-tax Act? Discuss. (6 Marks)
- (c) In the course of search operations under section 132, a tax payer makes a declaration under section 132(4) on the earning of income not disclosed. Can that State save the tax payer from a levy of penalty under section 271(1)(c)? (4 Marks)

Answer

- (a) This question has been answered by the Apex Court in *Polyflex (India) Pvt. Ltd. v. CIT* [2002] 257 ITR 343. The Apex court observed that in a case where a statutory levy in respect of goods dealt with by the assessee is discharged and subsequently the amount paid is refunded, it is the first part of section 41(1)(a) that more appropriately applies i.e. it will be a case where the assessee "has obtained any amount in respect of such expenditure". It will not be a case of "benefit by way of remission or cessation" of a trading liability. Where an expenditure is actually incurred by reason of payment of duty on goods and a deduction or allowance is given in the assessment of an earlier period, the assessee is liable to discharge that benefit as and when he obtains refund of the amount so paid. The possibility of the refund being set at naught on a future date will not be a relevant consideration. Once the assessee gets back the amount which was claimed

and allowed as a business expenditure during an earlier year, the deeming provision in section 41(1) comes into play and it is not necessary that the Revenue should await the verdict of a higher court. If the higher court upholds the levy at a later date, the assessee is not without remedy to get back the relief.

Therefore, the refund of excise duty pursuant to the decision of the CEGAT would be subject to tax by virtue of section 41(1) and it is not necessary that the Revenue should await the verdict of a higher court.

- (b) The Supreme Court in the case of *CIT v Anjum M H Ghaswala [2001] 252 ITR 1* has held that the Settlement Commission, while passing the final order under section 245D, does not have the power to reduce or waive interest statutorily payable under sections 234A, 234B and 234C except to the extent of granting relief in accordance with the norms laid down in the circulars issued by the CBDT under section 119, eg. Circular/Order No.400/234/95-IT(B) dated 23rd May, 1996. While the Settlement Commission arrives at the taxable income of the assessee on the basis of the records available before it, it has to levy the mandatorily chargeable tax and wherever interest is due under mandatory provisions like sections 234A, 234B and 234C, it has to include that interest also in the settlement.

Under Circular/Order no. 400/234/95-IT(B), dated 23rd May, 1996, the Board has empowered the Chief Commissioner and the Director-General to waive or reduce interest chargeable under sections 234A, 234B and 234C in the class of cases or class of incomes specified therein for the period and on conditions enumerated therein. Since this is a beneficial circular, the benefit can also be conferred on those assesseees who approach the Settlement Commission under section 245C on such terms and conditions as are specified in the circular. Section 245F empowers the Settlement Commission to exercise the powers of an income-tax authority. While exercising the power under this circular, the Settlement Commission will be enforcing the relaxed provisions for the benefit of the assessee in the process of settlement.

Thus, the Settlement Commission can waive/reduce the interest leviable under sections 234A, 234B or 234C only to the extent it can be waived by the Chief Commissioner/Director General as permitted by such circular.

- (c) As per *Explanation 5* to section 271(1)(c), the assessee shall not be deemed to have concealed income where, in the course of search under section 132, he makes a statement under section 132(4) that any money, bullion, jewellery or other valuable article or thing found in his possession or under his control, has been acquired out of his income which has not been disclosed so far in his return of income to be furnished before the expiry of the time specified in section 139(1), and also specifies in the statement the manner in which such income has been derived and pays the tax, together with interest, if any, in respect of such income. In such a case, the State can save the tax payer from levy of penalty under section 271(1)(c).

Question 6

- (a) State whether the information regarding possession of unexplained assets and income received from the Central Bureau of Investigation, a Government agency, can constitute “information” for action under section 132 of the Act. Discuss. (5 Marks)

- (b) In the course of an assessment proceeding, the Assessing Officer enhanced the value of the closing stock and added the difference to the total income.

In the assessment year subsequent to this, the assessee wants the Assessing Officer to enhance, by the same amount, the value of the opening stock of that year.

Discuss the validity of the claim. (5 Marks)

- (c) A foreign company, ST, has entered into an agreement with an Indian Company KN for supply of know-how and the agreement is within the Industrial Policy conditions laid down by the Central Government. In the year 2004-05, Rs.50 lakhs is paid, under the agreement, to ST by KN.

ST claims to have spent Rs.14 lakhs as expenses in India to be recognized as a deduction.

In the following situations, what will be your decision on the tax liability of the parties:

- (i) The agreement having been entered into before 1st June, 2002 and approved by the Government, KN pays to the Indian income-tax authorities the tax payable by ST;
- (ii) There is no agreement as to KN bearing the tax liability; the royalty payable is decided to be Rs.59 lakhs net of taxes. (5 Marks)

Answer

- (a) As per section 132(1)(c), authorization for search and seizure can take place if the authority, in consequence of *information in his possession*, has *reason to believe* that any person is in possession of money, bullion, jewellery or other valuable article or thing and these assets represent, either wholly or partly, income or property which has not been, or would not be disclosed by such person for the purposes of this Act. In the absence of such information, a search cannot be validly authorized.

The Apex Court in *UOI v Ajit Jain [2003] 260 ITR 80* has held that mere intimation by the CBI that money was found in the possession of the assessee, which according to the CBI was undisclosed, without something more, does not constitute “information” within the meaning of section 132, on the basis of which a search warrant could be issued. Consequently, the Supreme Court held that the search conducted on this basis and the block assessment made pursuant to such search was not valid.

- (b) The Supreme Court, in *Mahendra Mills Ltd.v PB Desai, AAC [1975] 099 ITR 135*, has held that since the closing stock of one assessment year furnishes the figure of the opening stock for the succeeding year, therefore, to the extent of ascertaining the closing stock and opening stock positions, the assessments for the two years telescope into each other. The record showing the closing stock of one assessment year formed a part of the evidence relevant to the assessment for the next assessment year. Therefore, the

value of the closing stock of the preceding year must be the value of the opening stock of the succeeding year. Hence, if the value of closing stock at the end of a year is enhanced, the enhanced value should be taken as the value of the opening stock of the next year for the purpose of income tax.

The claim of the assessee in this case is, therefore, valid.

- (c) (i) As per section 10(6A), in the case of a foreign company deriving income by way of royalty or fees for technical services from the Government or an Indian concern under the terms of an agreement entered into before 1.6.2002 relating to a matter included in the industrial policy of the Central Government, the tax paid by the Government or an Indian concern on such income would not be included in the total income of the foreign company. Hence, such tax paid would be exempt in the hands of the foreign company.

Therefore, in the present problem, in the first case, the tax paid by KN will be exempt from tax in the hands of ST. In this case, section 195A is not applicable and consequently, the royalty of Rs.50 lakhs should not be grossed up. As per section 44D, where a foreign company receives income by way of royalty from an Indian concern in pursuance of an agreement made on or after 1st April, 1976 but before 1st April, 2003, no deduction is allowable in respect of any expense or allowance under sections 28 to 44C in computing such income.

Total income of ST is	50,00,000
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Tax payable @ 20.91% (See Note below)

(20% + surcharge@2.5% + education cess@2%)	10,45,500
Less: Tax liability of ST paid by KN	<u>10,45,500</u>
Net tax payable	<u>Nil</u>

Note – The rate of tax is 20% as per section 115A(1)(b)(A), since the royalty is received in pursuance of an agreement made after 31.5.1997 but before 1.6.2005.

- (ii) In the second case, since there is no agreement as to KN bearing the tax liability, the benefit under section 10(6A) is not available. However, KN has to deduct tax at source on royalty payment to ST, a foreign company, as per section 195. Since in this case, KN has to pay the royalty of Rs.59 lakhs 'net of taxes' to ST, therefore, the royalty has to be grossed up.

The tax liability of ST has to be computed as under:

Net royalty income	59,00,000
Gross royalty income (59,00,000 x 100/79.09)	74,59,856
Tax on royalty of 74,59,856 @ 20.91 %	15,59,856

KN has to deduct this tax of Rs.15,59,856 at source under section 195.

Question 7

New Era Construction Ltd. furnishes the following particulars of its wealth for the valuation date of 31st March, 2005. Compute its net wealth and the wealth tax payable by it for the Assessment Year 2005-06:

	Rs.	Rs.
<i>Land in rural area (within 5 kms of Aligarh – purchased in 1990, construction on which is permissible) (Rs.90 lakhs)</i>		90,00,000
<i>Land in urban area (for construction of Mall)</i>		20,00,000
<i>Land in urban area (held as stock-in-trade since 1990)</i>		50,00,000
<i>Motor car (including one imported car worth Rs.6 lakhs)</i>		11,00,000
<i>Jewellery (held as stock-in-trade)</i>		18,00,000
<i>Aircraft for use of directors and auditors</i>		1,58,00,000
<i>Bank balance</i>		5,00,000
<i>Cash in hand as per cash book</i>		2,70,000
<i>Guest house and land appurtenant thereto in rural area</i>		8,00,000
<i>Residential flats of identical size provided to six employees for their use near factory in rural areas (salaries of two such employees exceed Rs.5,00,000 p.a.)</i>		15,00,000
<i>Residence provided to managing director (salary exceeds Rs.5,00,000 p.a.)</i>		10,00,000
<i>Flats constructed remaining unsold (not held as stock)</i>		30,00,000
<i>Residence provided to whole time director (salary Rs.15,000 p.m.)</i>		17,00,000
<i>The company has taken the following loans :</i>		
<i>(a) for purchase of jewellery</i>	6,00,000	
<i>(b) for purchase of aircraft</i>	7,00,000	
<i>(c) for flats constructed remaining unsold</i>	2,00,000	
<i>(d) for residence provided to whole time director</i>	90,000	

(10 Marks)

Answer

Computation of net wealth and wealth-tax payable by New Era Construction Ltd. for the A.Y.2005-06

Particulars	Rs.	Rs.
1. Land in rural area within 5 kms. of Aligarh (within the prescribed limit)		90,00,000

2.	Land in urban area (for construction of mall) [It has been assumed that the land has not been held as stock-in-trade]	20,00,000
3.	Land in urban area (held for more than 10 years as stock in trade – hence taxable)	50,00,000
4.	Motor car (including imported car)	11,00,000
5.	Jewellery (held as stock in trade – hence, not taxable)	Nil
6.	Aircraft for use of directors and auditors	1,58,00,000
7.	Bank balance - not an asset under section 2(ea)	Nil
8.	Cash in hand as per cash book - not an asset as per section 2(ea)	Nil
9.	Guest house in rural area	8,00,000
10.	(a) Four residential flats given to employees, whose salary does not exceed Rs.5,00,000 p.a. - exempt	Nil
	(b) Two residential flats given to employees, whose salary exceed Rs.5,00,000 p.a. - taxable	5,00,000
11.	Residential house given to Managing Director whose salary exceeds Rs.5,00,000 p.a.	10,00,000
12.	Unsold flats	30,00,000
13.	Residence given to whole time director (not taxable, since salary does not exceed Rs.5,00,000 p.a.)	Nil

Gross Wealth	3,82,00,000
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Less: Debts

1.	Loan for purchasing jewellery – Not deductible since jewellery held as stock in trade is exempt from wealth-tax	Nil
2.	Loan for purchasing aircraft	7,00,000
3.	Loan for flats constructed remaining unsold	2,00,000
4.	Loan for residential house provided to the whole time director – not deductible as the house is exempt from wealth-tax	Nil
		9,00,000

Net Wealth	3,73,00,000
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Computation of wealth tax payable for A.Y.2005-06

On Net Wealth up to Rs.15,00,000	-
On the balance wealth of Rs.3,58,00,000 @ 1%	3,58,000
Wealth Tax Liability	3,58,000

The suggested answers for Indirect Taxes (Paper 8) are based on the provisions as amended by the Finance (No.2) Act, 2004 and Notifications/Circulars issued up to 30.04.2005 which are relevant for November 2005 examinations.

PAPER – 8 : INDIRECT TAXES

*Question Nos. 1, 6 and 9 are compulsory. In addition thereto, answer any **two** questions from Part “A” and **one** question from Part “B”.*

PART – A

Question 1

- (a) (i) *Discuss in brief the concept of ‘Deemed Manufacture’.* (4 Marks)
- (ii) *TCL purchases duty paid metal rods and draws them into wire of a thinner gauge. Both the items fall under different tariff headings. The assessee claims that the process undertaken by it does not amount to manufacture. You are required to advise with reference to the present position of law in this regard.*

(4 Marks)

- (b) *With reference to CENVAT Credit Rules, 2004, discuss giving reason whether the following statements are **true or false**:*

- (i) *Credit of duties of excise on inputs can be availed irrespective of whether payment is made or not against the invoice, whereas credit of service tax on input services can be availed only after making payment of the invoice.*
- (ii) *An input service distributor is comparable to a dealer under the CENVAT scheme of inputs and capital goods.*
- (iii) *The manufacturer shall not be allowed to transfer unutilized input credit in case of transfer of ownership of the factory by way of sale along with the inputs and capital goods.*
- (iv) *A manufacturer availing CENVAT credit on inputs without ensuring that excise duty indicated in the invoice has been paid on such inputs is liable to a penalty.*

(2 x 4 = 8 Marks)

- (c) *ABC, an assessee availing the SSI exemption scheme, paid central excise duty of Rs.10,000 for the goods cleared in the month of March, 2005 on April 15, 2005. Discuss whether any interest will be charged from ABC for late payment of duty. If yes, what will be the interest liability?* (4 Marks)

Answer

- (a) (i) As per section 2(f) of the Central Excise Act, 1944 "manufacture" includes any process-
- (i) incidental or ancillary to the completion of a manufactured product; and
- (ii) which is specified in relation to any goods in the Section or Chapter Notes of

the First Schedule to the Central Excise Tariff Act, 1985 as amounting to manufacture, or

- (iii) which, in relation to the goods specified in the Third Schedule, involves packing or repacking of such goods in a unit container or labelling or re-labelling of containers including the declaration or alteration of retail sale price on it or adoption of any other treatment on the goods to render the product marketable to the consumer,

and the word "manufacturer" shall be construed accordingly and shall include not only a person who employs hired labour in the production or manufacture of excisable goods, but also any person who engages in their production or manufacture on his own account.

The processes that qualify to be "manufacture" as per clause (ii) and (iii) of section 2(f) are termed as deemed manufacture.

Thus, if any process which is specified in relation to any goods in the Section or Chapter Notes of the First Schedule to the Central Excise Tariff Act, 1985 as amounting to manufacture is carried out, such goods will be deemed as manufactured even if as per judicial decisions, the process may not amount to manufacture. For instance, Note 4 of Chapter 73 provides that in case of articles of iron and steel falling under Chapter 73, the process of galvanization shall amount to manufacture. Similarly, if any of specified processes (like re-packing, re-labelling, alteration of retail sale price etc.) is being carried out on goods covered in Third Schedule to the Central Excise Act, 1944, the process will be deemed to be as that of manufacture.

- (ii) The taxable event for levying excise duty is production or manufacture of the excisable goods. Section 2(f) of the Central Excise Act, 1944 *inter alia* provides that manufacture includes any process, incidental and ancillary to the completion of a manufactured product, and which is specified in relation to any goods in the Section or Chapter Notes of the Schedules of the Central Excise Tariff Act, 1985 as amounting to manufacture.

The definition stipulates that manufacture will include any process which is specified in the Section or Chapter Notes of the Central Excise Tariff as amounting to manufacture.

The Finance (No.2) Act, 2004 has inserted Note No. 10 in Section XV of the First Schedule to the Central Excise Tariff Act so as to provide that the process of drawing or redrawing a rod, wire or any other similar article, into wire shall amount to manufacture.

Therefore, in view of the above Section Note, the claim of TCL is not correct in law.

Note: *This issue had come up before the Supreme Court in the case of CCE v. Technowled Industries (2003). The Apex Court held that there was no manufacture of a new product when the gauge of the rod was made thinner and the product was*

finished a little better. Merely because there were two separate entries, it did not mean that the product became excisable.

However, in view of the above-mentioned amendment made by Finance (No.2) Act, 2004 this judgment does not hold good anymore.

- (b) (i) *True.* Credit of input services can be availed only after the output service provider makes payment of input services and the service tax payable on it, as shown in the invoice [Rule 4(7)]. However, in case of excise duty, credit is available as soon as the goods are received in the factory.

The reason for the differential treatment is that a manufacturer (input supplier) can clear the inputs from his factory only after paying the applicable duty irrespective of the time at which he receives the payment against the invoice while the input service provider pays the service tax only after he realizes the payment for taxable services (as the service tax is due upon realization only).

- (ii) *True.* The invoice issued by a dealer is acceptable under the CENVAT Credit Rules, 2004 as an eligible document for availing credit. In order to pass on the credit, the dealer has to obtain registration and file quarterly returns with the Superintendent of Central Excise. Likewise, the document/invoice issued by an input service distributor is also acceptable under the CENVAT Credit Rules, 2004 as an eligible document for availing credit. Similarly, in order to pass on the credit, the input service distributor too has to obtain service tax registration, comply with new rule 4A of Service Tax Rules, 1994 and file half yearly statement giving details of credit received and distributed, with the Superintendent of Central Excise.
- (iii) *False.* The manufacturer shall be allowed to transfer the credit lying unutilized in his accounts provided the transfer takes place with specific provision for transfer of liabilities of such factory [Rule 10(1)] and the said inputs and capital goods are duly accounted for to the satisfaction of the Deputy Commissioner of Central Excise or, as the case may be, the Assistant Commissioner of Central Excise. [Rule 10(3)]

Note: *It is also possible to answer as 'True' if it is assumed that there is no specific provision of transfer of the liabilities of such factory or the inputs and the capital goods have not been accounted for to the satisfaction of the Deputy/Assistant Commissioner of Central Excise.*

- (iv) *True.* Where the CENVAT credit in respect of inputs or capital goods is taken wrongly or without taking reasonable steps to ensure that appropriate duty on said inputs or capital goods has been paid as indicated in the invoice, then as per rule 15 of the CENVAT Credit Rules 2004, the person availing credit shall be liable to a penalty not exceeding duty on the inputs in question or Rs.10000/- whichever is greater.
- (c) The second proviso to rule 8(1) of the Central Excise Rules, 2002 lays down that where an assessee is availing the exemption under a Notification based on the value of clearances in a financial year, the duty on goods cleared during a calendar month shall

be paid by the 15th day of the following month. However, in case of goods removed during the month of March the duty shall be paid by the 31st day of March.

Sub-rule (3) of rule 8 provides that if the assessee fails to pay the amount of duty by the due date, he shall be liable to pay the outstanding amount along with interest at the rate specified by the Central Government vide notification under section 11AB of the Central Excise Act on the outstanding amount. Such interest shall be paid for the period starting from the first day after the due date till the date of actual payment of the outstanding amount. The rate of interest has been specified as 13% vide *Notification No. 66/2003 CE(NT) dated 12.09.2003*.

Therefore, since ABC has paid the duty for the month of March on 15th April, it will have to pay the duty with interest for the delay of 15 days.

The amount of interest shall be computed as follows:

$$= \text{Rs.} 10,000 \times 13/100 \times 15/365 = \text{Rs.} 53.42$$

$$= \text{Rs.} 53.00$$

Question 2

- (a) (i) Define retail sale price in the light of provisions of Section 4A of Central Excise Act, 1944. (4 Marks)
- (ii) What are the conditions under which MRP based valuation shall apply under Central Excise? (4 Marks)
- (iii) What legal/penal actions can be taken in case the retail sale price is not mentioned or is unduly tampered after the removal? (4 Marks)
- (b) Asha Ltd. supplies raw material to a job worker Kareena Ltd. After completing the job-work, the finished product of 5,000 packets are returned to Asha Ltd. putting the retail sale price as Rs.20 on each packet. The product in the packet is covered under MRP provisions and 40% abatement is available on it. Determine the assessable value under Central Excise law from the following details:

	Rs.
Cost of raw material supplied	30,000
Job worker's charges including profit	10,000
Transportation charges for sending the raw material to the job worker	3,000
Transportation charges for returning the finished packets to Asha Ltd.	3,000

(3 Marks)

Answer

- (a) (i) Explanation 1 to section 4A of the Central Excise Act, 1944 defines the retail sale price as the maximum price at which the excisable goods in packaged form may be sold to the ultimate consumer and includes all taxes, local or otherwise, freight,

transport charges, commission payable to dealers, and all charges towards advertisement, delivery, packing, forwarding and the like, as the case may be, and the price is the sole consideration for such sale.

However, in case the provisions of the Central Excise Act, rules or Standards of Weights and Measures Act, 1976 or the Rules made thereunder or under any other law for the time being in force require to declare on the package, the retail sale price excluding any taxes, local or otherwise, the retail sale price shall be construed accordingly.

- (ii) The provisions relating to valuation of excisable goods based on MRP are dealt with in section 4A of the Central Excise Act, 1944. The conditions under which the MRP based valuation shall apply are as follows:
 - (a) the excisable goods to be valued are covered under Standards of Weights and Measures Act, 1976 or related rules or under any other law and such law requires to declare on the package the retail sale price thereof; and
 - (b) the Central Government has notified the said goods as goods in relation to which the payment of excise duty shall be on the basis of the MRP less such deductions/abatements as it may allow in the notification. However, it must be noted that if the goods have been so notified, Standards of Weights and Measures Act or the rules made thereunder must require a declaration of the retail sale price on the package of such goods.
- (iii) If the retail sale price is not mentioned on the excisable goods or is unduly tampered after the removal, then
 - (i) such goods shall be liable to confiscation and
 - (ii) the retail sale price of such goods shall be ascertained in the manner prescribed by the Central Government and such price shall be deemed to be the retail sale price.
- (b) As the product is under MRP scheme, the duty shall be payable only as per the provisions of section 4A of the Central Excise Act i.e. on the basis of MRP less abatement and not on the basis of material cost plus job charges etc. Section 4A overrides section 4 of the Central Excise Act.

Hence, assessable value in this case shall be determined as under:-

	<i>Rs.</i>
Retail sale price of 5000 packets	$= 5000 \times 20 = 1,00,000$
Less: Abatement @ 40%	<u>40,000</u>
Assessable Value	<u>60,000</u>

Question 3

- (a) Answer in brief the following questions relating to export without payment of duty other than to Nepal and Bhutan under Rule 19 of the Central Excise Rules, 2002:
- (i) What is the type of bond to be executed? Who is exempted from furnishing such bond?
 - (ii) What is the export document for export clearance? How many copies are required to be prepared for it?
 - (iii) Is it necessary to prepare an invoice also? If yes, how should it be prepared?
 - (iv) What will be the duty payable, if goods are not exported within six months after clearance? (4 x 2 = 8 Marks)
- (b) Does the bar of unjust enrichment apply to all types of refunds? Does the refund of penalty attract such bar? (2 Marks)
- (c) State the various circumstances where goods are liable for confiscation under the Central Excise Law. Can the assessee get back the confiscated goods and if so how? (5 Marks)

Answer

- (a) Procedures and conditions for export without payment of duty to all countries except Nepal and Bhutan are specified in *Notification No.42/2001 C.E. (N.T.) dated 26.6.2001*. Part-wise answers to the questions are given below:
- (i) A bond in Form B-1 is required to be executed by a merchant exporter in case of export without payment of duty. The bond should be at least equal to the duty chargeable on the goods, with such surety or security as the excise officer may approve. Manufacturer- exporter is exempted from furnishing such bond. He can furnish an annual Letter of Undertaking (LUT) in Form UT-1.
 - (ii) ARE-1 is the export document for export clearance which shall be prepared in five copies (quintuplicate). The fifth copy is the optional copy which the assessee can use for claiming other export incentives.
 - (iii) Yes, the goods have to be cleared from the factory under an invoice which shall be prepared in terms of rule 11 of the Central Excise Rules, 2002. The invoice should be prominently marked as "FOR EXPORT WITHOUT PAYMENT OF DUTY".
 - (iv) Goods must be exported within 6 months from the date of clearance for export, unless extension is granted by Assistant Commissioner/Deputy Commissioner. If goods are not exported within 6 months from the date of clearance for export, the exporter should deposit the applicable excise duty on such goods along with the interest. As per rule 5 of the Central Excise Rules, 2002, the applicable duty shall be computed as per the rate and tariff value applicable on the date of removal of such goods from the factory.

- (b) No, the bar of unjust enrichment does not apply to all types of refunds. Only when the burden of the duty has been shifted by the manufacturer to the buyer, the refund gets hit by such bar.

No, refund of penalty does not attract bar of unjust enrichment [*CCE Chandigarh v. Shivalik Agro Poly Products Ltd. 2004 (173) ELT 64 (Tri-Del.)*].

- (c) Under Rule 25 of the Central Excise Rules, 2002, the excisable goods shall be liable for confiscation if any producer, manufacturer, registered person of a warehouse or registered dealer -
- (i) removes any excisable goods in contravention of Central Excise Rules/Notifications; or
 - (ii) does not account for any excisable goods produced or manufactured or stored by him; or
 - (iii) contravenes any of the provisions of Rules/Notification with an intent to evade payment of duty; or
 - (iv) engages in the manufacture or production or storage of any excisable goods without registration of the factory.

Section 34 of the Central Excise Act provides that whenever confiscation is adjudged under the Central Excise Act or the rules made thereunder, the officer adjudging it, shall give the owner of the goods an option to pay in lieu of confiscation such fine as the officer thinks fit. Therefore, the assessee can get the confiscated goods back by paying redemption fine as prescribed in the order of the officer adjudging such confiscation.

Question 4

- (a) Discuss whether remission of duty shall be granted or not, in the following cases, under the Central Excise Rules, 2002:
- (i) Excisable goods manufactured in the factory are claimed by the manufacturer as unfit for consumption or for marketing.
 - (ii) Duty paid goods were damaged due to breakage in handling.
 - (iii) Finished goods entered in Daily Stock Account (DSA) were stolen from the factory. (3 x 2 = 6 Marks)
- (b) With reference to Rule 12(2) of the Central Excise Rules, 2002, explain in brief the main provisions of the return in form E.R.-4, to be filed with the Central Excise Department by an assessee. What is the maximum penalty leviable for non-submission or late submission of E.R.-4 return? (4 Marks)
- (c) Write a brief note on power of rectification of mistakes given to Appellate Tribunal under Section 35C(2) of Central Excise Act. Whether the power of rectification includes the power to review the order also? (5 Marks)

Answer

(a) Rule 21 of the Central Excise Rules, 2002 *inter alia* provides that where it is shown to the satisfaction of the Commissioner that goods have been lost or destroyed by natural causes or by unavoidable accident or are claimed by the manufacturer as unfit for consumption or for marketing, at any time before removal, the Commissioner may remit the duty payable on such goods, subject to such conditions as may be imposed by him by order in writing. With reference to the said rule, the cases under consideration are discussed as follows:-

- (i) Remission of duty shall be granted as the goods have been claimed as unfit for consumption or for marketing by the manufacturer.
- (ii) Remission cannot be granted on duty paid goods as there is no provision for granting remission of duty after removal of the goods.
- (iii) Remission of duty in case of theft is not allowed as the goods are available for consumption somewhere else [Chapter 18 Part I Para 2.6 of CBE&C's Central Excise Manual, 2001].

(b) Every assessee paying duty of Rs.1 crore or more per annum through PLA is required to file Annual Financial Information Statement for the preceding financial year to which the statement relates by 30th November of the succeeding year in Form E.R.4. The main contents of the return are as under (all information is to be in Rs.lakhs) –

- (i) Financial year to which it relates
- (ii) Registration Number
- (iii) Name of the Assessee
- (iv) Details of Expenditure
- (v) Details of Income
- (vi) CENVAT credit details

The maximum penalty for non-submission or late submission can be Rs.5,000 under rule 27 of the Central Excise Rules, 2002.

(c) Under Section 35C(2) of the Central Excise Act, 1944, 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. Such a rectification shall be made when the Commissioner of Central Excise or the other party to the appeal brings the mistake to the notice of the Tribunal. Where such an amendment has the effect of increasing the liability of the other party then such an amendment shall be made only after issuing a notice and giving a reasonable opportunity of being heard to the party concerned.

The Appellate Tribunal u/s 35C is not empowered to review an order passed by it. The power of review is not an inherent power and must be expressly granted – *CCE v. Steel Co. Gujarat Ltd. 2004 (163) ELT 403 (SC)*.

Question 5

- (a) Write short notes on the following:
- (i) Place of Removal
 - (ii) Interest u/s 11AB (3 x 2 = 6 Marks)
- (b) What is Personal Ledger Account or PLA? How is it maintained? (5 Marks)
- (c) Briefly explain the procedure for removal of goods by a unit which is an 100% EOU for Domestic Tariff Area. (4 Marks)

Answer

- (a) (i) As per section 4(3)(c) of the Central Excise Act, 1944, 'place of removal' means:
- (i) a factory or any other place or premises of production or manufacture of the excisable goods;
 - (ii) a warehouse or any other place or premises wherein the excisable goods have been permitted to be deposited without payment of duty;
 - (iii) a depot, premises of a consignment agent or any other place or premises from where excisable goods are to be sold after their clearance from the factory;
- from where such goods are removed.
- (ii) Where any duty of excise has not been levied or paid or has been short-levied or short-paid or erroneously refunded, the person who is liable to pay the duty shall, in addition to the duty, be liable to pay interest. The interest shall be payable at a rate not below 10% p.a and not exceeding 36%p.a. The Central Government may fix the rate of interest by notification in the Official Gazette. *Notification No.66/2003 dtd. 12.09.2003* has specified such rate as 13% per annum.
- The interest shall be paid from the first date of the month succeeding the month in which the duty ought to have been paid, or from the date of such erroneous refund, as the case may be, till the date of payment of such duty.
- However, in such cases where the duty becomes payable consequent to issue of an order, instruction or direction by the Board under section 37B, and such amount of duty payable is voluntarily paid in full, without reserving any right to appeal against such payment at any subsequent stage, no interest shall be payable. The duty should be paid within 45 days from the date of issue of such order, instruction or direction, as the case may be. In other cases, the interest shall be payable on the whole of the amount, including the amount already paid.
- However, if in the appeal, the duty demand is increased or decreased, the interest is accordingly increased or decreased.
- (b) Personal ledger Account is an account with the Central Government, which is utilized for payment of duty of excise. The account is credited when the sum is deposited into the treasury and debited on payment of excise duty. Each debit and credit entry should be

made on separate lines and assigned a running serial number for the financial year. The PLA must be prepared in triplicate by writing with an indelible pencil and using double sided carbon. Original and duplicate copies of PLA shall be sent to the Central Excise Officer in charge along with the monthly/quarterly return.

The assessee may make credit in the PLA by making cash payment into the treasury or authorised bank through TR-6 challan. Copy of each such challan shall be sent by the assessee to the Central Excise Officer along with the monthly/quarterly return.

No restrictions exist with regard to any minimum amount, which should necessarily remain in balance to the credit of an assessee in his PLA. With the monthly payment system, there should be enough credit at the time of payment of duty for the month.

Mutilations or erasures of entries once made in the PLA are not allowed. If any correction becomes necessary, the original entry should be scored out and attested by the assessee or his authorized agent.

- (c) Rule 17 of the Central Excise Rules, 2002 provides that where any goods are removed from a 100% EOU to domestic tariff area, such removal shall be made under an invoice as per the procedure specified in rule 11 of the Central Excise Rules, 2002. Further, removal shall be made only after payment of appropriate duty by debiting the account current maintained for this purpose or by utilizing the CENVAT credit.

Such unit is required to maintain appropriate accounts related to production, description of goods, quantity removed and the duty paid in the prescribed form.

Such unit is required to submit a monthly return in Form E.R-2 within 10 days from the end of the month to which the return relates in respect of the excisable goods manufactured in, and receipt of inputs and capital goods in, the unit. The return should be submitted to the Superintendent of Central Excise.

PART – B

Question 6

- (a) Explain briefly with reference to the provisions of the Customs Act, 1962 any **two** of the following:
- (i) Adjudicating Authority
 - (ii) Customs Area
 - (iii) Smuggling. (2 x 2 = 4 Marks)
- (b) State briefly the provisions of refund on anti-dumping duty in certain cases. (2 Marks)
- (c) Assessable value of an item imported is Rs.1,00,000. Basic customs duty is 20%, additional duty of customs is 16%, and education cess is 2% on duty. Compute the amount of total customs duty payable. Also, state the amount of credit available to the importer and how it can be utilised by him. (4 Marks)
- (d) Your client loaded a machine on the vessel for export. He has paid import duty and

central excise duty on the components used in the manufacture. The vessel set sail from Mumbai, but runs into trouble and sinks in the Indian territorial waters. The customs department refuses to grant duty drawback for the reason that the goods have not reached their destination. Advise your client citing case law, if any.

(4 Marks)

- (e) India Car Co. is manufacturing passenger cars and has entered into a joint venture agreement and collaboration with Videshi Car Co. India Car Co. imported from Videshi Car Co. a shipment of 24 CKD packs (completely knocked down condition) of passenger car components. They filed Bill of Entry for clearing the goods, which were claimed to be components of motor cars. They also claimed benefit of a Notification exempting components, including components of motor cars in semi-knocked down packs and completely knocked down packs.

The Adjudicating Authority held that the imported components being complete cars in CKD packs, had the essential character of the finished product and as such the consignment were to be treated as motor cars and not components. It was also held that India Car Co. was not entitled to the benefit of the notification as the notification was only for components.

The questions for consideration are:

- (i) Whether the CKD packs imported into the country could be considered to be motor cars for the purpose of classification and clearance?
- (ii) Whether India Car Co. is entitled to the benefit of exemption notification?

(2 x 3 = 6 Marks)

Answer

- (a)
 - (i) As per section 2(1) of the Customs Act, 1962, 'adjudicating authority' means any authority competent to pass any order or decision under this Act, but does not include the Board, Commissioner (Appeals) or Appellate Tribunal.
 - (ii) As per section 2(11) of the Customs Act, 1962, 'customs area' means the area of a customs station and includes any area in which imported goods or export goods are ordinarily kept before clearance by Customs Authorities.
 - (iii) As per section 2(39) of the Customs Act, 1962, 'smuggling', in relation to any goods, means any act or omission which will render such goods liable to confiscation under section 111 or section 113.
- (b) According to the provisions of section 9AA of the Customs Tariff Act, 1975, where an importer proves to the satisfaction of the Central Government that he has paid any anti-dumping duty imposed on any article, in excess of the actual margin of dumping in relation to such article, he shall be entitled to refund of such excess duty. However, the importer will not be entitled for refund of provisional anti-dumping duty under section 9AA as it is refundable under section 9A(2) of the said Act.

(c) Computation of customs duty payable

	<i>Rs.</i>
1. Assessable Value	1,00,000
2. Basic Customs Duty @ 20%	<u>20,000</u>
3. Sub-Total	1,20,000
4. Additional Duty of Customs (CVD)	
@ 16.32% of Rs.1,20,000 i.e. (Rs.19,200 +384)	<u>19,584</u>
(16% + 2% Education cess on 16%)	
5. Education Cess 2% on Rs.39,584 [(2) + (4)]	791.68
6. Total Customs Duty Payable	
[(2) + (4) + (5)] Rounded off	40,376

Credit of total CVD of Rs.19,584 will be available to the importer. The cess component of Rs.384 included in Rs.19,584 will be available as CENVAT credit only for paying education cess on final products or taxable services. The balance Rs.19,200 will be available as CENVAT credit for payment of excise duty or service tax as provided in CENVAT Credit Rules, 2004. Education cess of Rs.791.68 paid on imported goods will not be available as CENVAT credit.

- (d) Rule 2(a) of the Customs and Central Excise Duties Drawback Rules, 1971 provides that "drawback", in relation to any goods manufactured in India, and exported, means the rebate of duty chargeable on any imported materials or excisable materials used in the manufacture of such goods. Rule 2(c) of the said rules *inter alia* provides that "export" means "taking out of India to a place outside India". Section 2(27) of the Customs Act, 1962 provides that 'India includes the territorial waters of India'.

In case of *CC v. Sun Industries 1988 (35) ELT (241)*, the Supreme Court held that the expression "taking out to a place outside India" would also mean a place in high seas, if that place is beyond territorial waters of India. Therefore, the goods taken out to the high seas outside territorial waters of India would come within the ambit of expression "taking out to a place outside India".

The emphasis in the aforementioned judgment was on the movement of the goods outside the territorial waters of India. It is then that an export may be said to have been taken place. In the instant case, the vessel sunk within territorial waters of India and therefore there is no export. Accordingly, no duty drawback shall be available in this case. Similar decision was given by the Supreme Court in the case of *UOI v. Rajindra Dyeing & Printing Mills Ltd. 2005 (180) ELT 433 (SC)*.

- (e) The facts of the given case are similar to the facts of the case of *CC, Bangalore v. Maestro Motors Ltd. – 2004 (174) ELT 289 (SC)* decided by the Apex Court.

- (i) As per interpretative Rule 2(a) of the General Rules of Interpretation of Customs Tariff, any reference in a heading to an article shall be taken to include a reference

to that article incomplete or unfinished, provided that, as presented, the incomplete or unfinished article has the essential character of the complete or finished article. It shall also be taken to include a reference to that article complete or finished (or falling to be classified as complete or finished by virtue of this rule), presented unassembled or dis-assembled. This rule lays emphasis on the essential character of the goods. Thus goods which have the essential characteristics of finished goods will be classified under the same heading in which the final product has to be classified.

In the *Maestro Motors* case, the passenger car components were imported in CKD packs. Thus, what was imported was completely knocked down cars. The components imported had the essential character of a complete car even though presented in unassembled form. Thus, in view of Rule 2(a) of the General Rules of Interpretation of Customs Tariff, the Supreme Court held that the components in CKD packs would be classified as motor car.

Therefore, in case of India Car Co. also, the CKD packs should be classified as cars for the purpose of classification and clearance.

- (ii) In the *Maestro Motors* case, it was observed by the Supreme Court that a notification has to be interpreted in terms of its language. If in the notification, exemption is granted with reference to tariff items in the First Schedule to the Customs Tariff Act, 1975, then the Rules of Interpretation must apply. In that case even for the purposes of the notification, the goods will be classified in the same manner as they are classified for purposes of payment of customs duty. However, where the language of the notification is plain and clear effect must be given to it.

In this case the notification exempted components, including components of fuel efficient motor cars in semi-knocked down packs and completely knocked down packs. The Apex Court held that for purposes of levy of customs duty, by virtue of interpretative Rule 2(a) of the General Rules of Interpretation of Customs Tariff, the components in a completely knocked down pack would be considered to be cars. However, in view of the clear language of the Notification, the components including components in completely knocked down packs would be exempted.

Thus, in view of the abovementioned judgment, the components in CKD packs imported by India Car Co. would get the exemption under the Notification, even though for purposes of classification and clearance they may be considered to be motor cars.

Question 7

- (a) *Explain the Doctrine of unjust enrichment with respect to refund of duty. Are there any exceptions to it and if so enumerate them?* (5 Marks)
- (b) *When is redemption fine imposed? Whether this fine under Section 125 of the Customs Act, once paid, be claimed as refund, in case the importer decides to abandon the goods?* (5 Marks)

- (c) *Explain briefly the provisions regarding drawback allowable on re-export of duty paid goods as such.* (5 Marks)

Answer

- (a) When an importer imports goods, he has to pay the customs duty on such goods. This duty is recovered from the purchasers when these goods are sold by the importer. In other words, the burden of duty is passed on to the purchaser. Subsequently, if the importer makes a claim for refund of duty and on acceptance of such claim if he retains the amount of refund with himself without passing it to the purchaser, then this would be called as unjust enrichment.

Therefore, wherever there is an over assessment or excess collection of duty, the refund shall be given only to the person who at the material time of grant of refund, bears the burden of duty and interest, if any. When the person who bears the burden of duty refunded is not identifiable or has not come forward to claim the refund, the refund shall be paid into a fund called 'Consumer Welfare Fund'. The importer or the clearing agent has to prove that he has not passed the burden of duty, in order to claim refund of duty.

Section 28D provides that every person who has paid duty under the Customs Act, unless the contrary is proved by him, shall be deemed to have passed the full incidence of such duty to the buyer.

The doctrine of unjust enrichment does not apply to the refund of duty and interest, if any, paid on such duty if such amount is relatable to:

- (i) drawback of duty payable under sections 74 and 75;
 - (ii) export duty as specified in section 26;
 - (iii) the duty and interest, if any, paid on such duty paid by the importer or the exporter, as the case may be, if he had not passed on the incidence of such duty and interest to any other person;
 - (iv) the duty and interest on imports made by an individual for his personal use;
 - (v) the duty and interest borne by the buyer, if he had not passed on the incidence of such duty and interest to any other person;
 - (vi) the duty and interest borne by any other such class of applicants as the Central Government may, by notification in the Official Gazette, specify. However, no notification under this clause shall be issued unless in the opinion of the Central Government the incidence of duty and interest has not been passed on by the persons concerned to any other person.
- (b) Section 125 of the Customs Act empowers a Customs Officer adjudging the confiscation to give an option to the owner of the goods or where such owner is not known, the person from whose possession or custody such goods have been seized to pay a fine as the said officer thinks fit, in lieu of confiscation of the imported goods. The provisions in this regard are as follows:

- (a) in case of prohibited goods, the proper officer **may** give an option to pay a fine in lieu of confiscation;
- (b) in case of other goods, the proper officer **shall** give an option of payment of fine, in lieu of confiscation;
- (c) the amount of such fine cannot exceed the market price of the goods confiscated less import duty chargeable (in the case of imported goods) thereon;
- (d) the assessee shall also be liable to pay any duty and charges payable in respect of such goods.

The provisions of section 125 give the importer an option to either allow the goods to be confiscated or pay redemption fine in lieu of confiscation. Hence, the redemption fine becomes liable only in lieu of confiscation. Now, where the importer has abandoned the goods, the scope for payment of any fine in lieu of confiscation comes to an end. Hence, the redemption fine, if already paid shall be liable to be refunded.

The same decision was given by the Madras High Court in the case of *Purfin Chemicals Pvt. Ltd v CEGAT, Madras (2004) (167) E.L.T. 145 (Mad.)*

- (c) For allowing duty draw back on re-export of duty paid goods, sub-section (1) of section 74 of the Customs Act, 1962 provides that:
 - (i) the goods should have been imported into India;
 - (ii) the import duty should have been paid thereon;
 - (iii) the goods should be capable of being easily identified as the goods, which were originally imported;
 - (iv) the goods should have been entered for export either on a shipping bill through sea or air or on a bill of export through land, or as baggage, or through post and the proper officer, after proper examination of the goods and after ensuring that there is no prohibition or restriction on their export, should have permitted clearance of such goods for export;
 - (v) the goods should have been identified to the satisfaction of the Assistant or Deputy Commissioner of Customs as the goods, which were imported, and
 - (vi) the goods should have been entered for export within two years from the date of payment of duty on the importation thereof.

However, in any particular case, the aforesaid period of two years may, on sufficient cause being shown, be extended by the Board by such further period, as it may deem fit. Once these conditions are satisfied, then 98% of the import duty paid on such goods at the time of importation shall be repaid as drawback.

Question 8

- (a) *What is the crucial/relevant date for determination of rate of duty under the Customs Act in the following cases?*
 - (i) *Clearance of Baggage*

- (ii) *Goods cleared for home consumption from a warehouse under Section 68 of the Customs Act*
- (iii) *Goods entered for export under Section 50.* (3 x 2 = 6 Marks)
- (b) *Write short notes on the following with reference to the Customs Act, 1962:*
 - (i) *Interest on drawback*
 - (ii) *Power to arrest.* (2 x 3 = 6 Marks)
- (c) *Briefly discuss the provisions of the Customs Act, 1962 regarding rejection of an application for advance ruling.* (3 Marks)

Answer

- (a) (i) As per section 78 of the Customs Act, 1962, the relevant date for determination of rate of duty in case of clearance of baggage is the date on which a declaration is made in respect of such baggage under section 77.
- (ii) As per section 15(1)(b) of the Customs Act, 1962, the relevant date for determination of rate of duty in case of goods cleared from a warehouse under section 68 is the date on which a bill of entry for home consumption in respect of such goods is presented under that section.
- (iii) The relevant date for determination of rate of duty in case of goods entered for export under section 50 is the date on which the proper officer makes an order permitting clearance and loading of the goods for exportation under section 51 - Section 16(1)(a) of the Customs Act.

(b) (i) Interest on drawback

Section 75A of the Customs Act provides for payment of interest on delayed payment of drawback. Where any drawback payable to a claimant under section 74 or 75 is not paid within a period of one month from the date of filing a claim for payment of such drawback, interest @ 6% p.a. shall be paid along with the amount of drawback. Such interest shall be paid from the date after the expiry of the said period of one month till the date of payment of such drawback [Section 75A(1)].

Similarly, if the drawback has been paid to a claimant erroneously, the claimant is required to repay the amount of drawback within a period of two months from the date of such demand. If he fails to do so, he shall have to pay interest @ 15% p.a. along with the amount of drawback. Such interest shall be paid from the date after the expiry of the said period of two months till the date of recovery of such drawback [Section 75A(2)].

(ii) Power to arrest

Section 104 of the Customs Act, 1962 empowers a proper officer (who is empowered by general or special order of Commissioner of Customs) to arrest any person in India or within Indian customs waters, if the official has reason to believe that the person is guilty of an offence punishable under section 135.

Such a person should be informed of the grounds of his arrest and taken to the nearest Magistrate immediately. The Customs Officer is vested with the powers of an Officer-in-charge of a police station for the purpose of releasing any person on bail or otherwise. The offences under this Act shall not be cognizable. An arrest can be made only as per the provisions of section 46 of the Criminal Procedure Code.

- (c) Under section 28-I(2) of the Customs Act, an application for advance ruling may be rejected on the following grounds:
- (i) if the question raised is already pending before a customs officer, Appellate Tribunal or any Court.
 - (ii) if the question raised is the same as in a matter already decided by the Appellate Tribunal or any Court.

No application shall be rejected without giving an opportunity to the applicant of being heard. On rejection, reasons for such rejection shall be given in the order.

PART – C

Question 9

- (a) (i) *Certain abatement/exemption of the gross amount charged has been notified for computing the value of some taxable services. What are the conditions to be fulfilled to avail such partial exemption?* (2 Marks)
- (ii) *What is the percentage of abatement granted in the following cases?*
- (i) *Services provided by a tour operator*
 - (ii) *Services provided by an outdoor caterer supplying food also*
 - (iii) *A commercial concern providing construction service where the gross amount charged includes the value of goods and material*
 - (iv) *Goods transport agency providing taxable service and paying service tax itself.* (4 Marks)
- (b) *Enumerate the specified services, other than accounting and auditing, provided by a practising Chartered Accountant which are liable to service tax.* (6 Marks)
- (c) *Hotel Marudhar Palace charges 10% of the bill amount as service charges and Department has asked them to pay service tax on it. The assessee has submitted that the amount @ 10% collected from customers is subsequently disbursed among the staff, therefore it is not part of their income and cannot be included in the gross amount charged by them. Examine the case and advise suitably.* (3 Marks)

Answer

- (a) (i) The partial exemption shall be available only when the service provider has not availed –
- (a) CENVAT credit of duty paid on inputs or capital goods under the provisions of CENVAT Credit Rules, 2004; and
 - (b) the benefit of exemption under *Notification No.12/2003-ST, dated 20.06.2003* in respect of value of goods and materials sold by him.
- (ii) Following abatement has been granted in the cases under consideration:
- (i) 60% of the gross amount charged in case of services provided by a tour operator. However, in cases where the tour operator solely provides services in respect of arranging or booking accommodation, an abatement of 90% from gross amount charged has been granted vide *Notification No. 40/97 ST, dated 22.08.1997* as amended by *Notification No. 12/2004 ST, dated 10.09.2004*. The gross amount charged should include the service charges for arranging or booking accommodation as well as the cost of the accommodation.
 - (ii) 50% of the gross amount charged inclusive of charges for supply of food
 - (iii) 67% of the gross amount charged
 - (iv) 75% of the gross amount charged from customer.
- (b) According to *Notification No.59/98-S.T. dated 16th October, 1998*, the following services (other than accounting and auditing) provided by a practising Chartered Accountant are liable to service tax:
- (i) certification that requirements of Schedule XIII to the Companies Act, 1956 have been complied with as regards statutory guidelines for appointment of managerial personnel and payment of managerial remuneration to them without the approval of the Central Government under section 269 and Schedule XIII, of the Companies Act, 1956;
 - (ii) certification of documents to be filed by companies with the Registrar of Companies under the Companies Act, 1956;
 - (iii) certification in Form 1 that the whole of the amount remaining unpaid or unclaimed for a period of three years from the date of transfer to the special account under sub-section (1) and sub-section (2) of section 205A of the Companies Act, 1956 has been transferred to the General Revenue Account of the Central Government under the Companies Unpaid Dividend (Transfer to General Revenue Account of the Central Government) Rules, 1978;
 - (iv) certification for exchange control purposes which a practising chartered accountant can issue as documentary evidence in support of certain applications under the Foreign Exchange Regulation Act, 1973;

- (v) certification of documents under the Exports and Imports Policy (1997-2000) of the Government of India;
 - (vi) certification in respect of valuation of instruments or assets as per rule 8A(7) of the Wealth Tax Rules, 1957;
 - (vii) verification of declarations in prescribed forms of compliances for obtaining a certificate of commencement of business or commencement of other business under section 149 of the Companies Act, 1956;
 - (vii) signing of the annual return of the listed companies under section 161 of the Companies Act, 1956.
- (c) The facts of the case are similar to the case of *Hotel Mela Plaza v. CCE Ghaziabad – 2005 (183) ELT 190 (Tri-Del.)*. The Hotel rendered mandap keeping services and charged 10% of the bill amount as service charges from its customers. It was contended by the assessee (the Hotel) that the amount @ 10% collected from its customers did not form part of its income as that amount was subsequently disbursed among the staff and hence, was not liable to service tax. In this case, the Tribunal observed that section 67 of the Finance Act, 1994 provides that the value of taxable service in relation to the services provided by a mandap keeper shall be the gross amount charged by such keeper from the client for the use of mandap, including facilities provided to the clients in relation to such use and also the charges of catering, if any. The Tribunal held that as the assessee was charging this amount from its customers for providing the service, which was taxable as above, therefore, the 10% service charges would be liable to service tax. Therefore, applying the ratio of the abovementioned judgement to the facts of the present case, it can be concluded that Hotel Marudhar Palace is liable to pay service tax on 10% service charges collected by it from its customers.

SUMMARY OF EXAMINERS' COMMENTS ON THE PERFORMANCE OF CANDIDATES

PAPER – 5 : COST MANAGEMENT

General Comments

The performance of the candidates is average. Examiners have reported a lack of understanding of the knowledge of basic concepts required for attempting questions on contemporary as well as traditional concepts. Students are advised to understand traditional concepts like standard costing etc, with a special emphasis on their limitations and strength. This shall help them in having a clear understanding of the need of the emergence of modern concepts and their objectives and usefulness.

Specific Comments

Question 1.(a) – This was a theory part requiring candidates to explain the different methods of Transfer Pricing. The question part was attempted reasonably well by the students.

(b) This theory part required students to explain how a Pareto analysis is helpful in pricing of products in a multi product environment. The answer to this question part was also satisfactory.

(c)(1) This theory part required students to explain the four components of a Balanced Scorecard which would be reported for a company. Very few students were able to explain all four components correctly.

(c)(2) This was a practical question part requiring a conceptual understanding of productivity, growth and price recovery variances. Most of the students were unaware of these variances and attempted the question on wrong lines. Growth was wrongly considered in percentage terms by many of the candidates.

Question 2.(a) This practical part required candidates to compute various variances and other cost components from the given data. The question required a clear understanding of cost accounting journal entries as required in a standard costing system. Most of the students were found wanting in this extremely important area. They were unable to comprehend the question and hence solved it on the wrong lines. However, most of the candidates were able to compute the labour spending variance correctly.

(b) This theory part required candidates to write briefly on pricing by the service sector. Many of the candidates restricted their answer to the hospitality and transportation industry.

(c) This theory question part required candidates to write a short note of ZBB. Most of the candidates answered this question part on the desired lines.

Question 3.(a) This was a practical question part requiring candidates to have a sound knowledge of the JIT concepts and their cost implications. Many candidates were unable to answer the question correctly. Calculations of different cost elements could not be done correctly by a majority of the candidates.

(b) This practical question part was well attempted by most of the candidates.

Question 4.(a) This was a theory part requiring candidates to critically examine the implications of holding large inventories in an inflationary environment. The question was attempted reasonably well by most of the students.

(b) This was a practical part requiring students to prepare a comparative statement of better and less efficient workers and identify benefits of expending on a training programme. Very few candidates attempted this question part on correct lines. Determination of output achieved by the better workers was wrong in most of the cases.

(c) This was a theory question part requiring candidates to explain the concept of ABC. The answer to this question part was satisfactory.

Question 5.(a) This practical question part required students to have a sound understanding of transfer pricing. This question part was attempted reasonably well by most of the candidates.

(b) This practical question part required candidates draw a project network and subsequently compute the probability of the project meeting the due date. The first three parts were correctly answered by most of the candidates; however, many were unable to compute correctly the probability of meeting the due date.

Question 6.(a) This numerical question part required candidates to formulate and solve a linear programming model from the given data. Most of the students were unable to work out correctly the optimal product mix of the three grades of coal

(b) This practical question part required a sound understanding of the knowledge of concepts of simulation. Allocation of random numbers was correctly done by many candidates but only a few were able to present the simulated twelve months sales, monthly and annual profit/loss.

PAPER – 6: MANAGEMENT INFORMATION AND CONTROL SYSTEMS

General Comments

The overall performance of the candidates was very poor. The answers exhibited their inadequate preparation and casual approach to this practical paper. Majority of the candidates have not written relevant and adequate answers. In certain cases, the answers were incomplete. The other deficiencies observed during the evaluation were poor handwriting of some candidates, spelling and grammatical mistakes, poor presentation of answers, non-highlighting of key points and wrong mentioning of question numbers.

Specific Comments

Question 1.(a) Majority of the candidates discussed about manual audit instead of explaining specific factors responsible for the ineffectiveness of the manual audit w.r.t. IS audit.

(b) Very few candidates wrote the objectives of IS audit correctly.

(c) Only few candidates could mention the considerations for choosing the right alternative of accessing the Internet.

(d) Most of the examinees were unaware of the basic security management steps such as password.

Question 2.(a) Hardly any candidate explained as to what is meant by systems approach.

(b) Most of the candidates could not define the term “system stress and system change” correctly.

(c) Candidates could not explain the fact finding techniques used by a system analyst.

Question 3.(a) Majority of the examinees could not discuss the purposes of executive information systems.

(b) Many candidates failed to discuss various issues that should be considered while designing systems input.

Question 4.(b) Instead of giving specific benefits achieved by implementing the ERP package, majority of the candidates explained the benefits of adopting computerised systems.

Question 5. (a) Majority of the candidates miserably failed to state various controls that can be incorporated in the system to make frauds difficult to perpetrate.

(b) Many candidates mixed up audit trail with audit techniques. Few examinees discussed general security measures for computer systems in stead of discussing the ways in which audit trail can be used to support security objectives.

Question 6. (a) Most of the candidates failed to highlight tangible and intangible benefits that can result from the development of a computerised system.

(c) The duties of the certifying authorities with respect to digital signature could not be highlighted by majority of the candidates.

Question 7. Most of the candidates failed to give specific and to the point short notes covering all the relevant issues for various terms asked in the question.

PAPER – 7 : DIRECT TAXES

General Comments

The examination is to test whether the candidates possess expert knowledge. However, it is observed that many candidates do not possess the required expert knowledge. In many cases, the answers are vague and based on surmises and conjectures. The questions have not been read carefully, and consequently, there is a tendency among the candidates to write lengthy answers dealing with irrelevant points. Further, the answers have not been written neatly and legibly. In many cases, the question number has been written outside the margin, which is intended for answers. Other deficiencies are very poor handwriting, poor English, lack of expression and spelling and grammatical mistakes.

Specific Comments

Question 1.

- (i)** Some candidates have wrongly treated land development charges as a revenue expense.
- (ii)** Fees paid to ROC for enhancement of authorised capital has been wrongly treated as a deferred revenue expenditure.

- (iii) Most of the candidates failed to arrive at the correct book profits and hence, were not able to correctly examine the applicability of section 115JB. The candidates could not give proper treatment to the debit balance of Rs.2 lakhs as on 1st April, 2004 in the profit and loss account, shown separately in the Balance Sheet, which represented unabsorbed business loss as per books of account. Since this loss is lower than the unabsorbed depreciation as per books of account, the loss should be deducted to arrive at the book profits.

Question 2.(a) Some candidates were not aware of the meaning of the term “intangible additions” and consequently, have failed to apply the provisions of *Explanation 2* to section 271(1) and section 271(1A).

(b) Many of the candidates were not aware of the instances where benefit of indexation for determination of capital gains is not available. Their answers were vague and irrelevant.

(c) Some candidates have wrongly answered that application for registration of a trust can be filed before the formation of the trust.

Question 3.(a) Many of the candidates were not aware of the provisions of new chapter XII-G which contains the special provisions relating to income of shipping companies. Even the candidates who were aware of the relevant provisions, committed mistake in rounding off of tonnage and computation of tonnage income.

(c) Some candidates have not applied the provisions of section 33AB correctly and therefore were not able to compute the deduction under that section. They could not get the correct order of allowing deduction under section 33AB, application of Rule 8 of the Income-tax Rules and set off of brought forward business loss. Tax consequences on sale of non-depreciable asset in the next year were also not correctly segregated between business income and short-term capital gains.

Question 4.(a)(i) Some candidates have wrongly disallowed employer's contribution to provident fund stating that it has not been paid within time, though the same has actually been paid within the prescribed time – it has, in fact, been paid during the previous year itself.

(iii) Many candidates have wrongly included share of profit, interest and salary of members in computation of the individual income of the members of the AOP.

(b) (i) The question is on computation of income of an individual who is a member of the State Assembly of Karnataka. Some candidates have wrongly considered the same as a political party and exempted income from house property.

(ii) Some candidates have wrongly stated that all allowances including salary of a member of the State Assembly are exempt under section 10.

(iii) Deduction under section 24(a) is 30% of Net Annual Value. Some candidates have wrongly taken the same as 20% or 33 $\frac{1}{3}$ % of Net Annual Value.

Question 5.(a) Some candidates have not understood the applicability of section 41(1) in respect of refund of excise duty, where the matter has been taken up in further appeal to the Court. They were not aware of the Apex Court's decision in *Polyflex (India) Pvt. Ltd. v. CIT (2002) 257 ITR 343*.

(c) Very few candidates have correctly explained the applicability of *Explanation 5* to section 271(1)(c) in such a case.

Question 6.(a) Though most candidates have stated that the information should be authentic and reliable to constitute “information”, they have concluded that information from CBI, a government agency, can constitute “information” for action under section 132 of the Act.

(c) Only a very few candidates have correctly applied section 10(6A) in the first part of the question. In the second part of the question, the grossing up provisions and tax rates were not correctly applied.

Question 7. 1. Some candidates have wrongly taken cash in hand in excess of Rs.50,000 as taxable wealth whereas in the case of a company, only cash in hand not recorded in the books of accounts is taxable.

2. A few candidates have wrongly stated that aircraft used by directors and auditors is not a taxable asset.

PAPER – 8 : INDIRECT TAXES

General comments

Overall performance was not up to the mark. Candidates were not aware of the latest case laws and the amendments in spite of considerable weightage being given to them in the past few examinations. It has been observed that the candidates neglect customs and service tax. Further, they tend to mix up the provisions of one Act with another while answering the questions, though separate parts are allocated in the question paper for each Act. It is advised that the candidates should give due importance to customs and service tax as well. Also, they should improve their presentation skills and avoid giving vague and general answers.

Specific comments

Question 1.(a)(ii) Most of the candidates were not aware of the Section Note introduced by the Finance (No.2) Act, 2004 in Section XV of the First Schedule to the Central Excise Tariff Act. Instead, they explained the concept of moveability and marketability.

(b) A large number of the candidates failed to give proper reasons in support of their answers. They just wrote “True” or “False”.

(b)(i) Majority of the candidates wrongly answered that credit of service tax on input service can be availed irrespective of whether payment is made or not as the CENVAT Credit Rules are the same in both the cases.

(b)(ii) Quite a large number of candidates were not conversant with the concept of ‘Input service distributor’ and as a result answered in a sketchy manner.

(b)(iii) Candidates answered that unutilized CENVAT credit is a part of the assets and liabilities of an organization that is being transferred and hence, unutilized input tax credit should also be transferred. They failed to mention the conditions prescribed in rule 10 of the CENVAT Credit Rules, 2004 which have to be fulfilled in order to transfer the unutilized credit.

(c) Candidates were not aware of the latest amendment in respect of interest for delayed payment of duty.

Question 2.(b) Majority of the candidates computed the assessable value by considering the cost of raw materials, job worker charges etc., instead of applying section 4A (MRP provisions).

Question 3.(a)(i) A manufacturer exporter is exempted from furnishing the bond in form B-1 in case of export without payment of duty under rule 19 of the Central Excise Rules, 2002. However, candidates wrongly answered that SSI units are exempted from furnishing such bond.

(a)(iv) Candidates wrongly explained the impact of customs duty in case of failure to export within 6 months. Some of them wrote that the goods shall be confiscated and sold in auction. They, however failed to state the liability in respect of excise duty.

(c) Rule 25 of the Central Excise Rules, 2002 specifies certain circumstances under which the excisable goods can be confiscated. However, most of the candidates wrote general and vague answers. They were also not aware of the provisions of section 34, under which the confiscated goods can be reclaimed by paying redemption fine.

Question 4.(a)(ii) Rule 21 of the Central Excise Rules, 2002 specifically provides that remission of duty is allowed at any time before removal of goods. Most of the candidates answered wrongly as they were not able to comprehend that the words 'duty paid goods' implied that goods had been removed from the factory.

(b) Some candidates considered ER-4 at par with ER-1 and thus explained the contents of ER-1 and wrote about filing of monthly return. They were also not aware of the penalty leviable on non or late submission of ER-4.

(c) Most of the candidates concluded wrongly that the Appellate Tribunal is specifically empowered to review an order passed by it.

Question 5.(a)(ii) Candidates mixed up the interest leviable under rule 8(3) of the Central Excise Rules, 2002 with the interest leviable under section 11AB of the Central Excise Act, 1944. Some candidates even confused the interest under section 11AB with interest on refund and interest on drawback.

(b) Here again, the provisions of PLA were mixed with the provisions of CENVAT credit.

(c) Candidates did not know the provisions in respect of rule 17 for removal of goods from 100% EOU to DTA.

Question 6.(a)(i) Few candidates wrongly included CBEC, Commissioner (Appeals) and Appellate Tribunal in the definition of adjudicating authority.

(a)(iii) Instead of explaining the provisions in respect of smuggling, candidates wrote the consequences when the smuggled goods are confiscated by the Customs Authority.

(b) Candidates were unable to explain the provisions in respect of refund of anti-dumping duty. They explained some irrelevant details as to when anti dumping duty may be imposed etc. and that excess duty once paid cannot be refunded.

(c) The question required the computation of total customs duty payable. Most of the candidates were able to compute the basic duty. However, they failed to include education cess on CVD. As a result, all further steps went wrong. Further, they were also not able to answer correctly as to the availment and utilization of CENVAT credit.

(d) Very few candidates answered correctly that export gets complete only when the goods reach outside the territorial waters of India.

(e) Only a very few students supported their answers with correct reasoning and interpretation of law and notification.

Question 7.(a) Most of the candidates failed to mention the exceptions to the doctrine of unjust enrichment. Some of them mixed up the exceptions with those contained in the excise provisions.

(b) Candidates were not clear about the concept of redemption fine and re-export.

Question 8.(a)(i) The relevant date in case of baggage was wrongly answered as the date of entry in India.

(b)(i) Interest on drawback was confused with interest under section 11AB of the Central Excise Act, 1944.

Question 9.(a)(i) Although few candidates mentioned the condition relating to non-availment of CENVAT credit, they failed to mention the second condition about *Notification No. 12/2003-ST, dated 20.06.2003* in respect of goods and materials sold.

(a)(ii) Candidates did not write the specific percentage of the abatement and instead, they explained irrelevant things in detail.

(b) Here again, the candidates did not mention the services specified in *Notification No. 59/98-ST, dated 16.10.1998* and wrote general answers based on guesswork.